

Comments on the Edwards Paper
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The implications of the U.S. current account deficit is the number one policy issue of concern to economists, or at least international economists, or at least international monetary economists, convening in Jackson Hole this week. Of particular concern is the possibility that deficits of this magnitude are unsustainable, that foreign financing might dry up abruptly, and that the dollar might fall sharply in response, fanning inflation, raising interest rates, causing serious difficulties for the financial system, and plunging the U.S. and world economies into recession.

Now that I have your attention, let me turn to the Edwards paper. More than a little ink has been spilled on its subject. To this river Sebastian Edwards adds three significant tributaries. First, he undertakes some simple finger exercises suggesting how much current account adjustment will ultimately be required of the United States.¹ Second, he provides a comprehensive survey and synthesis of the literature on the causes and effects of current account adjustments – in particular, of large adjustments which, following convention, he refers to as current account reversals. Third, he reports an econometric analysis of a sample of adjustment episodes, using as the control group a second sample of cases where current account reversals did not occur.

I learned a tremendous amount from the paper. I was convinced by the back-of-the-envelope calculations showing that the U.S. current account deficit will have to shrink substantially and soon. I was alarmed, as I presumably was supposed to be, that

¹ In calling these calculations finger exercises, I am not demeaning them; back-of-the-envelope calculations like these are how all of us start the process of thinking about such issues. I think of these calculations as “Mussanomics” or “Mussametrics,” Michael Muss (2004) having popularized the approach.

countries experiencing current account reversals, including large industrial countries, suffer significant output losses and persistent growth slowdowns.

I too believe that U.S. external liabilities cannot keep expanding faster than the U.S. and world economies indefinitely. I agree that stabilizing them as a share of U.S. GDP will require shrinking the current account by two thirds, to something exceeding 2 per cent of GDP. Catherine Mann's alternative, stabilizing them as a share of non-U.S. wealth, will require shrinking the U.S. current account by half, to something exceeding 3 per cent of U.S. GDP.

But I was less convinced by the statistical analysis of country data because of two problems, one that is endemic to the literature and another that is specific to this study. The approach here is an example of what we might call the "new empirical international economics," in which the author doesn't analyze a conventional cross section or panel data set where observations are ordered by time; rather, the unit of observation is the episode, where an episode is an event – say, a year when the current account deficit falls by 4 per cent of GDP – and a surrounding window of years on both sides. The control group is then made up of nonevents – years when the current account deficit did not shrink by this amount, again surrounded by the analogous window. This approach has a long history in economics; it goes back at least to the work of Richard Cooper, Jacob Frenkel and, yes, Sebastian Edwards on devaluation episodes in developing countries. More recently, it has been used by Gian Maria Milesi-Ferretti, Assaf Razin and others to analyze the effects of current account reversals.²

The problem with the approach is the endogeneity of the event of interest. Current account reversals can occur for different reasons. They can be provoked by

² See Milesi-Ferretti and Razin (1997).

different factors. And, depending what causes them, their consequences can be very different. Imagine, first, a sudden decline in foreign investors' assessment of the economic prospects of the United States and an abrupt fall in foreign financing for the deficit. This is the case of the sudden stop preceding the current account reversal that Sebastian concludes is typical. It will plausibly be followed by a fall in the dollar, import-price inflation, a rise in U.S. interest rates, and a recession. Now imagine, instead, faster productivity and output growth in the United States that narrows the gap between U.S. production and spending. This is the case that people who see the current account as reflecting the productivity and attractiveness of investment in the United States have in mind. The U.S. current account being the difference between output and absorption, again the deficit will shrink. But the behavior of other variables of interest may be quite different. With supply rising relative to demand, interest rates and inflation will fall. Growth will accelerate rather than slowing.

Here we see the problems for analysis created by the endogeneity of the current account. In each case, the reversal is the consequence – my academic colleagues will say “a general equilibrium outcome” – of other disturbances affecting the economy.

Different disturbances imply different behavior of other variables, depending on their nature. General statements about the behavior of those other variables make little sense because they compare apples and oranges. Rather, we should be analyzing the effects of specific disturbances – a global flight to quality, a domestic productivity shock, a foreign monetary or fiscal policy adjustment – on a country with a large current account deficit.

Sebastian addresses these points by estimating regressions of “treatment effects,” where he first estimates the determinants of current account adjustments and then uses

the fitted values to control for the endogeneity of reversals when analyzing their effects. I see two problems here. First, the treatment regressions are fragile – I know this from my own work on the subject.³ Second, the results are still used to make statements about the typical, or average, effects of current account reversals, where, in reality, reversals precipitated by different exogenous events will still have different implications for the behavior of, inter alia, output, interest rates and the exchange rate, and it is still essential to report different findings for different shocks.

There are also problems with using these kind of cross country comparisons to draw implications for future adjustment of the U.S. current account deficit. The U.S. is different from Sebastian's reversal cases. Those cases are dominated by countries like Malta and Greece. Their situation is obviously very different from that of the United States. Most of these countries finance (or, in the cases of Malta and Greece, financed) their current account deficits by borrowing abroad in someone else's currency. We know from the literature on balance-sheet effects that when external debt is denominated in foreign currency, a sudden curtailment of financing for the current account deficit can cause serious financial difficulties.⁴ The U.S., on the other hand, has the exorbitant privilege of borrowing in its own currency, which means that these balance sheet dislocations are less.⁵ Another factor influencing the dislocations associated with the adjustment is the credibility of monetary policy. (This matters importantly for the paper's comparison of the U.S. with Italy in the 1970s.) Joe Gagnon at the Federal Reserve Board has found that sharp declines in exchange rates lead to smaller increases in bond yields when the credibility of policy, as measured by the contemporaneous

³ See Adalet and Eichengreen (2005).

⁴ On the balance-sheet consequences of exchange rate changes, see Cespedes, Chang and Velasco (2000).

⁵ See Gourinchas and Rey (2005).

inflation rate, is greater.⁶ This second factor presumably will affect U.S. adjustment in the same direction as the first, namely, it will moderate the dislocations associated with the adjustment. However, working in the other direction is the fact that, since the U.S. is larger than Malta (I suppose I should apologize for saying that), the implications of its current account adjustment for the current account adjustment of the rest of the world cannot be neglected. If the U.S. experiences a current account reversal, then the rest of the world will see its current account balance move sharply toward deficit. If growth slows here, growth will slow elsewhere. And in turn this means that further destabilizing feedbacks to the initiating country cannot be neglected.

I must observe that the separate estimates for large industrial countries (note that the phrase “large industrial” sometimes appears in this part of the paper in quotes) do not really solve the problem. To be large you must be in the top quartile of countries in 1995 in terms of aggregate GDP. Among the countries experiencing current account reversals that satisfy this condition, by my calculations, are Denmark, Portugal, Finland, Greece, Ireland and New Zealand.

So, in conclusion, how do I see the U.S. current account situation playing out? There clearly is a major current account adjustment coming; the important question is when, since the longer this adjustment is delayed, the larger will be its magnitude (the larger being net U.S. external liabilities), and the more disruptive are likely to be its effects. Edwards’ calculations, together with work by Obstfeld and Rogoff (2004), suggest that the dollar will have to fall on a real trade-weighted basis by at least 20 per cent. The sooner this adjustment starts, the more smoothly it can proceed. The less will then be the need for abrupt shifts in exchange rates and other variables to keep U.S.

⁶ See Gagnon (2005).

external obligations from exploding. And the less abrupt are those exchange rate adjustments, the less disruptive will be the macroeconomic effects.

Smooth adjustment can be further facilitated, and disruptive shifts in asset prices and financial conditions avoided, if this relative price movement is accompanied by monetary and fiscal measures that encourage saving in the U.S. and spending in the rest of the world. Governments in each of the three major regions can contribute to this process. Emerging Asian countries can permit their currencies to appreciate slowly but steadily against the dollar. To be sure, the same real appreciation can be achieved by domestic inflation fueled by more expansionary monetary and fiscal policies, but it is preferable for Asian countries to continue reducing the role of the state in their economies, not for them to further increase public spending on infrastructure and other projects, or for countries like China to encourage continuing lending booms that further weaken the balance-sheet position of the banks. European countries and Japan can resuscitate investment spending by redoubling efforts at structural reform and adopting a more investment-friendly policy mix. In Europe's case, this means fiscal consolidation which will in turn give the ECB the confidence it needs to reduce interest rates.

Most importantly, the United States can adjust its macroeconomic policy stance. Most obviously, this means addressing the fiscal imbalance.⁷ But, in addition, there is an argument for the Fed to normalize the level of interest rates faster in order to reduce the risks of a disorderly correction of the current account.⁸ I find it peculiar that, in a

⁷ Even if reducing the budget deficit does not reduce the current account deficit one for one, it can still make a contribution. The argument for revenue enhancement is strong independent of current account pressures, since there are good reasons to expect increased expenditure pressures going forward on both terrorism/homeland security and health care for an ageing population.

⁸ With the rise in petroleum prices and hurricane-related damage to New Orleans, this may be a largely retrospective point, but it is no less important for the fact.

conference devoted to Chairman Greenspan's risk-management approach to the conduct of monetary policy, little if any attention has been paid to the argument that the Fed should have tightened faster to prevent the current account deficit from exploding and to reduce the risk of a dollar collapse.

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