The IMF has just issued another polite but sober analysis of America’s twin deficits. It is too bad that there was no similarly sober discussion of this problem in the recent U.S. presidential debates. The public-sector budget deficit, now running at nearly 5 per cent of GDP, is at the root of America’s external imbalance. And there is no solution to the problem in sight. Mr. Bush has staked his political career on massive tax cuts. Raising taxes now would only alienate his political base, something that he and his principal advisor, Karl Rove, have shown themselves loath to do. Mr. Kerry, if elected, will have to work with a Republican-controlled Congress, and divided government is a recipe for fiscal deadlock. It is thus unlikely that much progress will be made in solving this problem by the time of the next election in 2008, whoever is elected this year.

Lacking a credible plan, both candidates are behaving as if the problem does not exist. They can get away with this because there is no immediate crisis. Asian central banks, led by the People’s Bank of China and the Bank of Japan, are providing cheap finance for America’s external deficit. To keep their currencies from rising and export growth from slowing, these countries have been buying U.S. treasury securities as fast as the U.S. government pumps them out. This keeps U.S. interest rates low and the dollar relatively stable. It relieves the United States of having to rely on financial markets to fund its deficit. It prevents matters from coming to a head.

There are two schools of thought on how long this can last. The optimists, led by some prominent economists at Deutsche Bank, suggest that it can continue for another decade. China has 200 million underemployed workers yet to be absorbed into export-oriented manufacturing. Until this happens, it will be loath to let its currency rise. And this means that it will have to keep purchasing U.S. treasury bonds. The Chinese government’s statements at the recent G-7 summit – “we are not willing to be rushed into adopting a more flexible currency” – can be interpreted in this light.

The pessimists, led by some equally prominent economists at Morgan Stanley, warn that the end is near. Chinese officials understand that they cannot prevent their economy from overheating and avoid exciting property market speculation unless they begin setting interest rates independently. And setting interest rates at different levels from Mr. Greenspan’s requires letting the exchange rate move. The People’s Bank also sees the risk of losses on its dollar holdings if the greenback falls. This points to the likelihood that China will soon curtail its purchases of U.S. treasury securities. The obvious forecast is that it will do so as soon as the American presidential campaign is over to avoid making its policies into a political issue in the United States.

In fact, both extreme views are exaggerated. China is unlikely to significantly curtail its purchases of U.S. treasury securities anytime soon. To be sure, Chinese officials appreciate the need to better tailor domestic interest rates to domestic needs. But they are reluctant to do anything that threatens rapid export growth, since political stability in China hinges on the continued absorption of rural labor into urban employment. The consequence will almost certainly be very slow and cautious movement toward greater exchange rate and interest rate flexibility. Mostly likely, China will widen the trading band for the renminbi from 0.3 to 3.0 per cent next year. The year
after that, it may widen the band to 6 per cent. But if the People’s Bank is committed to preventing the remnimbi from rising more than that, it will have to keep buying U.S. treasury securities at something approaching the current pace.

A couple of years after that – say, around 2008 – things will change. Half or more of China’s underemployed labor will have been absorbed into the modern sector. The Chinese banking system will have been strengthened. The remnimbi can then be allowed to fluctuate more freely. And if the remnimbi grows more flexible, so will other Asian currencies, leading to a general reduction in foreign central bank support for the dollar. In addition, by 2008 U.S. external indebtedness will have risen to alarming levels, as high as 50 per cent of GDP. As foreign investors grow worried by these facts, they will start to sell their existing dollar balances. The result will be a sharp decline in the dollar and a sharp rise in U.S. interest rates.

The happy consequence of a weaker dollar will be a rise in U.S. exports, which will go part way toward eliminating the U.S. current account deficit. But raising exports takes time. If foreign financing dries up all at once, the main way that the U.S. external deficit will have to be eliminated is by compressing imports. The American consumer will have to spend less.

Higher interest rates will bring this about. Consumer spending in the U.S. has been so buoyant because of the low interest rates that have fueled the country’s housing boom. Higher house prices have raised household wealth, and the Fed’s exceptionally low interest rates – made possible by foreign central bank purchases of U.S. treasuries – have enabled households to access this newfound wealth by refinancing their mortgages. This has encouraged homeowners to consume more out of current incomes, explaining America’s low private savings rates.

Once foreigners curtail their support for the U.S. treasury market, this same process will run in reverse. In the face of higher interest rates, housing prices will stop rising and even fall. New home purchasers will face higher mortgage rates. U.S. savings rates will rise, and private consumption will decline. Absent action to narrow the budget deficit, the entire decline in spending needed to eliminate the external deficit will fall on the back of the consumer. High levels of household indebtedness make higher interest rates a powerful mechanism for bringing this about.

Inevitably, the consequence will be an exceptionally severe recession the next time around. And because this will involve a sharp decline in U.S. imports all at once, this will be an unusually sharp recession not just for the U.S. but also for the rest of the world. This is the sense in which current U.S. policies are mortgaging the future of the country and the world.

Alas, there is little reason to think that the next president, whoever he turns out to be, will make much progress in solving the fiscal problem. But 2008 is just about the time when things will fall apart. With an unusually serious recession as backdrop, the next election four years from now could be the most exciting in years.

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