The Dollar and the Deficits:
How Washington Can Prevent the Next Crisis

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Even as efforts to recover from the current crisis go forward, the United States should launch new policies to avoid large external deficits, balance the budget, and adapt to a global currency system less centered on the dollar. Although it will take a number of years to fully implement these measures, they should be initiated promptly both to bolster confidence in the recovery and to build the foundation for a sustainable US economy over the long haul. This is not just an economic imperative but a foreign policy and national security one as well.

A first step is to recognize the dangers of standing pat. For example, the United States' trade and current account deficits have declined sharply over the last three years, but absent new policy action, they are likely to start climbing again, rising to record levels and far beyond. Or take the dollar. Its role as the dominant international currency has made it much easier for the United States to finance, and thus run up, large trade and current account deficits with the rest of the world over the past 30 years. These huge inflows of foreign capital, however, turned out to be an important cause of the current economic crisis, because they contributed to the low interest rates, excessive liquidity, and loose monetary policies that—in combination with lax financial supervision—brought on the overleveraging and underpricing of risk that produced the meltdown.

It has long been known that large external deficits pose substantial risks to the US economy because foreign investors might at some point refuse to finance these deficits on terms compatible with US prosperity. Any sudden stop in lending to the United States would drive the dollar down, push inflation and interest rates up, and perhaps bring on a hard landing for the United States—and the world economy at large. But it is now evident that it can be equally or even more damaging if foreign investors do finance large US deficits for prolonged periods.

US policymakers, therefore, must recognize that large external deficits, the dominance of the dollar, and the large capital inflows that necessarily accompany deficits and currency dominance are no longer in the United States' national interest. Washington should welcome initiatives put forward over the past year by China and others to begin a serious discussion of reforming the international monetary system.

If the rest of the world again finances the United States' large external deficits, the conditions that brought on the current crisis will be replicated. To a large extent, the US external deficit has an internal counterpart: the budget deficit. Higher budget deficits generally increase domestic demand for foreign goods and foreign capital and thus promote larger current account deficits. But the two deficits are not "twin" in any mechanistic sense, and they have moved in opposite directions at times, including at present. The latest projections by the Obama administration and the Congressional Budget Office (CBO) suggest that both in the short run, as a result of the crisis, and over the next decade or so, as baby boomers age, the US budget deficit will exceed all previous records by considerable margins. The Peterson Institute for International Economics projects that the international economic position of the United States is likely to deteriorate enormously as a

result, with the current account deficit rising from a previous record of six percent of GDP to over 15 percent (more than $5 trillion annually) by 2030 and net debt climbing from $3.5 trillion today to $50 trillion (the equivalent of 140 percent of GDP and more than 700 percent of exports) by 2030. The United States would then be transferring a full seven percent ($2.5 trillion) of its entire economic output to foreigners every year in order to service its external debt.

This untenable scenario highlights a grave triple threat for the United States. If the rest of the world again finances the United States' large external deficits, the conditions that brought on the current crisis will be replicated and the risk of calamity renewed. At the same time, increasing US demands on foreign investors would probably become unsustainable and produce a severe drop in the value of the dollar well before 2030, possibly bringing on a hard landing. And even if the United States were lucky enough to avoid future crises, the steadily rising transfer of US income to the rest of the world to service foreign debt would seriously erode Americans' standards of living.

Hence, new record levels of trade and current account deficits would likely levy very heavy costs on the United States whether or not the rest of the world was willing to finance these deficits at prices compatible with US prosperity. Washington should seek to sharply limit these external deficits in the future—and it is encouraging that the Obama administration has indicated its intention to move in that direction, opting for future US growth that is export-oriented, rather than consumption-oriented, and rejecting the role of the United States as the world's consumer of last resort.

Balancing the budget is the only reliable policy instrument for preventing such a buildup of foreign deficits and debt for the United States. As soon as the US economy recovers from the current crisis, it is imperative that US policymakers restore a budget that is balanced over the economic cycle and, in fact, runs surpluses during boom years. Measures that could be adopted now and phased in as growth is restored include containing the cost of medical care, reforming Social Security, and enacting new taxes on consumption.

The US government's continued failure to responsibly address the fiscal future of the United States will imperil its global position as well as its future prosperity. The country's fate is already largely in the hands of its foreign creditors, starting with China but also including Japan, Russia, and a number of oil-exporting countries. Unless the United States quickly achieves and maintains a sustainable economic position, its ability to pursue autonomous economic and foreign policies will become increasingly compromised.

The Dollar's Long Shadow

Inside the United States, the international prominence of the dollar is widely seen as serving the country's national interests. Because of this global role and the foreign money it attracts to the United States, the dollar allows Americans to live beyond their means, as exemplified by the cheap Chinese goods at Wal-Mart, affordable vacations on the French Riviera, and US budget deficits financed by Middle Eastern countries.

Many foreigners share the view expressed by French officials in the 1960s that the dominance of the dollar confers an "exorbitant privilege" on the United States. They argue that this automatic financing of US external deficits—since most international transactions are financed in dollars—means that the United States has little need to take global considerations into account in formulating its economic policies. These foreign voices note the financial instability caused by wide fluctuations in the value of the dollar, such as its seesawing by 30-50 percent against the euro over the past

decade. Periodic sizable declines in its exchange rate have reduced—sometimes sharply—the value of the dollar holdings of both private investors and monetary authorities around the world. Hence, many international voices believe that the dollar-based monetary system is not in their interest, and they are increasingly calling for reform.

Both sides are wrong. Other countries gain from the convenience of a worldwide currency (as they do from having English as a worldwide language) and the subsequent reduction in transaction costs. Whatever their complaints, most governments are happy with the trade surpluses and the jobs created by the US deficits that their dollar financing allows. In fact, if the United States stopped running large trade deficits and acting as the consumer of last resort, many countries would be forced to rebalance their growth strategies to expand domestic demand instead of relying on exports. Other countries should be careful what they wish for when they propose dethroning the dollar.

That said, the United States itself would benefit from a reduction in the international role of the dollar. The deficits enabled by the dollar's prominence are indeed attractive in the short run—as are credit cards that allow deferred payments. US politicians looking toward reelection are thus understandably reluctant to jeopardize the dollar's status, not to mention afraid of being called "un-American" for not defending the national currency. After all, the deficits were not very damaging while they remained modest, as they did throughout the postwar period until the 1980s, during which time there were no plausible international alternatives to the dollar anyway.

The United States itself would benefit from a reduction in the international role of the dollar. The current crisis, however, starkly reveals the folly of blithely funding increasing US deficits. To be sure, China and other large foreign investors in the dollar did not force US financial institutions to make stupid subprime loans and ignore traditional credit standards. Nor did they force the US government and US financial regulators to conduct policies that were lax to the point of indifference. But the huge inflows of foreign capital to the United States—which rose steadily from the mid-1990s and reached record levels for several consecutive years until 2006—depressed interest rates by at least 100 and perhaps by as many as 200 basis points. They facilitated, if not overtly induced, the overleveraging and underpricing of risk. Meanwhile, US regulatory authorities were lulled into complacency. Even when the US Federal Reserve raised short-term interest rates in 2005, the influx of foreign funds kept long-term rates down and prevented the intended tightening of the money supply.

Moreover, the international role of the dollar makes it difficult, if not impossible, for the United States to keep its currency at the exchange rate that would support prosperity and stability in the US economy. This is because the exchange rate of the US dollar is, in large measure, the residual outcome of other countries using dollars to intervene in currency markets to meet their own exchange-rate targets: by weakening their own currencies to enhance trade competitiveness, they push the dollar toward overvaluation. This problem became so acute under the postwar regime of globally fixed exchange rates that the Nixon administration had to destroy the entire system in order to obtain needed dollar devaluations in 1971 and 1973.

Under the present mixed system, some major currencies (for example, the euro and the yen) are flexible, whereas others (notably, the renminbi) remain largely fixed, and many others (such as the ruble) function under managed floats, that is, they are freely traded, but their value is influenced by central-bank interventions in the market. In such a system, the exchange rate of the dollar can lie far away from its equilibrium value as a result of aggressive intervention by some foreign actors (such as China and, more recently, Switzerland) and market forces that emphasize financial, rather than trade, considerations. Yet US treasury secretaries feel required to repeat the "strong dollar" mantra

to try to maintain confidence in the dollar, even when doing so may prevent an orderly and healthy adjustment in its value.

Downsizing the Dollar

It is therefore time to reconsider the international role of the dollar. The dollar has been the dominant global currency for about a century for a simple reason: it has had no serious competition. The United States fell into currency hegemony mainly by default, as the status of the incumbent, the pound sterling, eroded with the long-term economic decline of the United Kingdom. Since then, no other currency has rested on an economy anywhere near the size of the United States' or been backed by financial markets that were at all comparable. The United States' long history of political stability and its adherence to the rule of law have further added to the dollar's appeal. In the past half century, every other country whose currency has been a candidate for major global status—from Switzerland and West Germany in the early postwar period to Japan later in the twentieth century and the members of the eurozone today—has overtly rejected the opportunity or adopted a studiously neutral stance toward it.

Both the United States and the rest of the world have an interest in continued globalization and efficient international financial markets, and so neither has any interest in entirely eliminating the international role of the dollar. In any case, inertia is such a powerful force in financial matters that a sweeping step of this kind is technically impossible. Instead, the United States should encourage two eminently feasible changes in the current international monetary order. The first is the further evolution of a multiple-currency system in which other monies increasingly share the international position of the dollar in private markets. The euro, based on a collective European economy as large as the United States' and with capital markets as extensive in most respects, is the most obvious candidate. The euro already rivals the dollar in some domains, such as currency holdings and private bond placements, and will become a full competitor whenever the eurozone countries adopt a more common fiscal policy. The Chinese renminbi is likely to acquire a significant international role once China allows it to be converted for financial as well as current account transactions and eases capital controls.

Some observers fear that a system of multiple currencies is inherently unstable. However, such a regime functioned smoothly for several decades before World War I, and a pound-dollar duopoly existed throughout the 1920s. A dollar-euro duopoly has already begun to emerge over the last decade. Competition between national currencies is likely to improve economic policies and performance by forcing market discipline on the governments and central banks behind these alternative currencies.

As their presence in private markets expands, these other currencies will also play a larger role in the reserve holdings of national monetary authorities. Currently, the dollar represents 65 percent of national reserves, and the euro, 25 percent. Those figures are likely to become much more balanced. The United States should not only accept a more varied currency regime as an inevitable reality but actively encourage such a development as part of its effort to recalibrate its own international economic position.

Second, in order to increasingly supplement national currencies in official monetary reserves, the International Monetary Fund can issue Special Drawing Rights (SDRs), the accounting unit used by the IMF in transactions with its members, currently composed of a basket of four currencies (the dollar, the euro, the yen, and the pound). This will enable countries to build up their reserves without having to run large trade and current account surpluses, thereby reducing pressure on the

global trading system. It would be hopeless and unnecessary to try to rigidly order the expansion of global reserves, as some ambitious schemes for reform have tried and failed to do in the past. But a more balanced composition of global reserve assets is quite feasible and very much in the interests of both the United States and the rest of the world.

The G-20 (comprising 19 of the world's largest national economies and a representative of the European Union) took a major step in this direction by agreeing in April 2009 to create $250 billion in SDRs, which were then allocated by the IMF in August. This took SDRs' share of global reserves from a previous level of under one percent to about five percent. The G-20 and the IMF should now go beyond this step—which was an emergency response to the crisis—to start a process of distributing SDRs annually, perhaps totaling $1 trillion over the next five years.

The United States should maintain a current account deficit averaging no more than three percent of GDP. In addition, the IMF should create a substitution account into which monetary authorities could exchange unwanted dollars (and other currencies) in return for SDRs without affecting global markets. This would both reduce the risk of future market disruptions and contribute to an increased role for SDRs—an important step because any significant diversification of China's, Japan's, Middle Eastern countries', or Russia's dollar holdings, or even rumors of such diversification, could adversely impact both the United States (by driving down its currency precipitously) and the eurozone countries and other countries whose currencies were bought up (by pushing their exchange rates up to uncompetitive levels). Just as it took the lead in creating SDRs in the late 1960s and early 1970s—and supported the idea of a substitution account in the late 1970s—the United States should now support an expanded role for this international currency.

As the global economy recovers, both private market actors and official monetary authorities will seek steady and sizable increases in their foreign exchange holdings. As long as the dollar remains the dominant international currency, this demand will generate capital inflows to the United States and push up the dollar's exchange rate, hurting US competitiveness and creating even larger US external deficits. For the United States to avoid the resulting trade imbalances and debt buildup, some of this incremental demand should be channeled into euros, renminbi, and SDRs. Both international monetary reform and a lesser role for the dollar are very much in the interest of the United States.

One Deficit Leads to Another

The problems described above become acute only if the trade and current account deficits of the United States return to high levels in the future. One of the few pieces of good news that has come out of the current crisis has been the sharp reduction in those imbalances. After rising to a record level of $800 billion and more than six percent of GDP in 2005, the US current account deficit seems poised to shrink by about 50 percent in 2009. About one-quarter of this improvement stems from lower oil prices—despite their temporary surge in 2008—and another portion derives from the fact that the US recession has had a bigger impact on imports than the decline in foreign demand has had on exports. Another important explanation is the improvement in US competitiveness due to the gradual and orderly fall in the value of the dollar: about 25 percent from 2002 through early 2008. This gain in the "real" trade balance kept US output growing through the first half of 2008 despite the downturn in domestic demand that began in late 2007, and it limited the extent of the recession in early 2009.

Even with this relatively good news, however, the United States' position as an international debtor has continued to rise, mainly as a result of its ongoing current account deficit. The United States' net

external debt climbed by more than $1.3 trillion in 2008 alone, to reach almost $3.5 trillion by the end of the year. Moreover, it appears that the recent improvement in the United States' external position is temporary and is likely to be reversed in the near future. The chief reason is the outsized budget deficit that the CBO and all other credible analysts project will last for at least the next decade and probably beyond. After nearing $1.5 trillion in the current fiscal year—more than three times the previous record—the internal deficit is likely to remain close to $1 trillion annually until 2020 or later. It could get even higher, depending on the future course of the economy (which will probably experience lower productivity growth) and government policies (which may fail to cut the costs of health care and other entitlement programs or to generate the additional revenues needed to pay for them).

These higher budget deficits promote higher trade and current account deficits for two reasons. First, on the "real" side of the economy, they push up domestic demand to a level that, when combined with natural levels of private consumption and investment, exceeds potential domestic output. This shortfall is met with the import of goods and services, which enables the United States to live beyond its means as long as the financing is available. Second, budget deficits stimulate inflows of foreign capital. Domestic saving is inadequate to meet the demand on the world's credit markets created by US government borrowing and to fund a healthy level of private investment. This shortfall is met with capital from abroad.

The chief mechanism through which higher internal deficits lead to higher external deficits is the exchange rate of the dollar. The additional debt that the government takes on to finance the budget imbalance increases US interest rates, which is undesirable in purely domestic terms because higher interest rates crowd out private investment and choke growth. High interest rates also attract large inflows of foreign capital, which, although they offset the crowding-out effect, work to push up the value of the dollar. This has an adverse effect on the competitiveness of US companies that export goods or compete with imports on the US market, and it expands the United States' trade and current account deficits.

One possible "remedy" is depressed investment—such as in the current recession—which lessens the demand for both foreign goods and foreign money. Another, more desirable alternative is a rise in private saving, which reduces both consumer spending, including on imports, and the need for foreign money. Washington does not want to rely on the first option, of course, because it would mean a continuously depressed economy and low productivity growth. But history suggests it cannot count on the second option. Hence, US policymakers must assume that any increases in the government's budget deficit—such as those that exist now and are expected over the foreseeable future—will generate increases in the United States' external imbalances and raise risk to unprecedented levels. Using the CBO data and assumptions of future growth, William Cline of the Peterson Institute has projected US trade and current account deficits through 2030.

The results are sobering: the US trade deficit in goods and services will exceed $3 trillion, about four times as much as the previous record, from 2006, in dollar terms and about eight percent of GDP. Although such a percentage is only modestly higher than the six percent level of 2006, it is worth remembering that 2006 was the year in which foreign capital inflows peaked, bringing the financial bubble to a head and setting the final stage for the current crisis. According to Cline's study, the greatest projected change is the rise in annual payments to foreign dollar holders needed to service the United States' external debt. Although the United States is already the world's largest debtor country in dollar terms, it makes no net payments now because US investments abroad earn much more than do foreign investments here.

Even if such favorable returns persist, Cline's projections show, the level of US debt will climb from under $5 trillion now to more than $50 trillion, and the annual cost of servicing that debt will soar to $2.5 trillion. By 2030, the United States will be transferring seven percent of its entire annual output to the rest of the world. In order to pay for its previous profligacy, the United States will have to forego $2.5 trillion—equal to the nation's current total annual spending on health care—of domestic consumption, investment, and government expenditures each year. At a minimum, this will lead to a long-term erosion of living standards in the United States.

Budget rectitude is the only reliable instrument for preserving a viable level of external deficit. These projections suggest that the United States' annual current account deficit will thus climb to almost $6 trillion by 2030, more than seven times its previous high. Such a sum would account for more than 15 percent of GDP, or two and a half times the peak rate of 2006, and would be at least triple the accepted international norm for sustainable current account deficits, which is four or, at most, five percent of GDP.

Under this scenario, the net international investment position, or net foreign debt, of the United States would exceed $50 trillion, or 140 percent of GDP—more than triple the accepted international norm of about 40 percent. Some observers believe that the United States has a longer leash than most states in this respect thanks to the importance of the dollar. But this role is likely to decline over the coming years. Moreover, it is not even clear whether the dollar's global prominence strengthens or weakens the ability of the United States to finance large deficits. Gross foreign dollar holdings—projected to exceed $80 trillion by 2030, compared with about $20 trillion today—provide ample scope for conversions out of the dollar, and these would make it even harder for the United States to fund deficits on the scale that Cline projects is necessary. Any such run on the dollar could also be triggered by capital flight from within the United States, as US investors become aware of the increasing inviability of the US economic position.

By 2030, Cline projects that outsized budget deficits will push US long-term interest rates up by two and a half percentage points. The value of the dollar would correspondingly rise by more than 20 percent, undermining US trade competitiveness and severely weakening one of the most critical parts of the US economy. Even if these numbers are substantially overstated, they are so far above any historical norms that a dollar crisis could hit long before they were reached. Paul Volcker, a former chair of the Federal Reserve, and I have suggested the possibility of such a crisis and the resultant hard landing since the 1980s. Voicing such concerns is more than simply crying wolf. The United States has indeed experienced close calls before: first, in the late 1970s, when it was still a creditor country, and then, to a lesser extent, in the mid-1980s.

The United States will be forced to undergo a major economic adjustment before the endpoint of these projections could possibly be reached. This could take the form of a gradual, if sizable, decline in the value of the dollar—especially if the Federal Reserve can retreat from its current expansionary strategy while maintaining credibility in its ability to control inflation. But even such a correction would require slashing both domestic consumption and domestic investment. If somehow such a correction were staved off until 2030, the required cutback in the domestic absorption of consumption and investment would amount to a stunning 13 percent of GDP—almost four times as large as the retraction likely to result from the current crisis.

It is not essential for the United States to fully eliminate its external imbalances. Theory and history suggest that a deficit of around three percent of GDP would be sustainable because US foreign debt would then grow no faster than the domestic economy on which it rests—especially if foreign capital were used for productive investment (as during the 1990s) rather than for private consumption and government spending (as during this decade). Maintenance of the deficit at this

level would permit the US net foreign debt to stabilize at about 50 percent of GDP—uncomfortably high but probably manageable. A central policy goal for the United States should be to maintain a current account deficit averaging no more than three percent of GDP.

Since the increases in the external deficit will probably be fairly modest over the next several years—and economic policy will continue to focus on recovery—there will be a strong temptation to defer attention to this problem and its underlying cause, the budget deficit. Foreign investors might well enable the United States to resume running deficits for a number of years. This course of action, however, could both replicate the scenario that brought on the current crisis and risk a sudden stop that could then trigger a hard landing. An infusion of foreign capital could again contribute to excessively easy monetary conditions and sow the seeds for more bubbles and crises.

Some renewed increase in the US external deficit is probably inevitable. Oil prices may rise from their 2009 average. The United States may recover from the crisis more rapidly than some of its main trading partners, particularly in Europe. The upward bounce of the dollar during the height of the crisis wiped out almost half the gains in US competitiveness of the previous six years. And the exchange rate could strengthen temporarily if the US Federal Reserve is able to start normalizing monetary policy before the European Central Bank and other monetary authorities.

Nonetheless, the United States should seek to limit or reverse these increases as soon as domestic and global economic conditions permit. The goal should be to promptly bring the external imbalances as close as possible to three percent of GDP, or even lower, and to hold them there for the foreseeable future. Without specifying any numbers, the Obama administration has signaled its desire to move in this direction. It has called for a US recovery that is "export-driven rather than consumption-oriented." It has rejected the restoration of the US role as "world consumer of last resort" and has counseled other countries to pursue their own recoveries by expanding domestic demand rather than relying on export-led growth. The final question is how to achieve these goals.

Saving for Success

The only healthy way to reduce the United States' external deficits to a sustainable level is to raise the rate of national saving by several percentage points. Such an increase could be achieved with a combination of increased private saving and a reduced federal budget deficit. Prior to the crisis, household saving in the United States was essentially zero; it has recently rebounded to the 5-7 percent range. This is presumably a reaction to the sharp decline in household wealth created by the fall in housing and equity prices during the crisis.

If these sources of wealth recover significantly—as equity prices have since March 2009—the trend of higher saving could easily reverse; thus, it would be risky to count on higher private saving alone to curb the appetite for foreign financing. In addition, because the very factors that produce a rise in household saving simultaneously tend to depress corporate profits and thus corporate saving, a sustained rise in household saving may not automatically equal a substantial increase in total private saving.

Unfortunately, there are no proven policies to reliably promote private saving. Previous US administrations have tried but failed by both raising and lowering tax rates on saving itself and on other components of income. Adjusting interest rates does not seem to encourage private saving, either.

This would seem to leave two plausible policy tools. The first is to shift the focus of US taxation from income to consumption; this might not only generate sizable budget revenues but also create incentives for private saving. The second option is to create a mandatory savings scheme, a measure that has proved effective in countries such as Australia and Singapore and is now being launched in the United Kingdom. Under such a system, all Americans would be required to set aside a small share of their income—probably one or two percent at the start—beyond what they now contribute to Social Security. Alternatively, under a voluntary version, employers could withhold a modest part of employees' wages for additional savings plans unless the employees opted out of them. The money could be managed either by individuals or by a specially created government entity. The problem with this scheme is what economists call "additionality": any individual who was already planning to save a certain amount could instead deposit those funds in his mandatory account, thereby making no incremental contribution to the national saving pool.

Hence, budget policy is the only reliable policy tool for increasing US national saving. There are, of course, a number of purely domestic reasons to avoid large budget deficits, from inflationary pressures to concerns over intergenerational equity to the relative inefficiency of government spending. However, the impact of large budget deficits on the international economic position of the United States—and by extension on its foreign policy and national security—has been systematically underestimated. It now must be given heavy weight in determining the future course of fiscal policy.

The goal of such a policy should be to balance the US federal budget over the average economic, or business, cycle. This would require running surpluses during boom years, which the United States should have done during the recent economic expansion of 2003-6. Modest deficits would be appropriate during downturns, as a result of automatic stabilizers—such as reduced tax receipts and higher government transfer payments—and countercyclical expansionary initiatives, such as this year's stimulus package. The objectives of such a policy would be to avoid adding to the national debt and to be sure that the buildup of net foreign debt does not exceed the growth rate of the US economy (which is at about three percent at present). This would allow that debt to be supported over time—and would hold down interest rates and the exchange rate of the dollar, helping limit future current account deficits.

Even a balanced budget would not guarantee a targeted level of external imbalance at all times. Periods of rapid US economic growth—especially when fueled by increases in productivity, as happened in the late 1990s—may require high levels of investment and increased borrowing from abroad and even higher imports to check inflationary pressures. And a decline in economic growth in the rest of the world could dampen US exports sufficiently to expand the US trade deficit no matter what occurs at home. Conversely, when domestic growth and private investment plunge, as has happened during the crisis, improvements in the US external balance can coincide with sharp rises in the budget deficit. Over time, however, budget rectitude is the only reliable instrument for preserving a viable level of external deficit. An additional benefit is that embarking on a credible path toward achieving such a goal will reassure foreign and domestic investors that there will be no precipitous decline in their current dollar holdings.

Money Games

A central goal of US foreign economic policy must be to prevent and counter deliberate currency undervaluations by other major countries, which keep the dollar overvalued and harm US competitiveness. China has been the glaring culprit in recent years: it has run current account surpluses exceeding ten percent of its GDP and has intervened massively in the currency markets to

keep the value of the renminbi from rising. China's currency has risen a good deal anyway, and its trade surplus is now coming down, but its external imbalance is still very large, and the renminbi remains priced at 20-40 percent below equilibrium. Switzerland, a small country that is an important player in world trade, is another case in point: its aggressive, although admirably transparent, intervention in the currency markets has served to weaken the exchange rate of the Swiss franc despite the country's huge current account surpluses. Over the next few years, as more countries seek to export their way out of the current crisis and build larger war chests of foreign exchange to self-insure against future exigencies, there could be more, and more serious, examples of such neomercantilism. Such a development would greatly complicate US efforts to avoid renewed increases in its own external deficits.

Any serious US effort to curb the United States' international imbalance will thus have to counter the beggar-thy-neighbor policies of other countries. The most desirable route would be multilateral surveillance and "name and shame" efforts by the IMF to identify currency misalignments and induce the perpetrators to make prompt adjustments. However, the IMF has no effective leverage over creditor countries; in fact, it has recently abandoned any serious effort to bring China's and other countries' currency imbalances under control. An alternative would be to enforce the provisions of the World Trade Organization that prohibit competitive currency action and authorize trade sanctions against violators.

The Bretton Woods system was erected at the end of World War II to avoid a repetition of the trade protectionism and competitive currency devaluations of the 1930s, which intensified the Great Depression and sowed the seeds of war. The system is now undergoing its first real stress test, and so far, it has not demonstrated its ability to fulfill its fundamental mission. Without effective multilateral action—or, in fact, to prod such action—the United States might have to take unilateral trade steps against violating countries, much as it did in 1971, when Nixon imposed an import surcharge, and, to a lesser extent, in the mid-1990s, when Bill Clinton applied trade pressure to get Japan to allow the yen to appreciate.

Any serious effort to rein in the United States' external deficits would pose a challenge for other countries, including China, Japan, and Germany—the next three largest economies in the world. These countries have relied on rising exports and trade surpluses in order to generate much of their economic growth, and they will have to expand domestic demand much more rapidly if the United States successfully rejects its traditional role as the consumer of last resort. Such a switch would not only make global growth more sustainable; it would also make growth more reliable for the individual countries themselves. A shift in focus from exports to domestic consumption should be feasible—especially for countries with sizable populations—but it will require substantial adjustments abroad. Officials in the Obama administration, as well as officials in the G-20, the G-8 (the group of highly industrialized states), and other international bodies, are already calling for such policy realignments.

Reforming the world's monetary arrangements would reinforce this global rebalancing strategy. By reducing the systemic role of the dollar and building up the international position of other currencies and SDRs, the United States would increase its own incentives to limit its deficits and enable other countries to add to their reserves without running surpluses. The cumulative effect would be greater prospects for international monetary stability and a reduced likelihood of future crises.

Paying To Play

The root of the United States' problem is domestic, however. As soon as recovery from the current crisis permits, the United States must implement a responsible fiscal policy. It should adopt new measures in the near future—while the economy is still recovering—that can be implemented over the medium and long terms, as growth resumes and the country can accommodate fiscal tightening without risking another recession. Enacting such measures now would work to generate confidence as the United States continues to emphasize recovery and thus minimize the risk that both US Treasury securities and the dollar will come under suspicion in the markets—something that could, if it happened, jeopardize the recovery itself.

Such a policy must include a meaningful down payment in addressing the structural problems at the heart of the United States' perilous financial outlook. There are at least three reforms that fall under the category of "decide now and implement later." The most important is containing long-term medical costs, an integral component of overall health-care reform that could save several percentage points' worth of GDP. The second is comprehensive Social Security reform, including gradual increases in the retirement age and an alteration of the benefits formula to reflect increases in prices rather than in wages. When fully phased in over a couple of decades, such changes could take another one to two percent of GDP off the deficit. The third measure is raising taxes on consumption, which would both generate needed revenue and provide new incentives for private saving. Consumption could be taxed with a retail sales tax or a value-added tax, or with a gasoline or broader carbon tax that would limit energy usage and have the additional benefit of helping control global warming.

Major procedural reforms will be needed as well. One essential step is the implementation of "pay-as-you-go" rules, which require that all increases in spending or tax cuts be financed by savings elsewhere in the budget. The statutory creation of a "fiscal future commission"—modeled on the Defense Base Closure and Realignment Commission, a federal body whose recommendations are subject to an up-or-down vote in Congress—could represent a major breakthrough. It might even be time to reconsider passing a balanced-budget amendment to the US Constitution, a provision that exists in nearly all US states and is now being pursued in a somewhat analogous form by the European Union. Whatever the specific policy approach, the underlying objective should be to create a system that will achieve a balanced budget over the course of the economic cycle.

A responsible fiscal policy would permit the Federal Reserve to run a relatively easy monetary policy, which would hold down interest rates and prevent overvaluation of the dollar. If the Obama administration is looking for a historical model, it should aim to replicate the Clinton-Greenspan policy of the late 1990s (a mix of budget surpluses and low interest rates) rather than the Reagan-Volcker policy of the early 1980s (a mix of large deficits and high interest rates).

In addition to fiscal consolidation, the United States will need to adopt a series of measures to enhance its international competitiveness and thus sustain current account equilibrium. Such efforts should focus on increasing productivity, as well as on energy and environmental policies designed to limit oil imports. In trade negotiations, the United States should seek to reduce foreign barriers to its exports, especially in its highly competitive service sector. US tax policy must create incentives for both US and foreign firms to locate their production in the United States by cutting corporate tax rates and treating offshore income no less favorably than do many other major countries.

President Barack Obama has called on all US citizens to face up to many of the realities that the country has ignored for too long: a financial regulatory system that contributed to the current economic crisis, a wasteful and unequal health-care system, an excessive reliance on fossil fuels and

the unstable countries that produce them, and the potentially cataclysmic harm to the planet due to global warming. The administration has advanced specific proposals on each of these issues. Now it must add to that agenda the goal of achieving sustainable equilibrium in the international economic position of the United States. If it does not, the United States risks replicating the conditions that brought on the current crisis or perhaps precipitating a crisis of even greater magnitude by building up its external deficits and its debt. So far, the Obama administration's rhetorical calls for long-term fiscal stability have not been coupled with substantive proposals to move significantly in that direction. The United States' success—or failure—in achieving economic equilibrium will go far toward determining the prospects for its global role, as well its prosperity, in the coming decades.

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