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Book Review

Book Review: The United States as a Debtor Nation

Aussenwirtschaft

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Cline, William R. (2005):

The United States as a Debtor Nation

Washington, DC: Institute for International Economics & Center for Global Development, 323 pp, ISBN 0-88132-399-3, US\$ 26.95

The United States is now the world's largest debtor nation. Its current account deficit has risen to levels never seen before. At the time of writing (October 2006), the trade deficit – the largest net component of the US current account balance – was reported to have set yet another record in August 2006 at US\$69.9bn. The resulting “global imbalances” have become the major international economic policy issue. In this volume, WILLIAM CLINE delivers an in-depth analysis of the growing US current account deficit and the net external debtor position that has resulted from it. All major issues are dealt with – some in greater, others in lesser detail. The book contains seven chapters, six of them analytical. The last chapter summarises the principal findings and discusses the major policy implications. Coming from a policy-oriented research institute, there is also a useful executive summary at the beginning.

The first chapter places the US net international investment position (NIIP) in an international comparative context and examines the validity of the international debt cycle theory. The United States clearly does not fit the theory, behaving like a “young debtor” nation where it should be a “mature creditor”. However, there are several other industrialised countries, such as Australia and Canada that do not fit the theory either. Chapter two considers the US situation in greater detail. Two features make it quite unique. First, there is the persistently favourable difference between the returns the US receives on its foreign assets and those that it pays on its liabilities. As a result, the US has until now received a positive net capital income from abroad despite being a net debtor. The second feature that makes it quite unique is the dollar's role as the major reserve currency. As a result, most of the US liabilities are denominated in its own currency. Exchange rate changes thus tend to stabilise the US foreign debt situation, since depreciation raises the dollar value of its foreign assets while leaving its liabilities mostly unchanged. These two features explain why the NIIP has not substantially risen during the past few years despite the huge current account deficits.

Chapter three examines the underlying behavioural patterns driving the US current account in order to project its likely future trajectory. Chapter four analyses in detail the role played by the fiscal deterioration under the BUSH administration and shows that it has been a key factor behind the current account deficits. According to CLINE's projections, the current account deficit will rise to eight percent of GDP by October 2008 unless there are policy changes. Developments since the book was written confirm that these projections remain highly realistic. To reduce the deficit to more sustainable levels requires a sizable real depreciation of the dollar, at least 20 percent according to CLINE. But this will not be enough by itself. CLINE's simulations suggest that a more competitive dollar will only have the desired effect if it is accompanied by a significant fiscal turnaround.

Chapter five considers the likelihood of a crisis. While traditional crisis benchmarks developed for emerging markets do not apply to the US case, there is still a risk that foreign investors will at some point reach a satiation point. Even if there is considerably more scope for increasing the share of US assets in foreign private portfolios, CLINE considers it likely that foreign central banks will start diversifying their reserve assets in

the near future. Once capital inflows dry up, there will be upward pressure on US interest rates raising the danger of a hard landing. Chapter six puts the analysis into a global context, by considering the likely impact of US external adjustment on the rest of the world. CLINE shows that while the bilateral dollar exchange rate adjustment required to reduce the imbalances would be quite large for many countries, the appreciation would be much smaller on a multilateral basis when effective exchange rates are considered. Of course, this presumes that there is a coordinated appreciation of the currencies of all major surplus countries, which is not a given due to the prisoner's dilemma problem. There is also the problem of how to compensate for the global slowdown in demand once the US current account deficit declines.

WILLIAM CLINE's volume is addressed at a broad readership interested in developing a thorough understanding of these issues. It would also be an illuminating supplementary text in courses on international macroeconomics. Academics will also find it extremely useful as background reading. However, they will probably consider the applied modeling parts a little old-fashioned by today's standards. Chapter four, for instance, contains what CLINE refers to as a "general equilibrium model", but few would recognise it as such. As there is no underlying intertemporal maximising framework, it is basically an old-style open economy macro model based on more or less ad-hoc relationships. However, this should not detract from the fact that CLINE has provided us with a first rate analysis of the US current account and foreign debt situation.

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