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Eight Reasons We Are Given Not to Worry About the U.S. Deficits

Jeffrey Frankel

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On behalf of the Commission on Growth and Development
1818 H Street NW
Washington, DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
www.growthcommission.org
E-mail: info@worldbank.org
contactinfo@growthcommission.org

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About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission's mandate is to "take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers."

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

The working papers, and all thematic papers and case studies written as contributions to the work of the Commission, were made possible by support from the Australian Agency for International Development (AusAID), the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (SIDA), the U.K. Department of International Development (DFID), the William and Flora Hewlett Foundation, and the World Bank Group.

The working paper series was produced under the general guidance of Mike Spence and Danny Leipziger, Chair and Vice Chair of the Commission, and the Commission's Secretariat, which is based in the Poverty Reduction and Economic Management Network of the World Bank. Papers in this series represent the independent view of the authors.

Abstract

The large U.S. current account deficit over the last decade—and the corresponding surpluses in China and elsewhere—have been interpreted in two very different ways. Many mainstream economists view the phenomena as primarily the outcome of a low rate of national saving in the United States, beginning with a large budget deficit (the other half of the "twin deficits"). In this first view, the current account deficit is unsustainable, and will eventually result in a sharp depreciation of the dollar. But this unsustainability view has been challenged by a variety of other economists, with equally impeccable credentials. This paper enumerates eight arguments that they have given as to why we need not worry about the current account deficit. The paper is skeptical of all eight, and sides with the unsustainability view. But they deserve a hearing. The eight are:

1. The siblings are not twins.
2. Alleged investment boom.
3. Low U.S. private savings.
4. Global savings glut.
5. It's a big world.
6. Valuation effects pay for it.
7. Intermediation rents pay for it.
8. Bretton Woods II.

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Eight Reasons We Are Given Not to Worry About the U.S. Deficits

Jeffrey Frankel[1]

I. Introduction: The Problem of the U.S. Current Account Deficit

The U.S. trade and current account balances have shown a downward trend for half a century, with the most recent alarming acceleration taking place from 2001 to 2006. The U.S. deficits hit record levels in 2006—6 percent GDP for the current account deficit. These levels would set off alarm bells if incurred in Hungary, Ukraine, or South Africa.

There are likely harmful effects in the short, medium, and long term. The short-term danger is protectionism in the U.S. Congress, which has taken the form of scapegoating China for our problems. The medium-term danger is a hard landing for the dollar, stemming from the rising dependence on foreign investors to finance the deficits. The hard landing would mean that U.S. securities markets would fall together with the dollar, and by some definitions of hard landing a recession would be part of the unpleasant adjustment process.[2] The long-term danger, from the viewpoint of Americans, stems from the high net debt to the rest of the world, now at about $3 trillion and still far from signs of reaching a plateau. To service this debt, America's grandchildren will suffer a reduced standard of living. Furthermore, dependence on foreign central banks and the newly famous Sovereign Wealth Funds may eventually bring about a loss of U.S. global hegemony.

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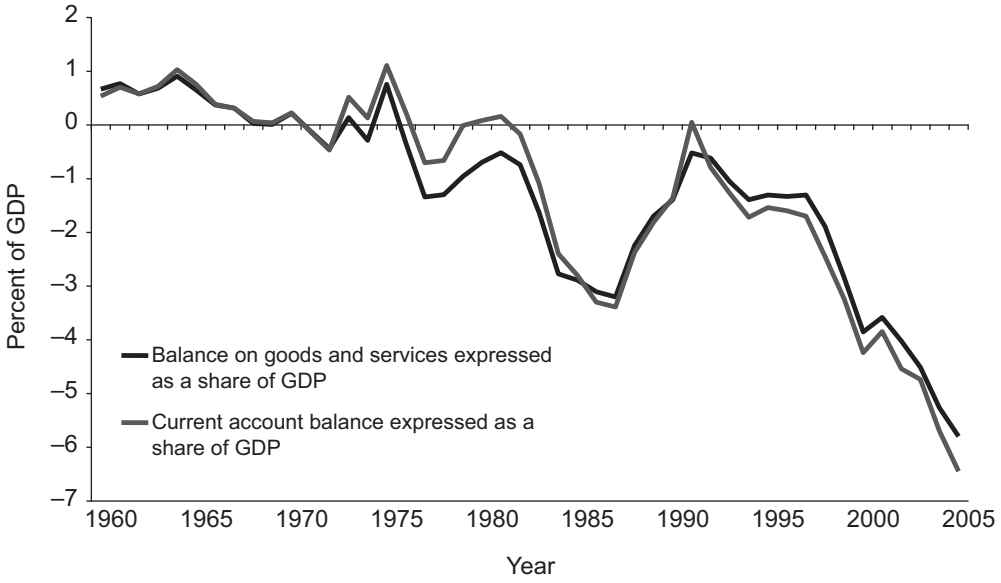
[1] Jeffrey Frankel is Harpel Professor of Capital Formation and Growth, Harvard University.

[2] Obstfeld and Rogoff (2001, 2005) were perhaps the first to warn of the renewed problem of U.S. current account sustainability. Edwards (2006), looking at other countries' deficits, finds that "major current account reversals have tended to result in large declines in GDP." He concludes that a day of reckoning for the United States is likely to arrive soon and that it will involve a fall in the dollar and in economic growth. Frankel (2004), Summers (2004), Blanchard, Giavazzi, and Sa (2006) and Chinn (2005) are also among those subscribing to the conventional view. Roubini and Kim (2004) warn of dire consequences. The preferable alternative way of adjusting to a much lower current account deficit would of course be a gradual path, helped by a reduction in the budget deficit, an increase in national saving, and a gradual depreciation of the dollar that stimulates exports and so sustains economic growth.

Figure 1: U.S. Trade Balance and Current Account Balance, 1960–2005



Source: Department of Commerce (Bureau of Economic Analysis).

Some observers measure the accumulating indebtedness relative to the size of the world portfolio or, especially, relative to world output, both of which can be thought of as relevant for the world's ability to absorb dollar assets. Viewed this way, the rise since 2001 does not look so alarming. If the United States were any other debtor country, however, the denominator would be a measure of U.S. ability to pay, such as U.S. output or U.S. exports or U.S. output of tradable goods—not a measure of the rest-of-the-world's ability to absorb. Empirically, the relevant determinant of the ability to pay turns out to be a trade measure like exports plus imports, not GDP—relevant in the sense that the ratio of trade to GDP is a good statistical predictor of immunity against sudden stops and currency crashes in a broad sample of countries.[3] This is not good news for the U.S. economy, which has a low X/GDP ratio, as a consequence of the size of the economy. Indeed this is the basis on which Obstfeld and Rogoff (2001, 2005) have been warning for a number of years that the United States eventually faces an abrupt, disruptive, and large depreciation of the dollar. If one computes foreign indebtedness as a ratio of exports, rather than as a fraction of the world portfolio, then the recent U.S. path may be explosive.

[3] Cavallo and Frankel (2005).

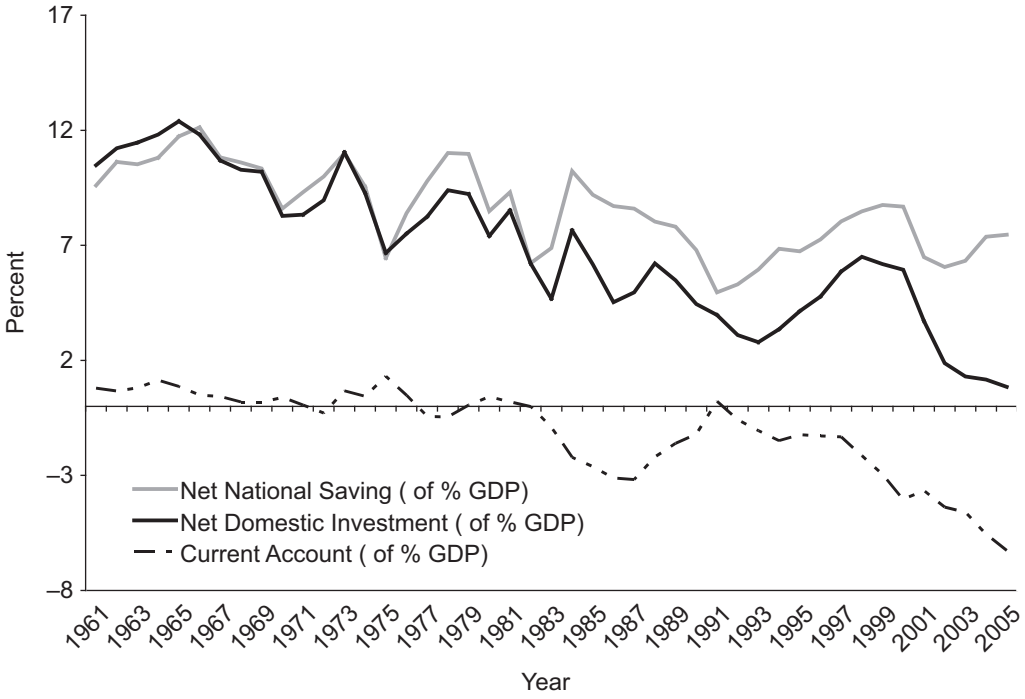
This note attempts to bring some further perspective, by reviewing two sides of the debate over the global imbalances. First, I will summarize the view that sees the origins of the U.S. current account deficit in "twin deficits" or the "U.S. saving shortfall," and which regards it as unsustainable. I once called this the mainstream view, but it has received so many challenges that I must acknowledge that the dissenters may outnumber the purveyors of the "conventional wisdom." Thus I will call it the "unsustainability" view. Then, I will review the most popular challenges, which suggest that the U.S. current account deficit is nothing to worry about.

II. The "Unsustainability" View: A Shortfall of National Saving in the United States

According to the unsustainability view, the U.S. current account fundamentally reflects a shortfall in national saving. The rapid widening of the deficit in early 1980s, and again at an accelerated rate during 2001–06, was associated at both times with strong declines in national saving as figure 2 shows.

True, trade deficits are affected by such determinants as exchange rates and growth rates at home and abroad. But these are just the "intermediating variables." More fundamentally, the U.S. trade deficit reflects a shortfall in national saving.

Figure 2: Net National Saving, Investment, and Current Account as Shares of GDP



Why did national saving fall in these episodes? Start with the numbers. Both times, in the early 1980s and 2001–06, the federal budget balance fell abruptly. In the first episode it deteriorated from a deficit that had averaged 2 percent of GDP in the 1970s, to a peak of 5 percent in 1983. In the second episode it swung from a 2000 *surplus* of 2 percent GDP, to deficits around 3 percent of GDP in 2003–04. The Bush administration, as soon as it assumed office in 2001, enacted large tax cuts, together with rapid increases in government spending. The president and other administration officials (though not the Council of Economic Advisers) explained that reduction in tax rates would produce more tax revenue. Of course this has not happened.

According to some theories, pro-capitalist tax cuts were supposed to have resulted in higher household saving. But both times, saving actually *fell* after tax cuts. U.S. household saving by 2005–2007 had virtually reached zero. Thus both components of U.S. national saving fell—public and private.

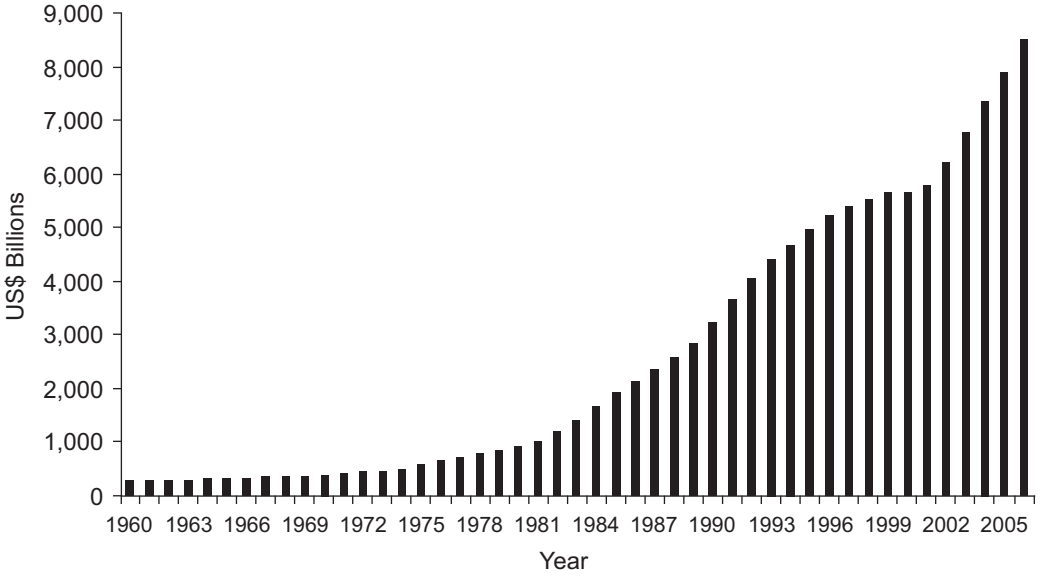
There are parallels not only with the Reagan administration in the early 1980s, but also with the Johnson administration in the late 1960s:

- big rise in defense spending
- rise in nondefense spending as well
- unwillingness of president to raise taxes to pay for increased spending
- resulting decline in the trade balance
- eventual gradual decline in global role of the dollar.

In the Johnson episode, the subsequent decline in the role of the dollar took the form of the end of the U.S. commitment to accept dollars in exchange for gold and eventually, in 1971, the end of the Bretton Woods system under which countries pegged to the dollar. In the second episode, the twin deficits probably contributed to a continued decline throughout the 1980s in the share of central banks' reserve portfolios allocated to dollars and the rise of the share of the yen and mark. Meanwhile, German and French leaders tried to supply a new international currency that would be stable in value since the United States seemed no longer able to do so. These efforts eventually bore fruit, first in the form of the European Monetary System, and then in the form of the birth of the euro in 1999.

The bout of American fiscal irresponsibility in the decade of the 2000s is actually worse than the 1980s. First, the retirement of the baby boom generation is that much closer than it was in 1981. Second, the national debt is much higher. Third, we now have other new fiscal time bombs as well, such as the phony sun-setting of tax cuts, the annual need to fix the Alternative Minimum Tax (AMT), and an exacerbated Medicare shortfall. The Bush administration seems to have lacked ability—which the Reagan administration and the elder Bush did have—to perceive when reality diverged from the speechwriters' script, and to respond

Figure 3: The National Debt Continues to Grow



Source: *Concord Coalition*, February 12, 2007.

with midcourse corrections. To the contrary, the White House never stopped proposing more tax cuts. Further, after a transitory dip in 2006–07, the much more serious deterioration in the budget situation will start after 2009 (although Bush White House projections stopped reporting the 10-year window). The cost of tax cuts will truly explode in 2010, if they are made permanent as the administration wants, as will the cost of fixing the AMT. The baby boom generation starts to retire in 2008; this implies soaring costs of Social Security and, especially, Medicare, in the not-distant future.

This "mainstream view"—that the shortfall in national saving is the primary driver—must contend with the conundrum of why long-term interest rates have been relatively low since 2001.

In my view, three major factors kept long-term interest rates low in the first half of this decade. The first was easy monetary policy by the Federal Reserve Board, the European Central Bank (less so), the Bank of Japan (more so), and the People's Bank of China. Low short-term rates led to the "carry trade": money flowed into bonds, stocks, real estate, emerging markets, and commodities—anywhere that it might earn a higher return than the very low rates that were on offer in the United States and Japan.

The easy monetary policy was reversed between 2004 and 2006, if one goes by interest rates. Why was there no contemporaneous reversal in the bond market and other markets? This was Alan Greenspan's "conundrum." One possible answer is that measures of credit by quantity continue to show ease. Bubbles were also a candidate explanation. Often in financial markets, for a year or two after fundamentals have turned around, prices keep moving under the own momentum, until the markets notice the lack of support, at which point

they come crashing down (for example, the 1985 dollar, 1990 Japanese stock market, 1995 yen, and 2000 U.S. stock market). Attributing unexplained movements to "bubbles" is not an attractive approach for an academic economist. But since many of the markets in question did indeed begin to correct in 2006–07, one must consider the possibility that the correction was a delayed reaction to the tightening of monetary policy, notwithstanding that the delay does some violence to our notions of well-functioning financial markets. In any case the Fed once again started to ease aggressively in late 2007.

The second factor that has kept U.S. long-term interest rates low in the first half of the decade was that foreign central banks were doing the same thing that the Fed was doing: buying U.S. securities. The third factor is that investors have not yet fully understood how bad is the long-run fiscal outlook in the United States (and in Europe and Japan as well). All three factors seem likely to come to an end soon.

III. Why We Are Not Supposed To Worry: Eight Challenges to the Mainstream View

The list of economists who have come up with ingenious arguments why we shouldn't worry about the U.S. deficits is by now rather long. Indeed the list is so long that one can probably no longer apply the label "mainstream" or "conventional wisdom" to the view that the source of the U.S. current account deficit is an unsustainable shortage of U.S. national saving.

I count at least eight distinct arguments in favor of the view that the current account deficit is sustainable and not a cause for worry:

1. The siblings are not twins.
2. Alleged investment boom.
3. Low U.S. private savings.
4. Global savings glut.
5. It's a big world.
6. Valuation effects will pay for the deficit.
7. Intermediation rents will pay for it.
8. Bretton Woods II.

Ultimately I don't buy these arguments. But it is well worth going through the list.[4]

[4] Eichengreen (2006) offers another review of the conventional view and its challengers.

1. The "twin deficits" view is wrong, because the budget and current account deficits do not always move in lockstep.[5]

This is a "straw man." Use of the term "twin deficits" does not mean to claim that current account and budget deficits *always* move together, and nobody pretends that they do. Of course the budget deficit and current account deficit can and do at times move in opposite directions, as in the U.S. investment boom of 1990s. The claim, however, is that *in the 1980s and the current decade, exogenous U.S. fiscal expansion led to both the budget deficit and the current account deficit.*

2. Capital is flowing to the United States due to its favorable investment climate and consequent high return to capital.

Apparently the argument of the current administration is that the capital inflows represent foreigners enthusiastically pursuing attractive investment opportunities created by the favorable business climate and high productivity growth of the United States.[6] It should be easy to dispose of this argument. First, the U.S. business investment rate is *less* in the first decade of the twenty-first century than it was in the 1990s IT boom (or than it was in the 1960s, 1970s, and 1980s). Second, FDI is flowing *out* of the United States, not in. (Where is it flowing to? Developing countries like China.[7]) Third, the money coming into the United States is largely purchases of short-term portfolio assets, especially acquisition of dollar forex reserves. The importance of foreign official purchases of dollars rose more than seven-fold from 2001 to 2006 (see table 1).

Table 1: Foreign Central Banks Finance an Increasing Share of the U.S. Current Account Deficit ($ billions)

Year	Δ foreign priv. assets in U.S.	Δ U.S. private assets abroad	Net priv. capital inflow	Δ Foreign official U.S. assets *	Official share of inflow
2000	1,004	559	445	43	**0.09**
2001	755	377	378	28	**0.07**
2002	681	291	390	116	**0.23**
2003	586	327	259	278	**0.52**
2004	1,064	910	154	398	**0.72**
2005	945	446	499	259	**0.34**
2006	*1,419*	1,063	356	440	**0.55**

Source: U.S. BEA and Treasury.

Note: Increasingly, foreign CBs' purchases of dollars are not recorded as such.

[5] Bernanke (2005) has been one of many making this point.

[6] Council of Economic Advisers (2006).

[7] How does the flow of FDI out of the United States and into China—not directly, as it happens, but let us say indirectly, via other OECD countries—square with the hypothesis of inferior property rights in the non-OECD world? Some recent papers suggest that if one allows countries to vary not only according to the development of their financial institutions but also according to a property rights parameter, one can explain the pattern of FDI flowing in at the same time that portfolio capital is flowing out. See Ju and Wei (2006) and the papers cited there.

Many observers have accepted at face value the official U.S. statistics that show the rate of purchases declining somewhat in 2005. But there are good reasons to think that central banks in Asia—and now, especially, oil-exporting countries—may be adding to their dollar holdings in ways that do not show up in the U.S. data as foreign official purchases, such as via European financial centers.

3. A fall in U.S. private saving has been as big a part of the fall in national saving as has been the budget deficit.

This is true. But recall that Bush tax cuts were supposedly designed to be pro-saving: abolition of the estate tax, sharp reductions in taxes on dividends and capital gains, and so forth. That was the excuse for their regressivity. As the private saving rate did not subsequently rise, this is a further indictment of our current fiscal policy. The same characterization applies to the Reagan tax cuts of 1981: they were supposed to boost saving but were instead followed by a fall in U.S. private saving rates (let alone national saving rates).

4. The problem is a global savings glut, not a U.S. saving shortfall.[8]

True, foreign net lending to the United States is determined by conditions among foreign lenders as much as in the United States. But the term "savings glut" is misleading because global saving is not really up.[9] The case of Japan, which was not long ago feared for its superhuman saving rate, is striking: the household saving rate has lately been 7 percent of disposable income, down from 23 percent in 1975. Nor is there a saving glut in developing Asia.[10] Rather than a rise in foreign saving being the driver, it is global investment that is way down. One could call this an *R* investment slump, as in Caballero, Farhi, and Gourinchas (2006). But in any case the pattern is inconsistent with the hypothesis that the exogenous change underlying the flow of capital to the United States is an increase in saving abroad: that would have shown up as an international rise in investment. The observed pattern is consistent, rather, with the hypothesis that the U.S. shortfall is sucking in capital from the rest of the world.

5. It's a big world.

The argument here is that world financial markets are big, relative even to the $3 trillion of U.S. net foreign debt, and are increasingly integrated.[11] As a consequence, foreign investors can bail us out for decades. If foreign investors keep moving, even slowly, toward fully diversified international portfolios (away from "home country bias" in their investments), they can absorb U.S.

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[8] Bernanke (2005).

[9] True, the overall saving to GDP ratio outside the United States had by 2004 climbed to a level slightly greater than that of the 1990s. But it is still less than the 1980s, the reference period in Caballero, Farhi, and Gourinchas (2006) (discussed below). More importantly, investment is down.

[10] Chinn and Ito (2005). China admittedly has an extraordinarily high saving rate.

[11] This view can be attributed to Richard Cooper (2005) and Alan Greenspan, among others.

current account deficits for a long time. Once again, this much is true. But, as already noted, when it comes to default or country risk, GDP or exports may be more relevant denominators for debt than is global portfolio size. Debt dynamics suggest that the U.S. debt/export ratio is currently on an explosive path.

6. Valuation effects: The U.S. current account deficit need not imply rising debt.

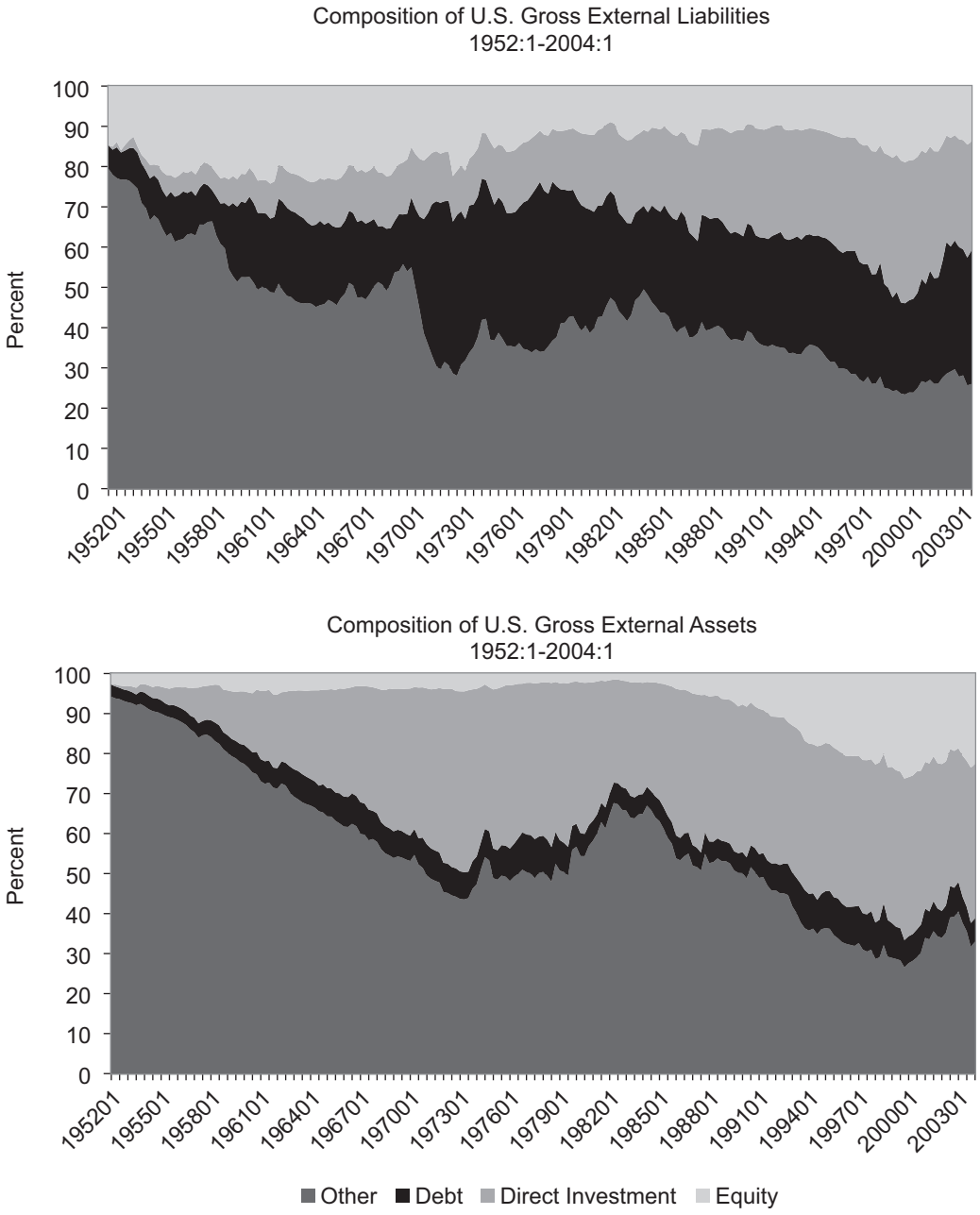
Lane and Milesi-Ferretti (2005) compute valuation effects. As a result of gains in the dollar value of foreign assets held by Americans, particularly via dollar depreciation, U.S. net debt has risen "only" to $3 trillion, despite a much larger increase in liabilities to foreigners. The question then becomes *how many times can the United States fool foreign investors?* Foreign investors will at some point start demanding higher interest rates on dollar assets if they are to hold a currency that cannot be expected to retain its value.

7. The U.S. as World Banker: Despite a negative international investment position, net investment income can remain in surplus due to intermediation rents.

As is well-known, the United States earns a higher rate of return on its assets abroad (especially FDI) than it pays on its obligations (especially Treasury Bills). In the 1960s, Kindleberger (1965) characterized the United States as playing the role of World Banker, taking short-term deposits and investing long-term. Today, Gourinchas and Rey (2005) call the United States a global "venture capitalist." Their chart, which is reproduced here as figure 4, shows that the composition of U.S. holdings abroad is tilted toward high-return FDI and equity, and away from low-return debt. Hausmann and Sturzenegger (2006) speak of "dark matter," by which they mean U.S. hidden assets of know-how that are not properly reflected in service export numbers. Cline (2005) calls the United States an *economic* net creditor, though a net international debtor in an accounting sense. But Daniel Gros (2006) figures that the accounting errors go the other direction, that foreign companies are understating profits of U.S. subsidiaries, probably to avoid taxes. The implication would be that the true situation is worse than the current account numbers indicate, not better.

Caballero, Farhi, and Gourinchas (2006) take as given U.S. comparative advantage in the ability to generate financial assets that others want to hold. This assumption is similar to arguments about America's unique good fortune in the form of its ability to serve as World Banker, supplier of intermediation services, owner of the foremost international currency, beneficiary of exorbitant privilege, or recipient of flight to quality. In the words of the authors, "Intermediation rents … pay for the trade deficits." But why is one on firmer ground taking any of these exceptionalisms as exogenously and eternally given, as opposed to considering that the willingness of foreigners to hold dollars may be an unsustainable disequilibrium?

Figure 4: U.S. Assets Give More Weight to High-Return Equity and FDI than do U.S. Liabilities

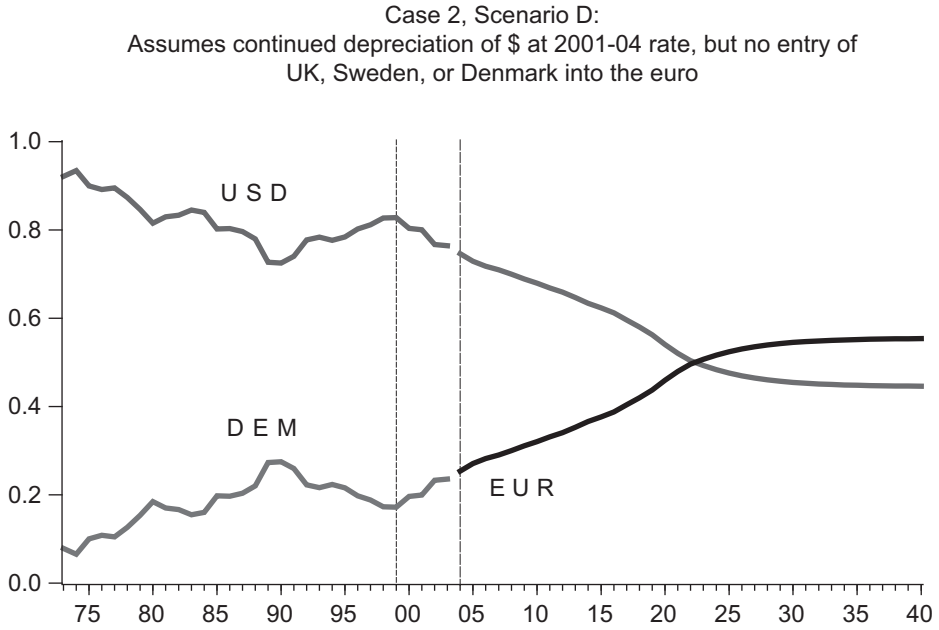


Source: Gourinchas and Rey (2005).

Some of these arguments rely on the dollar retaining its unique role in the world monetary system forever. The French in the 1960s called it the "exorbitant privilege": the rest of the world gives up real goods and companies in exchange for pieces of paper (dollars). The arguments assume that the dollar stays the premier international reserve currency held by central banks, and that the U.S. Treasury Security market will continue to be the preferred liquid asset for private investors as well. This has been true since World War II, but one can no longer assume that it will necessarily always be true: the euro now exists as a plausible rival over the longer term.

In a recent paper, Chinn and Frankel (2007) econometrically estimate determinants of reserve currency status: size of home economy, size of its financial markets, inflation rates, exchange rate volatility, trend depreciation, lagged adjustment, and a tipping phenomenon. We conclude that under certain scenarios—roughly *either* the United Kingdom joining the euro *or*, more likely, the dollar continuing to lose value in the future at the same rate as it has during the 2001–04 period—the euro could surpass the dollar as leading international reserve currency by 2022. Figure 5 shows the share of the dollar versus the euro in such a simulation. If this tipping took place the cost to the United States would probably extend beyond the simple loss of seignorage narrowly defined. We would lose the exorbitant privilege of playing banker to the world, accepting short-term deposits at low interest rates in return for long-term investments at high average rates of return. Global monetary hegemony is a century-long advantage that is not to be cast away lightly.

Figure 5: Simulation of Shares in Central Bank Reserve Holdings



Source: Chinn and Frankel (2007).

8. Bretton Woods II: China's development strategy entails accumulating unlimited dollars.

The view of Dooley, Folkerts-Landau, and Garber (2003) has received a lot of attention and has come to be associated in the United States with their employer Deutsche Bank. They begin, perceptively enough, with the observation that today's system is a new Bretton Woods, with Asia playing the role that Europe played in the 1960s—buying up lots of dollars to prevent their own currencies from appreciating. Then the authors go on to some more original and provocative ideas: China is piling up dollars not because of myopic mercantilism, but as part of an export-led development strategy that is rational given China's need to import workable systems of finance and corporate governance.

Initially, they were understood to be saying that this system could continue indefinitely. More recently, they have been pinned down as claiming only that it can go on for 10 or 15 years, comparable to the life of the Bretton Woods system.[12] My own view is that the Bretton Woods analogy is apt, but we are closer to 1971 (the date of the collapse of the Bretton Woods system) than to 1944 (the date of the actual meeting at Bretton Woods, NH) or 1958 (when currency convertibility was first restored in Europe). The current situation is more like the 1960s than Dooley, Folkerts-Landau, and Garber had in mind. It could have taken decades after 1958 for the Triffin dilemma to work itself out. But the Johnson and Nixon administrations greatly accelerated the process by expansionary fiscal and monetary policies (driven by the Vietnam War and Arthur Burns, respectively). These policies led rapidly to a declining trade balance and overall balance of payments, the collapse of the Bretton Woods system in 1971, and the failure of the attempted patch in 1973. There is no reason to expect better today. First, capital mobility is much higher now than in the 1960s. Second the United States can no longer necessarily rely on support of the foreign creditor central banks—neither on economic grounds (they are not now as they were then organized into a cooperative framework where each agrees explicitly to hold dollars if the others do), nor on political grounds (the United States is not as popular internationally as it once was). This is all reason to fear that the current imbalances cannot be sustained for very many years.

IV. The View from Late 2007

In the second half of 2007, financial turmoil gripped the world, in what was initially known as the subprime mortgage crisis. Liquidity in credit markets dried up. Stock markets fell sharply. The United States no longer seems to be the safe haven it has long been. Unlike in past episodes of increased global risk-aversion, emerging markets at first were affected somewhat less than the rich countries.

[12] Dooley and Garber (2005).

It is generally not a good idea to put these things into print, where a misforecast will live forever. But at the time of writing, the United States appeared to be poised on the brink of recession. The trade and current account deficits have begun to shrink, presumably in response to the slowing of the economy and the depreciation of the dollar. The day when deficit adjustment is forced on the United States, as predicted by the "unsustainability view," may be at hand. A coming recession may be more severe and long-lasting than the last one in 2001. The U.S. monetary authorities will ease, but are constrained from cutting interest rates as aggressively as in 2001 because now they must worry about the declining dollar and upside risks to inflation. The fiscal authorities will ease, but are constrained from cutting tax rates as aggressively as in 2001 because now they must worry about high national and international debt and a path of future budget deficits stretching as far as the eye can see. All this means that the adjustment is now likely to take the more painful of the two possible courses that the mainstream view has long warned of: dollar depreciation with recession, rather than pure expenditure switching. Even if it does not turn out that the day of reckoning is yet at hand, from now on we can probably no longer count on the dollar and economy being automatic safe havens.

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