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Twin Deficits and the Fate of the US Dollar: A Hard Landing Reexamined

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The tenuous macroeconomic climate that characterizes the U.S. economy today, signaled by record-level federal budget and trade deficits, has increasingly raised concern over the possibility of a hard landing for the U.S. dollar. This paper argues that such concern is warranted: a hard landing scenario – characterized by widespread capital flight and a large and sudden depreciation of the dollar – is indeed a realistic possibility. Further, the paper examines the tradeoffs of one strategy that has been offered to reduce the likelihood of a hard landing – confronting Chinese currency manipulation – and concludes that such a strategy involves potentially large tradeoffs, and is less preferable to one that falls more directly within U.S. government control, namely, reducing the budget deficit. Finally, it concludes with a brief discussion of the rationale for a strategy that focuses on reducing the budget deficit, and the prospect of fiscal discipline as a means to that end.

Introduction

The presence of "twin deficits" – a large federal budget deficit and an equally formidable trade deficit – are among the most pressing challenges facing the United States economy today. Projections based on current U.S. fiscal policy suggest budget deficits ranging from 2 to 3.5 percent of Gross Domestic Product (GDP) over the next decade, with substantially larger increases in

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the years that follow (Cline 2007; Chinn and Steil 2006; Gale and Orzag 2004). The trade deficit, which currently hovers around 5 percent of GDP, represents a similarly intractable problem. This tenuous macroeconomic climate, signaled by record-level deficits, has increasingly raised concern over the possibility of a "hard landing" for the U.S. dollar.

Although scholars differ over what precisely constitutes a hard landing, the notion generally refers to a sudden and direct transition in the economy from a state of expansion to one of dramatic economic slowdown or recession, generally accompanied by a collapse in the value of the currency. The major risk or worry of a hard landing stems, more precisely, from the possibility of a drastic reduction in the large net capital flows that are required to finance U.S. deficits (Bergsten 2007). Accordingly, the hard landing scenario tends to be characterized by widespread capital flight and a sharp (and perhaps very large) depreciation of the dollar (Rajan 2005).

In light of the current political and economic context, this paper argues that concern is indeed warranted: a hard landing, although certainly not inevitable, is a realistic and even likely scenario. Further, this paper examines the tradeoffs of one strategy that has been offered to reduce the likelihood of a hard landing – confronting Chinese currency manipulation – and concludes that such a strategy involves potentially large tradeoffs, and is less preferable to one that falls more directly within U.S. government control, namely, reducing the budget deficit.

Rethinking the Possibility of a Hard Landing

In arguing the case for the likelihood of a hard landing, I proceed by delineating precisely what is meant by such a notion, and why it makes sense, in light of the current context, to avoid dismissing it as a merely remote possibility. Amid this discussion, I consider some of the arguments that have been advanced against the hard landing scenario, including reasoning which suggests that the large trade deficit, in particular, should not be a cause for concern. Finally, I explain why such arguments may be overly optimistic, and generally tend to underestimate the possibility of a hard landing.

Throughout the last few years, many scholars have increasingly warned that large U.S. deficits are unsustainable, and may pose a significant threat to U.S. and global macroeconomic stability (Gale and Orzag 2004; Summers 2004; Obstfeld and Rogoff 2005; Cline 2005; Chinn 2005; Chinn and Steil 2006; Frankel 2006; Bergsten 2007; Cline 2007). Indeed, as Fred Bergsten points out in his recent testimony before the Budget Committee of the U.S. Senate, "The huge and growing international trade and current

account imbalances…represent the single greatest threat to the continued prosperity and stability of the United States and world economies" (Bergsten 2007). This threat manifests itself directly in the hard landing scenario. Scholars like Bergsten worry that burgeoning U.S. deficits may ultimately lead to a potentially sharp reduction, or even reversal, of the very large net capital inflows that are required to finance them (Bergsten 2007). As investor confidence erodes, particularly in response to the twin deficits and other perceived problems in the US economy, the underwriters of the U.S. imbalances may become unable or unwilling to effectively "prop up" the U.S. dollar. Any kind of sudden unwillingness – by even a relatively small proportion of investors – could potentially serve as a catalyst whereby other majority stakeholders would be encouraged to abandon their dollar-denominated assets and securities in favor of some other currency. This kind of large-scale capital flight would thus lead to the sharp reduction or reversal in capital flows that is feared by Bergsten and others. A sudden reversal of net capital flows to the U.S. would immediately cause an already sinking dollar to sink even further (and perhaps at a much larger and faster rate). Interest rates would rise and asset prices would inevitably fall, choking off consumption and perhaps leading to a severe disruption of the stock market (Bergsten 2007; Cline 2007). Such a combination of events would drag the U.S. economy into recession, and perhaps even generate a kind of lasting downward spiral from which the dollar – as the world's preeminent vehicle currency – would be unlikely to recover (Chinn and Steil 2006, 22).

Self-correction?

The situation described above is not simply a "doomsday" scenario – one that points to huge consequences but is of little real possibility. Given the current policy of "benign neglect," the hard landing scenario is, quite to the contrary, plausible and likely. Apart from muffled calls aimed at encouraging China to maintain greater currency flexibility, the U.S. Treasury Secretary has taken no steps to resist or reverse the fall of the dollar, and shows no sign of doing so in the future (Chinn and Steil 2006; Feldstein 2007). Indeed, having subscribed to the postulate that "deficits don't matter," the Bush Administration thus far has remained indifferent to the problems posed by the twin deficits and a declining dollar (Chinn and Steil 2006, 19). This policy of indifference stems from the belief that the trade deficit – along with a declining dollar – is part of a self-correcting cycle in which the dollar's depreciation will make U.S. exports more attractive internationally. According to this view, the resulting surge in exports will

generate higher export revenues, gradually reducing the trade deficit.

Such a view, however, fails to adequately take into account what will become of those revenues. Indeed, the presumption that a surge in exports will necessarily reduce the trade deficit is predicated on the notion that higher revenues will necessarily translate into additional income for consumers, and thereby result in an increase in consumer savings. As William Poole suggests, the savings rate is a key factor in explaining the U.S. trade imbalance (Poole 2005, 236). In the event that an increase in consumer income contributes to an increase in the U.S. savings rate, or perhaps even a redirection of spending toward domestic goods, then we might expect to see a reduction in the trade deficit. But in the event that income is directed instead toward buying additional Asian and/or European imports, then we can expect to observe no such effect.

Recent evidence tends to support the latter event. For example, trade data released from the U.S. Bureau of Economic Analysis (for January 2008) reveals that while export revenues have indeed risen in response to a weakening dollar, there has been no corresponding decline in imports. In fact, imports for the month of January substantially outpaced the rise in exports, resulting in a trade deficit of $58.2 billion. Even aside from record-level oil prices, which certainly play a part in explaining the magnitude of this figure, recent analysis of trade and currency data suggest that a dollar depreciation will not directly or immediately curb the demand for imports (Goldberg and Dillon 2007). Indeed, the responsiveness of U.S. imports to movements in the dollar is vastly lower than is often assumed (Chinn and Steil 2006). Thus, in the short run, we simply cannot depend on a declining dollar to "self-correct" the trade deficit.

The "deficits are good" argument

Still, some scholars downplay the threat posed by the trade deficit entirely, arguing that it need not be regarded as a sign of weakness or even a problem to be corrected (Poole 2005). According to this view, the U.S. trade deficit is simply a corollary of rapid rates of economic growth: as the United States grows more rapidly than its trading partners, the deficit inevitably widens. As a virtue of economic strength and vitality, deficits are therefore something to be celebrated rather than feared (Poole 2005). For proponents of this argument, the trade deficit is also a sign of future economic strength, demonstrating that the United States is an attractive place to invest. In this respect, the net debtor status of the United States is simply a reflection of the enthusiasm that investors have shown for U.S. financial markets – and a testament to the persistent fortitude and

creditworthiness of the U.S. economy.

The "deficits are good" argument, however, is undermined by two important considerations. First, the U.S. economy is currently driven much more by consumption than investment (Chinn 2005). This is an especially noteworthy consideration when one considers that it is investment, and not consumption, that is generally thought to provide the foundation for sustained economic growth. Indeed, there is a well-established link between economic growth and productive long-term investment – in such areas, for example, as health, education, and infrastructure (Jones 2002). In the absence of such investment, and a heavy reliance instead on variable patterns of consumer spending, the link between U.S. deficits and long-term economic vitality is ambiguous at best. Second, and perhaps more importantly, the large majority of U.S. capital inflows now occur in the form of purchases of U.S. government securities rather than in the form of foreign direct investment or purchases of U.S. stocks. As Chinn points out, the fact that foreign central banks are the primary financiers of U.S. deficits tends to refute any notion that suggests that sustained capital inflows are profit-driven, or that they necessarily derive from a superior climate for investors (Chinn 2005; Chinn 2006). Indeed, based on the nature of "investment" in the U.S., it is much more apt to conclude that the deficits represent a problem and liability rather than any kind of virtue.

In considering the extent of the liability posed by burgeoning deficits – and the commensurate possibility of a hard landing for the U.S. dollar – one must also take seriously the role of investor perceptions and expectations. Just as individuals who borrow perpetually risk losing credibility with their lender, so too does the U.S. economy jeopardize its standing among investors. As outlined above, a severe loss of confidence could cause investors (and even foreign governments) to precipitously turn on the dollar as their currency of choice. The possibility of such a shift, based on current U.S. spending and borrowing habits, is more likely and urgent of a concern than a policy of "benign neglect" confers.

Nevertheless, many of those who tend to admonish the "benign neglect" strategy remain skeptical of any real possibility for a hard landing. In dismissing the likelihood of a hard landing, some have called instead for a "soft landing" scenario – a more gradual and orderly reckoning of the U.S. trade imbalance (Rajan 2005; Bergsten 2007). Adherents of such a forecast chide the Bush Administration for not being more active in seeking a reduction in the deficits, but they ultimately concede, based on several factors, that a hard landing is rather unlikely (Rajan 2005; Bergsten 2007).

The "strong fundamentals" argument

In conceding the case in favor of a soft landing, economists have often pointed to the "strong fundamentals" of the U.S. economy (Bergsten 2007). According to this view, the sound fundamentals (i.e., strong institutions, relatively low rates of inflation, ect.) of the U.S. economy offer no incentive for capital flight out of the dollar, and will continue to attract the necessary levels of investment required to finance its deficits. But again, this view fails to adequately take into account the potential role of investor perceptions and expectations. From an investor's perspective, large and unrestrained deficits – combined with an ever-declining dollar and severe troubles in the housing market – may be more than enough to invoke a loss of confidence in the U.S. dollar, regardless of the maintenance of strong fundamentals.

No-other-game-in-town?

The "strong fundamentals" argument, however, is generally buttressed by a line of reasoning that suggests that there is simply "no-other-game-in-town." Proponents of this rationale question whether there is really any other option for parking all the liquidity that currently resides in the U.S. dollar. Indeed, this has been a long-standing rejection of any substantial movement away from the dollar. In the present age, however, this reasoning holds little merit. As Galati and Wooldridge reveal, euro financial markets continue to advance significantly against U.S. dollar markets in terms of liquidity and sophistication (Galati and Wooldridge 2006). The euro has already displaced the dollar as the world's pre-eminent currency in international bond markets (Oakley and Tett 2007). And while the U.S. dollar currently maintains its place as the dominant reserve currency, the fortitude of this position is waning (Wooldridge 2006). To be sure, the euro's position as a possible alternative to the dollar has grown substantially in recent years, and with this growth has come increasing signs of diversification away from the dollar (Eichengreen 2005; Eichengreen 2007; Oakley and Tett 2007; Krugman 2008). In light of these developments, it is imprudent to cling unreservedly to the idea that investors will always and inexorably remain committed to the dollar.

The "vested interests" argument

Despite the emergence of the euro as a possible alternative to the dollar, skeptics of the hard landing scenario point to the vested interests of Asian and Middle Eastern economies in sustaining a U.S.-led financial system (Murphy 2006). According to this argument, there is very little risk that

governments or foreign central banks in these countries would initiate an abrupt move away from the dollar, for such a move would dramatically reduce the volume of their large dollar holdings, and surely jeopardize their overarching goals of promoting political, economic and financial stability (Murphy 2006). But others have pointed to the increasing costs for countries like China in continuing to prop up the dollar. Indeed, China's accumulation of large dollar reserves and its policy of sterilization present major opportunity costs that ultimately cause one to question the long-term sustainability of the system (Zheng and Yi 2007).

Yet, we must also question what precisely is meant by "sustainability," for scholars and pundits have been issuing warnings of unsustainable deficits now for nearly a decade. Indeed, as early as 1999, Treasury Secretary Robert Rubin proclaimed that "the international system cannot sustain indefinitely large current account imbalances created by the disparities in growth and openness between the U.S. and its major trading partners" (Mann 1999, 149). But as Murphy suggests, the stern forecasts of a hard landing have, thus far, stubbornly refused to occur (Murphy 2006, 40). Again, for Murphy, this stubbornness is borne out by the vested interests of countries like China and Japan in propping up the dollar. These interests have clearly helped sustain U.S. deficits in the short-run, but do they give us reason to conclude that we can expect sustainability in the medium or long-run? And what, definitively, is the "medium" or "long" run? Finally, how many years does it take without a dollar collapse to refute the idea altogether, denying the short, medium, and long-run possibilities of a hard landing?

To be sure, forecasters are aware of the imprecision in their trade. As Murphy finally concedes, forecasting a dollar collapse is "devilishly hard" (Murphy 2006, 61). Ultimately, the fact that a hard landing has not *yet* occurred provides us with little basis to conclude that such a scenario won't ever occur. In making an informed decision about future possibilities, we are again compelled to examine the current political and economic context. As Bergsten suggests, a number of factors currently point toward the risk of a hard landing. He notes, for example, that the trade deficit is twice as large as its previous record, and has been increasing now for more than a decade, compared with a five-year run-up to its previous peak (Bergsten 2007). Even Murphy recognizes the changing conditions that could lead to a hard landing. For a summary of the multitude of potential catalysts, his analysis is worth quoting in full:

> "For markets are jittery everywhere; their fears almost endless. Renewed inflation in the United States, an unseasoned Federal

> Reserve chairman who has yet to confront his first real crisis, a politically crippled Bush Administration, the implosion of the U.S. housing bubble; all on top of spiking commodity prices, the ever-present threat of calamitous disruption to the flow of petroleum by events in the Middle East, the galloping U.S. trade and government deficits, and indeed worries over the Chinese financial system – any one of these, or yet something else, could trigger a panicked flight from the dollar that would overwhelm the ability and willingness of the East Asian central banks to contain the flood" (Murphy 2006, 62).

Based on this summary alone, it would be imprudent to suggest that a hard landing is only a remote possibility. Yet, scholars like Murphy are comforted by the thought that, in the event of a severe drop in the dollar, the relevant nations (e.g., the U.S., China, and Japan) would ultimately agree on joint intervention in the currency markets to support the dollar and protect their vested interests. The "vested interests" argument, therefore, is at least partially contingent on the notion that cooperation between states is politically feasible.

In emphasizing the vested interests of countries like China and Japan in intervening to rescue the dollar, Murphy and others tend to overestimate the prospects for cooperation. Indeed, Kirshner (2007) urges us to reevaluate the viability of the "vested interests" argument. According to Kirshner, "cooperation between states over exchange rates is inherently difficult" (Kirshner 2007, 187). In stark contrast to those who suggest that cooperation would inevitably occur in the event of the dollar's collapse, Kirshner insists that countries will be the least inclined to cooperate under circumstances of economic distress (Kirshner 2007, 188). He concludes, ultimately, that cooperation is "unlikely to develop due to fundamental differences…over economic ideology and geopolitical conflict" (Kirshner 2007, 205). Kirshner's analysis is instructive. In considering the prospects for cooperation, economically desirable outcomes are often trumped by ideological commitments and geopolitical circumstances. This conclusion rings especially true in light of the Bush Administration's current policy of "benign neglect" and its penchant for embracing unilateral tactics over multilateral solutions.

In sum, there are numerous factors that point to the possibility of a hard landing. The resilience that the U.S. economy has shown against past warnings should not be cause for a dismissal of fresh thinking on the subject. Indeed, as Eichengreen instructs, "uncertainty about whether a disorderly correction is imminent does not justify inaction" (Eichengreen

2006, 13). In heeding this instruction, let us now turn to our discussion of one particular strategy that has been proposed to mitigate the likelihood of a hard landing, and the potential tradeoffs involved.

Avoiding a Hard Landing

Confronting Chinese currency manipulation?

One of the most widely cited strategies for reducing the likelihood of a hard landing involves confronting Chinese currency manipulation. Proponents of this strategy argue that by hastening an appreciation of the yuan relative to the dollar, U.S. exports will become more competitive, which will act to reduce the trade deficit, and thereby serve to improve investor confidence along with the precarious climate of uncertainty. But as we shall see, this strategy involves significant tradeoffs – for the United States, Asia, developing countries, and the International Monetary Fund (IMF) – that are likely to undermine its viability and effectiveness.

While the obvious benefit of such a strategy for the United States is the potential improvement in its balance of trade, there could also be significant costs. First, such a strategy may, at least in the short run, end up having the opposite effect of that which is intended. As we have seen, the responsiveness of U.S. imports to fluctuations in the exchange rate is far from instantaneous. In considering the extent to which imports currently exceed exports, the higher dollar price of imported goods – resulting from an appeciation of the yuan – would in fact *worsen* U.S. trade performance, and contribute to even *larger* deficits (Chinn and Steil 2006). In the short run, a significant appreciation of the yuan could also be detrimental to the United States by cutting off the large amount of capital inflows that are necessary to finance its deficits. China's policy of sterilized intervention – and its resultant success in maintaining a devalued exchange rate – is contingent upon its ongoing purchase of U.S. Treasury bonds. Thus, if the yuan were allowed to appreciate, China would no longer have any need to purchase the vast number of Treasury bonds on which the United States so heavily depends.

In forcing China to appreciate, the United States also runs the risk of solidifying its position as a "coercive hegemon." Already facing much anti-American sentiment around the world, the United States can ill afford to increase resentment by coercing China to pursue an economic agenda that is counter to its own autonomous policy goals. Yet, scholars like Goldstein reject the notion that confronting China would cause a hardening of its position, and argue that Chinese currency manipulation should be subject to the same kinds of criticism that are leveled at its military-build up and

human rights abuses (Goldstein 2006). In dismissing the argument that citing China as a currency manipulator would provide the U.S. Congress with the justification it needs to enact protectionist legislation, Goldstein insists that the United States adopt a "tell-it-like-it-is" policy (Goldstein 2006, 13). But again, such a policy does not bode well for fostering diplomatic solutions or improving American sentiment. And it fails to provide China with a reasonable avenue for promoting its own agenda of ensuring political stability and promoting employment for its citizens. Indeed, Chinese currency manipulation is a crucial part of this agenda, and should not be considered akin to its military ambitions or alleged human rights abuses.

To his credit, Goldstein acknowledges that trade retaliation is not the smartest lever to deal with currency manipulation, and that unilateral action by the U.S. may provoke just such a response (Goldstein 2006). His solution, therefore, is to "multilateralize" the issue by pushing the IMF to fulfill its original mandate to "exercise firm surveillance over the exchange rate policies" of its member countries, particularly China (Goldstein 2006, 14). Yet, it is doubtful that such a solution would actually address the problems at hand. From the perspective of many countries around the world, the IMF is simply a puppet or manifestation of coercive U.S. hegemony. Pressuring the IMF to recall its original mandate at a time that best suits U.S. interests is unlikely to improve the status of either actor.

I have already alluded to some of the tradeoffs for China in allowing their currency to appreciate. There is no question that the process by which China abides in maintaining an artificially devalued exchange rate comes at significant cost. Indeed, China's sterilized intervention may lead to inefficiencies in the financial sector and significant problems of resource allocation (Mohanty and Turner 2006). Many scholars emphasize, in particular, the substantial opportunity costs that arise from China's large accumulation of dollar reserves. For example, Zheng and Yi point to increased risks for the Chinese financial system, mounting inflationary pressure, and large losses of wealth incurred by a weakening dollar – all a result of China's heavy foreign exchange accumulation and a consequent rise in speculative capital inflows (Zheng and Yi 2007, 23).

The policy proposals that Zheng and Yi offer to mitigate these risks, however, run counter to one that simply labels China as a currency manipulator. Their analysis, in encouraging only "gradual liberalization" and "small-scale diversification" (out of the US dollar), judiciously recognizes the tradeoffs that China faces in terms of having to ensure political stability and address "huge employment pressures" amid a "fragile financial system"

(Zheng and Yi 2007, 15, 23-24). In responding to employment pressures, China continues to rely considerably upon the performance of its export sector – which is in turn heavily contingent upon a devalued currency. A rapid appreciation of the yuan might very well serve to remedy operational and allocational inefficiencies in the financial sector, but such benefits are outweighed by considerations of a potentially dramatic slowdown in the Chinese economy – and the social and political instability that might result. Indeed, while the mounting costs and the waning benefits (of maintaining an inflexible exchange rate system) will ultimately force China to reconcile its employment concerns with those of a moribund financial system (Rajan 2005), allowing China to maintain its own commitment to a gradualist approach to currency reform is much preferable to a coercive policy that calls for immediate adjustment.

A policy that begets immediate adjustment is also likely to have adverse consequences in Japan. In considering that the economic relationship between China and Japan is more complementary than competitive, such a policy would conflict with Japan's status as a net importer of low-end Chinese manufactured goods, and its own comparative advantage as an exporter (to China) of raw materials and goods used for processing, such as steel and machinery. As highlighted above, a rapid appreciation of the yuan would hurt China's export performance, and cause a general slowdown in the Chinese economy. Because processing makes up a significant proportion of China's trade, such a slowdown would likely reduce the demand for Japanese exports in certain key industries (e.g. the steel and machinery industries). Indeed, for the Japanese economy, which has become increasingly reliant upon exports to China, a policy that induces an immediate appreciation of the yuan would almost certainly have a net negative effect (Kwan 2003).

Finally, one is inclined to inquire after the effect that such a policy might have on developing countries. It is certainly true that, like China, much of the developing world relies on export-driven growth to fuel their economies. Many developing countries may therefore welcome an appreciation of the yuan, at least insofar as it makes their own exports more competitive relative to Chinese goods. A policy that results in an appreciation of the yuan may also reduce the flood of cheap Chinese imports that have often overwhelmed the nascent markets of developing countries, such as in Mexico or many African nations, for example. These positive outcomes are certainly deserving of consideration. But as we have seen, there is ultimately no guarantee that the kind of solution offered by scholars like Goldstein will produce the desired effects. Quite to the contrary, a rapid

appreciation of the yuan could induce severe instability in China that could have potential spillover effects among both industrial nations and developing countries throughout the region. And in the event that China was to harden its stance against liberalization, the possible protectionist leanings that might result in the U.S. from labeling China as a currency manipulator would only serve to foster anti-American sentiment among developing countries.

In conclusion, a strategy that aims to unilaterally confront Chinese currency manipulation is likely to be ineffective, and yield undesirable outcomes overall. And as Kirshner's analysis suggests, true multilateral solutions (i.e., those that do not involve using the IMF as a tool for one's own agenda) that involve cooperative action on exchange rates are probably beyond reach (Kirshner 2004). Nevertheless, the risk involved in a hard landing for the U.S. dollar requires planned action. The scale of global economic problems today may create an incentive for cooperation in the future, and so efforts to establish coordinated action on exchange rates should by no means be ignored. But the magnitude of the risk is such that the United States would do well to start with targeting solutions that fall directly within its immediate realm of control. Ultimately, in seeking to avert the possibility of a hard landing, a much more appropriate means would utilize "the chief policy tool that we can deploy with some confidence" – reducing the federal budget deficit (Bergsten and Truman 2007).

Reducing the Budget Deficit

Twin deficits?

While a thorough examination of the relationship between the budget deficit and the trade deficit is beyond the scope of this paper, a brief discussion is in order. The discussion seeks to further elucidate the benefits of a strategy (for mitigating the likelihood of a hard landing) that focuses on reducing the budget deficit.

Some scholars – including, most notably, current Federal Reserve chairman Ben Bernanke – have expressed doubts over any presumed causal relationship between the budget deficit and the trade deficit. As Bernanke points out, the "twin-deficits hypothesis" – the notion that the deficits necessarily move in lockstep, or that the budget deficit fully explains the trade deficit – is questionable at best (Bernanke 2005). Yet, Bernanke does not deny that the federal budget deficit may act to exacerbate and contribute to a widening trade deficit.

Indeed, Chinn rightly urges us to recognize the role of U.S. fiscal policy in driving the trade deficit wider, and accordingly, asserts that "[r]educing

the rate of government spending and raising tax revenues should be at the top of the country's economic agenda" (Chinn 2005, 5). Chinn is not alone in his analysis. Many scholars have emphasized the importance of exercising fiscal restraint – spending less and saving more – as the primary means to reducing the trade deficit. Larry Summers, former Secretary of the Treasury, has declared that an increase in national savings is a necessary response to addressing the U.S. trade deficit (Summers 2004). And, as William Cline has pointed out in his testimony before the U.S. Senate, "Fiscal policy is directly relevant because government saving is part of national saving" (Cline 2007, 6). The budget deficit, as Cline instructs, is essentially a reflection of government "dissaving." Fiscal policy – in its unique ability to shrink the government's dissaving (i.e., the budget deficit) – is therefore the only instrument that can be effectively employed to increase national savings (and thereby reduce the trade deficit) (Cline 2007, 7).

The above analyses allow us to conclude, at the very least, that a reduction of the federal budget deficit follows a complementary path toward the ultimate goal of reducing the trade deficit. As we have seen, a burgeoning trade deficit poses major risks for the U.S. economy, and so for this reason alone, the U.S. government should be inclined to adopt fiscal policies that aim to reduce the budget deficit directly. But seeking to reduce the budget deficit is also a laudable goal in its own right. As Cline suggests, "there are major domestic reasons for moving aggressively to eliminate the fiscal deficit" (Cline 2007, 8). Most notably, insofar as this paper is concerned, is that some measure of fiscal discipline is critical for maintaining investor confidence and for instilling creditworthiness into the U.S. economy. Indeed, renewed growth of the budget deficit could plausibly serve as the trigger for a hard landing, with a lack of financial discipline acting as the proverbial "straw that broke the camel's back" of confidence in the dollar (Bergsten 2007). In this respect, the "twin deficits" – although not identical – are indeed complementary.

Fiscal Discipline: a hopeful prospect?

In recent months, a faltering U.S. economy has received increasing attention. As the 2008 Presidential candidates jostle for position over their records on national security and the war in Iraq, ordinary citizens have begun to voice their concern ever more loudly over pressing domestic issues. Yet, both politicians and citizens would do well to remember that the fate of the U.S. dollar is not merely a domestic issue: as highlighted above, the failure to target a domestic solution may have dire global consequences.

"Think globally, act locally" has become a popular catchphrase of en-

vironmental and conservation movements. Unfortunately, this phrase has not yet filtered over into U.S. economic policymaking. "Thinking globally" would prompt policymakers to recognize that decision-making at the domestic level is also inherently an international affair. "Acting locally," meanwhile, would require that policymakers begin taking the necessary steps to substantially reduce the budget deficit. Yet, in seeking to revitalize the economy and stave off a recession, the Bush Administration and the U.S. Federal Reserve have together pursued increasingly expansionary economic policies. While now may not be the time to introduce profound measures of fiscal austerity, President Bush's proposed economic stimulus package, as well as the Federal Reserve's recurrent slashing of interest rates, are both likely to result in further deterioration of the twin deficits, and increased risk of a hard landing. Indeed, in their preoccupation with responding to domestic concerns, the expansionary bent of current policy interventions reflects the willingness to "act locally" – but a failure to truly "think globally."

In the midst of an election year, efforts aimed at reversing the current course of fiscal expansion are likely to be few and far between. On the brink of recession, political parties will be especially apt to dissociate themselves with even the most cautionary measures of fiscal discipline. And even aside from recessionary concerns, attempting to strengthen the U.S. economy with fiscal discipline is bound to encounter fierce opposition. On the Republican side, for example, Senator John McCain has been thoroughly criticized by his party for his opposition to a permanent renewal of the 2001 Bush tax cuts. The threats of many Democrats to cut military spending for the Iraq war, meanwhile, have proven to be mostly rhetoric. And while both Republican and Democratic candidates alike have followed the mantra of change in voicing their opposition to lobby groups and special interests, the overwhelming pressure exerted by those interests amid a presidential campaign does not bode well for the prospect of fiscal discipline.

In light of the above, it is perhaps all too easy to be overtaken by a shadow of cynicism. Yet, despite the rhetoric inherent in an election year, there remains at least some impetus for optimism. To be sure, there are those who remain deeply concerned about the current state of the U.S. economy, but who are also mindful of the global problems posed by burgeoning deficits and a declining dollar. This conscious concern is manifest in the number of policy proposals that have been submitted as alternatives to the current stimulus plan, which judiciously recognize that encouraging further profligate spending is not an answer to the myriad

problems afflicting the U.S. economy. Indeed, a weak stimulus package that exacerbates the budget deficit without credibly impacting the possibility of recession is bound to do more harm than good. If politicians are to demonstrate their support for meaningful change, then they should start by pushing together for a policy that does more than simply pander to the concerns of an electorate. The general public, although perhaps less discerning of the problems and risks at stake, would be eager to embrace a bipartisan approach that goes beyond superficial solutions. Real solutions would ultimately recognize that the U.S. is indeed an economic diabetic, with fiscal rectitude as its insulin (Chinn and Steil 2006, 23). Accordingly, the only reasonable prescription for mitigating the many risks facing the U.S. economy – including that of a hard landing – is a coherent policy that encourages both the government and its citizens to begin saving more and spending less.

Notes

[1] Note that the trade deficit is often referred to interchangeably as the "current account deficit," "external deficit," or "external imbalance."

[2] Statistic here is based on a February 2008 press release from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis, which reports a trade deficit of 5.1 percent of GDP for 2007.

[3] Note that a country's balance of trade consists of foreign demand for its exports less its own demand for imports. The self-correction hypothesis is thus contingent upon the conventional wisdom regarding a country's trade performance, which suggests that a dollar depreciation – by making exports cheaper (for foreign purchasers) and imports more expensive (for domestic consumers) – will, all else equal, improve U.S. trade performance (i.e., reduce the trade deficit) via an increase in the demand for its exports and a reduction in the demand for imports. As revealed above, however, everything else is not equal; a decline in the dollar has not reduced U.S. demand for imports.

[4] Following Chinn (2005), the "deficits are good" argument suggests that the trade deficit is a natural corollary of economic growth, as rapid rates of economic growth lead to increases in consumption. Some of this consumption is of course directed toward the purchase of imported goods, which thereby widens the trade deficit.

[5] "Sterilization" refers to the Chinese economic policy aimed at offsetting the tendency of its currency to appreciate – due to an influx of short-term capital, or "hot money" flows.

[6] A full analysis of the current stimulus plan and/or consideration of alternative policy proposals is beyond the scope of this paper, but note that many of the

alternative proposals, in calling for a repeal of the forthcoming tax rebate, raise serious concerns over the effectiveness of the stimulus plan and its impact upon the budget deficit. One notable proposal – Conley (2008) – pays particular attention to the negative impact of such a plan on the budget deficit, and suggests that resources be devoted instead toward encouraging an increase in the savings rate.

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