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The transfer problem in reducing the U.S. current account deficit

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Abstract

Correcting global trade imbalances is a form of the transfer problem: spending must be transferred from trade deficit countries (mainly the United States) to trade surplus countries. Reducing the U.S. current account deficit requires that net saving be increased in the United States and reduced abroad—particularly in Asia. But contrary to most literature on the subject, exchange rates need not, and probably best not, be changed as part of the transfer process for improving the U.S. trade balance. To show why this is so, I draw on the older literature on the transfer problem associated with paying war reparations. Adjustment in absorption, i.e., aggregate spending, is two-sided because the loser (the transferor) must raise taxes to pay an indemnity to the winner (the transferee), which then spends it. But there is no presumption that the terms of trade must turn against the transferor. That is, the losing country, which is forced into running a trade surplus (or smaller deficit), need not depreciate its real exchange rate to effect the transfer.
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1. Introduction

Like it or not, the dollar is at the center of the world's monetary system, while simultaneously the United States runs large current account and trade deficits. Indeed, it could not have run such deficits for more than two decades if the dollar were not the definitive international money. Because much of the world is on a dollar standard, only the U.S. can borrow abroad indefinitely in terms of its *own* currency to cover its relatively low level of saving. This is possible as long as the U.S. Federal Reserve Bank keeps the purchasing power of the dollar fairly stable so that countries

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with trade surpluses are loath to appreciate against the currency in which most of world trade is invoiced. Thus, there is no immediate crisis and no need for precipitate action by governments – particularly on the exchange rate front – to "correct" the U.S. current account deficit.

Nevertheless, this continual U.S. borrowing is *unsatisfactory* even if *sustainable*. The world is treated to the spectacle of its richest economy grabbing the lion's share of international finance that would be potentially available for economic development in much poorer countries. As well, the process of transferring resources from the rest of the world creates tensions within the American economy itself.

What is the transfer mechanism? In order to transfer real resources from the rest of the world (apart from surplus-saving oil-producing emirates), the U.S. runs very large trade deficits in manufactures from surplus-saving industrial economies such as China, Japan, a host of smaller ones in East Asia, and Germany. This real transfer of manufactures needed to cover the shortfall in American saving speeds the contraction in employment in U.S. manufacturing beyond the natural rate of decline experienced by other mature industrial economies (McKinnon, 2005).

The upshot is a protectionist backlash in the United States, particularly by members of Congress with manufacturing constituencies. Instead of blaming America's own deficient saving which makes foreign borrowing necessary, American politicians incorrectly blame "unfair" foreign trading practices—undervalued currencies, substandard labor practices, dumping of subsidized exports in American markets, and so on. Rather than any imminent collapse in America's credit line with the rest of the world, this protectionist backlash is the serious threat to the world economy.

However, contrary to a widely held belief within the economics profession, devaluing the dollar is itself no panacea for correcting the savings (trade) imbalances across countries. The accompanying paper in this volume – "Exchange Rates and Trade Balances under the Dollar Standard", by Hong Hong Qiao (2007) – shows that, unlike what the old and familiar elasticities model of the balance of trade would suggest, having creditor countries like Japan or China appreciate the yen or renminbi against the dollar would have no predictable effect on their trade surpluses. In effect, their savings surpluses (or the American saving deficiency) need not be corrected if the dollar is devalued. Nevertheless, any such major change in the dollar's nominal exchange rate could create serious monetary imbalances in the world economy: deflation in the appreciating countries or inflation in the United States, with the tradeoff between the two being somewhat arbitrary (McKinnon, 2007a), but where any long run impact on the "real" exchange rate washes out.

Instead, correcting international trade imbalances must start with countries' changing domestic absorption, i.e. aggregate spending, relative to income. International adjustment requires that net saving be increased in the United States or reduced abroad—particularly in East Asia. However, this truism raises two closely related issues:

(1) Can international absorption adjustment work if it is just one-sided? For example, just the United States unilaterally raises taxes.
(2) Suppose that absorption adjustment is balanced and two-sided: taxes fall abroad as they increase in the United States. Would any change in the exchange rate be necessary or desirable to facilitate the transfer?

Unfortunately, modeling possible monetary-cum-price-level repercussions together with the transfer itself presents problems. Instead, I will follow the time-honored but treacherous tradition in international economics of separating out monetary issues from "real" ones.

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