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Macroeconomic Imbalances in the United States and Their Impact on the International Financial System

by

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ABSTRACT

The argument put forward in this paper is twofold: first, that the financial crisis of 2007–08 was made global by the U.S. current account deficit. This is because the outflow of dollars from the United States was invested in U.S. capital markets, causing inflation in asset markets and leading to a bubble and bust in the subprime mortgage sector. Second, there is global dependence on the U.S. trade deficit as a means of maintaining liquidity in financial markets. Since the U.S. dollar is the international reserve currency, international debt is mostly denominated in dollars. Because there is a high degree of global financial integration, any reduction in the U.S. balance of trade will have negative effects on many countries throughout the world—for example, those countries dependent on exporting to the United States in order to finance their debt.

Keywords: International Reserves; Financial Instability; Trade Imbalances

JEL Classifications: E58, F33, F41, G15

INTRODUCTION

While most economies grow through investment or export that expands demand, the U.S. economy has kept up its growth by increased consumption. Using its privileged position to borrow money, the U.S. has reached a historically unprecedented level of current account deficit, which has been followed by a debt crisis in 2007–08.

This paper argues that the financial crisis of 2007–08 is symptomatic of macroeconomic imbalances in the U.S., because the imbalances are eventually resolved in financial markets, and passed on to the real economy. On the other hand the international financial system is dependent on U.S. trade deficit for feeding liquidity into financial and commodity markets.

The paper breaks new ground in the analysis of the current financial instability in the U.S. by showing how it links up with macroeconomic imbalances and financial inflation in the U.S. economy, and how, through the foreign trade deficit, those imbalances and inflation are transmitting instability to the rest of the world. This approach is relevant because there is a dominant structural imbalance in the U.S. economy, but little theory addressing the consequences of the U.S. trade deficit for the international financial system. The academic debate, divided between monetarists and sceptics, has instead been centered on the question of whether the U.S. trade deficit is sustainable or not, with emphasis on domestic factors. However, neither of these positions offer a sufficient explanation of the present situation since they do not account well enough for the global integration of capital markets. In this context, a more systematic view will be used to analyze the relationship between the U.S. imbalances and the global financial markets. This will lead to the conclusion that the financial crisis in 2007–08 is transmitted to the rest of the world through the U.S. trade deficit; that there is a global financial dependence on the U.S. in addition to its political dominance; and that the U.S. macroeconomic imbalances cannot be resolved without affecting the rest of the world whose financial systems are dependent on dollars supplied by the U.S. through its current account deficit.

Section one presents the main views currently put forward on the macroeconomic imbalances. Section two examines how the dominant U.S. position in international finance is supported by the U.S. balance of payments deficit. Section three examines the links between the U.S. balance of payments and the current financial crisis. Section four discusses the effects of the US deficit on other countries. This is followed by a conclusion.

THEORIES

The U.S. has a higher level of current account deficit in the balance of payments than any other state has had before, because the value of imports to the U.S. is much higher than the value of their exports. This has happened simultaneously to the U.S. running a record high fiscal deficit, which is paid for by issuing new debt. The financing of the U.S. national debt has been done primarily in Asia, and particularly in China, and has during the last five years included inflows of around two billion U.S. dollars every day. (Trichet 2005, 6). The U.S. has in other words, been the recipient of the world´s savings, while emerging economies and developing countries have been the supplier. This has happened in combination with internationally low interest rates. (Summers 2006, 2).

The academic discussion about the U.S. trade imbalance has been dominated by two opposite positions, the monetarists and the sceptics, that primarily disagree on whether the U.S. current account deficit is sustainable or not. There has also been a debate on whether the U.S. is responsible for the global imbalances, or if emerging economies like China are to blame for saving too much without letting their currency appreciate.

The Monetarist Position

The theory of monetarism, developed by the economist Milton Friedman, has its main focus on the macroeconomic effect of the supply of money and central banking. Monetarism has been the dominant economic position in the U.S. and Europe since the 1980s. It is built on a basic assumption that markets tend toward equilibrium, and that deviations are random (Soros 2008, 97). In contrast to the so-called sceptics, or heterodox economists, the monetarists have not seen the U.S. current account deficit as an immediate threat to the U.S. national economy, opposing the view that exports are always “good,” while imports are “bad.” A central argument has been that the U.S. dollar is different from all other currencies, so what happens in the case of the U.S. economy cannot be compared to other countries with high trade deficits. As Serrano points out, the U.S. is in a unique position since the American dollar is the international means of payment, the Federal Reserve System (Fed) determines the basic interest rate of the dollar, and since the public debt in the U.S. is the most liquid dollar financial assets. (Serrano 2003, 1). According to Griswold the critique against the U.S. trade deficit ignores the strength of the U.S. economy during the past decades, and the positive correlation that imports have had to domestic production (Griswold 2007, 1). He points out that, in light of developments before 2007, there is no evidence that an increasing current account deficit is related to slower growth (Griswold 2007, 1).

Since the market system tends toward equilibrium, the monetarists believe that the global trade imbalances will resolve themselves in the long run, so that there is no reason to worry too much about the U.S. deficit. This position has been supported by the Bank for International Settlements (BIS). Although the BIS Annual report of 2005 pointed out that the U.S. deficit could result in long-time problems, leading to a decline of the dollar, financial turmoil, and even recession (Quoted in Glyn 2005, 13) the monetarists have mainly rejected the notion that there is a high probability for an economic disaster due to the U.S. deficit. They mostly believe that the only long-term effect of the dollar outflow will be inflation. Trade deficits are also defended because the dollar flow that is leaving the country is invested in the U.S. financial markets, which is understood to make the deficits less harmful to the U.S. economy. According to Griswold, economic growth has on average been twice as fast, during years when the U.S. trade deficit increased much, compared to years when it was reduced (2007, 7). This is explained by the fact that foreign investment in U.S. assets creates growth and helps to keep U.S. interest rates low (Griswold 2007, 7). However, this line of argumentation was put forward before the outburst of the subprime mortgage crisis in 2007.

The Sceptics' Position

In contrast to the monetarist position, a wide range of economists have claimed for years that the U.S. current account deficit is unsustainable and might lead to disastrous consequences for the global economy. Their argument is that if the U.S. external deficit is not drastically reduced, it might lead to a speculative attack against the dollar, and a serious crisis in the global economy. In a worst case scenario, the dollar might then lose the important role it has had in the global economy until today (Serrano 2003, 1).

Paul Krugman is one of the scholars who warned that the U.S. current account deficit might lead to a dollar crisis where the high level of foreign debt could lead to much higher capital losses to investors than expected, and great macroeconomic problems. (Krugman 2007, 438). Since the U.S. is running a current account deficit, it is building up debt to other countries, which is paid for by outflows in the financial account (Gosh and Ramakrishnan, 2006, 3). These liabilities have to be paid back in the future, so if the money is spent on consumption instead of investment that might create income in the future, there may come a day when U.S. dollars are no longer seen as a good investment. (Gosh and Ramakrishnan, 2006, 3). As Summers points out, the willingness of investors to accept claims on the U.S. might not last forever, (2006, 3) and he rejects the monetarist idea that the U.S. can continue to expand its level of foreign debt even if it is able to issue debt in its own currency (Summers 2006, 3). The sceptics’ solution to the U.S. deficit has primarily been to force the U.S. to deflation, by spending less and increasing its level of exports. This would lead to unemployment and have other serious consequences to the real economy, but it might be the only way to create a more stable international financial system in a long-term perspective. The warnings from Krugman and other heterodox economists have increased their credibility due to the financial crisis of 2007–08. Some of the things they warned about seem to be happening right now.

It´s China´s fault: Finally it is worth to mark that some economists, in particular the Chairman of the Federal Reserve in the U.S., Ben Bernanke, have a different perspective on the current account deficit in the U.S. He is pointing out that the focus on domestic factors in the U.S. in order to explain the deficit is one-sided and limits the understanding of the situation. Instead he uses a hypothesis called “The Global Saving Glut” (Bernanke 2007, 3) which underlines that increased savings and current account surpluses in developing countries have to be counterbalanced with deficits somewhere else. This is because the total saving in the world must equal investment, and the sum of national current account balances must be zero.

Since a large part of the problem, according to Bernanke, is found in parts of the world other than the U.S, it must consequently also be solved there (Bernanke 2007, 3). One of the main examples he uses is the situation in China, where export growth has led to higher incomes, while the access to consumer credit has been low, and people still feel a need to save. Combined with the Chinese government’s reluctance to appreciate their currency, this can help to explain the U.S. deficit. Bernanke therefore rejects the idea that the decline in public and private saving in the U.S. is the main reason for the macroeconomic imbalances, (2007, 2).

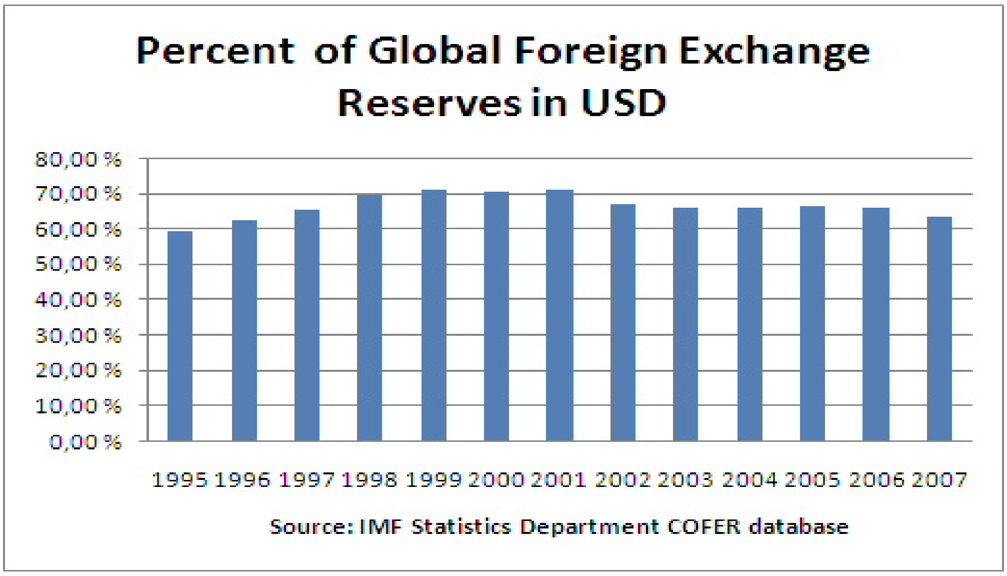
The argument in this paper: Most of the focus in the academic debate on the U.S. economy is seen in domestic terms, ignoring the negative side for other countries in the world of reducing the global trade imbalances. But, as an answer to the sceptics, using a twist of Bernanke’s argument, one cannot consider the consequences of a reduction in the U.S.

import-led growth without thinking through the consequences of export led growth of other countries. (Summers 2006, 3). If the U.S. goes into recession, something most economists agree is happening now, and reduces the level of imports; the rest of the world will suffer due to less demand for foreign export. Some countries might handle this better than others, but when it comes to the heavily indebted countries, they often export in order to be able to pay their foreign exchange debt, which is usually denominated in U.S. dollars. If the export markets are reduced, this could lead to a severe debt-crisis in these countries. The global risk is very high since the U.S. external deficit is creating an export stimulus demand close to two percent of world GDP (Summers 2006, 3). Many sceptics have worried about foreigners holding U.S. assets, in the form of debts, which then have to be repaid to them. However, the debt would still have to be repaid even if it were owned by Americans, and at the end of the day the central issue is the amount of the debt, and not who has lent the money.

THE U.S. DOMINANT POSITION IN THE WORLD ECONOMY

The U.S. as Supplier of Global Revenue

The U.S. has been a leading superpower since World War II, partly because the dollar as the international reserve currency has given asymmetric power to the U.S. economy.



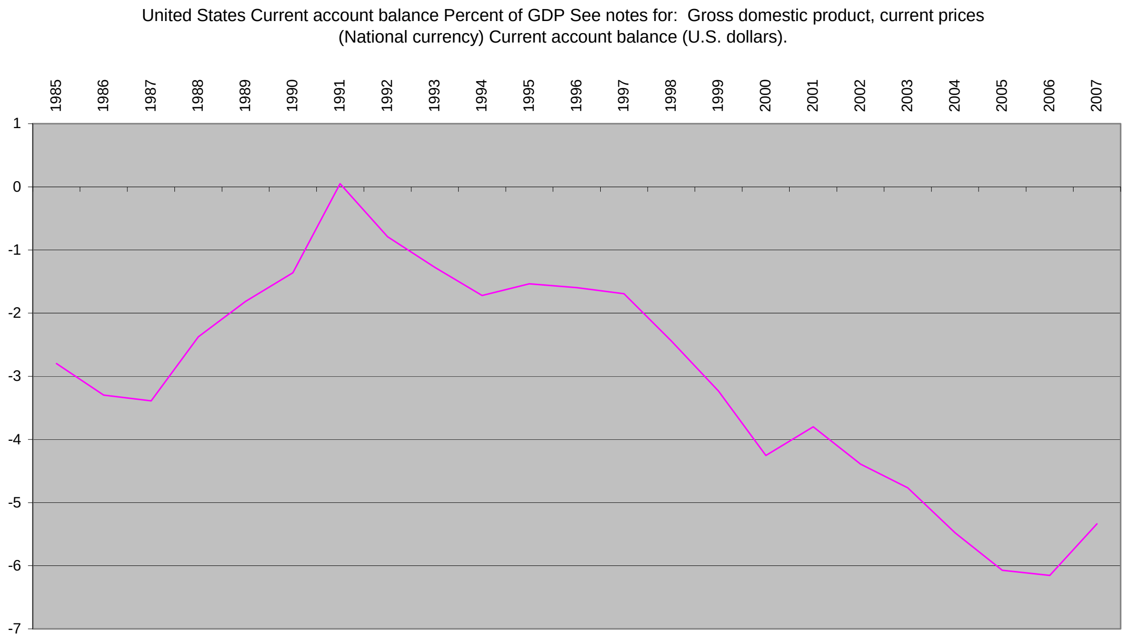
As the figure shows, the level of foreign exchange reserves held in dollars has declined slightly since 2001, mainly because the Euro is used more now. However, the U.S. dollar is, by far, the most important reserve currency in the world. Most of the current account surpluses and foreign exchange reserves are held by Asian countries. According to Lim (2008, 9) ten Asian countries hold 3.4 trillion dollars, or 59 percent of the world´s foreign reserves. China alone holds 1.3 trillion dollars, or 22 percent of the world´s reserves (Lim 2008, 9). Much of the current account surplus has been built up in the aftermath of the East Asian financial crisis in 1997 and 1998 when some of these countries ran out of reserves. Many of these countries have been building up their reserves precisely in order to avoid another crisis in future.

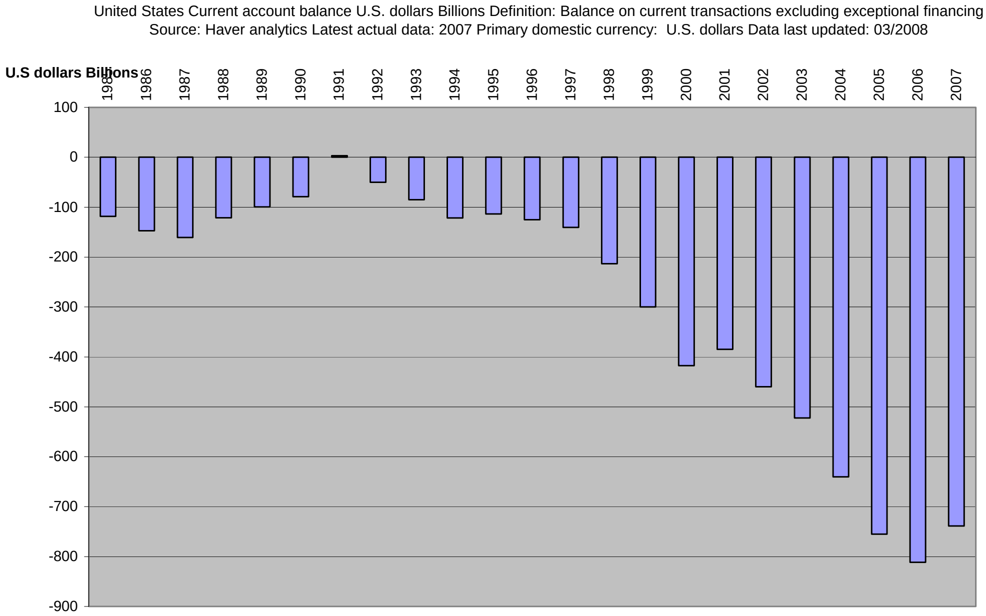
When the U.S. deficit has been lowered previously, it has led to a depreciation of local currencies against the dollar, and the price of borrowed U.S. dollars has risen. This can be seen as part of the reason for the debt crisis in the 1980s and 1990s. It can, therefore, be argued that the U.S. trade deficit is necessary to sustain the international financial system, since crisis has emerged when the U.S. has been closing the trade deficit. Galbraith has argued that a high dollar is beneficial since it gives the U.S. cheap imports and capital inflows that can pay for domestic activity, while a declining dollar would reduce the value of reserves in developing countries (Galbraith 2003, 4). In contrast to the focus in this paper, his main concern is what is good for the U.S. economy, regardless of the situation in the rest of the world. But in practice, the international monetary system has created a situation in which what is good for the U.S. is, in many cases, bad for the rest of the world, especially the dollar-indebted countries. A falling dollar makes dollar assets less attractive to foreigners, except central banks, but makes U.S exports more competitive. In reality it might be in the interest of foreigners who are sufficiently indebted in dollars to have a weak dollar and a large current account deficit, which is a central point in this dissertation. While the global growth was previously dependent on the mining of gold, it is dependent on the creation of dollars today. If the U.S. reduces its deficit it might therefore have negative effects on the world and lead to an outflow slowdown.

The U.S. Balance of Payment Deficit

In 2007 the U.S. balance of payments deficit amounted to 790 billion dollars, which makes the U.S. the world´s largest debtor state (Lim 2008, 9). In this chapter, the main characteristics of the U.S. current account deficit will be accounted for, including its relation to the public debt and its function in order to keep up domestic growth in the U.S., despite the fact that the industrial production in the U.S. has decreased while there has been significant GDP growth the last eight years.

The current account deficit related to personal over-consumption in the U.S. can be traced back to the 1980s, with the birth of consumer credit through the easy access to credit cards. Today every country trading with the U.S. runs a current account surplus with the U.S. (Shirk, 2007, 27). The level of the U.S. trade deficit has varied through the years, but increased rapidly in the first part of this decade, hitting a record level in 2006 when it accounted for 6.2 percent of GDP in the U.S. (Bernanke 2007, 4).





As the figures show, there was a temporary trade surplus in 1991, before a continued increase in the trade deficit started and rapidly changed the pattern of international trade balances in the world. In 2006, the aggregate current account surplus of emerging market countries rose to 643 billion U.S. dollars, to a large degree because of China´s growth (Bernanke 2007, 4).

Bernanke claims that the deficit is related to a decline in U.S. saving since the second part of the 1990s, while investment rates have not been changed much, holding a level of about 19 percent of U.S. GDP (Bernanke 2007, 1). But the decline in U.S. saving is not the cause of the deficit, as will be argued below. The cause of the deficit is that the rise in consumption has not been matched by a rise in industrial production or exports, because of underinvestment in the industry.

With the large trade deficits in the U.S., other countries have been using their saving to finance American consumption. This is somehow ironic since according to neo-classical economics, the returns to capital are supposed to be lower in industrially developed countries than in developing countries where capital is supposed to be scarce. In reality, the returns to capital are highest in emerging markets like China, which invest a lot in their industry, which causes higher profits. At the same time, there was a sustained decline in long-term real interest rates in many parts of the world. This phenomenon, which is closely related to the current financial crisis, is discussed more closely below.

Bernanke points out that “deficit countries can raise funds in international capital markets only to the extent that other (surplus) countries provide those funds.” (Bernanke 2007) He therefore doesn´t find it surprising that the increasing U.S. current account deficit is related to the trade surplus in other countries (Bernanke 2007). It is obvious that the high level of imports to the U.S. is related to a low level of exports, since there is a great trade imbalance between the U.S. and the rest of the world. However, the global equilibrium view has never been borne out in practice and the international credit system exists to finance trade imbalances and trade in those credits determines exchange rates.

The fiscal deficit in relation to the foreign deficit: While the EU has restrictions on the level of fiscal deficits, the U.S. has been running constant deficits on their budget. In September 2008 the level of national debt in the U.S. was 9,684 trillion dollars, which means 32,000 dollars for each inhabitant in the country, according to the so-called Debt Clock[1] based on statistics from the U.S. Department of the Treasury. As Soros points out, the U.S. budget deficit has been used to finance the current account deficit because the countries with a trade surplus have invested their reserves in U.S. bonds (Soros 2008, 97-98). This way, both the current account and the budget deficits of the U.S. has led to a great expansion of credit. (Soros 2008, 97-98) China and Japan are today the major foreign holders of Treasury Securities, accounting for about 47 percent of the U.S. foreign owned debt[2]. In June 2008 each of these two countries held U.S. Treasury securities for over 500 billion dollars (Soros 2008, 97-98).

In the past, banks held large quantities of government bonds which they could easily convert into cash at the central bank, which would always stand ready to buy government bonds at a good price. But because the Fed and other central banks have bought up some 60 percent of U.S. government bonds, the banking system in the U.S. and other places do not have enough government bonds as secure assets in their portfolios. This is one reason for the current instability in the international financial markets. Another factor that has contributed to

[1] U.S. National Debt Clock: http://www.brillig.com/debt_clock/

[2] Department of the Treasury: http://www.treas.gov/tic/mfh.txt

the increasing budget deficit is the rise in U.S. military spending. According to Stiglitz, “there is a very clear connection between the War in Iraq and the financial crisis we are experiencing now. The war has been fully financed through budget deficit.” (Quoted in Perelstein 2008a). He claims that economic problems have not become visible before now because the U.S. government has been stimulating the economy in the short run.

THE U.S. TRADE DEFICIT AND THE FINANCIAL CRISIS OF 2007–08

The Deficit and the U.S. Financial Markets.

As Minsky pointed out back in 1986, success leads to the belief that failures cannot happen, and when a long time has passed since the last financial crisis, people within the financial system believe that it will not happen again, that things are different. (Quoted in Lim, 2008, 7). The U.S. subprime mortgage crisis is an example of how fast a problem in one part of the internationally integrated financial system can be passed on to other parts, and affect the real global economy.

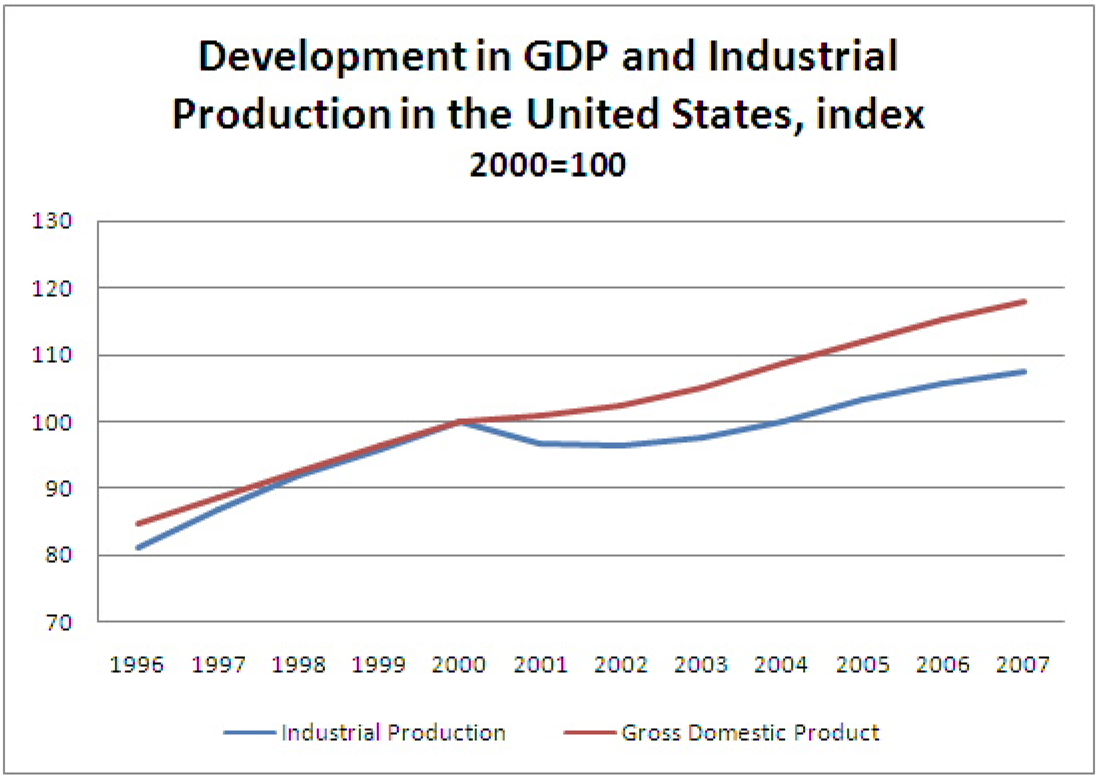
The outflows of dollars from the U.S. have been to a great extent reinvested in the country, allowed all asset markets in the U.S. like the housing market, the stock market, NASDAQ as well as the commodity markets, to recover after the dot-com bubble collapse in 2000. But it also caused inflation in all dollar-denominated asset markets, for example in the housing market, as seen in the former section. This section deals with a structural feature of the international financial market that allowed this bubble to grow.

The transmission of the U.S. trade deficit to the financial markets goes through the payment mechanism for the U.S. excess export that is paid for by crediting foreign exporters with dollar balances in U.S. bank accounts. When, for example, a Chinese exporter of electronics receives these balances they need to sell their dollars for local currency in order to be able to spend the money at home, for example to pay their workers, or make new investments. If the demand for local currency, in the case of China the yuan, is too high, it can appreciate, which is not desirable since it will make Chinese exports more expensive to buy, and lead to less demand, for example from the U.S. To prevent an appreciation, the local banking system and the central bank will usually buy the dollar inflow. The dollar credit balances would give low returns if they were put in a U.S. bank account, so they are usually used to buy dollar securities that are issued by the U.S. government, and give a better return. This is what inflates the U.S. securities markets and has led to the buying of all sorts of securities whose risks are unknown, for example the collateralized debt obligations (CDOs) linked to subprime borrowing.

This cycle can be summarized as follows: The U.S. needs to pay for imports, since they buy more than they sell. They pay with dollar balances that are used to buy bonds issued by the U.S. government to finance their budget deficit. This way the budget deficit is used to finance the U.S. current account deficit, and bring an unbalanced economy into temporary equilibrium. The problem occurs when the bubble in the asset market bursts, not only for the U.S. economy, but also for all the countries that have been dependent on the dollar outflow.

Unbalanced U.S. Economic Growth

In the case of the U.S. Rogoff points out that “Despite having one of the lowest savings rates in the industrialized world, the U.S. economy has enjoyed a remarkable period of sustained growth over the past eight years” (Rogoff 1999, 22).



Source: OECD stat

As the figure shows, growth between 1996 and 2000 was following the same pattern as U.S. industrial production, while the variables split in the beginning of the new millennium. The U.S. growth in real GDP continued to increase, whereas the level of industrial production declined. One reason for this is the rise of the U.S. dollar that has reduced the U.S. competitively. (Glyn 2005, 8) While the U.S. was previously a great exporter of industrial goods, it now depends heavily on imports, and growth has been achieved through increased consumption. If consumption declined, it would lead the economy into recession that would be very harmful for the whole economy. In order to keep the U.S. economy out of recession after the dot-com bubble in 2000, interest rates were lowered, and reached a record level of 1 percent in 2003 (Lim, 2008, 8). The low interest rates were made possible by the access of cheap exports from China with lowered inflation and increasing asset prices in the U.S. for example in the real estate sector. In order to keep the system going, with increased consumption on the cost of the trade balance, combined with the high fiscal deficits of the U.S., people had to keep spending money. In other words, the increasing dependence of U.S. economic growth on inflation in asset markets was underpinning consumption, while the growth in insurance banking and financial consultancy was underpinning employment growth in the U.S. As discussed in below, foreign holders of dollar balances are looking for higher returns for their dollars, they invest in U.S. securities to earn as much money as possible. Toporowski points out that when "the demand for financial securities exceeds the amount of money that holders and issuers of those securities are prepared to take out of the market, prices rise." (Toporowski 2008a, 5) And when the prices go up, the demand for those assets increases, due to a speculative demand from investors wanting to earn money from capital gains (Toporowski 2008a, 5). But the high demand for securities primarily leads to inflation of equities that do not have an exact agreed price of repayment. In fact, the price level of the CDOs in the subprime mortgage markets was highly unclear, and their presumed value was based on the rating done by U.S. rating agencies. The asset inflation made it possible for people to keep borrowing money against rising housing prices, or selling them with profits. (Lim 2008, 9) Toporowski defines the process of inflating capital markets as *financialization* or a "major shift in the structure of economic activity towards turning over capital in financial markets." (Toporowski, 2008b, 1) It can similarly be argued that the boom in the U.S. housing market is due to the high inflow of credit coming into that market, resulting in rising house prices. By the middle of this decade the household consumption in the U.S. was the main engine of growth accounting for about 33 percent of its GDP growth. (Lim 2008, 9) Much of the additional middle class spending (Lim 2008, 9) was financed by debt secured on real estate, and periodically written off when houses were sold at inflated prices. The security markets also recovered after the dot.com bubble burst because of the net credit inflow into the financial markets, which is a result of the U.S. current account deficit financing the buying of U.S. securities. This way, U.S. real GDP growth has become dependent on growth in asset markets, and this way it is correlated to the U.S. deficits in the balance of payments.

THE EFFECT OF U.S. DEFICIT ON OTHER COUNTRIES

The Balance of Payment Deficit Feeding Inflation

When foreign exporters are credited with dollar balances due to the U.S. current account deficit they are used to buy U.S. national debt, financing its fiscal deficit. Consequently, the dollar outflow from the U.S. has been flooding the international capital markets with American dollars, feeding asset or financial inflation to the rest of the world. Since the owners of the dollar debt are looking for a highest possible return, the situation has encouraged moral hazards, creating a bubble in the U.S. housing market, and eventually an increase in the prices of oil, food, and other commodities. The reason that the dollar-balances are re-invested in the U.S. capital markets is primarily that they have the most developed financial markets in the world, whereas most other countries are not able to invest the foreign capital safely in their own financial systems. It does not mean that there is no need for investment in emerging or developing economies, but rather that the U.S. has a comparative advantage in banking and finance, making it more profitable to invest there. The problem is that the systemic imbalances in the U.S. economy create a phenomenon which is often referred to as *excess liquidity*. It means that there is more liquidity in the system than what is needed, and since the money has to go somewhere it is invested in one asset market after another, inflating each in turn. When the bubble in the subprime mortgage market burst, it was followed by a jump in the prices of oil and food, mostly due to financial speculation via futures contracts. The excess liquidity of the U.S. can be seen as an example of how the consumption in the U.S. directly affected millions of poor people in the world who suddenly had to deal with huge increases in the price of food and electricity, which they depend on to survive. On the other hand, the U.S. macroeconomic instabilities are also a way of keeping the international economic system stable, as we will see in the following section.

Export-markets and Dollar-Debt in Other Countries

The U.S. current account deficit has until now either been considered unsustainable, like the sceptics argue, or as relatively sustainable and perhaps even beneficial to the growth of the U.S, as the monetarists have claimed. However, there has been little focus on the consequences of the trade imbalances for countries in the rest of the world, which is the main focus of this section. If the demand for foreign imports to the U.S. decreased the exporting countries in the rest of the world would suffer. Not only China, but all countries trading with the U.S. run a current account surplus with the U.S. (Shirk 2007, 27). There is also a continuous demand for the outflow of U.S. dollars because many countries need them to service their dollar debt.

It is possible to argue that a decline in the value of U.S. dollars would make it easier to pay the debt, since it then will be less to pay back. But this argument ignores the fact that many countries export in order to be able to pay their debt. According to Muchie, the IMF has demanded that 20-25 percent of the export earnings, mostly from countries in Africa, should be used to service their debt. (2001, 1). Boosting export earnings is a way for heavily indebted poor countries to raise money, which can be used to pay off old debt.[3] It is naturally relevant to discuss if it is right that some of the poorest countries in the world should be forced to export for example food that their own hungry population could have eaten. However, that is a question of development policies beyond the scope of this paper.

If the U.S. household sector starts saving more and buying fewer imports, the outflow of dollars will be reduced, and this would alter the percent order in the world economy, due to the global integration of financial markets. As Bernanke points out, it became easier for many emerging-market countries to pay down their external liabilities and buy assets in developed countries when they became net lenders to the U.S. (Bernanke 2007, 2). According to Summers, the U.S. current account deficit is equivalent to almost two percent of GDP to global aggregate demand (Summers 2006, 4). He points out that a reduction in the U.S. trade deficit would lead to an impulse of contraction to the rest of the global economy, which would happen if goods produced in the U.S. replaced the export industry of other countries. He therefore argues that the reduction in the U.S. current account deficit must equal the reductions in the surplus in other countries (Summers 2006, 4). But people in the U.S. cannot increase their saving without leading the U.S. into recession, as if reduced expenditure would

[3] Third World Network, http://www.twnside.org.sg/title/colo-cn.htm

only affect expenditure on imports to the U.S. in relation to consumption, which is usually the most stable element of expenditure in the economy, since people normally adjust their savings to finance their current standard of living. One of the few ways in which household consumption can be squeezed is by increasing debt repayments. This is already happening in the U.S. as a result of the ongoing financial crisis, but there is a limit on how much more an already heavily indebted population there is able to increase their payment. The countries that export to the U.S. will thus be in big trouble if the U.S. reduces its current account deficit—not primarily because of the danger for a depreciation of the U.S. dollar, as Krugman has warned about, but quite simply because many countries have become dependent of the dollar outflow from the U.S.

One can conclude that it is one thing to bring the U.S. economy into equilibrium. But doing so with the world economy as a whole is another matter. There is not much literature on the problem as presented, but the findings in this paper might be an indication that this field needs further investigation if the problems of the international financial system are to be resolved.

CONCLUSION

The U.S., as the world's most powerful economy, has used its privileged position to borrow more money than any other country could gain access to, and now holds a historically unprecedented amount of foreign debt.

This paper applies an original approach to the present situation of financial instability in the U.S. by showing how it is related to the macroeconomic imbalances and financial inflation in the U.S. economy, and how this transmits instability to other countries.

The arguments presented assert first and foremost that the financial crisis of 2007–08 is a consequence of the trade deficit in the U.S. Due to the large balance of payment imbalances the last eight years, the U.S. has flooded the international capital markets with dollars which have been invested in U.S. asset markets with high returns. A pertinent example is the case of the U.S. housing market. Since demand for these securities was high, prices have inflated, creating a bubble. The growth of the U.S. economy has been sustained by consumption made possible by easy access to credit. Second, this paper has identified key structural features that determine the dynamics of an international financial system dependent on U.S. trade deficits. These include the U.S. dollar as the international reserve currency, the U.S. trade deficit as a way of injecting reserves into the rest of the world financial system, and the U.S. provision of government bonds that are risk-free. This shows that the discussion on whether the U.S. trade deficit is sustainable or not is too narrow, since both the monetarists and the sceptics focus little on the consequences of the deficit for the rest of the world. Clearly, the current financial crisis is not caused by fraud in the U.S. financial markets, but results from trade imbalances being resolved in financial markets. But since the world has grown dependent on U.S. deficits to keep up liquid markets and pay external liabilities in U.S. dollars with incomes from exports, the U.S. macroeconomic imbalances cannot be resolved without gravely affecting the rest of the world which now holds large amounts of dollar securities.

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