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**America and foreign central banks are locked in a codependent relationship: America is addicted to spending, and the banks can't stop throwing money at it in order to keep their currencies down. This is unhealthy for both parties, say the IMF and the World Bank. But is there any political will to change it?**

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AMERICA has been warned many times in recent years that its profligate spending is dangerous, for itself and for the world economy. So far, however, Americans have ignored such doom-mongering, gleefully driving their current-account and budget deficits to record levels. Now the World Bank and the International Monetary Fund (IMF) seem to be trying to stage an intervention. This week, both have come out with reports on the global financial situation—and both reports give warning that America's fiscal irresponsibility poses serious risks to the world economy.

Neither organisation issues the kind of scathing indictment that might offend its most powerful constituent. Nonetheless, both make it pointedly clear that America's copious spending is a real, and growing, problem for the rest of the world. America's 12-month current-account deficit now stands at \$665.9 billion, or 5.7% of GDP. Since a negative balance in the current account must be complemented by a positive balance in the capital account, this means that foreign funds are streaming in. America is mortgaging its future to pay for current spending.

Part of the reason this spending is so hard to get a grip on is that it is happening on multiple levels. With interest rates low, consumers have been tapping into their home equity and taking on credit-card debt—the latest figures from America's Bureau of Economic Analysis show individuals' savings were just 0.6% of their income in February. Meanwhile, even after massive tax cuts, the Bush administration has forged ahead with ambitious spending

programmes. Thus, in 2004 the federal government's budget deficit hit \$412 billion, a worrying 3.6% of GDP. It is projected to fall only to \$365 billion, or 3% of GDP, in 2005.

The gap between income and spending has been financed by foreigners, especially central banks; more than half of all publicly available Treasury bonds are now held abroad (see chart). But the central banks that are buying up all this paper, particularly Asian ones, are trapped in something of a vicious circle.

The natural adjustment mechanism for America's rapidly growing foreign liabilities would be a declining dollar, which would lower demand for imports and make America's exports more attractive on foreign markets. But the Asian central banks are stalling this process because they want to keep their currencies from appreciating against the dollar and thus becoming less competitive—and buying sackloads of dollars and then dumping them into US Treasuries achieves just that. This simply enables America to borrow more, making the inevitable adjustment sharper when it comes. That risk, of course, makes dollar-denominated assets less attractive, meaning that the Asian central banks have to go to ever-greater lengths to keep their currencies from appreciating.

## **We can't go on like this**

The World Bank estimates that roughly 70% of global foreign reserves are now in dollars. That growing portfolio of dollar assets is vulnerable to currency correction. This is not such a problem if the dollar declines gently, but an abrupt change in its value could spell trouble, as central banks find themselves with gaping holes in their portfolios.

Central banks have another problem: many are reaching the limits of their ability to "sterilise" their currency transactions. In order to keep their exchange-rate operations from causing inflation at home (the natural result of keeping one's currency undervalued), central banks sell bonds on the domestic market in order to mop up excess money supply. However, this is expensive, since in many cases the interest rates on domestic bonds are significantly higher than on the Treasuries the central banks are buying. The World Bank estimates that this differential costs emerging-market central banks \$250m a year for every \$10 billion they hold in reserves.

There are further, institutional, limitations. The Reserve Bank of India, which is forbidden to issue debt or sell rupee assets on international markets, is running down its inventory of securities to sell. Last autumn, South Korea's central bank bumped up against the annual limits on the sale of government debt. And China, a huge consumer of American debt, has been stuffing securities into its state-owned banks at below-market rates. This has made its already-fragile financial sector even weaker, and cannot go on indefinitely.

But as the IMF notes (and the World Bank agrees), dollar depreciation cannot be the only mechanism of adjustment for current global imbalances. They want developing countries with artificially cheap currencies to make their exchange rates more flexible. Europe and Japan are urged to stimulate domestic demand, taking the pressure off America to be the world's customer—though this seems a little unfair to Japan, which has been energetic, if ineffective, in pursuit of consumer stimulus. And America, the Bank and Fund make clear, must get its fiscal house in order, cutting its budget deficit and encouraging consumers to save.

## **I can quit any time**

Unfortunately, like much good advice, these recommendations seem to have little hope of being implemented any time soon. The political pressure in Asia to subsidise exports with low exchange rates is intense. Interest rates in Japan have been near zero for four years, giving the central bank little room for additional action; meanwhile, the European Central Bank seems to be preparing for a rise in interest rates this autumn, to keep inflation near its target of just below 2%, which will hardly do much for demand. And in America, the political will to reduce deficits seems to be all but extinct.

Given all these reasons to worry, it might seem surprising that both the IMF and the World Bank are broadly optimistic about the world economy. But as they point out, growth in 2004 was robust, and the world is currently enjoying high levels of macroeconomic stability. Alan Greenspan is expected to deliver steady increases in interest rates, slowing American demand, and forcing its consumers to rebuild shaky savings; it is hoped that this will help bring about an orderly adjustment in the dollar's value. This will not be pain-free for the rest of the world—developing countries that have got sweet debt deals from investors fleeing low American interest rates will find their borrowing less easy to finance. But the resulting decline in imports should allow central banks to cut back on the breakneck pace of growth in reserves. And who knows? Perhaps once ordinary Americans are forced to live within their means, they will start demanding the same from their government.