

**Testimony of**

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**Before the  
Joint Economic Committee**

**“The Economic Outlook”**

**June 27, 2006**

## Ongoing risks from the large US current account deficit

I want to thank Chairman Saxton and the Joint Economic Committee for opportunity to testify. Today I would like to focus on a key risk to the outlook: the United States' dependence on foreign savings to make up for its own low rate of savings and to finance large current account deficits.

The US current account deficit reached 7% of US GDP – roughly \$900 billion --- in the fourth quarter of 2005. Despite a small fall in the first quarter, it will likely continue to expand during 2006. A current account deficit of 7% of GDP is comparable in size to the deficit of Mexico prior to its 1994/95 crisis, to the deficit of Thailand prior to its 1997 crisis and to the deficit of Turkey prior to the lira's recent sharp fall. The United States is not directly comparable to these emerging economies. However, the US deficit is of an unprecedented size for a large advanced economy – and certainly for the issuer of the world's leading reserve currency.

Sustaining a deficit of this size requires that the United States borrow close to \$1 trillion dollars a year from the world, sell close to \$1 trillion of American assets to foreign investors or do a mix of the two. Recently, the US has financed its deficit entirely with debt. That is a change from the late 1990s, when surging investment in the new economy attracted large equity flows into the US. Nor has US debt proven all that attractive to private market participants over the past few years. Much of the debt the US has sold to finance its current account deficit over the past few years has been bought by foreign central banks and government-controlled oil investment funds. Our biggest creditors are increasingly other governments, and not necessarily either democracies or allies – a key difference from the 1980s.

Ongoing trade and transfer deficits of the current size imply that total foreign claims on the US will increase rapidly, even taking into account the favorable currency composition of the United States external debt and external assets.<sup>1</sup> The 2005 United States net international investment position, the broadest measure of total foreign claims on the US economy,<sup>2</sup> is likely to be around 25% of US GDP -- higher than it has been since the 1880s. It will soon be much bigger.

Going forward, the current account deficit will only stay at 7% of US GDP if the trade deficit starts to shrink. The current account deficit is the sum of the trade deficit, the deficit in transfer payments and the balance between the payments the US makes on its external debt and the income the US receives on its investment abroad. From 2000 to 2004, the interest rate the US had to pay on its rising debt stock fell substantially, falling from over 6% to around 3%. With both the stock and the interest rate now rising, interest payments on the United States' growing external debt stock are poised to increase

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<sup>1</sup> Many US external assets are denominated in foreign currency and rise in value as the dollar declines, helping to offset some of the rise in US debt from ongoing deficits.

<sup>2</sup> The net international investment position is the difference between all US external assets – including US direct investment abroad – and all US external liabilities, including foreign direct investment in the US.

sharply. Consequently, the current account deficit will continue to grow even if the trade deficit stabilizes.

Large deficits pose two distinct risks. One risk is that the external financing needed to sustain the United States' current pattern of growth will not be available. Forecasts of continued US growth implicitly assume that the world – including the People's Bank of China, the Bank of Russia, the Saudi Arabian Monetary Agency and other official actors -- will continue to provide the US with the large credit line needed to finance large ongoing deficits. Any shortfall in financing would likely result in a falling dollar, higher US interest rates, slower overall growth and a shift in the composition of the US economy. Sectors that have benefited from low interest rates would be hurt; sectors that export or compete with imports would benefit. The more abrupt the adjustment, the greater the losses in the sectors that stand to be hurt and the smaller the offsetting gains. Export industries don't develop overnight.

The other risk is that the US trade and current account deficit will continue to expand, increasing the stock of foreign claims on the US economy. The US is currently taking on external debt to finance a mix of government deficits, current consumption and investment in sectors – like housing – that seem unlikely to generate future export revenues. If the US were to finance its 2006 deficit with equity not debt, it would need to sell the equivalent of 45 companies the size of Unocal to foreign investors – and then sell even more similarly-sized companies in 2007. The larger the deficit now, the larger the share of future US income that will have to be devoted to making payments on the United States' external debt. Future US workers will need to support a larger retired population here in the US and contribute to the retirement income of Chinese, Japanese, and others holding US debt. A growing deficit now also increases the risk of a sharp adjustment in the future.

Policy changes both here in the US and in our trading partners abroad could help to limit these risks. The recent rise in the US external deficit has been associated with rising external surpluses in the world's emerging economies, and specifically a rise in the surplus of China and the major oil exporters. The fall in US savings – and the rise in savings in many emerging economies – has not simply been the product of private market forces. US government policies have played a significant role in reducing the US savings rate and in encouraging investment in residential real estate, increasing our dependence on savings imported from abroad. Government policies in our key trading partners have blocked natural market pressures for their exchange rates to rise, resulting in unprecedented growth in reserves and large capital flows from poor countries to the United States.

Before going into the needed policy changes, I want to explore three analytical points in greater detail:

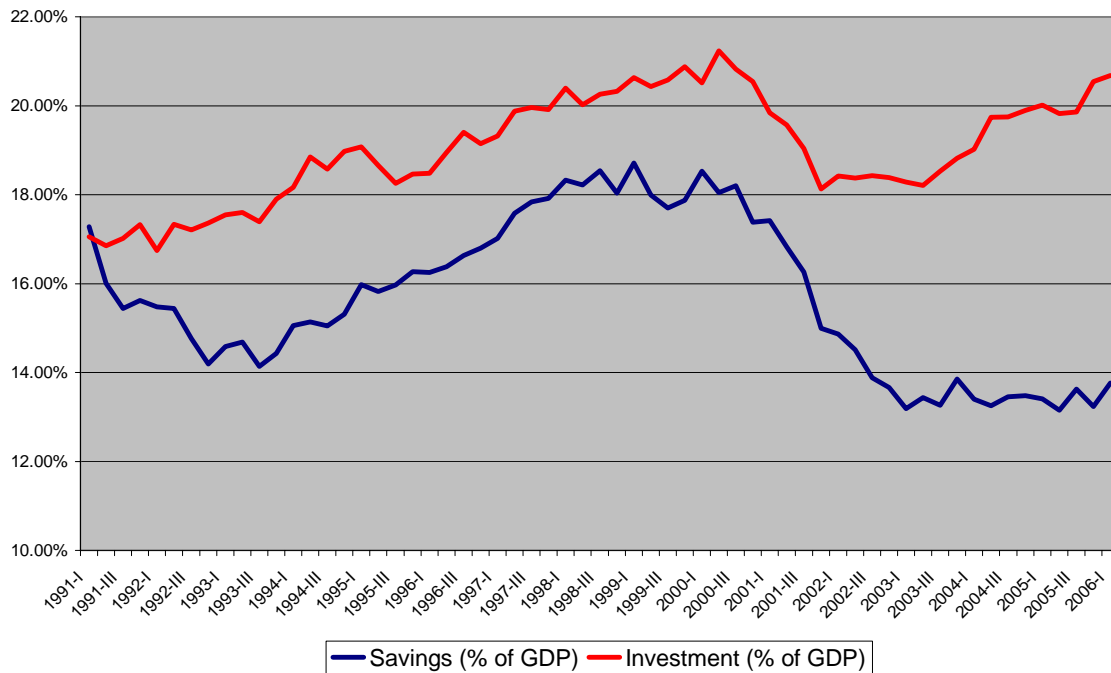
- The US current account deficit has risen largely because of a fall in savings and a rise in residential investment – not because of a surge in business investment.

- Foreign central banks – not private market participants – have played a key role financing the increase in the US current account deficit. US data likely understates US dependence on financing from central banks and oil investment funds.
- Even if the pace of both import and export growth moderates, the US current account deficit is poised to grow significantly. Significant reductions in the trade deficit – and much faster export growth relative to import growth – will be needed to keep the US current account deficit stable as the amount of interest the US has to pay on its net external debt begins to rise sharply.

The rise in the current account deficit reflects a fall in savings

The current account deficit can be thought of as the gap between what the US earns abroad – whether from selling goods and services or from its existing investments – and what the US pays abroad. It also reflects the gap between what the US saves and what the US invests. A country that invests more than it saves must borrow savings from abroad – and in the process, runs a current account deficit.

**Savings v. Investment**

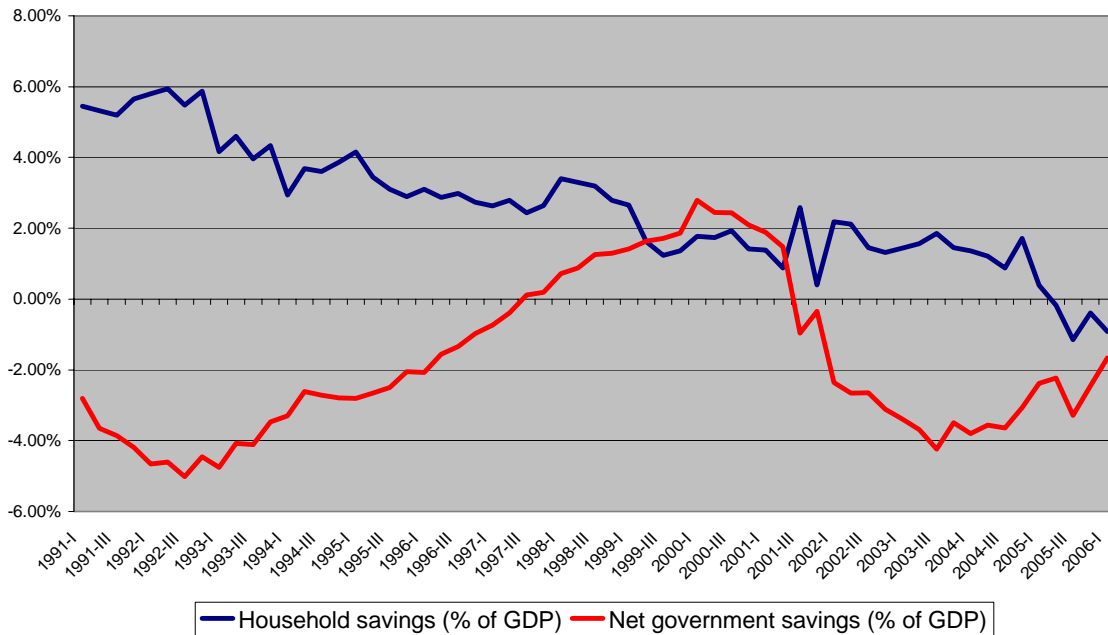


In the late 1990s, both savings and investment were increasing, though investment increased more than savings. The recent increase in the United States’ current account deficit however stems from a steep fall in national savings between 2000 and 2003. Indeed, net savings in the US are so low that the majority of net new investment –

investment in excess of what is needed to replace the existing capital stock – if financed by borrowing from abroad.

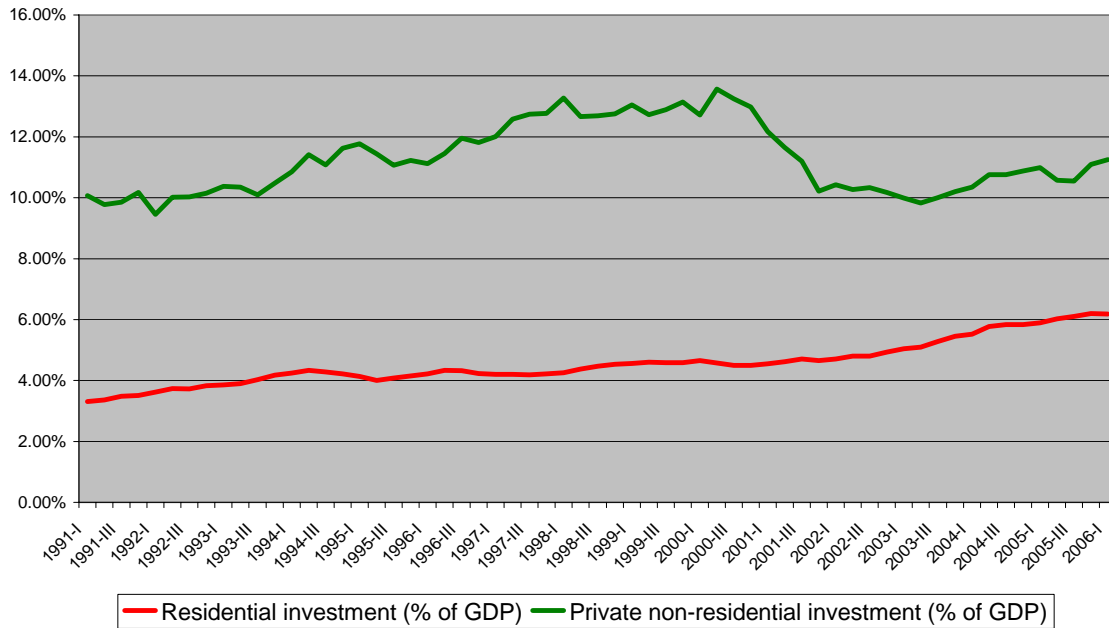
The recent fall in savings stems both from the shift from fiscal surpluses to fiscal deficits and the fall in household savings.

### Both government and households contributing to low national savings



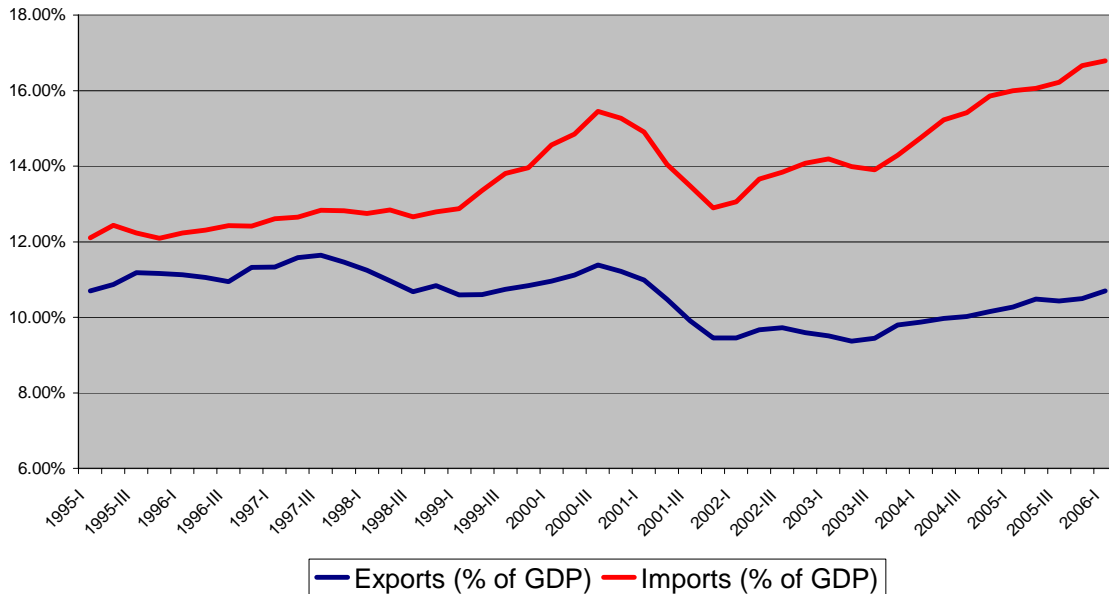
Large current account deficits are generally considered less of a concern if they stem from surge in investment, particularly investment in sectors likely to generate future export revenues. A country that borrows to import the capital goods needed to develop a newly discovered large oil field is borrowing to invest in a project that will increase both the country's future income and its capacity to generate the export revenues needed to make payments on country's external debt.

**Recent rise in gross investment stems from investment in real estate; business investment below levels in late 1990s**



Unfortunately, the recent rise in US (gross) investment primarily reflects a surge investment in residential housing. Business investment is up a bit, but remains well below its levels in the late 1990s.

**Imports growing relative GDP;  
exports no higher as a share of GDP  
than in the middle of the 1990s**



US exports have increased relative to GDP since 2003, spurred by the dollar's fall against the euro and relatively strong global growth. But even so, goods and services exports remain smaller, relative to US GDP, than they were in the mid-1990s. Little evidence suggests current US investment is biased toward likely sources of future export receipts. It is difficult to see how suburban housing will generate future export revenues.

US data understates US dependence on financing from foreign central banks

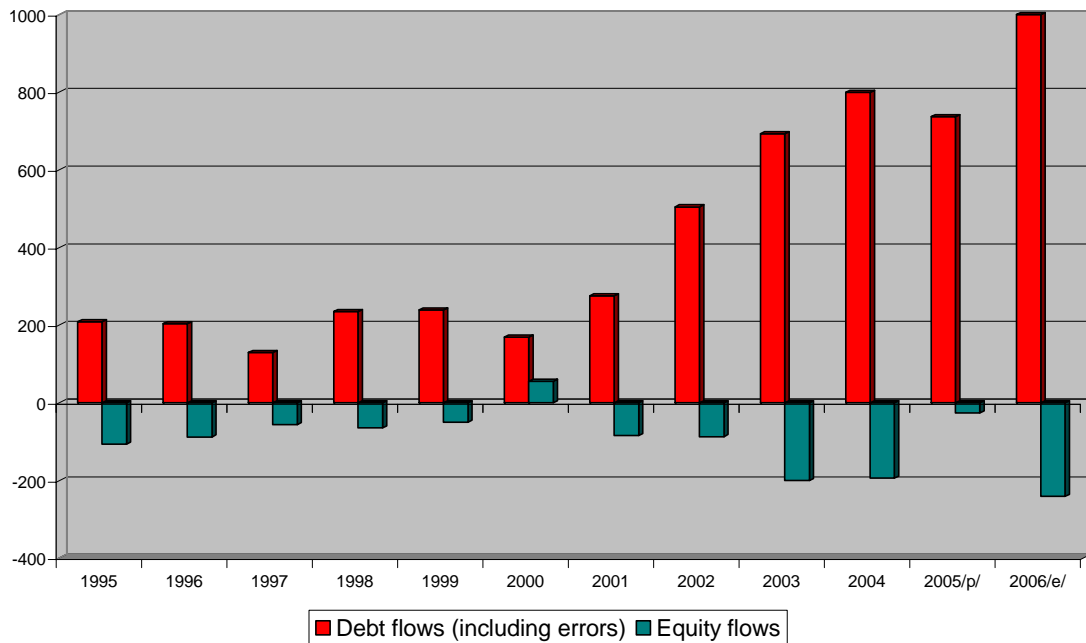
In the late 1990s, the growing US current account deficit was financed by surge of foreign demand for US equities – and strong foreign direct investment into the US. Everyone wanted to participate in the new economy. Those equity flows have disappeared. Recently, US investment in foreign equities – both foreign stocks and direct investment – has exceeded foreign investment in US equities.<sup>3</sup>

As a result, the recent increase in the US deficit has been financed entirely with debt.

<sup>3</sup> 2005 is a bit of an exception. However, the net equity inflow in 2005 stems entirely from the Homeland Investment Act. US firms with investment abroad stopped reinvesting ongoing earnings in their foreign operations and instead opted to bring their existing profits home. The result was a big fall in outflows. Net outflows resumed in the first quarter of 2006.

## US external deficits financed with debt

Capital flow data in \$ billion. All data from BEA; 2006 estimate based on q1 data

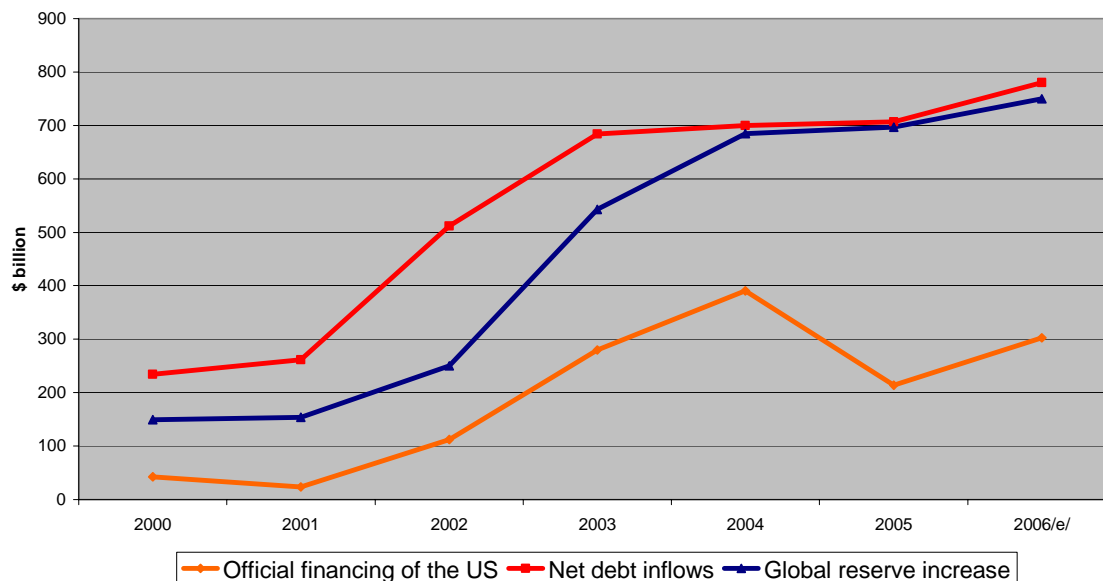


Much of the demand for US debt has not come from private investors, but rather from foreign central banks and oil investment funds. This is clearly visible in the US data for 2003 and 2004. In both these years, a surge in global reserve accumulation was matched by a surge in recorded central bank inflows to the US. In 2005, however, recorded official flow to the US fell even though global reserve accumulation did not.



## Total debts flows track global reserve data better than the official inflow data in 2005 ...

Official financing and debt flows data from the BEA;  
2006 based on q1 data, Global reserve growth estimates from Roubini Global Economics



Central banks also built up dollar deposits in the international banking system, which, as Lars Pederson of the IMF has noted, indirectly helps to finance the US,<sup>4</sup> even if such deposits are not formally inflows into the US. Combining these two data sources, it is possible to track a large share of the increase in global reserves in 2003 and 2004, but not in 2005. Only around \$310 billion of an estimated \$690 billion increase in global reserves<sup>5</sup> shows up in the US data and international banking data reported by the Bank of International Settlements.<sup>6</sup> Central banks did increase their purchases of euros, pounds

<sup>4</sup> See Box 1.6 of the IMF's April 2006 International Capital market report. Pederson writes: "Over the same period (the year 2005 through September), deposits of all monetary authorities in BIS reporting banks denominated in dollars rose by \$110 billion. The largest offshore component of these dollar flows is not part of the US balance of payments although near-perfect arbitrage between offshore and onshore funding markets means these deposits effectively support the value of the dollar exactly as would an onshore deposit."

<sup>5</sup> My estimate for global reserve growth is based on the IMF data, but includes three additional items: the increase in the foreign (non-reserve) assets of the Saudi Monetary Agency, the growth in Taiwan's reserves (Taiwan is not a member of the IMF) and reserves that the People's Bank of China shifted to Chinese state banks. My estimates also take into account changes in the dollar value of the existing stock of reserves stemming from changes in the euro's value against the dollar. The euro's rise against the dollar contributed to the headline increase in reserves in 2003 and 2004, and the euro's fall against the dollar in 2005 reduced the headline increase in 2005. My calculations try to adjust for this.

<sup>6</sup> See Robert McCauley, "Distinguishing global dollar reserves from official holdings in the United States," BIS Quarterly Review, September 2005. For more on different measures of central bank financing of the US, see Matthew Higgins and Thomas Klitgaard, "Reserve accumulation: implications for global capital flows and financial markets," Current Issues in Economics and Finance, Volume 10, no. 10. Federal Reserve Bank of New York. September-October 2004.

and other reserve currencies in 2005, but the \$380 billion gap between known flows into dollars and total increase in global reserves is extremely large.

	Official inflows (U.S. data)	Dollar reserves in int. banks (BIS, table 5c)	Bank of Japan deposits in Japanese banks	Known increase in dollar reserves (BIS methodology)	Estimated increase in reserves (IMF data, adjusted for valuation, in dollars)	Increase counting Saudis, Taiwan And Chinese bank recap	“Gap” between known and estimated reserve increases
2002	115.9	14.3	-0.2	130	221	250	120
2003	278.3	84.3	60.9	423.5	442	543	119.5
2004	387.8	100.5	-2.1	493.1	626	685	191.9
2005	199.5	80.2	-3.1	309.6	602	691	382.4

This gap is presumably explained by a change in the set of countries adding to their reserves. Japan not only keeps most of its reserves in dollars, but almost all purchases of US securities by the Bank of Japan seem to show up in the US data. However, Japan stopped adding to its reserves in early 2004 and by the middle of 2004 had finished investing most of those dollars in US securities. In 2005, by contrast, all of the increase in the world’s reserves came from emerging markets, and particularly from China and the world’s oil exporters. There is good reason to believe that the US data does not fully capture central bank purchases of US debt. A relatively small fraction of China’s reserve increase shows up in the US capital inflows data.<sup>7</sup> The same point applies with even more force for the world’s oil exporters. Recorded flows from the Gulf to the United States actually fell in 2005, despite the increase in oil prices and the rapid growth in Gulf foreign assets. Most observers believe that the Gulf states use London based custodians for many of their purchases of US assets.

Counting the increase in the various oil investment funds of the Gulf states (estimated at nearly \$100b by the IMF) along with the growth in Saudi central bank assets, the total increase in official assets in 2005 likely approached \$800 billion. More than \$200 billion of that almost certainly was invested in the US. Like Harvard’s Martin Feldstein, I believe that the US data now significantly understate true demand for US assets from foreign central banks and oil investment funds.<sup>8</sup>

<sup>7</sup> Interestingly, the annual survey data showed a much larger increase in Chinese holdings of US debt than was recorded in the monthly flow data (the Treasury international capital system data).

<sup>8</sup> See Feldstein’s December 1995 speech at the Central Bank of Mexico. Lars Pedersen of the IMF makes a similar point Box 1.6 in Chapter 1 of the IMF’s April 2006 International Capital Markets report. He notes: “Oil exporter assets in mature markets are not fully reported, creating an understatement of official transactions. Chinese official asset buying is more fully reported than the oil exporters, but together these official flows may be significantly understated in the U.S. balance of payments.” Pedersen observes that the “official managed” assets of the large oil-exporting nations rose by between \$300-450 billion in 2005. That total should be higher in 2006.

Judging from the pace of their reserve growth, the central banks of China, Russia and Saudi Arabia have become the three most important sources of demand for US debt. In the past – whether in the 1960s or the 1980s – most of the financing for US deficits came from close US allies, and from democracies. That is no longer the case.

A fall in central bank demand for US assets would not be disruptive so long as it came during a time of very strong private demand for US debt. But a meaningful risk exists that a fall in central bank demand for US debt could trigger a fall in private demand for US debt, at least at current interest rates. Perhaps an even greater risk is that central banks may not be willing to increase the amount of financing to the US given the already elevated levels should private demand for US debt falter – as it did in 2003 and 2004.

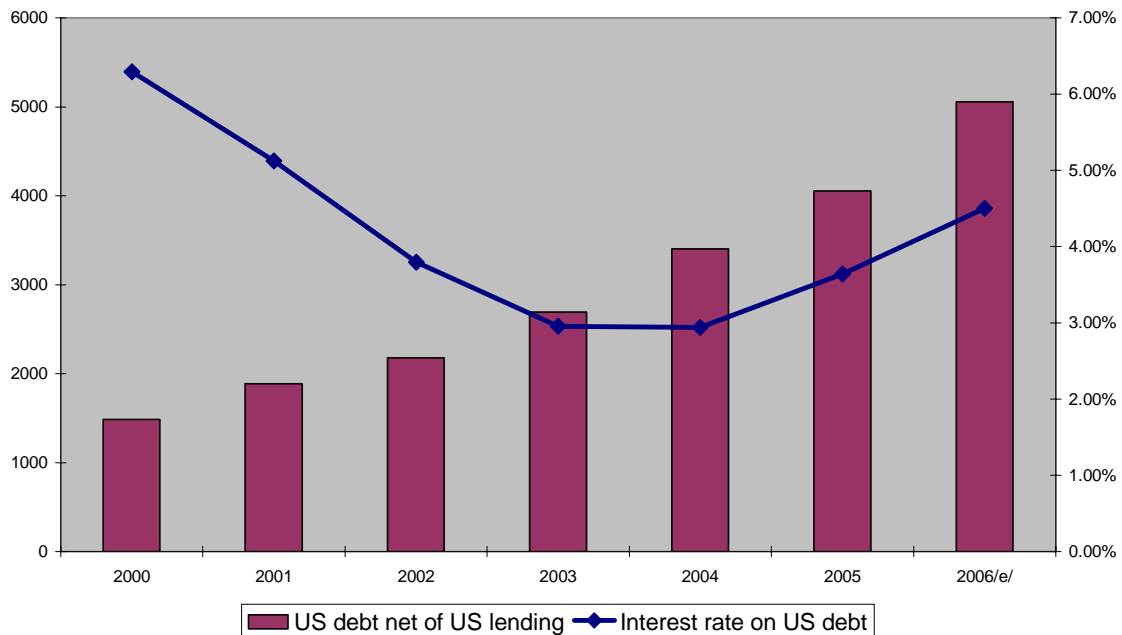
The US current account deficit will remain close to 7% of US GDP even if the US trade deficit begins to fall

Over the past few years, a rise in the United States external debt stock has not led to a rise in the interest payments that the US must pay on its external debt. Falling interest rates offset the rising stock. Interest payments actually fell from around \$275 billion in 2000 to \$185 billion in 2003, even though the United States gross external debt rose from \$4.35 trillion to \$6.2 trillion, as the interest rate on US debt fell from 6.3% to around 3%. The interest rate has now started to rise, but estimated 2005 interest payments of \$315 billion were rather low relative to gross US debts of \$8.6 trillion. Unfortunately, with short-term rates heading above 5%, the average interest rate on US external debt will not remain at 3.65% for long. Some US external debt is offset by the loans the US makes to borrowers abroad. But US debt net of US lending is rising fast. In 2000, US lending exceeded US borrowing by 1.5 trillion. In 2005, that total was more like \$4 trillion.<sup>9</sup> Barring a change in the composition of financial inflows into the US, it will continue to increase by about a trillion a year even if the US trade deficit stabilizes.

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<sup>9</sup> The US net international investment position can be divided into three parts: US borrowing net of US lending; US equity investment abroad net of foreign equity investment in the US and US currency held abroad. The last is an interest free loan to the United States. The final 2005 data is not yet available. I estimate that the US borrowed about \$4 trillion more than it lent, US equity investments abroad were worth about \$1.2 trillion more than foreign equity investments in the US and foreigners held around 0.35 trillion in US currency. That would imply a net international investment position of around negative \$3.1-\$3.2 trillion.

**Falling rates won't continue to offset rising debt  
US external debt is net of US external lending**



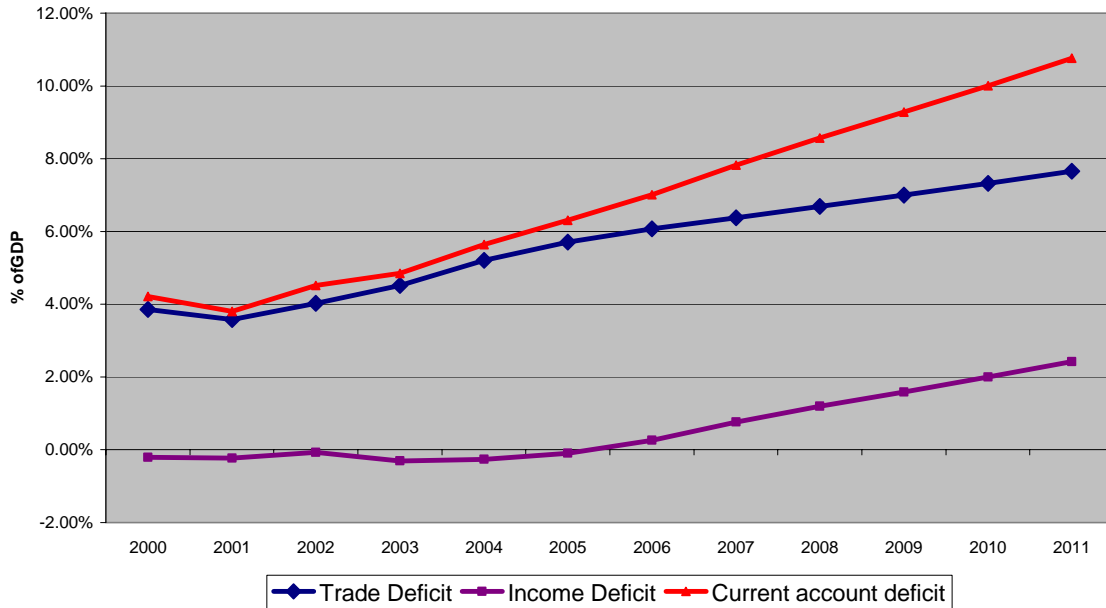
US foreign direct investment (FDI) abroad has consistently had a higher reported return than foreign direct investment in the US, largely because reported returns on foreign direct investment in the US are very low.<sup>10</sup> Combined with low US interest rates, the returns on US FDI combined to keep the income balance<sup>11</sup> in surplus. That is about to change.

Rising debt will soon combine with rising rates to generate a significant deficit in income payments. In some sense, the increase in interest rates will make the real cost of all the debt the US has taken on to finance ongoing deficits more apparent. The shift in the income balance has an important implication. Even if the pace of expansion of the US trade deficit slows, the overall current account deficit will continue to increase.

<sup>10</sup> Daniel Gros of CEPS has noted that this difference largely stems from differences in reported reinvested earnings. US firms report large reinvested earnings; foreign firms operating in the US report very low reinvested earnings. As a result, the reported return on foreign direct investment in the US has consistently been below the interest rate foreigners could have earned if they had bought long-term US government bonds. Dr. Gros does not believe that this difference is real but rather reflects data limitations. If Dr. Gros is right, the US income balance is already in a substantial deficit.

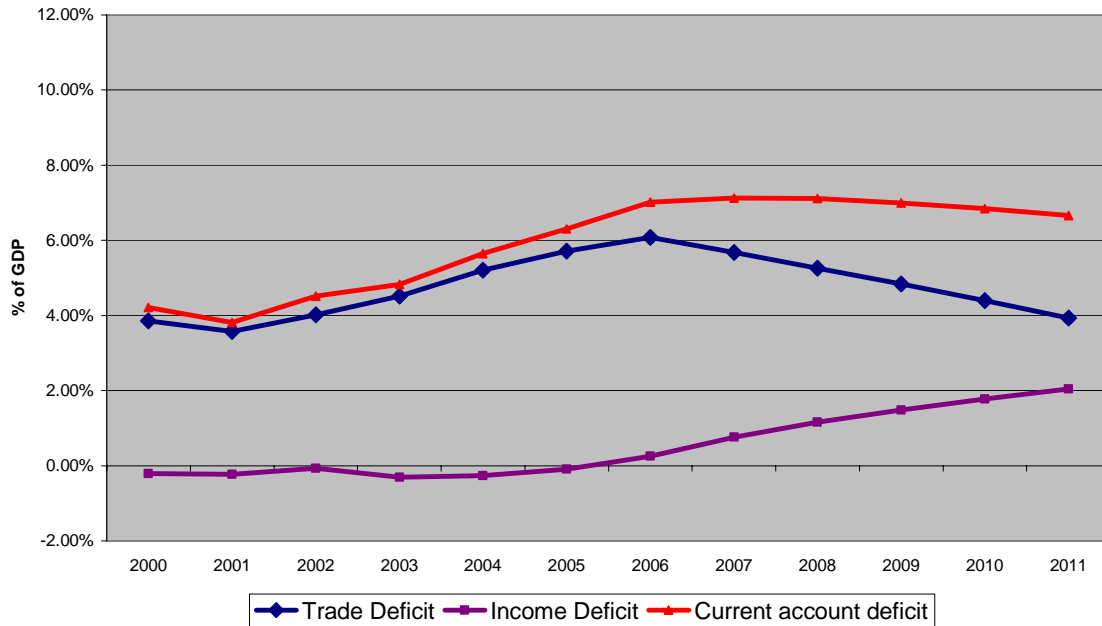
<sup>11</sup> The income balance is the difference between what the US has to pay on its external debt, the dividends the US pays on foreign portfolio investment in the US stock market and the returns foreign investors earn on their direct investment in the US relative to what the US earns on its investment abroad.

**Status quo is unsustainable --  
It implies 10% of GDP/ \$1600 billion current account deficit in 2010,  
even if pace of deterioration of the trade deficit slows**



Even if the US trade deficit stabilizes at current levels – something that requires US exports to grow 60% faster than US imports on a sustained basis – the current account deficit will continue to expand on the back of rising net interest payments. Keeping the US current account deficit roughly constant over the next few years requires that the US exports grow about twice as fast as US imports – 9% v 5%.

**Large US deficits even with adjustment -- 2010 deficit is still around 7% of GDP (\$1100 billion)**

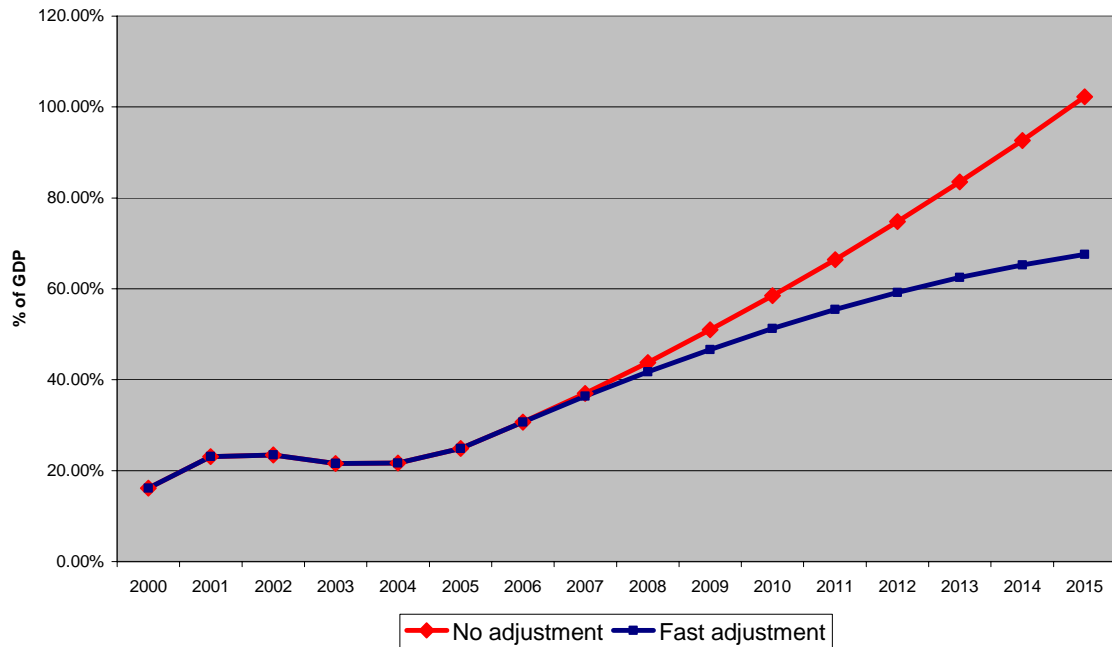


In both the case where the US trade deficit continues to expand and the case where the trade deficit begins to fall, total US external liabilities will increase much faster than US assets. The net international investment position of the United States – the broadest measure of amount that the US owes the world<sup>12</sup> -- will deteriorate substantially.

<sup>12</sup> The net international investment position (NIIP) includes foreign direct investment, portfolio equity investments (“stocks) as well as external debt.

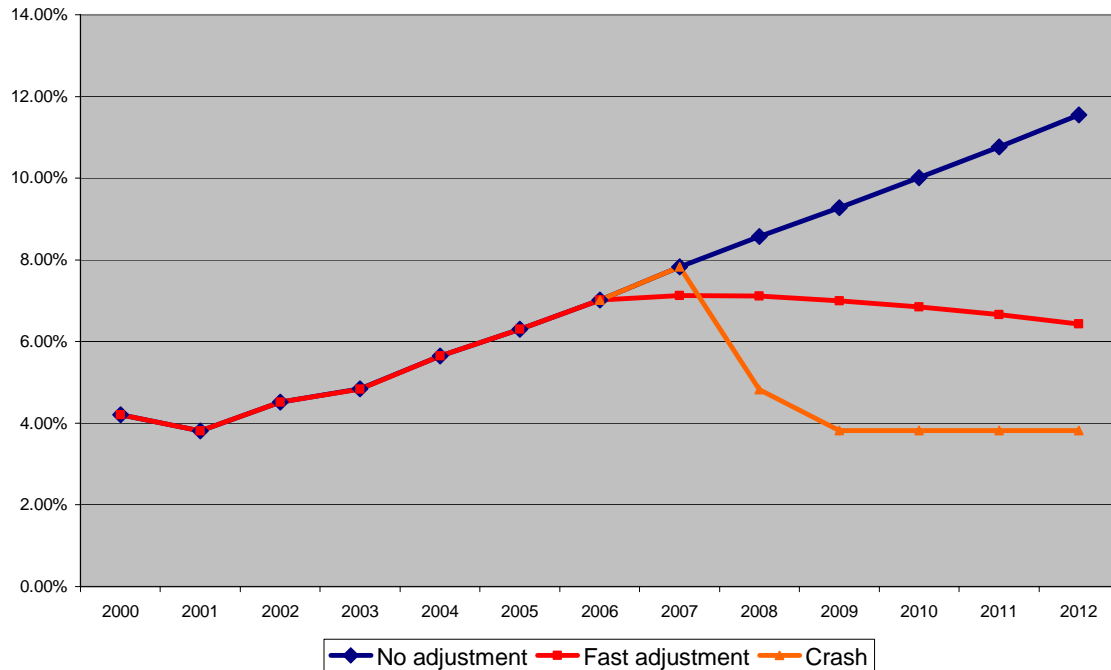
## US Net International Investment Position

(Data: BEA; 2005 estimate, 2006 on forecasts)



The projections shown here do not take into account the possibility that future falls in the value of dollar will increase the dollar value of the United States external assets. Consequently they may slightly overstate the likely deterioration in the US net external debt. However, they provide a rough guide to the future. Even if the US puts itself on a path that would bring the US trade deficit down to around zero in about ten years, US net external debt would still increase to around 60% of US GDP as a result of the deficits associated with a process of gradual adjustment. If the adjustment is delayed, the total increase in US external debt will be even larger – or the adjustment process will be more rapid.

## Possible future evolution of the US current account deficit



### Conclusions

The President of the New York Federal Reserve Bank, Tim Geithner, has observed that private markets will eventually force the US and the world to adjust even if existing policies are unchanged. But he also has noted that the risk of disruptive market moves that might significantly lower US growth during the adjustment process is far lower if that process is supported by appropriate policy changes.

Here in the US, reducing the budget deficit remains the most obvious way to increase overall national savings. Recent estimates by both the IMF and Menzie Chinn of the University of Wisconsin suggest that a one dollar reduction in the fiscal deficit could lead to a reduction of up to fifty cents in the US current account deficit – far more than the Treasury argued in a recent paper. In my judgment, bringing the revenues in line with expenditures likely requires more than just spending restraint. Government revenues – excluding those revenues dedicated to Social Security – remain quite low. The recent improvement in the fiscal deficit reflects a surge in corporate tax revenues that may not be sustained.

Efforts to reduce US demand for oil, as Menzie Chinn of the University of Wisconsin has emphasized, could also help. Such measures would both reduce the volume of oil the US needs to import and, by taking pressure off global supply, help to reduce the price the US pays for its imports.

Policy changes are also needed by our trading partners. They include:



- Greater willingness by China, some other Asian economies and many oil exporters to allow their currencies to appreciate against the dollar. Natural market pressures are pushing for appreciation: keeping the RMB around 8 to the dollar requires that China's government intervene massively in the foreign exchange market. China's central bank alone likely spent \$250 billion<sup>13</sup> – over 10% of its GDP – in 2005 buying dollars. China likely will need to spend more in 2006, as its current account surplus has continued to grow. Many oil exporters' dollar peg has led their currencies' value to fall in real terms even as their export revenues soared. The annual increase in global reserve accumulation was around \$150 billion in 2000 and 2001. It rose to nearly \$550b in 2003 and close to \$700 billion in 2004 and 2005. All the 2005 increase came from emerging economies.<sup>14</sup>
- Greater distribution of the profits of Chinese firms, which are currently used to finance investment, and the development of a stronger system of social insurance in China. Both would help to lower China's exceptionally high savings rate – and turn China into an engine of global demand growth for a broad range of products, not just for commodities.
- Finding innovative ways to inject – prudently -- more oil revenues into the economies of the oil-exporting countries rather than just using the surge in oil prices to build up the government's offshore dollar and euro deposits. Many oil exporters have budgeted for \$30 barrel oil even as oil has risen toward \$70. As a result, the surge in oil revenues has led to a surge in government savings – and, one expects, a surge in oil-state financing of the US.

I have emphasized the policy changes needed in emerging economies since the offsetting surpluses that balance the rise in the US current account deficit are found in the emerging world. Europe is roughly in balance: deficits in Spain, France, the UK and Eastern Europe offset surpluses elsewhere. Japan's surplus has not risen like that of the world's emerging economies. However, the willingness of European economies to accept further appreciation of their currencies relative to the dollar and the willingness of Japan to accept a stronger yen will be an essential part of the global adjustment process. A

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<sup>13</sup> China reported a somewhat smaller increase in its reserves in 2005. However, it reduced its reserve accumulation by transferring \$15 billion to one of its four large state commercial banks, and by another \$5 billion by engaging in various swap transactions. Moreover, the headline increase understates China's actual intervention, as the overall number was reduced by the falling dollar value of China's euro reserves. The \$250 billion estimated increase adjusts for such valuation effects, for the transfer to the state bank and for the currency swaps.

<sup>14</sup> These totals are adjusted to reflect valuation changes. They assume around 65% of the world's reserves are invested in dollars, and around 35% are in euros, yen, pound and other non-dollar assets. This split is consistent with the IMF's data on the currency composition of the world's reserves. The IMF's data does not include China, but this split is also consistent with most estimates of the currency composition of China's reserves (over 70% of China's reserves are likely to be in dollars). The totals also include Taiwan's reserves (which are not included in the IMF data), the Saudi Monetary Agency's non-reserve foreign assets and reserves China's central bank has transferred to three Chinese state banks.

stronger euro and a stronger yen will require that both Europe and Japan base their growth on domestic demand.

It is often argued that the necessary adjustment to close the US trade deficit poses little risk to the US economy, but a substantial risk to the economies of our trading partners. They no longer will be able to rely on a growing US trade deficit to spur their own economies. Moreover, dollar depreciation would reduce the value of our creditor's external assets while increasing the value of US assets abroad.

Both points are true, but they come with important caveats. First, if the global economy slows during the adjustment process because other countries can no longer rely on the US, it will be much harder for the US to increase its exports. Second, the US will still run large current account deficits and need to import large sums of savings from the rest of the world even after the trade deficit stabilizes and begins to fall. If our creditors increase the interest rate they charge to compensate for the risk of dollar depreciation, the negative impact of higher interest rates on the US economy would likely more than offset the positive impact of greater demand for US exports. The US only wins in a financial sense from dollar depreciation if our creditors do not demand adequate compensation for this risk.

Changing from a pattern of global growth based on expanding US trade deficits to one based on a slowly contracting US trade deficit will not necessarily be easy, for either the US or the rest of the world. Yet change is necessary. Gradual adjustment starting from a trade deficit of around 6% of GDP and a current account deficit of 7% of US GDP likely implies, as I noted before, ongoing current account deficits of close to 7% of US GDP for the next five years or so. If the adjustment process is delayed, the ongoing deficits associated with a gradual adjustment process will be larger and the United States final level of external debt will be greater. Moreover, the risk that that adjustment process won't be gradual is larger.

The US current account deficit is not a reflection of slow global growth – global growth has actually been very strong recently, contributing to relatively strong US export growth. Nor is it likely that an acceleration of global growth alone will be sufficient to allow the US trade deficit to adjust.<sup>15</sup> Rather, the likely challenge will be to sustain the current pace of global growth with less impetus from domestic demand growth in the US.

The United States is an important market for many countries, giving nearly everyone a stake in the orderly adjustment of the US deficit. But the US should not base its own policies on the risky expectation that the US is too big and too important a market for other countries to allow it to fail – or assume that any shortfall in private demand for US assets will be offset by a surge in central bank financing. We don't know precisely the limits of our creditors are, but the willingness of the world's central banks to extend an unconditional credit line to the United States must be limited.

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<sup>15</sup> See recent research from Mann and Plueck

The United States has unique advantages that have allowed it to finance large current account deficits at relatively low rates for some time. The majority of economists believe that the odds still favor an orderly adjustment process. I hope they are right. But this process – supported by appropriate policy changes – needs to get started. So far there hasn't been any adjustment. All historical comparisons are subject to one important caveat: never before has an economy as big and as important as the United States run deficits of the current magnitude.

Former Treasury Secretary Larry Summers reminded us recently that just because large deficits have been financed relatively easily in the past does not mean that they will continue to be financed as easily in the future. We in the US do not typically pay attention to financial markets in Iceland, New Zealand and Turkey. But the value of all their currencies has fallen sharply this year, in large part because of concerns about their current account deficits. Interest rates in all countries are up. Turmoil in these markets should provide another warning. Experience teaches us that it is better to implement necessary policy changes when markets are calm – not to wait until markets demand change.