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The Dollar, Deficits and Demography or Why the U.S. will be a Capital Importer into the 21st Century

Summary

The major industrial nations are now experiencing an upheaval in their relative balance of payments positions which is unprecedented since the First World War. At current rates of borrowing, the U.S. will have an external debt exceeding one trillion dollars by the early 1990's while Japan will become the world's largest creditor nation, with external assets of over $500 billion. Most analysts consider these developments to be a freakish abnormality resulting from large American budget deficits, but they also reflect economic changes of a more permanent nature, including the increasing mobility of capital in the world financial system, structural reforms in the U.S. tax system, and differences in relative population growth rates among the major industrial nations. Such dramatic changes in the global balance of payments will require policy-makers to rethink many traditional assumptions about how the world economy operates or risk repeating the disastrous experiences of the late 1920's with currency misalignment, protectionism, and debt repudiation. This will be difficult because the U.S. is a debtor nation with the habits of a creditor nation while Germany and Japan are creditor nations with the habits of debtor nations. Although there is nothing wrong with the U.S. importing capital, its external borrowing has to occur within a framework of more balanced domestic growth and more broadly based global expansion than has occurred so far in the 1980's. Unless there is more effective international economic policy cooperation, the rapid growth of U.S. external indebtedness also could have adverse implications for western security by reducing the willingness of the American people to support high levels of defense spending for Europe and Japan.

In the short-term, there has to be a co-ordinated fiscal stimulus in Europe and Japan, centering on structural tax reform to compensate for fiscal tightening and slower growth of domestic demand in the American economy. In the intermediate-term, there has to be an acceleration of programs for reviving capital flows to the developing countries, including more participation in Wall Street's transnational securities boom and increased access to Japan's large savings surplus. In the long-term, the major industrial nations also must commit themselves to the establishment of exchange rate target zones which will encourage sustainable currency values, productive resource transfers between countries, and trade based on comparative advantage.

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Most of the great questions in world economic policy during the late 1980's are likely to revolve around the emergence of the U.S. as a large debtor nation (Table 1).

Should the world's wealthiest nation be a long-term capital importer? If the U.S. does import capital, will it someday have to run a trade surplus in order to make interest payments on its external loans? If the U.S. is to run a trade surplus in the 1990's, which nations will run trade deficits? Can the dollar maintain its status as a reserve currency if the U.S. has a trade deficit and large external debt generating political pressure for devaluation?

Table 1: Current Account Deficit/GNP*

	1978	1979	1980	1981	1982	1983	1984	1985	1986
U.S.	−0.7	−0.1	0.2	0.2	−0.2	−1.0	−2.6	−3.0	−3.1
Japan	1.7	−0.9	−1.0	0.5	0.7	1.8	2.8	3.3	3.8
Germany	1.4	−0.8	−1.8	−0.8	0.5	0.7	1.0	2.0	3.0
France	0.6	0.0	−1.4	−1.4	−3.0	−1.7	−0.6	0.0	1.0
U.K.	0.4	0.0	1.6	2.4	1.5	0.8	0.3	0.2	−0.1
Italy	2.4	1.7	−2.5	−2.3	−1.6	0.2	−0.9	1.0	0.7
Canada	−2.2	−2.0	−0.6	−2.0	0.4	0.2	0.3	−0.2	−1.0
Holland	−0.8	−1.1	−1.5	2.1	2.8	2.9	4.1	5.0	6.0
Sweden	0.0	−2.2	−3.6	−2.5	−3.6	−1.0	0.4	−0.6	0.5
Australia	−3.5	−1.5	−2.3	−4.8	−5.3	−3.9	−4.6	−5.5	−6.0

* The major capital importers during the 1980's have been industrial countries. Developing countries are still importing some funds but on a much smaller scale than during the 1970s.

At first glance, it seems inconceivable that the U.S. should be a capital importer. During the 19th century the U.S. was a developing nation and imported capital, but during most of the 20th century, the U.S. has been a capital exporter. It first shifted from debtor to creditor status during the First World War by recycling as loans its export earnings from selling food and military supplies to Britain and other allies. In the 1920's, the Federal Reserve pursued a highly expansionary monetary policy specifically designed to stimulate world growth by encouraging large U.S. capital outflows to Latin America and Europe. After 1945, the U.S. became the world's central banker. Because of the dollar's de facto status as world reserve currency, the U.S. was able to export dollars through military spending or asset purchases which foreigners stockpiled in private portfolios or central bank balance sheets. As President De Gaulle often complained, the dollar's unique status allowed the U.S. to run capital account deficits in excess of its trade surpluses because those deficits were the world's major source of new liquidity growth.

Aside from the dollar's special international status, it also was conventional wisdom until recently that industrial nations should aim for current account balances and that only developing nations should import capital. So far in this decade, though, world balance of payments trends have turned this assumption upside down. The major capital importers have been industrial nations; the U.S. followed by Australia, France and a few Scandinavian countries. Most developing countries have ceased to import capital on a large scale while a few newly industrialized countries, such as Taiwan, have even become large-scale capital exporters. Whereas the dominant capital flows in the world economy during the 1970's were between OPEC and the developing nations via the large American banks, the major growth area in global financial intermediation today consists of securities purchases in North America and Australasia by the investment institutions of high savings societies in East Asia and continental northern Europe. At current rates of borrowing, the U.S. is likely to have an external debt of one trillion dollars by the early 1990's compared to an external investment surplus of nearly $200 billion in 1982.

Most discussions about America's emergence as a large external debtor treat the phenomena as an unsustainable abnormality resulting from freakish policy developments during the early 1980's.

First, the U.S. has been running a highly expansionary fiscal policy since 1981 which has outstripped the economy's domestic financial resources. As Table 2 illustrates, the combination of a large federal budget deficit, a large increase in private sector investment and strong consumer spending during 1983–1986 created a savings shortage which forced the U.S. to become a large-scale capital importer for the first time since 1914.

Secondly, most other major industrial nations have been running economic policies which are fiscally divergent but financially complementary to policies in the United States. While the federal budget deficit in the U.S. has grown from 1% of GNP in 1980 to 4–5% recently, the opposite has happened in Japan and Germany. As a result, Japan and Germany have been generating excess savings while the U.S.

Table 2: U.S. Savings and Investment as a Percentage of GNP*

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Savings																
Gross Private Savings	16.2	17.3	16.8	18.0	17.3	19.0	18.0	17.8	18.2	17.8	17.5	18.0	17.6	17.4	17.9	17.2
Personal Savings	5.7	6.0	5.1	6.5	6.6	6.5	5.4	4.6	4.9	4.7	5.0	5.2	4.9	3.8	4.5	3.6
Net Corporate Savings	1.8	2.4	2.8	2.7	1.4	2.3	2.6	3.1	3.1	2.5	1.4	1.4	0.6	1.9	2.4	2.7
Depreciation	8.7	8.8	8.9	8.7	9.3	10.1	10.1	10.1	10.2	10.6	11.1	11.4	12.1	11.6	11.0	10.9
Federal Government Surplus	–1.2	–2.0	–1.4	–0.4	–0.8	–4.3	–3.0	–2.3	–1.3	–0.6	–2.2	–2.1	–4.6	–5.2	–4.5	–5.0
State and Local Gvt Surplus	0.2	0.2	1.1	1.0	0.5	0.3	0.9	1.4	1.3	1.1	1.0	1.1	1.1	1.4	1.8	1.5
Gross Savings	15.2	15.6	16.5	18.5	16.8	14.9	15.9	16.9	18.2	18.3	16.3	17.1	14.1	13.6	15.2	13.8
Net Foreign Investment	0.5	0.1	–0.2	0.6	0.4	1.4	0.5	–0.4	–0.4	0.1	0.5	0.3	0.0	–1.0	–2.4	–2.9
Investment																
Gross Private Domestic Invt.	14.7	15.6	16.7	17.6	16.3	13.7	15.6	17.3	18.5	18.1	16.0	16.9	14.1	14.7	17.6	16.5
Inventory Change	0.3	0.7	0.9	1.4	1.0	–0.4	0.9	1.1	1.3	0.5	–0.3	0.8	–0.8	–0.2	1.7	0.3
Residential Fixed Investment	4.0	5.0	5.7	5.4	4.4	3.9	4.6	5.5	5.7	5.5	4.5	4.0	3.3	4.5	4.8	4.8
Nonresidential Fixed Investment	10.4	9.9	10.1	10.7	10.9	10.2	10.1	10.8	11.5	12.1	11.8	12.1	11.6	10.5	11.1	11.5
Net Nonresidential Fixed Invt.	1.9	1.6	1.7	2.6	2.6	1.8	2.0	2.6	3.3	3.7	3.1	2.8	1.4	–0.3	0.1	–0.2

* The U.S. savings rate has changed little in response to the Reagan tax program enacted during 1981. As a result, the large rise in private investment and public borrowing forced the U.S. to become a capital importer. The new tax reform program may reduce the need for foreign borrowing by depressing investment during 1987.

has become the world economy's borrower and spender of last resort. Although Reaganomics was originally sold to the American public as a supply side program for stimulating domestic output through enhanced tax incentives for work, savings and investment, it inadvertently evolved into the world's first experiment in global Keynesianism.

Thirdly, there was a sharp decline in bank lending to the developing countries after 1982, which further increased the supply of surplus global liquidity available for financing U.S. credit demand.

Finally, the U.S. still has the world's largest and most diversified financial markets while the dollar itself continues to account for nearly 70% of all foreign exchange reserves. The U.S. financial markets are not merely a natural receptacle for the world's surplus liquidity. Despite floating exchange rates, the dollar's reserve currency status continues to create a portfolio demand for the currency beyond that needed for ordinary commercial transactions. In the 1950's and 1960's, this demand was satisfied through capital account deficits. In the 1980's, it has been satisfied through current account deficits.

While cyclical policy divergences and the third world debt crisis can explain much of the rise in U.S. external borrowing during the 1980's, it is unclear whether the factors behind the emergence of the U.S. as an external debtor are as totally cyclical and transient as most analysts contend. Although the U.S. has been a capital exporter during most of the 20th century, there is no theoretical reason why it should be dependant solely upon domestic savings to finance its growth. The movement of capital in the world economy is dependant upon many different factors, not merely whether a country is rich or poor. Where can resources be employed most productively? Does the political system of a country guarantee property rights? Is public policy supportive of economic growth? In the late 19th century, for example, a large share of British overseas investment was concentrated in countries which actually had a higher per capita income than Britain, including the U.S. and Australia. Several structural changes now occurring in the world economy suggest that the U.S. could again be a long-term capital importer even if its budget deficit shrinks and fiscal policy overseas becomes less restrictive.

First, private capital enjoys greater freedom of movement in the world economy today than at any other time since 1914. Secondly, the U.S. has been pursuing a radical tax reform program, which could alter the American economy's relative growth rate in the future. Thirdly, the major industrial nations are in the midst of a demographic upheaval which will cause the population of Europe and Japan to age quite rapidly during the next few decades while the population of the U.S. is likely to age more slowly.

Financial Deregulation

In most industrial countries today, private investors enjoy far more freedom of movement in deploying their funds than at any time since the Second World War. Exchange controls were prevalent in most industrial countries during the 1950's and were not uncommon after that. In the past decade, though, there has been a steady international progression towards both domestic and external financial liberalization starting with the U.S. in the mid-1970's, Britain in 1979 and Japan more recently.

Except for U.S. attempts to offset the growth retarding effects of protectionism during the 1920's with heavy purchases of foreign bonds, the current period is the first time since 1914 that there have been large movements of private portfolio capital between the major industrial nations. Until recently, transnational investment consisted primarily of official aid, direct expenditures on plant and equipment, or Eurodollar bank lending, which was largely a recycling of OPEC's payments surpluses. Stock markets and bond markets were not important conduits for capital flows; pension funds, which now account for 20–30% of gross savings in many countries, were typically limited to domestic investing. Financial deregulation, as well as developments in computer and communications technology, have created a new global framework for capital mobility more akin to the 19th century British Empire and its financial appendages (Argentina and the U.S.) than anything which we have so far experienced in the politically tumultuous 20th century. Indeed, except for technology, today's globalized financial markets have more in common with the financial world in 1886 than 1956.

Economic research published a few years ago suggested that international capital flows had little effect on the savings and investment behavior of the major industrial nations during the 1960's and 1970's, but there are three major problems with using the history of the 1970's as a framework for analyzing the current period. First, global financial liberalization has largely been a phenomenon of the 1980's. OPEC was the primary intermediary for capital transfers during the 1970's. Secondly, since capital was less mobile until recently, there was a strong bias towards achieving a curent account balance in most countries. Unless a country was still underdeveloped, current account deficits were typically associated with weak exchange rates and rising inflation. Finally, comparisons of national savings/investment balances do not reflect the large sums of money now being routed through offshore tax havens. These funds, as well as other measurement problems, have helped to create a $90–100 billion statistical discrepancy in the world's current account during recent years.

On an informal basis, the financial markets have created a dollar currency area in the world economy which extends beyond the narrow confines of the official U.S. balance of payments and which often produce self-correcting adjustments in trade and capital flows. In the 1970's, for example, the U.S. loaned funds of Latin America which were recycled back to this country in the form of orders for new machinery or capital flight to purchase securities and real estate. The recent expansion of the U.S. trade deficit with Latin America simply reflects the fact that funds which flowed to the Spanish speaking sections of the dollar financial area during the 1970's are now funding homebuilding, defense expenditures and personal consumption in the U.S. itself. If these funds were still flowing to Latin America, the trade deficit would be smaller but U.S. interest rates would be higher and domestic consumption weaker. In the 1980's, a comparable relationship has developed between the U.S. and East Asia in the opposite direction. Japan has become the eastern pillar of the dollar financial area while the U.S. has become the western half of a greater Japanese co-consumption sphere spanning the whole Pacific Basin. Although less well known, a similar trade and financial recycling relationship also has developed with Taiwan, which now has $60 billion of foreign exchange reserves. If we adjust the U.S. balance of payments for these relationships, the external deficit of the dollar currency area is much smaller than the payments deficit of the U.S. itself. Because today's global intermediation process is market-driven, there is no guarantee that Asians will always be willing to hold large stocks of dollar financial assets, but in the 1980's no other country has financial markets deep enough to absorb the huge pools of liquidity created by international financial deregulation, restrictive European and Japanese fiscal policy and the U.S. import boom.

U.S. Tax Policy

The second factor which has driven more of the world's surplus savings to the U.S. since 1980 has been the leadership of the Reagan administration in encouraging large reductions in personal and corporate taxation. The 1980's has been an era of tax reform throughout the industrial world, but no other country has gone as far as the U.S. in reducing both average and marginal tax rates. While discussions of the Reagan program's international effects have focused primarily on the stimulus it gave to aggregate demand, it is also important to examine the microeconomic effects of the Reagan tax cuts on investment spending, interest rates, and capital flows.

The Reagan administration's first tax program in 1981 significantly expanded corporate depreciation allowances while reducing marginal tax rates on personal investment income to their lowest level since the 1920's. The higher after-tax return on real assets increased the U.S. economy's equilibrium level of real interest rates and encouraged a capital spending boom which quickly outstripped America's relatively inelastic supply of domestic savings. Indeed, some U.S. corporations have actually reduced their pension contributions since 1984 because high investment returns were causing them to become overfunded.

The post-1981 rise in the U.S. trade deficit was the means by which the world financial system corrected the savings imbalance resulting from higher American investment returns. First, the expansion of the trade deficit provided foreigners with the extra income needed to purchase U.S. securities. Secondly, the loss of American trade competitiveness depressed output in many tradeable goods sectors and thus helped to bring overall U.S. asset back into line with those available elsewhere.

In economic theory, it is impossible to have a high profit sector indefinitely, as capital will flow into it until profits are equalized. In the case of the U.S. economy after 1981, this process occurred through appreciation of the exchange rate and the increased penetration of U.S. markets by foreign manufacturing industry. Ironically, what the Treasury gave U.S. industry through expanded tax allowances, the currency markets took back through a commercially uncompetitive dollar exchange rate.

The growth of the federal budget deficit and monetary policy uncertainty also contributed to the upsurge of U.S. real interest rates after 1981 but private investment would have been much weaker and hence interest rates lower without the expanded depreciation allowances. It was the interaction of changes in U.S. microeconomic policy with financial liberalization on other countries, not merely divergent budget deficits, which made possible a large rise in U.S. private and public borrowing financed by foreign savings. Indeed, the country which has been the largest exporter of savings to the U.S. recently is also the country which has a tax system that is most complementary to America's – Japan (Table 3). The U.S. has a low personal savings rate and a high cost of capital because it provides tax allowances for all forms of personal or corporate borrowing. The 1981 tax bill helped to compensate for America's high cost of capital by greatly expanding the corporate

Table 3: General Government Financial Balances*
Surplus (+) or deficit (–) as a percentage of nominal GNP/GDP

	1980	1981	1982	1983	1984	1985	1986
United States	–1.3	–1.0	–3.5	–3.8	–2.9	–3.5	–3.4
Japan	–4.4	–3.9	–3.6	–3.7	–2.2	–1.3	–0.8
Germany	–2.9	–3.7	–3.3	–2.5	–1.9	–1.1	–0.8
France	+0.2	–1.8	–2.7	–3.1	–2.9	–2.6	–2.5
United Kingdom	–3.5	–2.8	–2.3	–3.7	–3.9	–3.1	–3.2
Italy	–8.0	–11.9	–12.6	–11.7	–13.0	–14.0	–12.9
Canada	–2.7	–1.6	–5.0	–6.2	–6.2	–6.1	–5.0
Netherlands	–4.0	–5.5	–7.0	–6.5	–6.2	–5.0	–6.9
Sweden	–3.7	–4.9	–6.3	–5.0	–2.3	–2.3	–1.2
Australia	–1.4	–0.5	–0.2	–3.7	–3.4	–3.0	–2.2

* There has been an unprecedented divergence in the fiscal policies of the major industrial nations during the 1980's. Policy was highly expansionary in the U.S. but more restrictive elsewhere.

sector's depreciation allowances. Japan, by contrast, has a tax system which subsidizes investment more indirectly. There are high tax rates on corporate income and few allowances for investment. But the Japanese cost of capital is relatively low because of meagre tax allowances for personal borrowing, large tax allowances for savings and financial regulations which discourage personal borrowing. A Japanese family with two children, for example, can have nearly $250000 of tax free savings but tax allowances for mortgages are equivalent to only 0.2% of Japan's national budget compared to 4% in the U.S. In an age of capital mobility, it is logical that a country which subsidizes savings but not investment (Japan) should export capital to a country which subsidizes investment but not savings (the U.S.).

In fact, Japan had a current account surplus approaching 3% of GNP as far back as 1972, long before there were complementary U.S. and Japanese budget deficits. This reflected a structural tendency towards oversaving in Japan which was disguised for a decade by rising oil prices. But for OPEC, Japan might have become a major capital exporter to the U.S. and other countries in the mid-1970's.

Obviously, there are limits to how far national rates of saving and investment can diverge. As the U.S. imports capital, it has to build up a stock of export generating assets in order to satisfy future debt servicing obligations. On a global basis, one can also question the optimality of resource allocation resulting from the interaction of highly divergent tax systems within a framework of uncontrolled capital mobility. Should the U.S., for example, be exporting manufacturing jobs to an overcrowded chain of Asian islands, where per capita incomes now exceed $16000 per annum but 60% of the homes are not yet connected to sewers, so that its workaholic citizens can generate a savings surplus which is then recycled back across the Pacific via the Treasury debt market to subsidize the construction of more vacant office buildings in Houston and Los Angeles?

Whatever the potential distortions, though, the constraints on U.S. external borrowing in a world without capital controls are likely to be qualitative microeconomic factors, not just simple debt/GNP ratios. When will foreign investment depress U.S. asset returns by saturating profit-making opportunities in the non-tradeable as well as the tradeable sectors of the economy? Can the Federal Reserve maintain confidence in the dollar if national tax policy encourages U.S. corporations to become so top heavy with debt that there is strong political opposition to future monetary restraint? Will the growth of import penetration so depress manufacturing investment that the U.S. economy slides into a recession?

The importance of relative asset returns in driving capital flows is illustrated by the fact that the dollar's past movements have often correlated pro-cyclically with the performance of the U.S. economy. When U.S. growth is robust and the American economy offers high real asset returns, the dollar tends to be in demand. When the U.S. economy performs poorly or American asset returns are too low to compensate for the risk of inflation, such as in the late 1970's, the dollar usually declines.

The dollar's fluctuations since 1984 demonstrate this pattern clearly. The dollar began declining during mid-1985 even before the New York G-5 summit conference because the gap between American asset returns and foreign asset returns was narrowing due to slower growth in the U.S. economy and faster rates of recovery outside North America. As the benefits of the Reagan fiscal stimulus flowed increasingly to foreign imports, American manufacturing output stalled and U.S. interest rates fell.

The U.S. Treasury Secretary, Mr. James Baker, deserves a lot of credit for helping to blunt protectionist pressure in the U.S. Congress by accelerating the dollar's correction, but he could not have brought the dollar down so quickly if the U.S. had been enjoying an economic performance comparable to 1983–1984.

What remains to be seen in 1988 is whether the new U.S. tax reform bill will attract even larger capital flows to the American economy by reducing personal tax rates or whether the bill will depress growth and reduce capital inflows by increasing effective business tax rates.

While the 1986 tax reform bill has produced large reductions in nominal tax rates for both corporations and individuals, its impact on effective tax rates is more mixed. The curtailment of tax allowances for investment will increase the effective aggregate tax rate of the U.S. non-financial corporate sector from 25% to 31%, with the largest increases occurring in the manufacturing sector. If one accepts the argu-

ment that the 1981 tax bill increased the economy's equilibrium level of real interest rates by boosting asset returns, the higher tax rates on business should lower investment returns, reduce interest rates and depress the dollar. It also could be argued that the tax reform bill will reduce the American economy's need for external savings by boosting the personal savings rate, but it is unclear whether the savings effect of tax reform will be significant. Historically, the U.S. personal savings rate has been very insensitive to changes in taxation and interest rates. Since the new tax law will only reduce effective marginal tax rates by a few percentage points and curtail many tax sheltered savings programs, it is possible that there will be only a modest savings response to tax reform. The introduction of a top personal tax rate of 27% versus 33% for the corporate sector also could encourage firms to increase dividend payout ratios and hence reduce the supply of retained earnings available for financing capital expenditures. Under such circumstances, the gap between U.S. savings and investment could decline by enough to reduce the country's need for external savings but more because of lower investment spending than higher savings.

While the microeconomic shock effects of tax reform are likely to depress the U.S. economy and the dollar exchange rate during the short-term, its long-term impact will depend upon whether the economy and capital flows are more responsive to nominal tax rates or effective tax rates. If the economy is more sensitive to effective tax rates than nominal ones, tax reform will depress the dollar by reducing investment and external borrowing. But if nominal tax rates are as potent an influence on economic behavior as many supply siders promise, there could ultimately be a significant improvement in U.S. growth performance, which would increase the country's need for external savings. The large reductions now occurring in American personal tax rates also could encourage a new brain drain to the U.S. from high marginal tax rate societies in Europe, Latin America and Asia.

One of the most immediate tests of the U.S. tax reform bill's potential on foreign capital and labor will be the response of the Canadian government to it. In recent decades, Canada has pursued a typically corporatist fiscal policy of taxing individuals heavily and corporations lightly. As with the United Kingdom before Mrs. Thatcher, Canada's marginal tax rates on personal income are far above tax rates in the U.S., but Canada's depreciation policies are among the most generous in the industrial world. If Canada persists with such tax policies while maintaining a relatively open trading relationship with the U.S., North America could become an interesting laboratory for testing the impact of tax incentives on resource allocation. The large differentials between U.S. and Canadian taxation should encourage firms to locate their capital intensive operations in a high depreciation corridor along the Ontario border and their human intensive activities in a low personal tax corridor on the American side of the border. Under such circumstances, Canada could develop an economy consisting of only three major sectors – the government, traditional resource extraction industries, and a string of robot operated manufacturing facilities managed by satellite remote control from the headquarters of expatriate Canadian firms located in Buffalo, Detroit and Florida.

Demography

The third factor which appears to be altering the direction of capital flows in the world economy today is demography. The populations of Japan and continental northern Europe are aging rapidly while the population of North America is aging more slowly. By the year 2010, the size of the retired populations of both Germany and Japan will be equivalent to over 40% of the labor force compared to 29% and 15% today. In the U.S., by contrast, the pensioner population will be equal to only 25.6% of the labor force and perhaps even less if immigration from Latin America continues to grow (Table 4).

These demographic trends provide one of the strongest arguments for why the U.S. is likely to remain a capital importer.

First, in an open and integrated world economy, rich but aging societies should export capital to countries with young populations in order to build up a stock of productive assets for servicing future retirement needs, as happens between different generations within industrial societies themselves. Since the U.S. has a much younger population than Europe and Japan, it is a logical user of their retirement savings. In fact, one of the major motivations for

Table 4: Aging of Populations*
(Number of Pensioners as percentage of Labor Force)

	1985	2010[1]	2030
US	24.0	25.6	41.5
Japan	18.3	40.1	42.7
West Germany	29.0	40.8	63.6
France	31.0	39.5	54.6
Britain	30.3	28.1	37.6
Italy	27.1	33.6	46.5
Canada	16.0	22.6	39.4

* One of the major reasons why the U.S. could be a capital importer during the next few decades is the fact that the population of Europe and Japan are aging far more rapidly than the population of the U.S. [1] OECD projections.

the restrictive fiscal policies which Japan and Germany pursued during the first half of this decade was concern about unfunded state pension obligations doubling their public sector debt as a share of GNP during the early years of the next century. Secondly, the U.S. is more tolerant of large-scale immigration than Japan or many European countries. Thus, while the U.S. indigenous birthrate is declining, total American labor force growth should continue to be bolstered by large an influx of people from Latin America and Asia. Just as the Haitinization of the African continent is encouraging millions of black Africans to seek employment in white ruled South Africa, so are Texas and Florida evolving into enterprise zones for millions of Latin Americans seeking to escape from economic mismanagement in their own countries. With the number of legal and illegal migrants to the U.S. averaging 1.5–2.5 million per annum, U.S. immigration is well below the levels which occurred during the early decades of the 20th century, when immigration rates were equal to nearly 10% of the existing population. But even a U.S. labor force growth rate of only 2–3% will still make for a significant contrast with the shrinkages now projected to occur in Europe and Japan (Table 5).

The third reason projected demographic changes are likely to encourage capital flows to the U.S. is that the high cost of funding retirement obligations could lead to a sharp rise in European tax burdens during the early years of the next century. Under such circumstances, the governments of Europe will have to chose between raising retirement ages, reducing tax progressivity drastically, or losing more young workers to North America.

As there is no precedent since the industrial revolution for the kind of demographic upheavals which now confront Europe and Japan, it is possible that traditional relationships between population movements and capital flows will be reversed. Instead of exporting capital to the U.S. and other regions with young populations, Europe and Japan may develop such capital intensive economies that they ultimately end up utilizing more of their savings at home (assuming technology actually permits such large-scale substitution of capital for labor). The free movement of people permitted within the European Common Market also may encourage a large migration of Greeks, Spaniards and Irish to Germany, France and Holland. Although declining, those countries' birth rates are still well above the European average. In fact, the Turks already account for nearly 4% of Germany's population.

Whatever the exact course Europe and Japan pursue, though, demography will become a progressively more important influence on growth

Table 5: Total U.S. Immigration as a Percentage Share of Population*
(Decade Aggregations; in thousands)

	1900–09	1910–19	1920–29	1930–39	1940–49
Immigration (sum)	8 202.388	6 347.380	4 295.510	699.375	856.608
Population (avg)	83 111.900	99 143.800	114 564.100	126 996.200	140 209.200
Immigration/Population	9.869%	6.402%	3.749%	0.551%	0.611%
	1950–59	1960–69	1970–79	1980–85	
Immigration (sum)	2 499.268	3 213.749	4 232.325	3 395.045	
Population (avg)	164 744.200	192 498.900	215 025.900	233 586.000	
Immigration/Population	1.517%	1.669%	1.969%	1.453%	

* U.S. immigration rates are well below the levels of 1890–1920, but could escalate due to Latin America's economic mismanagement.

rates, tax burdens and capital movements during the final years of the 20th century.

The Risks of External Borrowing

While there are several structural reasons why the U.S. should remain a capital importer, the transformation now occurring in the American balance of payments will still provide a major challenge to economic policy makers both here and overseas.

First, U.S. financial markets will become increasingly vulnerable to interruptions of capital flows resulting from changes in foreign monetary policy or investor perceptions of the United States. On three occasions in the 19th century, there were large increases in U.S. interest rates because of crises in the British financial markets. Today, the U.S. financial markets are becoming equally sensitive to changes in Japanese monetary policy.

Unlike most developing countries, the U.S. enjoys the advantage of being able to borrow in its own currency. Whereas countries such as Mexico have to service their foreign loans in appreciating dollars, the U.S. could reduce its real debt servicing burden by devaluing the dollar. In fact, some analysts believe the U.S. should devalue the dollar simply to tax Japanese investors for the cost of defending their country. Such a strategy would be risky though because it could ultimately produce a large rise in the U.S. inflation rate and hence be costly for domestic investors, not just foreign ones. As in the 1970's, it would probably trigger panic selling of U.S. financial assets and eventually require an excessive amount of Federal Reserve tightening to restore confidence in American policy.

Although the U.S. Treasury has successfully talked the dollar down since 1985 without destabilizing domestic financial markets, it is important to remember that the large U.S. interest rate decline during 1985 and early 1986 produced capital gains in bond prices greater than the dollar's depreciation. If Japanese and other foreign investors cannot find some financial or real asset in the U.S. capable of generating capital gains in excess of probable currency losses, they will purchase dollar financial assets only if there is a large rise in U.S. interest rates or such a sharp correction in the exchange rate that the dollar itself becomes a good speculative buy. As a result of the country's need for external savings, both the U.S. Treasury and the Federal Reserve will have to be highly sensitive in the future to foreign perceptions of U.S. economic policy. Traditional capital importing countries, such as Australia or Canada, have always conducted policy with an eye on the currency markets, but it has usually required significant foreign exchange market instability to focus American attention on foreign perceptions of domestic policy.

The second constraint created by America's growing external debt will be a need for increased allocation of investment to tradeable goods industries. Historically, countries with large external debts have had to run trade surpluses in order to service their loans. Since the U.S. will probably have a net external deficit on investment income of $ 100–150 billion by the early 1990's, it also will have to move gradually towards trade surplus in order to prevent the total current account deficit from expanding exponentially. While there was a healthy rise in business capital spending during 1983–1985, the investment share of GNP is still far below its previous highs. The overvaluation of the dollar between 1981 and 1985 also appears to have encouraged an overconcentration of investment in non-tradeable sectors of the economy. As Figures 1–3 illustrate, investment in commercial real estate has risen to record levels as a share of GNP since 1982 while investment in manufacturing industry has increased by much less.

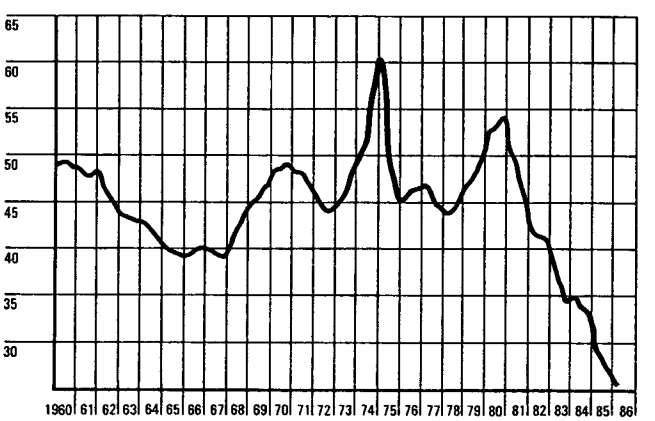

Figure 1: Nonfinancial Corporate Taxes as a Percentage of Nonfinancial Corporate Profits, with IVR and CCA adjustments; four quarter moving average. (U.S. policy also stimulated growth after 1981 by sharply reducing corporate taxation through improved depreciation allowances.)

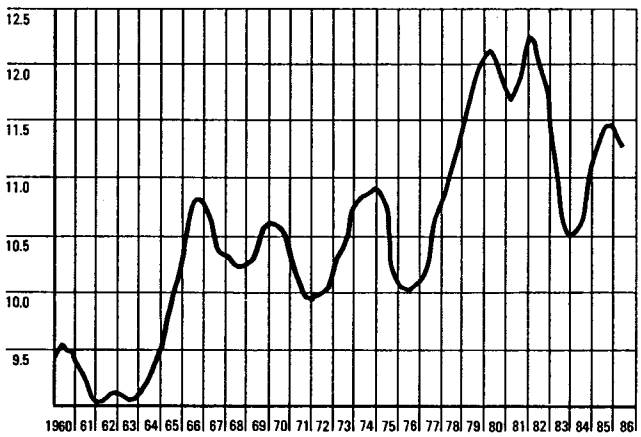

Figure 2: Business Fixed Investment as a Percentage of GNP; four quarter moving average. (There was a large rise in U.S. business fixed investment during the period 1982–1985, but it did not rise to new highs as a share of GNP despite the country's heavy external borrowing.)

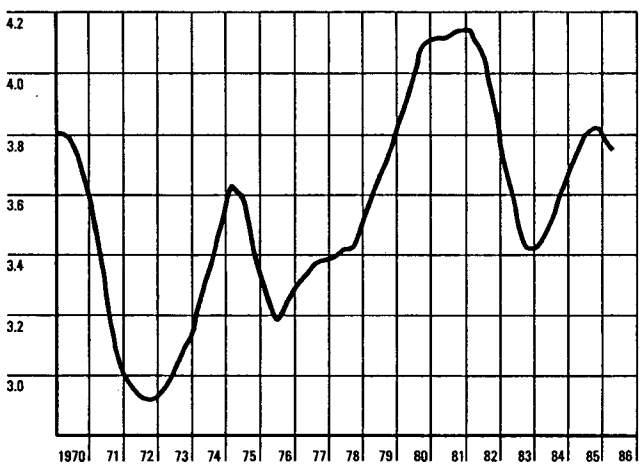

Figure 3: New P&E Expenditure by Business – Manufacturing as a Percentage of GNP; four quarter moving average. (The strong dollar also reduced capacity utilization rates in manufacturing and depressed capital investment.)

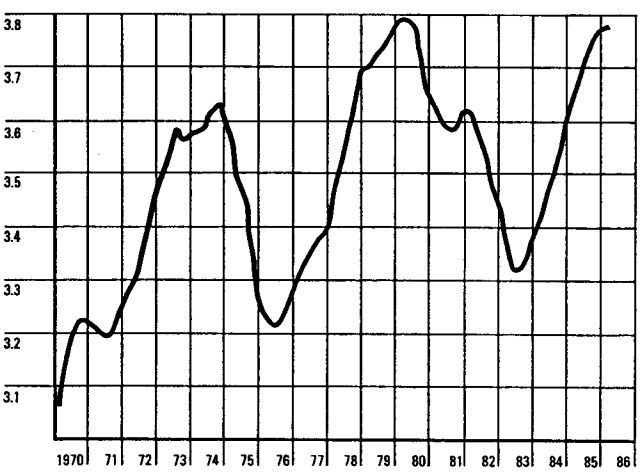

Figure 4: New P&E Expenditures by Business – Commercial and Other as a Percentage of GNP; four quarter moving average. (Investment in the commercial real estate sector rose to record levels as a share of GNP.)

Since rising import penetration and weak exports have depressed U.S. capacity utilization rates, it is not surprising that manufacturing investment has stagnated while commercial real estate has boomed as Figure 4 shows. In many ways, the American tax shelter industry evolved into the Republican equivalent of the W.P.A. during the early 1980's. But if the U.S. is to remain a capital importer on a long-term basis, there will eventually have to be a significant reallocation of resources to sectors producing tradeable goods and away from those catering to defense and domestic demand. Without such a shift, the country's external debt, interest payments, and trade deficit will grow far more rapidly than nominal income and ultimately produce a dollar free-fall in the currency markets.

How can the U.S. encourage a reallocation of resources to tradeable goods sectors? Several different policy adjustments will be necessary, and only some of them are domestic.

First, the U.S. will have to reduce the public sector's claims on domestic and foreign savings through some combination of spending cuts or tax increases, preferably on consumption. If the federal budget deficit remains at 5% of GNP, the country's domestic and external debt levels will continue to grow far more rapidly than investment. Such heavy borrowing will be easy for the financial markets to accommodate in an environment of sluggish growth, but it will leave the economy with a large debt servicing burden in the 1990's. This, in turn, will generate pressure for more rapid monetization of the federal deficit in order to restrain interest rates, accelerate the growth rate of nominal GNP and reduce the real value of government interest payments. By leaving the budget deficit at such high levels, the Reagan administration is also creating a risk that future Congresses may attempt to increase revenues by restoring high marginal tax rates without reinstituting the allowances which have traditionally been used to reduce effective tax rates. In contrast with the U.S., most other industrial countries which have enacted tax reform programs during the 1980's have funded them through higher consumption taxes.

Secondly, other industrial countries will have to shift from export to domestic led expansion in order to offset the growth retarding effects of U.S. fiscal restraint on the world economy. In 1985, the U.S. Treasury used G-5 summit con-

ferences to lobby for more stimulative growth policies among its major trading partners. So far, though, the summit process has produced only modest changes in foreign fiscal policy while the outlook for deficit reduction in the U.S. has been clouded by uncertainty about implementation of the Gramm-Rudman bill as well as the revenue effects of tax reform. As a result, the U.S. is increasingly using the threat of dollar devaluation to force competitive monetary convergence and lower interest rates upon Germany and Japan. This policy will help to sustain growth in the short-term but it also carries numerous risks.

The dollar could fall so sharply that U.S. long-term bond yields would rise instead of declining with short-term interest rates. By relying so heavily on monetary ease to offset rigidities in global fiscal policy, central banks also could inadvertently encourage speculative excesses in stock markets and residential real estate prices. In fact, the German and Japanese economies are poorly equipped to respond to monetary stimulus, alone. Because of depopulation, Germany is estimated to have nearly a million vacant houses or apartments. Japan, meanwhile, is only starting to modify the structural bottlenecks in its taxation and regulatory policies which discourage homebuilding, personal borrowing, and private consumption.

In addition to monetary relaxation, Japan needs to reduce the direct taxation of labor income, liberalize its allowances for investment and consumer borrowing and impose at least some tax on hitherto tax-exempt savings vehicles such as postal savings accounts. Tax rates on Japanese ordinary income are at high levels (over 70%) because the tax base itself is limited by the large exemptions for investment income. Tax reform and land reform could have a more dramatic impact on the Japanese economy than simple increases in public spending because they would probably alter the household sector's overall propensity to spend.

Germany has been hostile to American suggestions for more stimulative fiscal policy because it expects at least 3–4% real growth in domestic spending this year and has unpleasant memories of the U.S. push for synchronized global stimulus during the late 1970's. But Germany also could bolster its growth performance through structural reforms. Its marginal tax rates are among the highest in Europe while its labor market is one of the most rigid. In fact, most Germany analysts expect the country's unemployment rate to decline more through workforce shrinkage during the late 1980's than actual job creation.

The third component of any plan to revive U.S. manufacturing industry should be the creation of new programs for reviving capital flows to the developing countries. They were an important engine for world growth during the 1960's and 1970's, generating significant demand for U.S. capital goods exports. Since 1982, though, many developing countries have lost access to credit markets or even become net exporters of capital through debt servicing.

There will be no simple way to revive capital flows to countries suffering from economic mismanagement, depressed commodity prices and flight of domestic savings. At the September 1985 IMF meeting, Treasury Secretary James Baker took a useful first step towards helping them by proposing expanded lending facilities as a quid pro quo for microeconomic reforms. But since the U.S. is now a deficit country without any excess savings, what the international aid agencies really need is the Japanese equivalent of a Marshall Plan for Latin America and Southeast Asia. If possible, the U.S. should try to encourage the development of such a plan as a quid pro quo for its defense spending commitments in the Pacific and open access to the American market.

In addition to new lending facilities, greater efforts must be made to encourage more equity investment in the developing nations. Countries such as Canada and Australia have been large-scale capital importers for many decades but primarily in the form of equity rather than debt. As a result, their property income payments to foreign asset holders fluctuate with the profit generating capacity of their economies, not interest rates in New York and Tokyo.

In the first few decades after independence, many developing countries resisted equity investment because they perceived foreign ownership to be a threat to local sovereignty. But with the debt crisis limiting opportunities for bank lending, opposition to equity investment should now diminish. Given the increasing internationalization of Wall Street, some investment banking firms might also be able to develop new hybrid bond and equity instruments for developing countries, perhaps offering investors some

of the yield attractions of a junk bond (preferably linked to commodity prices) as well as warrants on local equity. The fact that U.S. retail investors purchased several billion dollars worth of Australian bonds during the first half of 1986 despite the chronic weakness of the currency suggests that the New York junk bond market would now be receptive to selective Latin American paper. Equity mutual funds also have been launched recently for Thailand, India, Korea and Taiwan.

Some commentators believe that reform of the exchange rate system will have to precede any further movement towards global convergence. In the long-term, they are probably correct because the exchange rate system has to provide clear price signals to governments and investors about savings imbalances and resource allocation. In the first half of the 1980's, the U.S. Treasury encouraged the dollar's depreciation in order to sell more debt externally without paying any attention to how the money was being invested within the American economy. Many developing countries are now using highly competitive exchange rate policies to build up trade surpluses without letting real incomes rise by enough to encourage more investment in domestic consumption sectors. After the turmoil of the past decade, American business clearly needs reassurance that the exchange rate system will not be allowed to crowd out U.S. production of tradeable goods on the same scale as it did in 1982–1985.

Under present circumstances, though, exchange rate management will probably have to be a complement to the process of global policy adjustment rather than a precondition for it. If the world moves too quickly to establish rigid exchange rate zones, the U.S. could end up importing deflationary policies from Germany and Japan rather than exporting reflationary policies. In fact, international economic adjustment during the 1920's was actually handicapped by Britain's attempt to reestablish a pre-war exchange rate parity which its economy could not sustain. The U.S. could suffer a similar fate if it attempts to peg the dollar at too high a level before correcting its domestic savings/investment imbalance and shrinking the current account deficit. As a result, exchange rate movements during the next several quarters are likely to remain levers for encouraging policy adjustment in Europe and Japan rather than final objectives in their own right. In fact, there are already a few signs that the U.S. and Japan may now start to synchronize their monetary policies in ways which could cause the German mark to rise sharply against both the yen and the dollar. This, in turn, should cause France and Italy to cut interest rates, devalue against the mark and generate more pressure within Germany itself for a new economic policy mix.

Conclusion

In many ways, the world economy is now confronted with a crisis of senility and adolescence in its balance of payments. The aging societies of Europe and Japan need to export capital. Many of the countries with young populations have lost the political and financial infrastructure for importing capital which existed during the colonial era or the special access to OPEC funds which occurred during the 1970's. Hence, by default, all of the world's surplus savings are flowing to a handful of middle aged Anglo-Saxon societies in North America and Australasia with large budget deficits, high consumption propensities and aggressive financial systems capable of manufacturing tradeable debt. As the buoyancy of American consumer confidence surveys will testify, the excessive concentration of surplus global liquidity in the U.S. economy has been highly beneficial for domestic living standards. But it also has created a global economic disequilibrium that is increasingly unsustainable. American manufacturing output has been stagnant for nearly two years, so U.S. business is lobbying aggressively for trade protection. If the U.S. continues to play the global Keynesian for several more quarters, American debt levels will reach such high levels that the Federal Reserve could ultimately be confronted with a liquidity trap in the domestic economy itself.

In geopolitical and historical terms, the magnitude of the changes now occurring in the global balance of payments are unprecedented since the 1920's. Consider, for example, the similarity between the problems created by the changing international roles of the U.S. and Britain during that period and the U.S. and Japan today.

In the half-century before the First World War, the British balance of payments had been the linchpin of the international economic system. As the dominant power, Britain had accumulated a large stock of external assets that generated a stream of investment income equal to nearly 8% of GNP. It used this income to run a trade deficit that allowed developing countries, such as the U.S. and Argentina, to earn export income for servicing their overseas loans. This equilibrium was shattered by the First World War, which forced the liquidation of so many British assets that the country's external investment income shrank to only 3–4% of GNP during the early 1920's.

As Britain's ability to export capital diminished, the U.S. became the world's major creditor power. Under the leadership of Benjamin Strong, the Federal Reserve pursued an expansionary monetary policy in order to encourage capital outflows and stimulate world growth. But while the U.S. was eager to assume Britain's role as a supplier of capital, it continued to adhere to its 19th-century tradition of protectionist trade policy. Moreover, despite active central bank policy co-ordination, U.S. monetary expansion alone could not overcome the international growth constraints resulting from war reparations, exchange-rate misalignment and trade restrictions. Instead, it generated U.S. stock market and real estate booms. While many of the historical circumstances are different, there are three important similarities between the current period and the 1920's.

First, if the U.S. trade deficit stabilizes at current levels as a share of GNP, the U.S. will experience a deterioration in its net external investment account comparable to that suffered by Britain as a consequence of the First World War. An external investment income surplus equal to 1–2% of GNP in the early 1980's will become a deficit equal to 2–3% of GNP during the first half of the 1990's. Since the U.S. is not borrowing solely to finance military expenditures, the deterioration in its capital account will not have as damaging an effect on the economy as wartime borrowing did on Britain's. But the rapid growth of the U.S.'s external debt will still erode the country's growth potential if there is not an offsetting rise in the level of investment and exports required to service it.

Second, as with the U.S. during the 1920's, Japan is now assuming the financial role of a great creditor nation without also assuming the trade role required to make the international system function properly. Japan is moving towards large surpluses on both external investment income and trade whereas creditor nations have traditionally run trade deficits.

Finally, as in the 1920's, other potential growth centers in the world economy are unable to pursue expansionary policies because of large external debt burdens or inability to import capital. In Latin America, today's debt overhang is actually larger in GNP terms than Germany's reparations burden after World War I. As a result, many developing countries have pushed their currencies to deeply undervalued levels on a purchasing power parity basis in order to generate trade surpluses for dept servicing and to encourage growth through exports rather than external borrowing.

Because of structural changes now occurring in global capital mobility, taxation and demography, there are good reasons why the U.S. should remain a capital importer but its external borrowing has to take place within a framework of more balanced domestic growth and more broadly based global expansion than has occurred so far. The fact that the U.S. is now borrowing externally sums equal to 3–4% of GNP compared to a previous high of 1.5% in the 1870's, when the U.S. truly was a developing country, suggests that the current global balance of payments equilibrium is unhealthy and unsustainable.

In the short-term, there has to be a co-ordinated fiscal stimulus in Europe and Japan, centering on structural tax reform to compensate for fiscal tightening and slower growth of domestic demand in the American economy. In the intermediate term, there has to be an acceleration of programs for reviving capital flows to the developing countries, including more participation in Wall Street's transnational securities boom and increased access to Japan's large saving surplus. In the long-term, the major industrial nations also must commit themselves to the establishment of exchange target zones which will encourage sustainable currency values, productive resource transfers between countries and trade based on comparative advantage.

It is often said that national self-interest will make it difficult, if not impossible, for the ma-

jor industrial nations to subordinate their domestic policies to larger international objectives. But the fact is global economic and financial integration have proceeded too far for governments to draw clear distinctions between internal and external objectives. As a large capital importer, the U.S. cannot define its exchange rate policy solely on the basis of commercial advantage; it also has to be sensitive to foreign investor confidence. As the world's largest capital exporter, Japan has to accept a wider range of international responsibilities than prevailed during her early years of industrialization. Germany, meanwhile, has a vested interest in encouraging a recovery of American exports because it will help to prevent the U.S. from massively devaluing European retirement savings during the 1990's.

As in the 1920's the industrial nations must either come to terms with the implications of the world's changing economic structure or risk destabilizing the international system. The U.S. is a debtor nation with the habits of a creditor nation. Germany and Japan are creditor nations with the habits of debtor nations. The dollar's reserve currency role has given the U.S. more flexibility in adjusting to its new debtor status than many smaller countries would have, but it will not eliminate the need for adjustment over time. Nor are the international implications of America's changing financial status strictly economic. It also could have great political and military consequences. Will the U.S., with an external dept exceeding 20% of GNP and a potentially weak currency, continue to accept responsibility for defending the free world? Might not the American people reduce military assistance to Europe and Japan if their investors start to dump dollar financial assets and force a large rise in American interest rates? These questions are far from new. In the late 1960's the U.S. threatened to withdraw troops from Germany if the Bundesbank joined the bank of France in swapping dollars for gold. But during the next decade, the vulnerability of the U.S. financial markets to a dollar crisis will be greater than at any other time in modern American history. As with the Sterling crises of the 1950's and 1960's, such pressures could erode America's capacity for global hegemony and leadership. In fact, historians may someday classify the Reagan administration as the last truly internationalist American government because it was prepared to sacrifice so many domestic manufacturing and commercial interests to the cause of global recovery, free trade and external borrowing for rearmament.

Unfortunately, most of the successful efforts at multilateral policy co-ordination during recent years have consisted of efforts to restrict trade flows through the creation of international cartels. If as much political effort could be directed at correcting the microeconomic rigidities in labor and taxation policies which distort capital flows, resource allocation, and employment practices, trade conflicts could be resolved through faster expansion of world demand and output, not further politicization of each country's market share.

For historical reasons, the two great Anglo-Saxon nations have inherited a variety of international responsibilities which are increasingly beyond their economic grasp while Germany and Japan have enjoyed economic success partly because their political roles were so severely curtailed after 1945. As late industrializers, Germany and Japan pursued expansionist policies during the early decades of the 20th century which had a devastating impact on both themselves and the world. Ironically, now that both countries have the economic means to play international roles on a scale commensurate with their former imperial ambitions, they have turned insular and parochial, frequently conducting economic policy from the perspective of provincial accountants rather than the great powers they have become. It is essential to future international economic relations that this gap between power and perception diminish.

Between 1982 and 1985, it was possible for the expansionary fiscal policies of 280 million English-speaking people in North America and Australasia to pull the world out of recession and sustain a moderate global economic expansion. But the international system now needs a new growth engine. The 300 million people in the surplus-savings societies of East Asia and Northern Europe must either spend more themselves or develop new mechanisms for lending their excess cash to some of the four billion people in the capital-deficient developing countries that have yet to share in this expansion. The U.S. cannot play the role of global borrower and spender of last resort indefinitely even if it remains a moderate capital importer through the final years of the 20th century.

Appendix

There is a strong disagreement among U.S. economists about whether the Reagan budget program was the most optimum way to pull the world economy out of recession during the early 1980's. Critics such as Dr. Martin Feldstein or Mr. David Stockman would emphasize the damage done to American manufacturing industry by large external borrowing and the opportunities for growth which would have resulted from lower interest rates and a less overvalued dollar exchange rate. Supporters of the Reagan policy argue that high real interest rates, the overvalued dollar, and the U.S. trade deficit resulted solely from monetary policy and that the Reagan program was a boon to both the U.S. and world economy.

Since it is impossible to isolate one component of policy its secondary effects on other aspects of policy, not to mention other countries, there is no way of conclusively demonstrating that the economy would have behaved much better or much worse in the short-term under a policy mix different from Reagan's. A smaller budget deficit probably would have produced less extreme changes in the level of real interest rates, the dollar, and the trade deficit, but there were sufficient elements of a liquidity trap present in the global economy during the early 1980's to suggest that the Reagan administration's expansionary fiscal policy was, on balance, a positive force for recovery.

First, the world was in transition to sharply lower inflation during the early 1980's: as in previous periods of price adjustment, nominal interest rates would have lagged behind changes in economic fundamentals with or without large budget deficits. Secondly, many central banks were using money supply growth targets as policy anchors during the first half of the 1980's despite the fact that disinflation and falling interest rates had altered the stability of the money demand relationship which were the original justification for such targets. Since money velocity fell by far more than economists expected as a consequence of disinflation and deregulation, these targets gave a restrictive to monetary policy which would have made it difficult to stimulate world recovery without an expansionary fiscal policy. Thirdly, the economies of Japan, Germany and some other European countries do not appear to be as responsive to interest rate stimulus as the U.S. economy. Their consumer lending sectors are less developed; their demand for new homes and consumer durables is now constrained by static or shrinking populations; their business sectors would have had ample unused capacity in 1982–1984 and hence little incentive to invest without a large rise in exports to the U.S.

In the case of the developing countries, meanwhile, it is doubtful that the money center banks would have extended additional credit to Mexico, Argentina and many other third world countries after 1982 even if U.S. interest rates had fallen more quickly than they did. A different U.S. policy mix would have reduced the debt servicing burden created by high interest rates. But smaller budget deficits also would have weakened U.S. consumer demand and most models suggest that Latin America's balance of payments is more responsive to changes in American growth rates than to changes in the level of interest rates.

As is often the case in economic debates, both critics and supporters of Reaganomics have used too many simplistic generalizations and homilies in evaluating the program's effects. In 1982–1984, critics exaggerated the short-term risks posed by large budget deficits when the U.S. was literally the world economy's borrower and spender of last resort. Conversely, because of the country's easy access to foreign savings, supporters of the President's policy have underestimated the long-term dangers poised by large government deficits. If the Reagan program had been introduced during the early 1970's, when the world economy was much stronger, the U.S. would have found it more difficult to import capital and hence the Federal Reserve would have probably have had to monetize more of the government's borrowing in order to stabilize interest rates. But because the Reagan program co-incided with the most severe world economic slump in half a century, it was possible for the U.S. to run a high deficit policy during the first half of the 1980's without major inflation risks.

Critics would argue that President Reagan has been incredibly lucky, but such a judgement is too harsh. Some of the original architects of the Reagan program, such as Dr. Robert Mundell, predicted as long ago as the mid-1970's that the U.S. could become a capital importer with the right policy mix while mainstream economists argued that savings in the world economy were insufficiently mobile to permit large capital flows between industrial countries. The Reagan administration's luck was that its unorthodox policies co-incided with a number of cyclical upheavals and structural changes in the world economy which facilitated heavy external borrowing by the U.S. But while large American budget deficits were tolerable in the unusual global policy environment of the early 1980's, they will not be acceptable to the financial markets indefinitely. The challenge now is to encourage a gradual movement towards convergence in global fiscal policy, lower interest rates throughout the industrial world, and a sectoral rotation in the leadership of the U.S. economy from domestic consumption to tradeable goods manufacturing.