The United States as an Indebted Empire

By Desmond Lachman

This article first appeared in TechCentralStation.com on February 4th, 2005. Many thanks to Desmond Lachman and Nick Schultz, Editor at TechCentralStation.com, for permission to reprint.

One has to be amazed at the complacency of US policymakers about the geo-political dimension of the large US balance of payments deficit. For so long as a large external deficit persists, foreign central banks will continue accumulating massive financial claims on the United States, which they could potentially use to express their displeasure about US policy abroad. The growing financial leverage that the US is presently conceding to its potential adversaries would seem to be reason enough for the US Administration to take the US balance of payments problem very much more seriously than it presently does.

In his excellent book, *The Colossus*, Niall Ferguson draws attention to the dramatic contrast between the United States' external finances today and those of the European empires, which preceded it. In that context, he reminds us that in the heyday of the European empires, the dominant economic power was supposed to be a creditor nation, investing a large proportion of its own savings in the development of its colonies. As a vivid example of a country that used capital exports as the basis of its dominant economic position, he cites England, which at the height of its economic power between 1870 and 1914 ran current account surpluses averaging 5 percent of GDP a year.

The present sorry state of the United States external finances could not be further removed from those of the earlier European powers. As a result of consistent external deficits since 1982, the United States has moved from a position of being the world's largest creditor nation, with net external assets equivalent to almost 15 percent of GDP in 1982, to being the world's largest debtor nation, with net external liabilities equivalent to 30 percent of GDP by 2004. More disturbing still is the fact that the US net external debt is on a path to exceed over 100 percent of GDP within the next twenty years should the US fail to rein in its presently large external deficit.

An aspect of the growing US external indebtedness that cannot be over-emphasized is the proportion of that indebtedness that is owed to foreign central banks. According to Bank for International Settlement data, over the past five years alone, foreign central bank financial claims on the US have more than doubled to their present level of around US$2,500 billion. The prospects are all too real that US financial indebtedness to foreign central banks will only increase in the years ahead, given that foreign central banks are now financing almost half of the US$650 billion US external current account deficit.

The United States' excessive reliance on foreign central banks must raise the real risk that the dollar's decline could become disorderly, with untoward consequences for US financial markets. Last week, the *Financial Times* published findings of a recent comprehensive survey of foreign central bank portfolio managers, which revealed growing discomfort on their part about their central banks' massive dollar reserve holdings. These managers feared that their central banks would suffer large financial losses on these holdings were the US to fail to soon address the underlying causes of the US external deficit. Accordingly, they had already begun shifting their banks' international reserve holdings out of dollars into euros and they expected to continue doing so in the period ahead.

Beyond the economic considerations that might motivate central bank dollar sales, one would think that the US Administration would be equally concerned about the potential for politically motivated such sales. As Barry Eichengreen, the noted economic historian, reminds us, it is not so long ago that General Charles De Gaulle used France's large dollar holdings in the early 1970s to express displeasure about the US handling of the Vietnam War. By unloading France's dollar holdings, he pulled the plug on the erstwhile Bretton Woods fixed exchange rate system, whose collapse shook global financial markets.

The question that now needs to be addressed is whether the foreign central banks' massive dollar reserve holdings might not place the US in an untenably vulnerable economic position. Might for instance China not be tempted some day to unload its vast dollar holdings to express its displeasure over US policy concerning the Straits of Taiwan? Or might not the OPEC countries be tempted to use their large dollar holdings to register their disagreement over US policy in the Middle East? These considerations would make one think that the days are long since gone that the US external finances can afford to be treated with the same benign neglect that they have been treated over the past four years.

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