

# The Way We Live Now

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John Maynard Keynes, in the preface to his 1936 theory of employment, faulted 1930s thinking for "a lack of clearness and of generality." Never mind that Keynes's own theory was not wholly clear or general. What is odd is that prevailing ideas today about the dollar and the U.S. trade balance are also unclear and too narrow.

One of these ideas is that a major weakening of a country's currency, such as the U.S. dollar experienced over the past three years, is a sign of economic illness -- a deterioration of some economic institution or a wrong turn in some economic policy. Although that weakening may bring some benefits, as going into shock may benefit an injured person, it is seen as a call for reforming the economy or retrenching on social policies burdening the economy.

## Euro and Yen

For trained economists this is a murky idea. They would ask whether, if currency strength means a sound economy, the regained strength of the euro and yen means that reforms in the eurozone and Japan can safely be called off. Maybe dollar weakness is the market's recognition that those regions are debating how to revitalize their economies.

Economists might also ask why, if dollar weakness reflects an unsound U.S. economy, the dollar was very weak in 1995-96, then very strong until 2002. It was the same old economy: U.S. economic institutions and policies -- and those of Europe too -- changed little over that span. ("There is," as Adam Smith put it, "much ruin in a nation.") They would ask why, if the U.S. economy has become unsound, the dollar in real terms -- the real exchange rate, which factors in relative price levels at home and abroad -- is now only as weak against the euro as it was back in 1995-96 and stronger than it was back then against the yen. The real exchange rate between the dollar and the euro looks to be more a reflection of the U.S. unemployment rate relative to the eurozone's than anything else. Exchange markets are not very imaginative nor very forward-looking.

Another idea, one to which some economists subscribe, is that the currency shifts of late are a manifestation of another problem. The U.S. trade deficit -- and the broader deficit in the U.S. current account -- has grown worse, much worse, since the mid-1990s, to the point where something major has to happen to put the deficit on a sustainable path. A decreased supply of saving in the U.S. and depressed investment demand in continental Europe are seen as the causes. When the deficit is so inflated and not coming down, the dollar must be weak enough to persuade foreigners that U.S. exports will be sufficient to repay the mounting foreign loans and investments. At this point, though, there is a division of opinion.

Those pessimistic about the powers of the market hold that changes in economic policies or institutions are crucial to getting the current account deficit and exchange rate reliably

and promptly onto a sustainable path. Any real solution to the "imbalance" requires interventions to boost the supply of saving in the U.S. or to boost investment demand in the rest of the world, if not decreased saving abroad or decreased investment here. The tail is to wag the dog: Instead of relying on markets to work out an accommodation to what citizens through their national governments want to do, governments are to intervene in order to erase the problem that markets cannot handle.

Those with greater confidence in markets believe we can expect a further dollar depreciation that will be of sufficient magnitude to put the deficit on a downward path to some sustained level. One might ask these optimists why the dollar doesn't drop like a stone to so weak a level that the current account deficit is quickly put on a path of gradual reduction. The answer given is that the dollar has weakened each year since 2001. Each year the weakening was expected to be enough to put the deficit on a declining path, yet each year one thing or another happened to derail the deficit from turning the corner -- from another U.S. tax cut to another year without real recovery in Japan and the Continent. As a result the dollar has gone on falling. The dollar will go on inching its way down, optimists believe, till it appears the economy has reached the equilibrium path of falling deficit -- or a path that can pass for it. (Some optimists see the deficit having to fall only to 2% to 3% of GDP -- not far from today's 5%.)

Like most readers, I suspect, I am more in tune with the optimists than with the pessimists. Some of my own research recognizes deep advantages in capitalism, a market system driven by entrepreneurs and financiers leaping into the unknown. But a market's thinking can be too narrow. Sometimes another model would help the market to come closer to an equilibrium path. I have in mind a quite different model of the dollar's weakening and subsequently recovering -- a model centered around market forces, particularly demographic forces, which gives at most a secondary role to fiscal policy, institutional decay and moral rot.

This model revolves around the epochal event hanging over the present situation: the explosion over the next few decades of Medicare and Social Security outlays for the baby boom generation. The key point is simple: In any surprise-free scenario, or equilibrium path, the expectation of this future fiscal burden causes the U.S. current account to go into surplus -- a surge of exports and import cutbacks -- until the period when the baby boomers' are exercising their huge medical and pension claims, during which the current account jumps into deficit. The logic is that the nation will do outsized saving in the early years to make room for the huge bulge of Medicare and OASDI (Old Age Survivor and Disability Insurance) claims that lie ahead; and since the global capital market is not going to place anything like the whole of that extra saving in U.S. capital, a large part of it must go overseas -- in extra exports the income from which is invested abroad. The horde of overseas assets is gradually sold off as the boomers are exercising their claims. (Maybe those surpluses would run 1% to 2% of GDP.)

Correspondingly, the dollar will be far weaker in this scenario than that imagined by the optimists. It must weaken enough to shift the current account balance from today's deficit not just toward a sustainable deficit level but to the needed surplus.

Such a scenario is a case of what economists call intertemporal general equilibrium. The equilibrium path of the trade deficit is tied up with equilibrium in general. Consumers are in equilibrium, thus they base their spending on correct expectations about their true wealth position. People know how heavy their taxes will have to be for the state to cover the unfunded part of the future entitlement spending; and, to the extent taxes are not increased, how much their benefits will have to be trimmed accordingly.

The theoretical existence of an intertemporal equilibrium is one thing, its attainment another. Markets, as I argued in a 1965 book, need some prompting to get right their expectations of future taxes -- clues such as high present taxes. At the present time households are badly under-predicting their future tax liabilities -- or, if the U.S. government is going to cut entitlements -- over-predicting their future benefits. Either way, they are spending too much, so the current account cannot get out of deficit. Once households are better informed their spending and the dollar will both drop. (Yet budget and tax policy has to follow through.)

### **Reduced Consumption**

The optimists' calculations are directed at a "partial" equilibrium in the foreign exchange market that abstracts from a consumer spending spree that is inconsistent with the huge burdens looming in the future -- a tax increase or a benefit haircut or both. The trade deficit cannot improve much nor will the dollar weaken much more as long as household spending remains in disequilibrium.

Once expectations are closer to reality -- once households expect a tax increase or a benefit haircut or both -- we will see significantly reduced consumption, thus lower imports, more output left for export, and a much weaker dollar. That is too bad. But the longer we wait to get back to reality the worse it will be. In denying the need for tax hikes or benefit trims, the government is staving off a further decline of the dollar at the price of requiring a greater decline later, once people catch on. For the excessive accumulation of foreign debt now will require a greater cutback of consumer spending in the future than what would have been required had expectations been correct all along.

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