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Could the twin deficits jeopardize US hegemony?

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Abstract

The American twin deficits are back. One obvious cost is a possible hard landing. A less obvious possibility is that imperial overstretch could eventually cost the US its global hegemony. This paper addresses many challenges to the twin deficits view that have been offered: the Starve the Beast rationale for the budget deficit, the straw-man question of whether the budget and current account deficits are always twins, the wishful thinking that the US has an investment boom, the correct point that private saving is low as well as public saving, the claim of a global savings glut, the observation that global financial markets are big, the hope that valuation effects or unmeasured services as world banker will allow Americans to continue the exorbitant privilege of consuming at others' expense indefinitely, and the proposition that China will happily buy dollars indefinitely. When all novel viewpoints are considered, one is still left with the reality of an unsustainable path of high budget deficits, low national saving, and high current account deficits.
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1. Introduction

I have several major points to make in this paper, as follows:

I. The twin deficits are back.
II. While many economists have come up with ingenious counter-arguments, the twin deficits that confront us now and in the future are indeed a serious source of concern, for at least three sorts of reasons:

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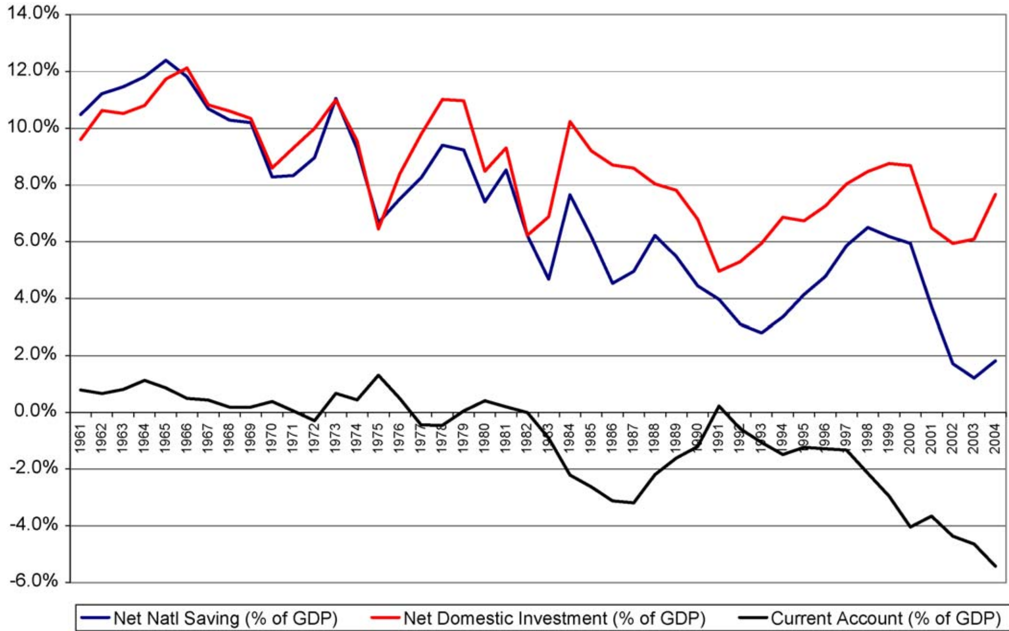

Fig. 1. National savings, investment and current account, as a share of GDP.

a. Economic costs in the short and medium run.
b. Possible loss of US global economic hegemony, and
c. Possible implications for loss of US global political hegemony.

2. The twin deficits are indeed back

The recent trend in the US current account deficit – now over 6% of GDP – is not sustainable. But the origins are in macroeconomics, not in trade policy. The increase in the current account deficit since 2000 has been associated with a fall in US National Saving (Fig. 1), which in turn has been associated with rising federal budget deficits (as well as low private saving). This level of deficits will continue, despite promises to the contrary. Thus we are experiencing a repeat of the twin deficits of the 1980s.[1]

The parallels between the two decades are numerous. In both cases, the federal leadership launched permanent tax cuts, with little simultaneous discipline on the rate of growth of government spending (including – but not limited to – spending that goes under the name "national security," some of which is pork). In both cases the result was record budget deficits (Fig. 2). The parallels also include shifting rationales for the tax cuts. Within each of the two decades, at first, the administration in large part based the case for tax cuts on the Lafferite claim that there they would increase corresponding tax receipts; then, when large deficits materialized, the same administration shifted to the Starve the Beast rationale, arguing that budget deficits would put

[1] Frankel, "Twin Deficits and Twin Decades," conference sponsored by the Federal Reserve Bank of Boston, at Wequasett, June 14–16, 2004. In The Macroeconomics of Fiscal Policy (MIT Press: Cambridge MA).

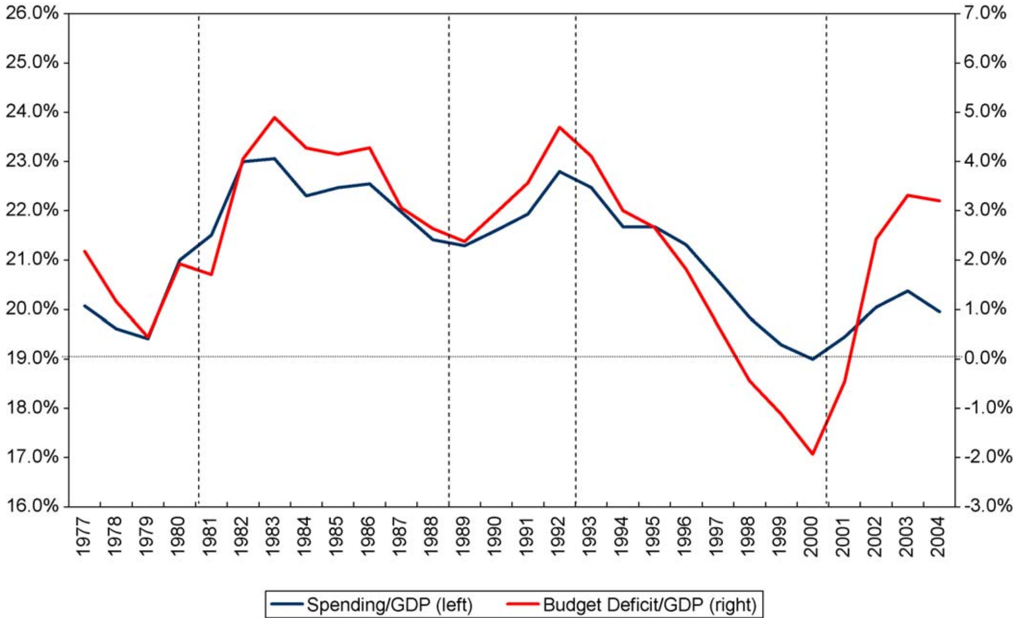

Fig. 2. US federal budget deficit and spending as % of GDP.

downward pressure on government spending more effectively than the alternative. (The alternative seems to me to be the regime that was in place during the 1990s, with its spending caps and Pay As You Go restrictions on tax cuts.) The two rationales are contradictory: if cutting tax rates would stimulate tax receipts, as the Lafferites claim, then the Starve the Beast reasoning would predict government spending to go up, not down! But, in any case, neither the Lafferite claim nor the Starve the Beast hypothesis is true. The history (illustrated in Fig. 2) shows that the Starve the Beast claim does not describe actual spending behavior. Spending as a share of GDP tends to be cut under a budgetary discipline regime of "shared sacrifice" that simultaneously raises tax revenue (the regime in effect during the 1990s); spending is not cut under a Starve the Beast regime that cuts taxes (as was done in the 1980s and the current decade).

3. While many of the counter-arguments that some economists have come up with are ingenious, the twin deficits, and particularly the low US rate of national saving should indeed be a source for concern

The debate over whether the US is suffering from a twin deficits problem, for which the cost will ultimately be high, is surprisingly lively. "Lively" because the variety of alternative views, and the pedigrees of their authors, make it difficult to claim as clear a consensus among mainstream economists as one would have thought.

There are at least seven alternative views that challenge the twin deficits worry:

1. The siblings are not twins
2. Purported i Investment boom
3. Low US private savings

4. Global savings glut
5. It's a big world
6. Revaluation effects will pay for deficits
7. China's development strategy entails accumulating unlimited dollars

1. One sometimes hears that the "*twin deficits*" view is wrong, because the budget and current account deficits do not move in lockstep and sometimes even move in opposite directions.[2] This is a straw man. Use of the term "twin deficits" does not mean that current account deficits and budget deficits *always* move together. Nobody pretends that they do, unless to set up a straw man in order to be able to knock it down. (If anyone can find any quote anywhere from anyone saying the two always move together, I would like to see it.) Not all siblings are twins. The current account balance and budget balance would not move in the same direction if there was a big exogenous increase in investment.
2. *Investment booms* are generally better than booms led by expansionary monetary or fiscal policy. This is especially true if they are generated by technological innovation or good free-market reforms. The US experienced an investment boom in the 1990s, particularly in the areas of information and communications technology and other business capital goods. The result was a rising current account deficit even while the budget deficit was completely eliminated. But, wishful thinking aside, this does not describe the current decade (unless perhaps you count the "housing bubble") any more than it described the 1980s, two decades in which the budget deficit and low private saving have indeed led the current account deficit.

   In some ways, the current bout of fiscal irresponsibility is worse than the 1980s, the last time that massive wishful thinking of this sort was applied to record current account deficits. First, the retirement of the baby boom generation is that much closer than it was in 1981. Secondly, the national debt is that much higher. Thirdly, we now have other new fiscal time bombs as well, such as phony sun-setting of tax cuts, the need to fix the Alternative Minimum Tax (AMT), and the greatly exacerbated Medicare shortfall. Fourthly, the current administration seems to lack the ability – which the Reagan Administration and elder Bush did have – to perceive when reality diverges from the speechwriters' script and to respond by making a mid-course correction. To the contrary, the White House continues to propose and put into effect still more tax cuts. That Japan and Europe have debt and demographic problems at least as bad as ours is of some reassurance. But it only reinforces the prediction that the trend for world interest rates from here on out is likely to be upward.
3. The fall in *US private saving* has been as important a contributor to the fall in national saving, and thereby the crowding out of net exports as has been the increase in the budget deficit. This is true, and I would be happy to redefine the first of the twin deficits as a shortfall in domestic saving, whether public or private. But recall that the Bush tax cuts were supposedly designed to be pro-saving (the abolition of the estate tax, the near-abolition of taxes on dividends and capital gains, etc.). That was the excuse for their regressivity. If the private saving rate has not subsequently risen, then this is merely a further indictment of our current fiscal policy. Precisely the same characterization applies to the Reagan tax cuts of 1981, which were supposed to boost saving but were instead followed by the beginning of the big decline in US private saving rates.

[2] Bernanke (2005) is one of many people making this obvious point.

4. *Global savings glut*: Ben Bernanke, followed by others, has said that the problem is a global savings glut, not a US saving shortfall.[3] They are correct that the forces determining the foreign net lending to the US is determined by conditions among the foreign lenders as much as in the US. But "savings glut" is a slightly misleading word. Global savings and investment are not up. Rather, global investment is down.[4] There is of course much that China and other countries should do in terms of macroeconomic policy and, especially, structural reform, to improve their economies. But the US is in no position to lecture on this score. The temptation to blame others for our trade deficit is political. Even in the Clinton years, when the US fiscal and economic position was very strong, sending delegations abroad to lecture others about the superiority of the US model did not go over very well. Now we have no standing at all. It is our responsibility to get our own house in order first. If anything, we need delegations from Chile, Estonia and Slovakia to tell us how to run our economies, delegations from Argentina, Brazil and Korea to tell us how to bounce back from overindebtedness, delegations from Mexico and Chile to tell us how to develop reliable electoral institutions, and delegations from Northern Europe to tell us how to be good global citizens and abide by international commitments, etc.
5. *It's a big world*

   Richard Cooper[5] and others have pointed out that world financial markets are very large, relative even to the trillions of dollars of US debt. We cannot be sure that foreign investors will not be willing to bail us out for years to come, even decades. After all, some have been warning about a hard landing since the early 1980s. Simple calculations show that if foreign investors keep moving, even slowly, in the direction of fully diversified international portfolios that optimal diversification theory suggests (and thus away from "home country bias" in their investments), they can absorb US current account deficits for a very long time. This is true. But it is unlikely that the portfolio shares of investors everywhere will eventually fully converge (nor does theory say there should be no home bias). Furthermore, when it comes to default risk or country risk, GDP or exports are more relevant denominators for the debt than the size of the global portfolio.[6] Currently debt dynamics calculations suggest that US Debt/GDP and Debt/Export ratios are on unsustainable or explosive paths. Putting a date on the day of reckoning is impossible. But it will come.
6. *Valuation effects* will pay for it. A number of authors have recently rediscovered implications of the once-surprising fact that, despite years of US current account deficits, the net international investment income account remains in surplus. One explanation is well-known: the US earns a higher rate of return on its assets abroad (especially FDI) than it pays on its obligations

[3] "The Global Saving Glut and the US Current Account Deficit," Remarks by Governor Ben S. Bernanke, Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, March 10, 2005.

[4] By 2004, the saving/GDP ratio outside the US had climbed to a level that was a bit above that of the 1990s (while still below the 1980s). Investment, however, is still way down. This pattern is not consistent with the hypothesis that the exogenous change is an increase in saving abroad, because some of that should show up as an increase in investment. It is consistent, rather, with the hypothesis that the US shortfall is sucking in capital from the rest of the world.

[5] "Living with Global Imbalances: A Contrarian View," Policy Briefs in International Economics, no. PB05-3, Institute for International Economics, November 2005.

[6] Actually, exports are a more relevant denominator than GDP, an unfortunate point in light of our low export/GDP ratio. See Maurice Obstfeld and Ken Rogoff "Global Current Account Imbalances and Exchange Rate Adjustments," in William Brainard and George Perry (Eds.), *Brookings Papers on Economic Activity*, 1:67–146, 2005; and "Perspectives on OECD Capital Market Integration: Implications for US Current Account Adjustment," In Federal Reserve Bank of Kansas City *Global Economic Integration*: *Opportunities and Challenges*, March 2001, pp. 169–208. Or Cavallo and Frankel (2005): "Does Openness to Trade Make Countries More Vulnerable to Sudden Stops, or Less? Using Gravity to Establish Causality" NBER Working Paper No. 10957, revised, December 2005.

(especially treasury bills). Another is that in many years the US has experienced substantial capital gains due to appreciation of foreign currencies against the dollar, or appreciation of FDI and equity held abroad when expressed in terms of local currencies.[7] An under-recognized factor is that, statistically, most of these gains do not register in the year in which they occur, but rather appear magically later when the accounts are revised (e.g., at five-year benchmarks). This explains the puzzle why the US was reported to pass from net creditor to net debtor at least three times over the last two decades, and has also been reported to pass from a positive to negative investment balance several times.

For present purposes, the main point is that these arguments all rely on what the French in the 1960s called the "exorbitant privilege" in which the rest of the world gives up real goods and companies in exchange for pieces of paper (dollars). They rely on the assumption that the dollar will continue to be the premier international reserve currency held by central banks, and more generally that the US will continue to play the role of "world banker" – issuing short-term liabilities and investing long – and that it will continue to be the destination of "flights to quality" when there are crises in the Mideast or emerging markets. This has been true since World War II, but one can no longer assume that it will necessarily always be true. More on this below.

7. The *development strategy of China* and other developing countries entails accumulating unlimited dollars.

A diagnosis of the current global monetary situation by Dooley, Folkerts-Landau, and Garber, which is by now well-known, takes as its starting point that today's system is a new Bretton Woods, with East Asia playing the role that Europe played in the 1960s. I think that much is right. Their ideas have been provocative and ingenious: China is piling up dollars not because of myopic mercantilism, but because it is part of an export-led development strategy that is rational given China's need to import workable systems of finance and corporate governance. However, it is not in my view a sustainable situation. It may be a Bretton Woods system, but we are closer to 1971 (the date of the collapse) than to 1944 (the date of the agreement) or 1958 (when convertibility was first restored). Perhaps we are at 1967, in that the Administration has still not seen the need to pay for its rapidly increasing defense and domestic spending, and is thereby accelerating the deterioration of the balance of payments.

Why do I believe we are closer to the end than the beginning? Firstly, capital mobility is much higher now than in the 1960s. Secondly, the United States can no longer necessarily rely on the support of foreign central banks for reasons I will elaborate on momentarily. Third, on the China side, eventually it will have to develop a workable system of finance and corporate governance system domestically, or else suffer a domestic financial crisis, probably centered on the banking system. The latter is perhaps the more likely of the two outcomes, but either way it means an end to the excess liquidity pouring from China to the US.

4. Economic costs in the short and medium run

Of course in the long run, the cost of a low rate of national saving regardless what form it takes, is that (i) we are borrowing from the future and will eventually have to pay it back, and (ii)

[7] E.g., Lane and Milesi-Feretti (who compute valuation effects), Gourinchas and Rey (who speak of the US as a global "venture capitalist"), Hausmann and Sturzenegger (who speak of "dark matter"), and Cline (who argues that the US, though a net international debtor in an accounting sense, is an *economic* net creditor). Many of these authors provide useful perspectives and calculations. I am only taking exception to the extent their bottom line could be interpreted as "there is nothing to worry about."

it slows growth. This is true regardless to what extent the cause of the low national saving is a large budget deficit or low private saving. It is also true regardless whether it shows up in a large current account deficit or low investment. But that sort of day of reckoning could be many years off. What are the possible shorter-term costs?

In the medium term one cost is the danger of protectionism.

Another is the long-feared "hard landing" in which global investors lose interest in the path of ever-rising holdings of US assets, with the result that the dollar plunges, US interest rates rise, and securities markets fall. The dollar depreciated considerably from 2002 to 2004. Admittedly, this trend temporarily reversed in 2005, and the US has had to pay little or no price for its profligacy, so far. For example, long-term interest rates remained surprisingly low in 2005. I predict that this will change before long, however. I would guess by 2008 at the latest. This is the year when the first baby-boomers will begin retiring, and the failure of White House claims regarding the downward path of future deficits will be clear.

By means of what policy prescriptions should current account adjustment be accomplished? The "dollar depreciation" versus "budget cutting" choice is a sterile debate. Both policy shifts can affect the trade balance. As in the late 1980s, the desirable approach is a credible long-run path of deficit reduction *together* with depreciation. But the current official path of deficit reduction (i.e., in half by 2009 and to zero by 2012) is not in fact credible. What about the question of the "second best" policy? If we take the budget deficit as given, perhaps some dollar depreciation is desirable—e.g. what has already happened over the last three years, which will eventually show up in the trade balance. But the benefits are limited. Interest rates will rise. The rise may come through higher inflation. But the pass-through coefficient has fallen, so currency depreciation does not translate into inflation as much as in the past. So the effect will probably come in large part through higher real interest rates. Budget deficits mean that some sector of the economy will be crowded out. Higher interest rates will transfer some of the burden of crowding out, which would otherwise have fallen entirely on the dollar-sensitive sectors (net exports), to interest-rate-sensitive sectors (domestic demand). The housing sector will probably be the first to go.

It is unlikely that policy coordination will help manage the adjustment process. None of the coordination precedents fits particularly well. The European quid pro quo that is familiar from the Bonn Summit of 1978 and other occasions – fiscal expansion – would not be appropriate this time around. Furthermore, the Plaza Agreement of 1985 is a less promising precedent than many seem to think, because the dollar is not now, as it was then, stronger than can be justified by fundamentals. A potential package today would include Asian central banks *together* agreeing to let their currencies appreciate (each one being reluctant to do so on its own), and perhaps also the Europeans agreeing to stand by to rescue the dollar in case it goes into freefall, as was stipulated under the Louvre Agreement. But the United States is unlikely in any case to exercise the requisite leadership, and particularly unlikely to cut its budget deficit. Without the relevant "quo," why bother discussing the "quid"?

It is not clear when the dollar (and bond market) will complete their descent. In 2005 we saw a temporary reversal in the trend, a la Mundell-Fleming, as the Fed withdrew the substantial monetary ease of 2002–2004.[8] I believe that the American bond market may be more vulnerable to an abrupt decline in the coming years than is the dollar. During 2001–2004, the bond market

[8] This is not ex post reasoning on my part, e.g., "There are, to be sure, a number of important differences between the pattern of the 1980s and the current decade. Interest rates have been low (nominal and real) during 2001–2004, and the dollar began to depreciate in 2003—just the opposite of the Mundell-Fleming prediction and the experience of the 1980–1984. But this is not surprising: the Federal Reserve lowered interest rates aggressively in 2001, just the opposite

was buoyed by three factors, each of which has virtually come to an end: easy monetary policy (purchases of US securities by the Fed), the purchase of US securities by Asian central banks and the fact that investors may still be putting some weight on official government projections of declining future deficits. Investors have yet to internalize fully the dismal outlook in more objective forecasts. When these three factors come to an end, long-term interest rates should rise from their levels near 4% at the time of writing, to above 6% (=approximately $2\frac{1}{2}$% inflation + 2% real short-term rate + 1% normal term premium + 1% extra term premium for an expected path of rising debt/GDP). That is not even counting the possible unforeseen factors such as new instability coming from the Middle East or new oil price increases. It seems to me that a future crash is more likely to come in the bond market, because it is so clearly out of line today, than in the currency market, equity market, commodity markets, emerging markets, or even real estate markets. But all are vulnerable.

5. Possible loss of US economic hegemony

I claimed a moment ago that the US can no longer necessarily rely on the support of foreign central banks. One reason for this, which holds even if China continues to keep its currency undervalued[9] in order to enjoy export competitiveness, is that it can diversify its currency basket out of dollars, without allowing an appreciation on a trade-weighted basis. (Indeed this is the change that it officially announced in July 2005, but has not yet actually been implemented.) The important point is that there now exists a credible rival for lead international reserve currency, the euro, which has many of the desirable characteristics of an international currency. This was not true in the late 1970s and early 1990s when the press feverishly speculated that the dollar might be overtaken by the yen or mark. It is true that each Asian central bank stands to lose considerably, in the value of its current holdings, if dollar sales precipitate a dollar crash. But I agree with Barry Eichengreen that each individual participant will realize that it stands to lose more if it holds pat than if it joins the run, when it comes to that.

If we are relying on the economic interests of other countries, we cannot count on being bailed out indefinitely. In a recent paper, Menzie Chinn and I econometrically estimate determinants of reserve currency status (size of home economy, size of its financial markets, inflation rates, exchange rate volatility, trend depreciation, lagged adjustment, and a tipping phenomenon), and conclude that, under certain scenarios, the euro could surpass the dollar as leading international reserve currency by 2022. If this happened, the cost to the US would probably extend beyond the simple loss of seignorage narrowly defined. We would lose the exorbitant privilege of playing banker to the world, accepting short-term deposits at low interest rates in return for long-term investments at high average rates of return. When combined with other political developments, it

of what it did in at the beginning of the earlier recession/presidency/decade (and in 1990 as well). The Mundell-Fleming prediction applies specifically to a fiscal expansion that is *not* accommodated by monetary policy, whereas the 2001–2004 expansion clearly has been accommodated so far. In this sense the Vietnam-era expansion of the late 1960s may be a better precedent for today's deficits than was Reaganomics in the 1980s. Not only were the two wartime fiscal expansions accommodated by monetary policy, but they also showed up in growing US balance of payments deficits that largely put the dollar at the mercy of foreign central banks. The real test for the current decade will come when the Fed responds to the recovery by raising interest rates."—"Twin Deficits and Twin Decades," conference sponsored by the Federal Reserve Bank of Boston, at Wequasett, June 14–16, 2004. Forthcoming, *The Macroeconomics of Fiscal Policy* (MIT Press: Cambridge MA).

[9] I do agree with many others that the yuan is undervalued. Frankel, "On the Renminbi: The Choice Between Adjustment Under a Fixed Exchange Rate and Adjustment under a Flexible Rate," NBER WP No. 11274, 2005.

might even spell the end of economic and political hegemony. These are century-long advantages that are not to be cast away lightly.

6. Possible implications for loss of US political hegemony

If individual economic self-interest will not keep foreigners buying dollars indefinitely, might major foreign governments feel an obligation to do so on geopolitical grounds? They did so in the 1960s, in part because the Soviet threat drew the Western allies together, which produced a degree of solidarity and cooperation (notwithstanding troublemaking by Charles DeGaulle) that is not in evidence today. Even then, the Bretton Woods system broke down. To recap the history, the day of reckoning implied by the Triffin Dilemma was in any case accelerated substantially by the expansionary US fiscal and monetary policies of the Viet Nam War era, and the resulting widening of the balance of payments deficit. International investors sold dollars. In August 1971 the United States responded by unilaterally closing the official gold window and devaluing the dollar, thereby ending the Bretton Woods regime. By March 1973, all the major industrialized countries had given up the effort to keep their currencies pegged to the dollar. Central bank holdings of the yen and the mark rose rapidly in the remainder of the 1970s and 1980s, though the level still remained well behind the dollar for easily understood reasons.

The problem of the 1960s was only increasing obligations to foreign central banks—a deficit in the overall balance of payments. The more recent problem is that, but a large current account deficit as well, and rapidly rising obligations to foreign private investors. As is well known, we have gone from world's largest creditor to world's largest debtor. To quote Larry Summers, a

> "...troubling aspect of this dependence on foreign capital is its geopolitical significance.... There is surely something odd about the world's greatest power being the world's greatest debtor. In order to finance prevailing levels of consumption and investment, must the United States be as dependent as it is on the discretionary acts of what are inevitably political entities in other countries?"[10]

There is of course an important historical precedent for the declining international role of the dollar. The pound sterling was the premier international currency of the gold standard period. Historians estimate, for example that 60–90% of the world's trade was invoiced in sterling in the 19th century. In 1899 the share of pound in known foreign exchange holdings of official institutions was more than twice the total of the next nearest competitors, the franc and the mark, and much greater than the dollar.[11] The US economy in the late 19th century surpassed the British economy in size (1872) and US exports pulled ahead of UK exports during World War I. During the years following 1914, the US passed from net debtor to net creditor while the UK moved in the opposite direction. This had much to do with British borrowing from the United States so as to fight World War I. The dollar was the only currency to remain convertible into gold at a fixed price into the 1920s. As it emerged as a major international currency, the dollar's use in

[10] "The United States and the Global Adjustment Process," Third Annual Stavros S. Niarchos Lecture, Institute for International Economics, Washington, DC, March 23, 2004.

[11] For numbers and references, see Frankel and Menzie Chinn, "Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?" for NBER conference on *G7 Current Account Imbalances: Sustainability and Adjustment*, Newport, RI, June 1–, 2005, Richard Clarida (Ed.) ER Working Paper No. 11508, July 2005.

international trade and finance widened increasingly. The pound retained its dominant position as key currency in the interwar period, in large part due to the inertia in such arrangements that was noted above. As late as 1940, the level of foreign-owned liquid sterling assets was still double the level of foreign-owned liquid dollar assets. By 1945, however, the position of the dollar and pound, as measured by this statistic, had precisely reversed. World War II – entailing further US lending, UK borrowing and other economic consequences – had completed the dollar's rise to ascendancy.

The decline in the pound was clearly part of a larger pattern whereby the United Kingdom lost its economic pre-eminence, colonies, military power, and other trappings of international hegemony. As some of us wonder whether the United States might now have embarked on a path of "imperial over-reach," following the British Empire down a road of widening federal budget deficits and overly ambitious military adventures in the Muslim world, the fate of the pound is perhaps a useful caution. The Suez crisis of 1956 is frequently recalled as the occasion on which Britain was forced under US pressure to abandon its remaining imperial designs, but the important role played by a simultaneous run on the pound is often forgotten.[12] Paul Kennedy's (1989) suggestion of the imperial overreach hypothesis and its application to US hegemony may have been essentially correct but 20 years premature, much like the forecasts of those in the early 1990s who warned prematurely of the dollar's imminent demise.

Over the last four decades, our allies have been willing to pay a financial price to support American leadership of the international economy, because they correctly saw it to be in their interests. In the 1960s, Germany was willing to offset the expenses of stationing US troops on bases there so as to save the United States from a balance of payments deficit. In the 1980s, the US military was charged less to station troops in high-rent Japan than if they had been based at home. In 1991, Saudi Arabia, Kuwait, and a number of other countries were willing to pay for the financial cost of the war against Iraq, thus temporarily wiping out the US current account deficit for the only time in a 20-year period. Repeatedly the Bank of Japan, among other central banks, has been willing to buy dollars to prevent the US currency from depreciating (late 1960s, early 1970s, late 1980s).

During the same period that the United States has lost its budget surplus and the twin deficits have re-emerged, i.e., since 2001, we have also lost popular sympathy and political support in much of the rest of the world.[13] In the past, deficits from imperial overstretch have been manageable because others have paid the bills for our troops overseas: Germany and Japan during the Cold War, Kuwait and Saudi Arabia in 1991. Now the hegemon has lost its claim to legitimacy in the eyes of many. Next time the US asks other central banks to bail out the dollar, will they be as willing to do so as Europe was in the 1960s, or as Japan was in the late 1980s after the Louvre Agreement? I fear not.

I do not mean to express an optimistic forecast regarding European economics or governance. Euro enthusiasts suffered some serious setbacks in mid-2005.[14] Europeans have made many mistakes, the leaders and public alike.

[12] E.g., James Boughton 2001, "Northwest of Suez: The 1956 Crisis and the IMF," *IMF Staff Papers* 48, no. 3, 425; and "From Suez to Baghdad," Charlemagne, *Economist*, March 22, 2003, p. 47.

[13] In sharp contrast to international attitudes five years ago, the US is now viewed unfavorably in most countries surveyed by the Pew Global Attitudes Project. Other surveys give similar results.

[14] A slowdown of some major European economies, gross violation of the Stability and Growth Pact, rejection of a new EU constitution in French and Dutch referenda, a deadlock over the EU budget, and a renewed depreciation of the euro.

But so have Americans. Most assessments of the sustainability and adjustment of the US current account see a role for substantial depreciation of the dollar in the future, whether operating via expenditure-switching or a valuation effect. Our results suggest that such dollar depreciation would be no free lunch, and could have consequences for the functioning of the international monetary system as profound as the loss of the dollar's pre-eminent international currency position, and along with it the exorbitant privilege of easily financing US deficits.