Bergsten: "The US is importing about $1 trillion of foreign capital a year. We're draining much of the world savings to finance our own external debt."

C. Fred Bergsten, director, Institute for International Economics

Whatever happened to the US recovery?

This economic guru is decidedly upbeat about the economy and sees 4 percent growth next year. He is troubled, however, by the country's huge budget deficit, which he expects will drive up interest rates and contribute to the decline of the dollar.

Dubbed by USA Today "one of the 10 people who can change your life," C. Fred Bergsten runs the Institute for International Economics, a leading Washington, D.C.-based think tank that specializes in international economic analysis. Bergsten has been at the helm since the institute's founding more than 20 years ago. During that time, government leaders, business leaders and even U2 lead singer Bono, in his capacity as an AIDS awareness activist, have called on him for advice.

A free trade advocate and an outspoken supporter of multilateral institutions like the International Monetary Fund and the World Bank, Bergsten has been a frequent presenter at the World Economic Forum, where he has addressed issues ranging from China's economic emergence to doing business in the tripolar world of the euro, the yen and the dollar. In 2000, he was called to appear before US congressional committees to testify on international economic issues more than any other scholar.

Bergsten was born in Brooklyn, New York, the son of a Methodist minister and a schoolteacher. After graduating from Central Methodist College, he earned his M.A., M.A.L.D. and Ph.D. degrees from the Fletcher School of Law and Diplomacy at Tufts University and started his career as an international economist with the US State Department. During the Nixon administration, he was the assistant for international economic affairs at the National Security Council to National Security Advisor Henry Kissinger and also served as the Assistant Secretary of the Treasury for International Affairs and the Under Secretary for Monetary Affairs. From 1991 until 1995, Bergsten chaired the Competitiveness Policy Council, which was created by Congress to analyze the competitiveness of US industry and formulate recommendations. Among the council's recommendations: invest more heavily in the education and training of the US workforce and encourage more public and private savings.

Bergsten has written or edited more than 25 books on international economic issues and in 1999 was cited by Fidelity Investments as one of the top 50 people who can move markets. When Outlook Managing Editor Tish Burton sat down with him in his office near Dupont Circle in June, he was decidedly upbeat about the US economy. Bergsten was troubled, however, by the country's huge budget deficit, which he expects will drive up interest rates and contribute to the decline of the dollar.

"[The U.S.] is already the world's largest debtor country."

Outlook: It seems like we've been promised a recovery in the United States for some time now. What is your forecast for the next 12 months?
Bergsten: I have been very bullish on the economy. I think we'll have 4 percent growth by next year.

What impact do you see the US budget deficit having on the economy?
In the short run, the increase in the deficit stimulates the economy. As a long-term proposition, I think the effects will be very negative. And what it, of course, presages, as it did to some extent in the '80s, is much higher interest rates than otherwise would be the case.

Can you put this into historical context as far as US budget deficits are concerned?
In the short run, this looks like $400 billion or $500 billion, which would be roughly 4 to 5 percent of GDP. The previous peak, I guess, was actually under Bush Sr., in '92, when I think we got to just about 6 percent of GDP. And then it came down very steadily until it hit a surplus of 2 percent of GDP only two years ago. So it actually improved 8 percentage points over about an eight-year period. It wasn't quite that smooth, but there was an average improvement of 1 percentage point a year for almost a decade. And that was both the cause and the result of the economic boom of the '90s.

And today?
In two years, it's almost all been blown, and we're back to a 4 or 5 percent of GDP deficit—not quite back to the 6 percent of the early '90s, but certainly on a path to get there shortly. So it looks like we'll be back in the same range as the previous peak within the next two or three years on the current trajectory.

Will deficits be as big a problem for the US economy as they were in the 1980s?
There are two reasons why the effect of the budget deficit today might not be as bad. [There is] much better US productivity performance and much greater US integration into the world economy now than even 10 to 20 years ago, which means there are more competitive pressures keeping inflation down. It's not at all clear that interest rates will go up all that sharply in absolute terms, given global competitive pressures, the sharp productivity growth and the total lack of inflation.

What impact will deficits have on the exchange rate?
The exchange rate effects are actually a bit ambiguous. When the US budget deficit soared in the '80s, the dollar soared; for the first five years, it was great for countries exporting to the US. But this time, it's not as clear what will happen, because the budget deficit is starting to soar when we already have a huge trade deficit. Last time, under Reagan, we were in balance, and we were drawing down credit balances accumulated over 70 or 80 years that had made the US the world's largest creditor country.

And now the situation has been reversed.
We're already the world's largest debtor country. We already have a $500 billion trade deficit. And that was with the budget more or less in balance. Now the budget deficit soars, the trade deficit gets worse, so it means the dollar exchange rate may well come down a lot more as a result of the need to head off an even higher US trade deficit. So the dollar has been going down now for over a year. My guess is it will continue to go down substantially for at least another year or so.

How will that impact countries that are not dollar-based?
It will be difficult for them to compete

with dollar-based competitors around the world. [They] may need to shift more of their production to the US. The big non-US multinationals may want to invest here, or shift their output mix in the direction of their US locations, because the dollar exchange rate will probably be a lot lower.

What other impact will the US budget deficit have on businesses based outside the United States?

They are affected over the longer run, because higher interest rates could dampen US growth. [That makes it a] less buoyant market for foreign business, whether through exports or through their US subsidiaries.

How will the United States finance the deficit?

The US is already importing about $4 billion of foreign capital every working day to cover the combination of our current account deficit and our capital outflow, which is close to half a trillion [dollars] a year. So the US is importing about $1 trillion of foreign capital a year—which is well over half, incidentally, of the incremental savings in the rest of the world. So the US is already a huge capital sink: We're already draining much of the world savings to finance our own external debt.

This was the situation even when our budget was pretty much in balance, as recently as two years ago. Now the budget deficit goes up sharply. At least in the short run, that's going to push the trade deficit up even more. This means that the US is going to be borrowing even huger amounts from the rest of the world to finance that.

And to do that, the United States will need to make itself an attractive place for them to put their money.

The rest of the world may not lend us that money without a significantly lower dollar, and maybe higher interest rates. So there are going to be at least two effects. One, the US is a much bigger competitor for capital to finance its own profligacy. And it will probably have somewhat higher interest rates in order to affect that. So for foreign companies looking to borrow, looking to generate capital outside the United States, the going will be rougher.

Let's shift to the rest of the world. What are you expecting in Europe and Asia?

It's a mixed bag in both places. In Asia, you have the one other growth pole in the world economy, which is China. It will continue to grow at 7 or 8 percent for another 20 years or so. Japan is at the opposite end of the spectrum: 12 years of stagnation. No real sign of getting out of it. So you have the world's second and third largest economies, Japan and China, neighbors, going in opposite directions. The rest of Asia is somewhere in between. Korea, on the whole, is strong. Southeast Asia, on the whole, is strong.

And in Europe?

Europe is structurally different from the US in the sense that these countries have much more stable economic performance. They have shallower cycles. They have less buoyant growth at the peak and less slowdown at the trough, mainly because the governments are a much bigger factor in their economies. Their [growth] range will be 1 to 3 [percent], while in the US it is zero to 5. They are less dynamic, but they also have less severe downturns.

I think they will gradually strengthen their productivity performance by importing some of the things we've done over the last 10 or 15 years. Some of the smaller economies have already picked up very well—Ireland, Portugal, Spain, to some extent, Holland, Denmark.

The problem is what happens to the Big Three, particularly Germany and Italy. And I think they are gradually being driven to more competitive reforms. I think the requirements of the euro will push that too. But it's slow and there's a lot of resistance. [The Institute for International Economics has] done a piece on whether Germany is the next Japan. And the conclusion is not that bad, but it shows some similar signs.

Is that because they had to absorb East Germany or because they have structural rigidity?

Both. There is all this talk about how there is a market economy, but most of the companies are privately held and competition is not very aggressive.

The absorption of East Germany continues to be big baggage. I think [change] will come slowly, like in Japan and elsewhere. But over a 5- or 10-year period, I think Europe will actually be a lot better off. Five or 10 years out, I'd be modestly optimistic about Europe. But in the short run, still pretty sporadic.

So which of these countries is in a position to fund the US deficit?

Well, in recent years, it's been primarily Asia. The Europeans invest a lot here, but we also invest a lot in Europe. The net capital flow is huge in gross terms, in both directions. But it's offsetting. The biggest net flow has been into the US out of East Asia. So their high savings basically [pays for the US debt]. ■