The dollar

Let the dollar drop

Feb 5th 2004
From The Economist print edition

Some think the dollar has fallen too far. On the contrary, it has not fallen by enough

Get article background

THE dollar is the world's dominant currency. Should the world therefore be worried by its recent plunge against other currencies? Plenty of people seem to think so. When central bank governors and finance ministers of the G7 economies meet this weekend in Boca Raton, Florida, the fate of the dollar will be high on their agenda. Since 2001 the dollar has fallen by 33% against the euro and by 15% against the Japanese yen. Currency traders around the globe will scrutinise every word from Boca Raton, looking for a signal that governments might act together to stem the dollar's decline. Many businessmen will be holding their breath as well.

This is understandable. Any shift in currencies produces winners and losers. And yet the real problem facing the world economy is not a suddenly weak dollar, but a dollar which remains, even after its recent decline, too strong. The drop in the greenback was inevitable and should benefit both America and other countries, because it will help to reduce America's vast current-account deficit, which is arguably one of the biggest threats to the global recovery. For the same reason the dollar should, and almost certainly will, fall further. But some countries are not prepared to allow the dollar to fall by enough to complete the necessary adjustment to America's finances.

America's current-account deficit stands at 5% of GDP, and most economists reckon that this percentage needs to be reduced by at least half. That would stabilise the ratio of America's foreign liabilities to GDP, which has surged in recent years. So far the dollar has fallen by 15% in trade-weighted terms against a broad basket of currencies. Nevertheless, after adjusting for inflation, its value is still close to its 30-year average. It may need to fall by another 20% over the next few years if the current-account deficit is to be halved (see article).

American policymakers seem happy to let the dollar slide. Europeans, however, complain that the burden of adjustment has fallen disproportionately on their currency, the euro. As the euro has soared against the dollar, central banks in Japan, China and other Asian countries have bought dollars to hold down the value of their own currencies. By doing so, they financed over half of America's current-account deficit in 2003. Without that money the dollar would have fallen further.

Missing signals

In the short term, Asia might thus be seen as America's saviour. But in the longer term Asian governments are delaying a necessary adjustment by allowing America's deficit to loom large for longer. This is likely to lead to an even bigger and more dangerous build-up of American foreign debt.

The behaviour of Asia's central banks has also blunted the necessary market signals to which even America must, eventually, pay heed. The current-account deficit is a direct, arithmetical reflection of insufficient domestic saving. In particular, America needs to prune its government budget deficit. However, it feels even less reason than usual to do so. Normally, when a government's budget deficit swells so fast (to 4.6% of GDP this year, from a surplus of 2.4% of GDP in 2000) and its currency is falling, investors would demand higher bond yields to compensate them for the increased risk. That penalty gives governments both a warning and an incentive to borrow less. But Asian governments are devouring American Treasury bonds with little regard for the usual risk-return characteristics. As a result, bond yields are being held artificially low, subsidising America's borrowing spree.

This has allowed the Bush administration to point misleadingly to low bond yields as evidence that its budget deficit is not harming the economy, and to think that cutting the deficit is less urgent. President George Bush's plan, set out this week in his budget, to halve the deficit over five years is based on unrealistic assumptions and fantasy accounting (see article). A fiscal stimulus was justified when the American economy was on the brink of a deep recession in 2001, but now that the economy is booming again, borrowing needs to be cut.

Asia's game

In essence, Asian governments are buying American Treasury bonds in order to ensure that Americans can afford to keep spending money on Asian goods. This cannot go on forever. Despite their mercantilist instincts, sooner or later Asia's central banks will have to face the fact that they are holding far too many risky, low-yielding dollars. If they stop buying, it could trigger a sharp fall in the dollar and a jump in bond yields. Delaying the natural adjustment in the dollar and bond yields is likely to mean that, when the inevitable correction comes, it will be much more painful.

If financial markets do turn nasty, then everybody will carry some of the blame. Japan and China will be guilty of trying to block market forces and hence an earlier adjustment in America's trade deficit. With Japan's economy now growing faster than the euro area and its firms' profits surging, Japan can probably afford a stronger yen. Its continuing worry about deflation can be better addressed by printing more money. And China needs to allow its currency to move upwards, not just to help the rest of the world, but also to rebalance its own overheating economy. Without such a rebalancing, inflation or a property boom and bust could destroy growth. The Chinese might find it easier to accept such advice if they are given a seat at the G7 table, where they clearly belong.

The euro area is also far from blameless. Policymakers wring their hands about the “brutal” rise in the euro, yet the euro is still close to fair value against a basket of currencies. If Europeans are worried that a stronger euro will hurt their economies, then the solution is simple: the European Central Bank should cut interest rates to boost demand.

However, America must bear much of the blame for its failure to do anything to curb household and government borrowing and so boost saving. Its easy monetary and fiscal policies are now beginning to look reckless. The dollar's slide has rightly shifted some of the burden of economic adjustment on to other economies. Sooner or later, though, America will have to face up to its own responsibilities, too.