The dollar's delicate balancing act

By Martin Wolf

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The dollar, said John Connolly, treasury secretary to Richard Nixon, "is our currency, but your problem". Gerhard Schröder, Germany's chancellor, knows what he meant. In his trip to Washington last week, the weak dollar was at the front of his mind. Unfortunately for him, US policy-makers have no desire - and little ability - to help him.

So what do US policy-makers want? They wish to achieve full employment, or what economists call "internal balance". If this means a gigantic current account deficit or a tumbling currency, so be it. As issuer of the principal reserve currency, the US is also the world's borrower of last resort. US policy-makers respond to whatever the rest of the world economy throws at them. The rest of the world is driving the US economy along a Gadarene debt path.

Wynne Godley, of the Cambridge Endowment for Research in Finance, has illuminated the dilemma in several papers, most recently one co-authored with Alex Izuretia.* He suggests thinking in terms of the financial balances - the gap between income and expenditure - of the foreign, public and private sectors, which must sum to zero.

During the stock-market bubble, the US private sector moved into an unprecedented deficit. Between the first quarter of 1992 and the third quarter of 2000, its financial balance deteriorated by 11.5 per cent of gross domestic product. Something else happened over that period: an explosive increase in net foreign lending to the US - the inverse of the current account deficit. As a corollary, the fiscal position improved. Then, when the bubble burst, the private deficit shrank, while the public sector's position moved in the opposite direction.

America's rocketing external deficit faces a shortage of fuel

In the boom of the 1990s, the driving force was the surge in private spending. In the bust of the early 2000s, when corporations slashed investment and improved profitability, massive fiscal expansion and monetary easing rescued the economy. The Bush administration's fiscal policy is open to criticism for both its regressive impact and its long-term unsustainability. But, in combination with the Federal Reserve's

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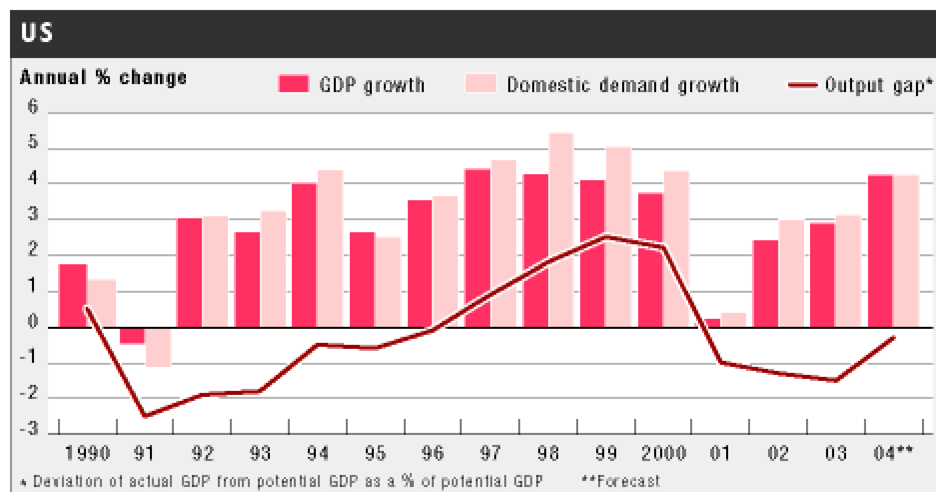
aggressive monetary policy, it has returned the economy to growth. Meanwhile, the external deficit has continued to grow. Domestic spending has not been driving the current account deficit. The rising external deficit has been driving domestic spending, instead. The external tail wags the domestic dog.

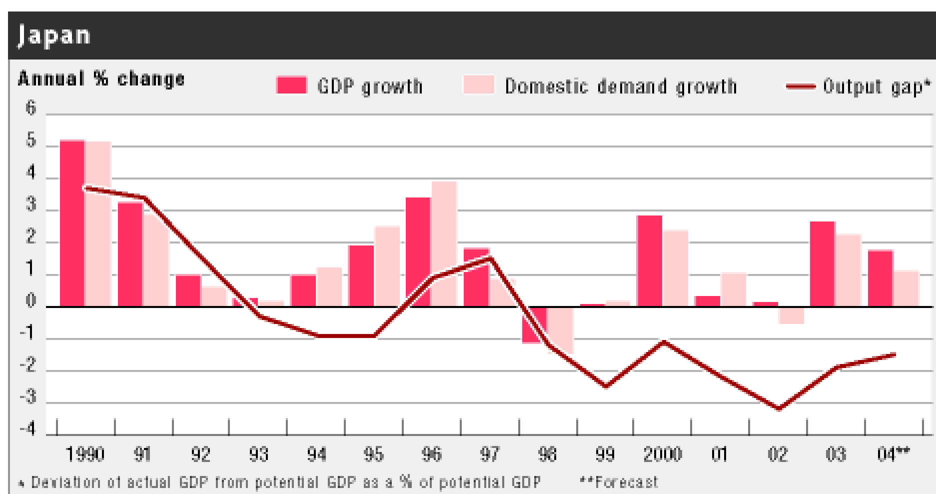
world war, the US became the world's dominant creditor nation. Since the end of the cold war it has turned into its biggest debtor. As a share of global gross product, last year's US current account deficit of $550bn (£290bn, €440bn) was the largest such imbalance in recorded history.Read

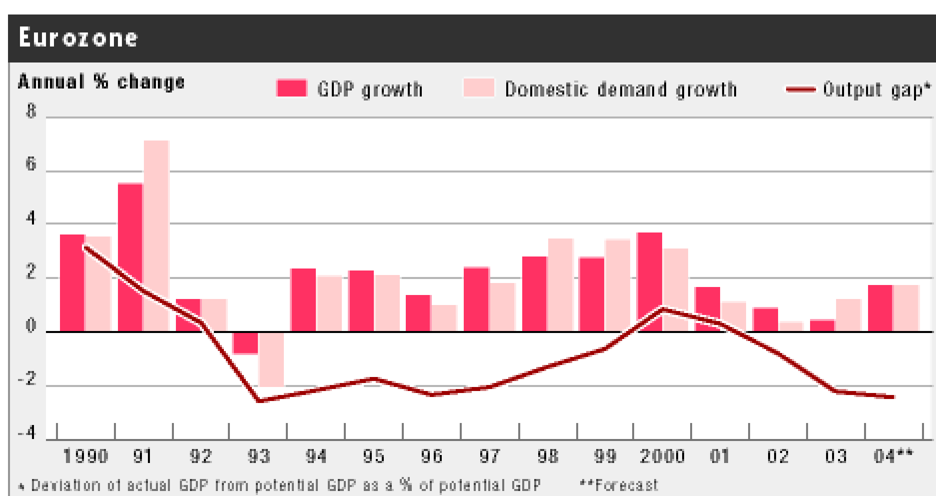
This high and rising external deficit is *not* just a reflection of fast US economic growth. In not one of the last eight years did US GDP grow faster than domestic demand. This was not only true when growth was fast, but also when the economy slowed. Achieving a given rate of growth has required still faster growth of domestic demand. This strongly suggests the real exchange rate has been at uncompetitive levels - or, more technically, at levels inconsistent with both internal and external balance over the longer run. In the second half of the 1990s, the explanation for the appreciation was private capital inflows. But this era has ended. In 2002 and the first three quarters of 2003, just over a quarter of the finance of the US current account deficit came from official, not private, sources.

If the US ran a current account deficit of just over 5 per cent of GDP last year, the rest of the world must have run a surplus of about 2 per cent of GDP. Unfortunately, in its September 2003 *World Economic Outlook* , the International Monetary Fund was able to identify only $384bn of this surplus for 2003. Nevertheless, all regions - except Latin America and Africa, forecast to run deficits of $14bn and $4bn, respectively - were forecast to run surpluses last year. Japan's was $121bn, that of Asian newly-industrialised economies (NIEs) $76bn and that of Asian developing countries $42bn, making the overall Asian surplus $240bn. The eurozone's was $62bn.

The US is not, in fact, the only high-income country to have bigger deficits. According to the Organisation for Economic Co-operation and Development, Australia, Spain and the UK ran aggregate current account deficits last year that were $82bn bigger than in 1996. But these shifts, large as they are, are dwarfed by the US move from a deficit of $117bn to one approaching $550bn.







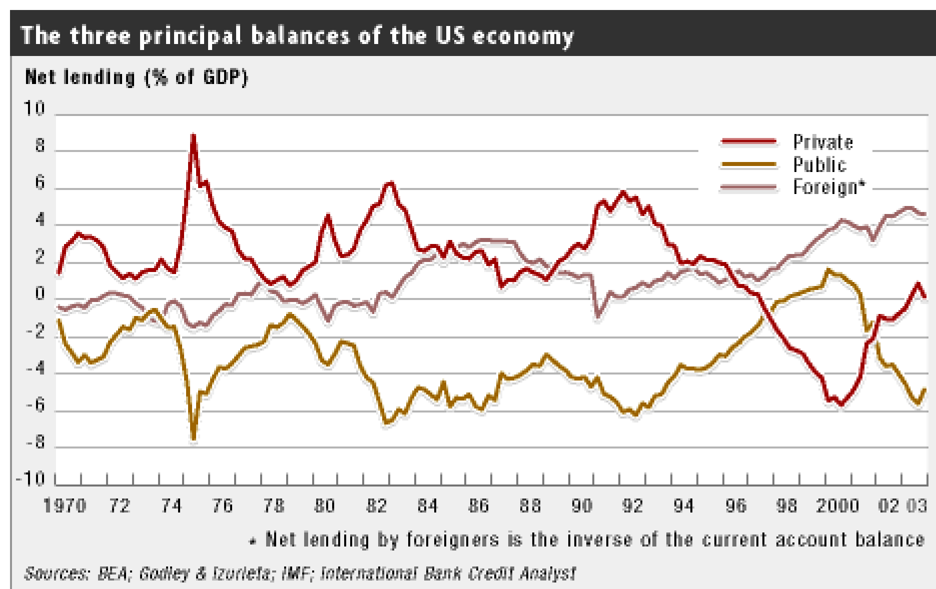
Since the US current account deficit has been growing, so have surpluses elsewhere. In 1996, before the Asian financial crisis, non-Japan Asia ran a current account deficit of just $41bn. By 2003, according to IMF forecasts, this had become a surplus of $118bn. Japan's surplus also rose, from $66bn to $121bn. Overall, Asia's surplus increased by $215bn. The other group of countries to run much bigger surpluses were oil exporters.

Today, the significant surplus regions fall into three groups: the eurozone and Japan (aggregate surplus in 2003 forecast at $184bn); the rest of Asia (forecast at $118bn); and oil exporters, including Russia and Norway (forecast at $113bn).

Ever since the end of its bubble era, Japan's private sector has been in chronic and rising financial surplus, recently reaching close to 8 per cent of GDP. The counterparts have been public sector deficits and current account surpluses. Last year, according to IMF forecasts, these were 5.2 per cent and 2.7 per cent of GDP, respectively. Demand has also been chronically weak and the output gap consistently negative, according to the OECD, which indicates chronic excess capacity. Japan has also struggled to keep its exchange rate down: between December 2001 and December 2003 its foreign currency reserves grew by $265bn.

The eurozone looks more balanced than Japan, with a private sector financial surplus forecast at just 2.3 per cent of GDP in 2003. But demand growth averaged just 2 per cent a year between 1994 and 2003. In most years, domestic output has grown faster than demand. So the eurozone has been subtracting from, rather than adding to, net demand

for the rest of the world's output. It also has chronic excess capacity.



Asian NIEs have a huge surplus of savings over investment: for 2003, this is forecast at 6.5 per cent of aggregate GDP. Developing Asian countries ran a savings surplus of close to 2 per cent of GDP. But they are also attractive to foreign private capital. To keep their exchange rates down and avoid net debt accumulation, these countries are accumulating currency reserves at a phenomenal rate. Last September, the IMF forecast their accumulation at close to 5 per cent of GDP in 2003.

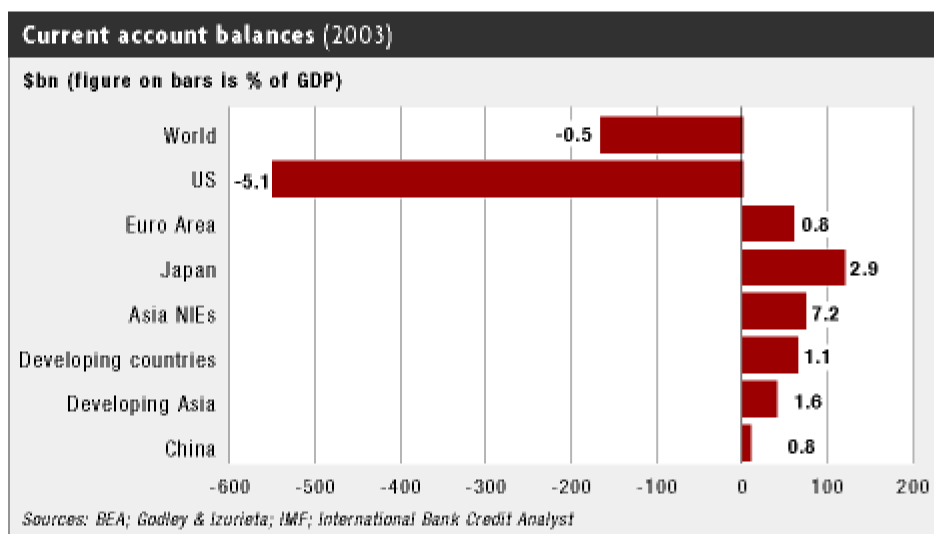
Finally, the oil exporting countries are the beneficiaries of relatively strong oil prices. It is normal for their aggregate surpluses to rise when prices are high. In time, they are likely to spend much of it. Their surpluses are likely to be a temporary, rather than permanent, feature of the global balance of payments.

To summarise, we can spy five dominating features of the global macroeconomic landscape.

First, the eurozone and Japan, which generate a third of global GDP between them - much the same as the US - have very weak domestic demand.

Second, developing and newly industrialised Asia, containing the world's fastest growing economies, also has high domestic savings, strong debt aversion and a consequent determination to run current account surpluses and recycle capital inflows into foreign exchange reserves.

Third, Japan combines features of the eurozone and some of its Asian neighbours: slow demand growth; high savings; and a determination to slow exchange rate appreciation.



Fourth, a big divide has emerged between countries that allow their exchange rates to float relatively freely - which includes most of the OECD (except Japan) and the big Latin American countries - and those that do not, including much of Asia.

Finally, the US and a few other high-income countries, including the UK, are simply adjusting to surpluses generated elsewhere. The result has been massive accumulations of liabilities by the private or public sectors.

How then is all this going to end? Part of the answer is that the weakness of the dollar is forcing the needed adjustment. In the US, it will raise output and, in time, reduce the need for huge financial deficits. In economies with floating exchange rates, appreciations lower inflation and increase pressure for expansionary monetary policy. Even the European Central Bank will be unable to resist Mr Schröder and his ilk forever. In economies with fixed, or heavily managed floating exchange rates, the pressure comes through monetary expansion and so, inflation. If China does accept a currency appreciation, the rest of Asia is likely to follow.

This then is an optimistic view of global adjustment. But there are also some noteworthy risks. One is of a precipitate, rather than smooth, decline of the dollar. The dollar will probably need to fall further if the US is to combine internal balance with a manageable external deficit. Yet an abrupt fall could trigger sharp rises in US long-term interest rates and declines in US asset prices. This could cut household spending, thereby generating a renewed economic slowdown. It might, alternatively, drive the Fed towards debt-monetisation and so towards higher inflation.

Another risk is that neither Japan nor the eurozone is able to generate satisfactory growth in domestic demand. In that case, the external adjustment imposed upon them might also create a sharp domestic economic slowdown or even recession.

Yet another risk is that non-Japan Asia resists currency adjustment to the bitter end. That would postpone the external adjustment, in the short run, but lead to high inflation and accumulations of bad debts in their financial systems, in the longer run.

A final risk is that the external and internal adjustments do not happen: the US ends up with ever growing current account deficits, US protectionism explodes and the role of the dollar as a reserve currency comes into question.

A world in which macroeconomic health can be achieved only at the expense of ever greater private and public debt accumulation in its biggest and richest economy is unstable. It is also perverse. If the world has surplus capital, more

of it should go not to the world's richest country, but to far poorer ones. That this is not happening is a grievous failure. For this reason, if no other, we need to find a way to sustain global economic activity that does not depend on a growing mountain of US debt.

** "Balances, Imbalances and FiscalTargets: a New Cambridge View" February 2004, www.cerf.cam.ac.uk/home/index.php*

Sources for charts: OECD; Thomson Datastream