Economy: Bottom Dollar

The greenback's fall is stoking fears of a global crisis. Behind the slide: a world economy wildly out of balance.

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March 21 issue - There's been plenty of good news of late about the U.S. economy, so let's start with that: employment is expanding (2.4 million new payroll jobs in the last year); inflation remains low (less than a 2 percent rate in the past quarter); the stock market is higher (up 11 percent on the Dow from its November low), and business investment is impressive (rising at a 14 percent rate in late 2004). Indeed, the recent news has been so good—a major exception being $50-a-barrel oil—that we're hearing again of the "Goldilocks" economy, which grows fast enough to increase jobs and slow enough to muffle inflation. But beyond all the upbeat indicators lurks a potentially frightening problem that unsettles even the wisest and most seasoned economic observers. It's not government budget deficits, a possible housing bubble or even $2-a-gallon gasoline. It's the dollar.

If you've been following closely, you know that the dollar has been declining steadily against many foreign currencies. From recent highs—reached in mid-2001 or early 2002—the dollar has dropped 38 percent against the euro, 23 percent against the yen and 25 percent against the Canadian dollar. And most economists expect the slide to continue. By the year-end, the euro may rise to $1.45 from $1.34 and the yen to 97 from 104 (that's 97 yen to the dollar), says economist Nariman Behravesh of Global Insight. But, of course, you probably haven't been following closely. For most Americans, the subject of the dollar—its value on foreign-exchange markets—is a yawner. A depreciating dollar makes foreign vacations more expensive, puts pressure on the prices of imported cars and shoes and (the good part) improves the global competitiveness of U.S. manufacturers. Normally, these matters aren't high on our "must know" list. But now is not normal.

The significance of the dropping dollar is that it's actually a symptom of a larger and more troubling development. For 15 years the American economy has been the engine for the world economy through ever-increasing trade and current-account deficits (the current account includes other overseas payments like travel and tourism). In 2004, the U.S. current-account deficit is estimated to have reached $650 billion, a record 5.6 percent of the economy (GDP). Other countries' economies benefit from sending their goods to eager American buyers, and the United States in turn sends massive amounts of dollars abroad to pay for those goods. The trouble is that there are now more dollars than foreigners want to hold. If there's a glut of anything—apples, computer chips, Beanie Babies—prices go down. So when surplus dollars are sold for euros, yen or pounds, then the dollar drops in value against those currencies.

If you sense a contradiction, you're right; and there's the dilemma. The world economy can't get along without our massive trade deficits—and perhaps can't get along with them, either. Americans' consumption binge is propping up global trade and employment, but it's also threatening a financial upheaval that could hurt global trade and employment. With their export earnings, foreigners have bought huge amounts of U.S. stocks, bonds and other investments: at the end of 2003, $1.8 trillion of corporate bonds and $1.5 trillion of stocks. The doomsday scenario, considered unlikely by most economists but not impossible, is that a crash of the dollar would trigger a broader panic. Foreigners would sell their U.S. stocks and bonds, driving down those markets and bringing massive losses to everyone. They would sell because a dropping dollar would make their American investments worth less in their own currencies. Consumer and business confidence would drop; a recession in the United States and abroad might follow.

What's especially unnerving is that no one knows how to disarm the dilemma. If you think that some economist—or even Alan Greenspan—has a realistic solution, think again. We've entered an unmapped forest; no one has been here before. "We've never had the leading economic power with [such —an international] debt," says economic historian Barry Eichengreen of the University of California, Berkeley. The longer our huge trade deficits continue, the stronger the underlying financial pressures become. Foreigners either have to increase their holdings of U.S. stocks, bonds and other assets, or they have to sell their dollars. But the real problem is the dependence of so many other countries on the U.S. trade deficits for their own economic growth. Their surpluses are the mirror images of our deficits. In 2004, current-account surpluses were 3.7 percent of GDP in Japan, 2.3 percent in China, 2.9 percent in Germany, 6 percent in Taiwan and 7.8 percent in Belgium, estimates Economy.com.

It would be healthier for everyone if these big imbalances narrowed. On paper, this is easy. Americans need to export more and to consume less. We could raise taxes, decrease government spending and increase interest rates; all those steps would dampen consumer spending and promote saving. Meanwhile, the Asians could permit their currencies to rise against the dollar—unlike the euro, China's yuan and the currencies of many other Asian countries are pegged to the dollar. That would make their exports to us more expensive and our exports to them less expensive. Finally, the Europeans could liberalize their markets and lower interest rates. Their economies would grow faster. Taken together, this package would achieve what economists call a "rebalancing'' of world economic growth. The United States would have an export-led expansion, not import-led consumption. Europeans and Asians would produce more for themselves and buy more from us.

Unfortunately, this nifty bit of economic engineering has proved impossible in practice. All those trade deficits and surpluses are not just economic statistics: they also reflect national tastes and temperaments. Not surprisingly, the economic policies the world needs have collided with local politics.

Led by Japan, Asian countries have practiced export-led economic strategies for decades. They're loath to change, because they fear that anything else won't work. Japan's own experience has only deepened its anxieties. In the late 1980s, the yen rose and made Japan's exports less competitive; ever since, the country's economy has languished (from 1994 to 2004, growth has averaged a meager 1.5 percent). Not surprisingly, China has refused to revalue the yuan, which has been at 8.28 to the dollar since 1994. Unless the yuan is revalued, other Asian countries won't raise their currencies because they fear losing competitiveness to China, argues Fred Bergsten, director of the Institute for International Economics (IIE) in Washington, D.C.

As for Europeans and Americans, they're also stuck. We Americans like to shop. And we don't like taxes and do like government benefits. Which is to say: despite ritualistic denunciations of budget deficits, most Americans find them preferable to the alternatives. In Europe, sluggish economic growth (2.1 percent for the euro area from 1994 to 2004) reflects heavy regulation and high taxes. In 2003, all taxes in the United States totaled 31 percent of GDP, reports the Organization for Economic Cooperation and Development, in Paris. By contrast, they were 50 percent of GDP in France, 45 percent in Germany and 46 percent in Italy. These three big continental economies have been particular drags on Europe. Modest efforts to relax regulations and reduce taxes have been highly controversial and haven't yet had much effect. In Germany, Chancellor Gerhard Schroder came into office in 1998 promising to reduce unemployment below 4 million; it recently passed 5.2 million, an unemployment rate of 12.6 percent.

The result is a global political stale-mate that perpetuates a pattern of world economic growth that might one day be highly damaging to all of us. "It is a reality that [many] countries have a vested interest in a large and chronic U.S. trade deficit," writes Catherine Mann of the IIE. Similarly, it's been in the interest of most Americans (though not factory workers) to be flooded with cheap foreign imports that also keep down the prices of directly competitive American products. But these mutual interests could be dangerously shortsighted. They exist only as long

as foreigners willingly invest their surplus export earnings in dollars. There's no guarantee that this will happen, because foreign exporters and investors aren't necessarily the same people. A foreign exporter may receive dollars and then sell them for local currency (say, euros); then some other foreigner, perhaps a pension fund, buys the dollars with euros and invests the dollars in American stocks and bonds.

So the critical question becomes: can this arrangement survive? On that, economists split into two polar camps—with many straddled in between.

One camp insists that it can survive, because it serves strong national interests. Asian countries and particularly China need to create millions of jobs for political and social stability. China also wants to attract foreign investment in factories, because that brings new technologies and proven management skills. The best way to do this (goes the theory) is to remain a big exporter with a cheap currency. To prevent their currencies from rising against the dollar, Asian countries will buy as many surplus greenbacks as necessary. From year-end 1997 to year-end 2004, China's foreign-exchange reserves (invested heavily in U.S. Treasury securities) rose from $143 billion to $578 billion, South Korea's from $20 billion to $199 billion and Japan's from $220 billion to $834 billion (although the yen floats, Japan tries to limit its rise). And Americans also get a good deal: we send foreigners pieces of paper—say, Treasury bonds—and get cars, clothes and computer chips. Because everyone gains, the system can stay "intact for the foreseeable future," conclude economists Michael Dooley, Peter Garber and David Folkerts-Landau of Deutsche Bank.

Not so, say other economists. The present situation is inherently unstable. "The problem is that too many countries are required to prop up the United States," says Desmond Lachman of the American Enterprise Institute. Even if Asians buy dollars, other government central banks (their equivalent of the Federal Reserve) might sell. Or they might simply stop buying more dollars. The present U.S. current-account deficit means that foreigners have to increase their dollar holdings by almost $2 billion a day. A recent survey by Central Banking Publications of 65 central banks—apparently not including the Bank of Japan or the People's Bank of China—found that two thirds were moving away from dollars toward euros. Private investors could also desert the dollar. Indeed, it's vulnerable to almost any unpleasant surprise. Consider what happened in late February when the Bank of Korea said it might shift foreign-exchange reserves away from the dollar. Not only did the dollar fall, but the Dow dropped 174 points. That's precisely the sort of chain reaction many economists fear. (The Bank of Korea later said its statements had been misinterpreted.)

Perhaps the most prominent straddler is Alan Greenspan. In congressional testimony and speeches, he has suggested that the present massive trade and current-account deficits can't continue indefinitely—but that their reduction can be "orderly." Translation: most ordinary people won't notice, because—through some messy combination of shifting exchange rates, investment patterns and government policies—the world economy would gradually move toward more balanced trade patterns without a major crisis.

This is certainly plausible. There are some favorable omens. Japan's moribund economy shows signs of improving. The dollar's steep depreciation against the euro hasn't yet had any big impact on the U.S. stock and bond markets. Finally, Asian countries may naturally produce more goods for their own citizens, as expanding middle classes increase their consumption. Economist Donald Straszheim reports that a major Chinese shoe manufacturer plans to have 1,000 retail stores by 2008, up from 350 now. If the Chinese and other Asians spend more at home, they'll be less de-pendent on export-led growth and more open to revaluing their currencies.

But the truth is that no one knows what will happen. Since World War II, the dollar has been the major currency for global trade. It's used for a lot of two-way trade that never touches America. For example, about 80 percent of Thailand's and South Korea's exports are sold in dollars, reports a Federal Reserve study. Even in France and Germany, the dollar share of exports is about a third. What this means is that, as long as the dollar plays this global role, the United States

doesn't have to eliminate its trade and current-account deficits. The world wants and needs dollars. Modest deficits of perhaps 1 percent to 2 percent of GDP would provide them.

Whether we'll get there any time soon is hard to say. One disappointment is that the dollar's recent depreciation hasn't yet stopped the trade deficit from growing. In theory, it should have: a cheaper dollar should make our exports less expensive and our imports more expensive. Greenspan has offered one explanation. Foreign exporters to the United States have reduced their profit margins rather than raise prices and lose U.S. sales, he said. Likewise, a cheaper dollar may have aided U.S. exporters only modestly. Robert Piazza, president of Price Pump Co. in Sonoma, Calif., says that the "dollar has helped in Europe"—but European exports represent only about 5 percent of the firm's business.

Because the dollar is so important to the world, it's inevitably an instrument of U.S. foreign policy. This has long been true. After World War II, Europe was short of dollars. The Marshall Plan provided the extra cash that Europeans needed to buy food, fuel and machinery for reconstruction. In the 1970s the dollar became a bone of contention, because President Richard M. Nixon abandoned the Bretton Woods system of fixed exchange rates—a system that Europeans liked—and high U.S. inflation caused the dollar to depreciate on exchange markets. The Europeans believed that both events destabilized the world economy and put their exports at a disadvantage. If today's dollar problem turns ugly, there would almost certainly be a backlash from other countries. Already, the Europeans feel abused, because—with most Asian currencies pegged to the dollar—the euro has absorbed most of the anti-dollar sentiment. People who want to sell dollars buy euros; the higher euro weakens Europe's export competitiveness and threatens even slower economic growth.

Although the irritation and anger are understandable, they're also misleading. The real issue is whether the present pattern of global economic growth is inherently unstable—and whether it can be easily corrected. America's huge and expanding trade deficits have served as a narcotic for the rest of the world. As with all narcotics, resulting highs have been artificial and, to some extent, delusional to both the dealer and the addicts. The question now is whether everyone can go straight, before the addiction becomes self-destructive. It is whether the Asians can curb their export dependence; whether the Europeans can revitalize their economies; whether the Americans can control their overconsumption. The dollar's fluctuations and frailties are mainly the outward manifestations of this larger predicament. To paraphrase former Treasury secretary John Connally: the dollar may be America's currency, but it's the world's problem.

With Melinda Liu in Beijing

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