Economics focus

Checking the depth gauge

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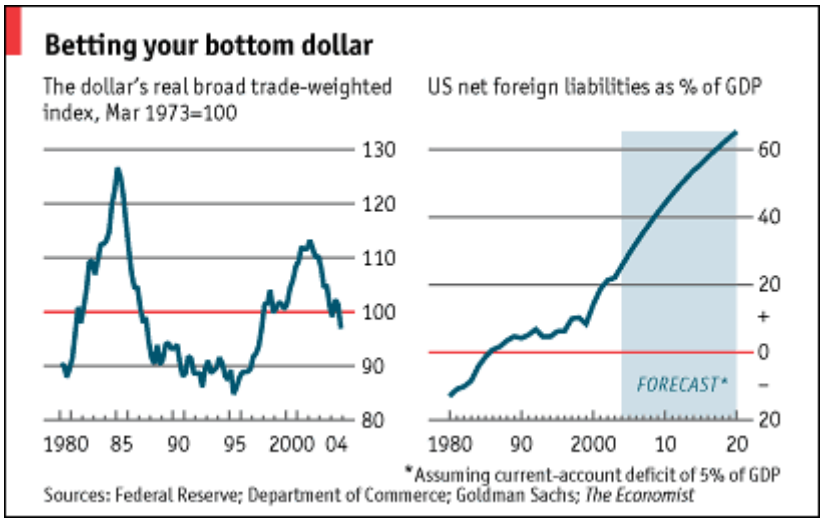
How low might the dollar sink?



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AS THE dollar hit another new low against the euro, briefly breaching $1.30 on November 10th, an increasing number of economists are asking how far the greenback might fall and how its slide will affect the world economy. One of the most alarming answers comes from Paul Volcker, Alan Greenspan's immediate predecessor as chairman of the Federal Reserve. He recently said that he thought there was a 75% chance of a currency crisis in the United States within five years.

It is easy to see how this might happen. America's current-account deficit is running at a record 6% of GDP this year, and on existing policies it will continue to widen. America's net foreign liabilities are already 23% of GDP, and economists at Goldman Sachs calculate that this figure will reach more than 60% by 2020, even if the current-account deficit stabilises at 5% of GDP (see chart). Other countries, such as Australia and New Zealand, have sustained large external deficits for long periods, but America's borrowing is much bigger in absolute terms. It is eating up around 75% of the excess saving of Japan, China, Germany and other countries with current-account surpluses. If the dollar did not have the advantage of being the world's main reserve currency, America would already be in serious trouble. Instead, the willingness of Asian central banks to lend to the United States has allowed its

deficit to keep growing for longer. Nevertheless, the deficit is unsustainable: sooner or later it will need to shrink, and that will involve a cheaper dollar.

A new paper* by Maurice Obstfeld, an economist at the University of California, Berkeley, and Kenneth Rogoff, of Harvard, a former head of research at the International Monetary Fund, predicts that the dollar will fall by another 20% in real trade-weighted terms even if America's external deficit unwinds gradually. If the adjustment is more abrupt, the dollar will dive by more than 40%.

Many economists try to estimate how much the dollar needs to fall in order to eliminate or at least to reduce the current-account deficit. But Mr Obstfeld and Mr Rogoff argue that such analysis is flawed. America's current-account deficit reflects inadequate domestic saving. Cutting it therefore requires that American saving rises or that demand in the rest of the world increases. A fall in the dollar would be a by-product of this adjustment. But without an increase in saving, even a big fall in the dollar would make only a small dent in America's current-account deficit.

The two economists assume that the current-account deficit shrinks as a result either of increased saving by American households (because, for instance, the country's house-price boom ends) or of a strengthening of demand in Asia and Europe. Then, using a model of the global economy, they focus on the changes in relative prices of traded and non-traded goods needed to ensure that demand matches supply in domestic product markets as the current-account deficit narrows.

According to conventional wisdom, a weaker dollar reduces the trade deficit by boosting American exports. That is true, but Mr Obstfeld and Mr Rogoff argue that the main pressure for a fall in the dollar comes instead from the need to encourage Americans to consume fewer traded goods (ie, both imports and goods that could be exported) and to buy more non-traded goods and services. If the current-account deficit is reduced through an increase in household saving, spending on non-traded as well as traded goods will drop. To maintain equilibrium in domestic markets and to prevent a rise in unemployment, the consumption of non-traded goods needs to rise relative to that of traded goods. This in turn requires a decrease in the relative price of non-traded goods. This means that the dollar's real exchange rate must fall.

From this way of viewing the likely fall in the dollar, the substitution of American for foreign traded goods is less important than of non-traded for traded goods. But because traded goods account for only around 25% of America's GDP, the current-account deficit of 5-6% of GDP amounts to an enormous 20-25% of traded-goods production. Thus closing the external deficit while maintaining domestic equilibrium requires a big change in the relative price of non-traded versus traded goods, and therefore in the exchange rate.

An echo of the seventies?

The real question is not whether the dollar needs to fall, but how drastic the economic effects of its fall will be. In the mid-1980s, the greenback's trade-weighted value declined by 40% with few ill-effects in America. The world economy absorbed the shock reasonably well. Unfortunately, the authors see more parallels today with the dollar's collapse in the 1970s, when the Bretton Woods system broke down. Like

today, that was a time of large budget deficits, loose monetary policy and rising oil prices, and America faced open-ended costs to pay for a war. Today, the combined costs of fighting in Iraq and maintaining security at home could easily match the cumulative 12% of GDP that the Vietnam war cost. There is therefore a risk that the global economic consequences might be as severe as those which followed the demise of Bretton Woods, with higher interest rates and a drop in global output.

If Mr Obstfeld's and Mr Rogoff's gloomier prediction turns out to be correct and the dollar falls by 40% or more, then this would, in effect, amount to the biggest “default” in history. This would not, of course, be a conventional failure to service debt, but could be viewed as default by stealth. America borrows from others largely in its own currency, so by letting the dollar drop it would wipe trillions off the value of foreigners' dollar assets. In such circumstances, the risk of a financial crisis is not negligible. As Mr Rogoff puts it: “The world is set to jump off the top of a waterfall without knowing how deep the water is below.”

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* "The Unsustainable US Current Account Position Revisited". NBER working paper 10869, November 2004