

# Where will the US dollar go?



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Even though it is likely to weaken considerably, the US dollar will continue to be the world's reserve currency for the foreseeable future, says Berkeley professor Barry Eichengreen, if only because there are no viable alternatives. Although the US current account deficit will again probably widen once the current recession ends, it will not reach the dimensions of a few years ago. Professor Eichengreen challenges the theory that the existence of a big US external imbalance was an illusion, but he points out that how the US external account adjusts depends on countries other than the US: "Global rebalancing has two sides," he says, and asks where the foreign demand needed for rebalancing will now come from. The answer, he believes, is from emerging markets like Brazil, Russia, India, and China — "China can't do it by itself."

Professor Eichengreen questions the case for a second economic stimulus in the US: "We need to give the first stimulus time to work and avoid exciting the bond market vigilantes." He is concerned, too, about what type of international financial landscape will emerge from the current crisis: "The new lines of responsibility for financial supervision are far from clear." But he does not foresee a major revision of the Bretton Woods institutions.

*The Brazilian Economy* — The huge external current account deficit of the United States, and the massive surplus in China, were of considerable concern to economists in the 1990s and this decade. Many predicted that this imbalance would be corrected and discussed the possibility of a "hard landing" in which the US and global boom would stop dramatically and painfully. In fact, the long phase of rapid growth came to a sudden end not because of a traumatic adjustment of the US current account but with the outbreak of the financial crisis last September. Moreover, it is not clear that the balance of payments of the United States has been a major cause of the turbulence, although some analysts point out that ample Chinese financing of the US current account made possible the credit binge that led to the crisis. Is the current financial turbulence related to the correction of the external imbalance of the US economy?

**Barry Eichengreen** — We have seen the U.S. current account deficit shrink by half as American demand for imports has fallen. There is debate about whether the same level of import demand and the same 6% of GDP current account deficit will return once the crisis is over. My view is that at least part of the change will be permanent. US households are currently saving 7% of household income, and this increase in saving is likely to persist as they attempt to rebuild their retirement accounts. And foreign appetite for U.S. debt securities is falling as well, since the US is no longer seen as a supplier of high-quality financial assets to the same extent as before.

Ricardo Hausmann and Federico Sturzenegger argue that there has not been a big US external imbalance and there are no serious global imbalances once assets are valued according to the income they generate (this is the “dark matter” hypothesis). Hausmann and Sturzenegger observe that while the US has net external liabilities, the country is a net recipient of income from abroad. Their hypothesis is that US assets are worth more than their face value because of intangibles like safety, liquidity and access to technology. Calculating the present value of the flows of rents receivable and payable in the US for the rest of the world, Hausmann finds that the country had no external current account deficit and has not increased its net debt position in relation to the rest of the world. Is there any truth to this explanation? Do US external imbalances really not matter?

I was never a believer in “dark matter.” To the extent the theory had merit, it reflected the fact that US investors were buying foreign equities while foreigners were buying US government debt. Because of the greater riskiness of equities, US investors were receiving more compensation. Now foreign investors are no longer buying the debt offerings of Freddie Mac, Fannie Mae, and the US Treasury; increasingly, they’re buying US equities, partly through their sovereign wealth funds, so they will be receiving more compensation for their additional risk. The so-called dark matter return differential will be no more.

Niall Ferguson (financial historian, Harvard University) argues that expansionary US Keynesian policy will not be effective but will cause volatility in financial markets. The current financial crisis is essentially a problem of excessive debt; to solve it requires a major restructuring of not just mortgages but also banks.

Massive US budget deficits of 12% of GDP and public debt doubling will eventually undermine the US dollar as an international currency. In short, where will the US dollar go?

There are a lot of assumptions implicit in that question. I do agree that the dollar will weaken against the currencies of emerging markets. As Americans consume less, that weaker dollar will help the US to export more—assuming foreign demand for our exports picks up. But that’s my medium-term view, my view of what will happen over the next three to ten years. No one can guess what will happen in the short term. Currency forecasting is a mug’s game, as they say.

But I also think that the stimulus is working. Professor Ferguson’s question presumes that deficit spending in the United States, resulting eventually in a higher debt ratio, will crowd out private spending one for one. With interest rates close to zero and relatively little private spending at the moment to crowd out, I think he’s making a mountain out of a molehill. If the US runs deficits in excess of 10 per cent of GDP indefinitely, we will get into trouble, no doubt about it. Investment and growth will suffer. But those are problems for 2011 and after, when the economy is growing again, not for today.

Despite the massive US budget deficits, there has been a remarkable increase in private savings (from negative to about 7% of GDP) and the latest US trade balance data indicate a substantial improvement (the trade balance deficit was cut in half to US\$120 billion in Jan.-Apr. 2009 compared with US\$240 billion a year earlier). Would this suggest

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that the US external account is adjusting gradually (the “soft landing” hypothesis) through expenditure-switching (Americans consume less and the rest of the world consumes more)? Is a hard landing unlikely?

What has happened so far is not expenditure-switching but expenditure-reducing. U.S. imports and exports have both gone down in the recession; it follows that as a result the difference between them (the deficit) has gone down. Expenditure-switching needs to come next, enabling us to export more while importing less. Depreciation of the dollar will help. But how smoothly this will work is a question. A great deal depends on demand from emerging markets, not least Brazil.

Global rebalancing has two sides—it takes two to tango. Since there is not going to be additional demand from Europe or Japan, both of which are going to be growing at best slowly, by process of elimination that additional demand will have to come from emerging markets, especially the BRIC countries, Brazil, Russia, India, and China. So if the dollar depreciates, it is their currencies that are going to have to be on the other side of this trade.

Obviously, if China and other emerging countries can't stimulate their domestic demand and US savings remain high — the American shopping mall closes down — the global recovery will be protracted. At the same time, it does not seem that the interruption of symbiosis between the US and China economies will trigger a US balance of payments crisis because US private savings are increasing enough that the US Treasury needs to sell fewer bonds to China. How likely is China to change its export-led growth model in the short run to offset the US increase in savings?

*How can the international financial institutions be reformed? There needs to be more clarity about priorities.*

China can't offset the decline in spending by the United States by itself. The Chinese economy is barely a third the size of the US economy at market exchange rates. This means that to offset the decline in U.S. spending there will have to be an accompanying rise in spending by the other big emerging markets, India, Russia, and Brazil, and by the oil exporters as well.

**Although confidence indicators have recovered recently in some advanced and emerging countries, economic growth (except for China) was contracting in the first quarter of 2009. What are the recovery prospects for the global economy? Will it turn around in 2010?**

I'm hopeful that we will see positive global growth some time in 2010 — I just don't know when, whether this will start toward the beginning or the end of the year. But whenever it begins, that growth will be tepid, that is to say relatively weak, by the standards of the typical recovery. Banks in the advanced countries, which remain inadequately capitalized, won't be lending to the normal degree. The monetary-fiscal policy mix will be unfriendly to investment. Structural change and the search for new growth engines to replace the financial sector will be painful. So there are any number of reasons to expect a subdued recovery.

**As the crisis unfolds, it seems that the global financial system has contracted to the point that credit is unlikely to recover to the pre-crisis level any time soon. What type of international financial landscape will emerge from the current crisis?**

I certainly hope that credit doesn't recover to where it was! Monetary policy was too loose, notably in the United States. There were excessive inflows of capital and liquidity from

China. And leverage was excessive. We don't want to go there again. We need a more vigorously regulated and more transparent financial system. And with the financial sector growing more slowly, countries like the U.S. are going to need new growth engines like high tech and green technologies.

Some argue like the French president, Nicolas Sarkozy, that "we must rethink the financial system from scratch, as at Bretton Woods." How likely is a Bretton Woods II? What reforms of the international financial and monetary system, in particular of the IFIs, are likely to occur?

The likelihood of a Bretton Woods II is approximately zero. In other words, our leaders are unlikely to go back to the drawing board and start from scratch. That's not the way the world works: existing institutions are deeply embedded, and existing stakeholders, including the big financial institutions, will push back. Very briefly after the Lehman Bros. bankruptcy everything might have been on the table. But that period of "extraordinary politics" is already over.

What should we focus on? Requiring financial institutions to hold more capital. Making capital adequacy requirements less procyclical. Clamping down on regulatory arbitrage. Insisting on more transparency. Reforming compensation practices in the financial sector to align the interests of key decision makers with the long-term interests of society and their own firms. Giving chief risk officers more independence from the chief executive officer and tying their compensation to the stability of the firm. Moving trading in credit default swaps and other derivative securities onto an

organized exchange. None of these changes are revolutionary, but they are no less important for that fact.

**Indeed, the financial earthquake that struck the world economy in 2008 did not resolve what has been a dilemma for many years: Is it possible that the United States will continue indefinitely borrowing from the rest of the world and at the same time the dollar will maintain its hegemonic role in world economy? Will the US dollar be eventually replaced by another currency?**

Clearly, the dollar has grown less attractive as a reserve currency. Its reputation has certainly been tarnished by the crisis. The problem is that there are no attractive alternatives. Winston Churchill once said that democracy is the worst form of government except for all the others. The same applies to the dollar. What could replace it as a reserve currency? Markets for euro area bonds are not as liquid as the markets for U.S. treasuries, and some euro area countries have serious problems. The yen has never seemed a likely possibility. Switzerland and

Britain are too small to issue first-class reserve currencies. Some day China's renminbi might be the answer, but not for decades. Or maybe it could be agreed internationally to make something like the IMF's special drawing rights the reserve currency. That would also take decades. So like it or not, what we have for the time being is the dollar.

It may seem unfair that despite past US mismanagement and though the dollar is going to weaken, it will still remain the world's dominant reserve currency. But sometimes life is unfair. ▀

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