A New Year for the Dollar
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The strength of the dollar tops nearly everyone's year-end list of economic surprises of 2005. With the United States running the largest current account deficit in its history, the greenback was almost universally expected to weaken last year. Instead it strengthened by nearly 8 per cent against the currencies of other developed countries, yielding contarians a healthy rate of return.

But 2006 is another year. Is dollar depreciation now imminent?

What one expects of the dollar depends on how one interprets the U.S. deficit. And here – no surprise – economists do not agree. A first school of thought blames the deficit on deficient U.S. savings. The U.S. gross national saving rate has fallen to 13.6 per cent, down by 3.3 per percentage points from 1983-2000 and barely half the levels prevailing in the rest of the world. Household saving as conventionally measured has fallen to zero, while public saving has swung from +2.5 per cent of GDP in 2001 to -3.5 per cent of GDP today. Only high corporate saving has kept aggregate U.S. savings rates in positive territory. Since U.S. consumption has shown little sign of slowing and the Congress has taken no serious action on the budgetary front, this implies continuing current account deficits and a weaker dollar going forward.

A second school of thought instead attributes America's deficit to the attractions of investing in the United States. This emphasis is consistent with the literature pointing to accelerating U.S. productivity growth. It is consistent with the high levels of corporate profitability evidently anticipated by those who have bid U.S. asset markets up to high levels.

The only problem is that the U.S. investment rate, far from rising, has actually fallen by 2 per cent of GDP from the levels scaled in the bubble years of the 1990s. Moreover, since 2001 foreign investment has flowed not into U.S. equities but into government debt. It is hard to imagine that non-residents rushed into U.S. treasury bonds because they were impressed by the rapid productivity growth of the U.S. nonfarm business sector.

Where both the deficient-saving and buoyant-investment interpretations emphasize events in the U.S., the two remaining schools of thought point instead to developments in the rest of the world. Thus, there is Bernanke's global savings glut hypothesis: that savings rates have risen in Asia and Europe and this additional liquidity has nowhere better to flow than to the United States. Unfortunately for Mr. Bernanke, savings rates outside the United States barely budged over the period when the U.S. current account deficit was exploding. Yes, Chinese savings rates rose sharply, but China still accounts for only a small fraction of global savings and investment.

And even if this view has some validity, its implications for the dollar are not heartening. Japanese saving will fall as the country finally exits from its deflation and consumer confidence recovers. Saving rates in China will fall as that country builds a social safety net and develops financial markets on which households can borrow to purchase homes and pay for their kids' education. And if the rest of the world saves less, there will then be less liquidity to flow into dollar securities.

Finally, there is the school of thought emphasizing stagnant investment outside the United States. Compared to the early 1990s, investment as a share of GDP is down by 9 percentage points in Japan. It is down by 3 percentage points in Europe. Compared to the period preceding the Asian crisis, it is down by 5 percentage points in the Asian NIEs and by 10 percentage points in the four big ASEAN economies. With these regions investing less, they have more resources to place in U.S. securities.

But, again, this view does not bode well for the dollar. If Japan is finally now exiting from its deflation, its investment will rise. In the euro area, structural reform will eventually boost growth and investment. Investment rates have already begun recovering toward pre-crisis levels in ASEAN and the NIEs. Increases in investment in these surplus regions will inevitably move their current accounts toward balance, implying a reduction in the U.S. deficit and, necessarily, a fall in the dollar.

So which interpretations are right? The New York University economist Nouriel Roubini likens the existence of the different perspectives to the Kurosawa film *Rashomon,* in which a series of observers give conflicting accounts of the same events. In Kurosawa's film the competing accounts are all self serving, a pattern that Roubini suggests carries over to the discussion of global imbalances.

However, Roubini departs from Kurosawa in arguing that there is only one true version of the facts. In contrast, I – like Kurosawa – would argue that the advocates of the four interpretations have each got their fingers on an aspect of the larger reality. Their accounts are not incompatible. In each case, however, they are partial. Grasping the nature of the problem requires acknowledging that there is some validity to all four views. The slump in U.S. savings, the attractions of U.S. investment, a modest rise in savings in the rest of the world, and an investment slowdown centered on Asia have all contributed to the emergence of the prevailing global imbalances. A better analogy is therefore the Asian proverb of the blind men and the elephant.

Still, the fact that there are four sets of factors at work will be cold comfort to dollar bulls, since all four point to a weaker dollar. There is no sign that U.S. saving is recovering. The attractions of investing in the U.S. will weaken as foreign central banks match the interest-rate increases initiated by the Fed. Japanese and Chinese savings rate will decline. And Asian investment is already picking up.

Fortunately, a weaker dollar is to be welcomed. The currency's perverse strength in 2005 only caused the U.S. current account deficit to widen further, as U.S. imports cheapened and the country's exports were rendered more expensive. Were the dollar to remain at current levels, the U.S. current account would burst through 10% of GDP by the end of the decade. Clearly, foreign investors will not be willing to finance deficits of this magnitude. My guess is that the U.S. current account deficit will have to fall to at most half of current levels in order to stabilize foreign claims on the United States at levels acceptable to foreign investors, at say 60 per cent of U.S. GDP. In turn this will require a further real effective depreciation of the dollar of at least 20 per cent.

To be sure, how much the deficit will have to shrink and how far the dollar will have to fall depend on when adjustment begins. The longer that adjustment is delayed, the larger will be the stock of U.S. external liabilities, and the larger will have to be the increase in net exports needed to service it. If adjustment begins now, in contrast, the necessary depreciation of the dollar will be more limited. Moreover, if the adjustment begins now, the depreciation of the dollar can be spread over several years. But the longer it is delayed, the faster the change in currency values will have to be once it finally comes. And the larger and more rapid is the dollar's fall, the more disruptive will be the effects.

The worst-case scenario is one in which adjustment is delayed until foreign finance dries up abruptly, forcing America's current account deficit to be eliminated at a stroke. The result would be very sharp compression of U.S. and global demand.

Better would be for the dollar to start falling slowly but steadily now. As the Fed boosted interest rates in response to the incipient inflationary consequences, U.S. households would begin saving again. The U.S. would import less. The U.S. deficit could be narrowed gradually.

To be sure, the consequences would not be entirely happy for the rest of the world. Asia, which depends so heavily on the U.S. market, would feel the effects as a demand slowdown. Fortunately, China and most of Emerging Asia have room to use fiscal policy – to boost public spending on health care, education and infrastructure – in order to sustain demand and growth. Japan, alas, has no fiscal room for maneuver. It will have to hold its breath and hope that its recovery is self-sustaining.

Will the dollar cooperate? If the greenback moves "the wrong way," it will not be the first time. We can only hope that, in 2006, the markets have a roadmap.

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