The Levy Economics Institute of Bard College

Policy Note

2005 / 3

IS THE DOLLAR AT RISK?

KORKUT A. ERTÜRK

A massive fiscal stimulus and, until recently, aggressive monetary easing have been successful in raising bond and real estate prices to unprecedented levels, inducing a credit boom that has prevented private consumption from falling. While it might still be too early to say that it worked, the strategy has indeed, for the time being, prevented the U.S. economy from slipping into a severe depression after the collapse of the stock market at the turn of the millennium.

But, in the meantime, the aggregate macroeconomic imbalances have clearly gotten worse (Papadimitriou et al. 2005). The budget deficit has risen steadily every year in the last four years and was estimated to exceed $400 billion in 2004. The current account deficit is already well in excess of 5 percent of GDP. The value of assets owned by foreigners in the United States has by now reached $3.3 trillion, almost 30 percent of GDP, and is double the share of four years ago. This amount now exceeds what Americans own in the rest of the world, and net investment income—interest plus dividend payments—will increasingly turn negative for the United States as interest rates go back up in the future.

There has been some improvement in the level of indebtedness in the corporate sector in the last few years, but households' indebtedness remains at an all-time high. The saving rate out of household disposable income is barely positive, and the overall national saving rate is slightly above a minuscule 1 percent of GDP. The weakening of the dollar, about 16 percent on a broad

Research Associate Korkut A. Ertürk is an associate professor and chair of the University of Utah Department of Economics.

The Levy Economics Institute is publishing this research with the conviction that it is a constructive and positive contribution to the discussion on relevant policy issues. Neither the Institute's Board of Governors nor its advisers necessarily endorse any proposal made by the author.

Copyright © 2005 The Levy Economics Institute

trade-weighted basis since its peak in February 2002, shows no sign of having any real impact on the current account deficit, making one wonder how much further the dollar can decrease without triggering a sharp rise in U.S. interest rates.

The Dollar: A Bleak Outlook

Technically, an even weaker dollar could allow the U.S. economy to expand at the expense of the Asian and European economies (Godley et al. 2004). But, if that meant higher interest rates, the level of private consumption in the United States could not possibly maintain its current level, and a severe recession would surely result. Given the high level of indebtedness of the household sector, the negative impact of sharply higher interest rates on private consumption would be considerably stronger than the positive impact on exports stimulated by the lower dollar.

What happens to interest rates in the United States as the dollar continues to lose value depends on the degree to which the foreign demand for U.S. financial assets slackens. A drawn-out, gradual weakening of the dollar would make U.S. assets less and less attractive for foreign investors, and would sooner or later push up their yields to levels that can more than compensate for the higher devaluation risk they now possess. In fact, within the last year, net private capital flows have almost consistently remained below $57 billion, the average monthly U.S. current account deficit, requiring official purchases to make up the difference. For all intents and purposes, the United States is now dependent on a handful of foreign (mostly east Asian) central banks to attract enough capital to cover its foreign deficit.

Arguably, a steep dollar devaluation, rather than a slow downward drift, would be better for the U.S. economy, as it would wipe out the devaluation risk of U.S. assets in one fell swoop, making them cheap and attractive to foreign buyers once again. Moreover, the net asset balance of the United States vis-à-vis the rest of the world would also improve considerably after a maxi devaluation. But it is doubtful that the United States would be able to bring about an abrupt devaluation, even if it wanted to, short of causing a complete financial breakdown. Barring cataclysmic events, it appears that what will happen to the dollar and U.S. interest rates in the near future will increasingly be dictated by the interests of foreigners, such as the Chinese and other Asians, who are already in possession of a massive cache of U.S. dollars. This means that the United States will find it increasingly difficult to maintain any real control over its financial and economic destiny.

A Structural Conundrum?

Given this structural bind, it is possible to speculate about three distinct scenarios for the near future. First, against all odds, the economic recovery takes hold in the United States, and the world economy settles on a path of sustainable growth. The United States would then resume being the engine of world growth by continuing its role as the importer of last resort, and exports could continue to lead aggregate demand in much of the rest of the world. The twin deficits would then cease to be a problem: the current account deficit would be equity financed by private foreign investors, and the budget deficit would, over time, simply shrink—in ratio to GDP, if not in absolute level—with higher output growth.

The second possibility is a complete collapse of the dollar and cataclysmic turmoil in financial markets worldwide. This could occur if, for some unexpected reason, financial panic overwhelmed the ability of world central banks to absorb a massive worldwide dollar sell-off. Thus, even if no one desired it, there could be a run on the dollar. Such weakening could snowball out of control, especially if smaller central banks around the world yielded to the temptation to break rank first and diversify out of the dollar before it lost more of its value. Bigger players might not be able to stop the destabilization process once it was set in motion. The financial press is already awash with stories about central bankers making plans to diversify reserves in order to reduce their exposure to the dollar and about oil producers parking ever smaller amounts of proceeds in dollar-denominated accounts. No matter how it happened, the ultimate effect of a run would be an abrupt rise in U.S. savings, brought about by sharply curtailed spending and output, with disastrous effects on the rest of the world as well. The impact would be similar to that of an abrupt reduction in the federal deficit.

By now, the first scenario looks increasingly far-fetched, if not impossible. The housing price bubble is the single most important obstacle the U.S. economy will face in the next couple of years. The U.S. personal saving rate is so low mainly because households are able to tap into the overvalued equity in their houses by refinancing their mortgages. That, clearly, will not continue. When housing prices begin falling, the effect could, potentially, be much worse than the bursting of the stock market bubble. The impact could be devastating because, currently, household property holdings are almost twice as large as the aggregate size of stock portfolios in the United States (*Financial Times* 2004). Also, the Federal Reserve will have less room for monetary easing, and the budget deficit cannot be increased much more. Moreover, recent news reports about financial irregularities and undeclared losses at Fannie Mae, while not surprising, are another sign of serious trouble ahead.

Yet, it appears that just as financial markets are losing all faith in the viability of this first possibility (i.e., U.S.–led recovery), the pieces are increasingly being held together by the fear of the second (i.e., complete collapse of the dollar). The latter is indeed too frightening to contemplate. Hence, the term, "the balance of assured mutual financial destruction," coined recently by Larry Summers, captures the knife-edge quality of the unstable state of the dollar. The first possibility, as described above, is but a chimera; the second, a nightmare. That alone, one would think, makes a third option desirable. What would a third option be?

That option would depend on whether those who are in a position to make or break the dollar would be able to engage the United States "constructively," now that it is no longer in a position of strength. With the political, economic, and military strain of Iraq beginning to show, time will tell if the current U.S. "charm offensive" against Europe is too little, too late. Many in Europe (and around the world) feel that a "humbled George W. Bush administration" will be impossible unless neoconservatives lose face in Washington, while others will argue that Europe cannot afford to let a failed United States turn its back on the rest of the world. However, the economic and political costs of keeping the United States engaged on its own terms—with its neoconservative unilateralism intact—will continue to rise steadily. In the event, the world will prepare harder for the day when it will have to wean itself from the U.S. markets. The Asian central banks are unlikely to start selling off dollars in financial markets any time soon, though their governments will probably become increasingly assertive in trying to use their cache of dollars to acquire control over real resources around the world. The recent Chinese incursion into the Canadian oil sector and China's stepped-up investments throughout Latin America are cases in point. Judging from the reaction in the U.S. Congress to the planned purchase of IBM's personal computer business by the Chinese-controlled Lenovo Group, political tensions are sure to rise, perhaps even before economic complications take center stage, and, as a result, the dollar might have a respite in the short run. What happens in the longer term might be more certain.

Disquiet and Division

An extended period, characterized by increasing unease about the weakening dollar and heightened uncertainty about other major currencies, is bound to blunt the attractiveness of the dollar for wealth owners in the rest of the world. Once the dollar ceases to be the magnet it has been until recently, not only will hot money flow out of the center, but "local" wealth will return home in the periphery. For developing countries, this holds the promise of at least a partial respite from their vulnerability to international capital markets in the era of globalization. If they bear fruit, some of the current attempts at establishing regional economic and financial networks can help entrench this relative expansion of "breathing space" in the developing world. For instance, the growing cooperation within Asean Plus Three (APT), which brings the member countries of the Association of Southeast Asian Nations together with China, Japan, and South Korea, can eventually give rise to a regional financial network. This idea is similar to that of an Asian Monetary Fund, which the United States and the International Monetary Fund (IMF) stridently opposed in the aftermath of the Asian crisis.

It is often remarked that whatever doubts the world might have about the leadership qualities of the United States—whether in terms of its ability to act as the economic engine of world growth or keep to the moral high ground—the world has no alternative. Lest this give a false sense of stability, however, the issue might be the dissipation of U.S. power, rather than a transfer of its power to another entity. A loose alliance of countries that have come to define their self-interest with the creation of a multipolar world that bypasses the United States might be in the making. A recent Central Intelligence Agency assessment finds that, "An EU [European Union]–China alliance, though still unlikely, is no longer unthinkable," and notes that, because of its growing ties to China, Europe's allegiance could, eventually, shift away from the transatlantic alliance (Dombey and Spiegel 2005). That such an assessment was made is highly significant. Despite strong U.S. opposition, the EU is setting up a satellite network, called Galileo, that will break the monopoly of the U.S. global positioning system, and moving ahead with its own rapid reaction force and military planning agency independent of NATO. The United States is even more irritated by the EU's determination to lift the arms embargo against the Chinese and by China's planned involvement in the European satellite network. In 2003 I mused, in another policy note (Ertürk 2003), about the possible emergence of a formidable Eurasian bloc—bringing together a viable reserve currency (the euro), a credible capacity for nuclear deterrence and oil production (Russia), and an economic kingmaker (China)—before remarking that it was basically inconceivable. Today, that proposition, though still farfetched, is no longer empty.

References

Dombey, D. and P. Spiegel. 2005. "Why Europe is Ready to Lift its Weapon Ban on China." *Financial Times*, February 14.

Financial Times. 2004. "America's Ominous Housing Bubble," December 4.

Godley, W., A. Izurieta, and G. Zezza. 2004. *Prospects and Policies for the U.S. Economy: Why Net Exports Must Now Be the Motor for U.S. Growth.* Strategic Analysis. Annandale-on-Hudson, N.Y.: The Levy Economics Institute.

Ertürk, K. A. 2003. "The Future of the Dollar: Has the Unthinkable Become Thinkable?" Policy Note 2003/7. Annandale-on-Hudson, N.Y.: The Levy Economics Institute.

Papadimitriou, D. B., A. M. Shaikh, C. H. Dos Santos, and G. Zezza. 2005. *How Fragile Is the U.S. Economy?* Strategic Analysis. Annandale-on-Hudson, N.Y.: The Levy Economics Institute.

Recent Policy Notes

Is the Dollar at Risk?
KORKUT A. ERTÜRK
2005/3

Manufacturing a Crisis: The Neocon Attack on Social Security
L. RANDALL WRAY
2005/2

The Case for an Environmentally Sustainable Jobs Program
MATHEW FORSTATER
2005/1

Those "D" Words: Deficits, Debt, Deflation, and Depreciation
L. RANDALL WRAY
2004/2

Inflation Targeting and the Natural Rate of Unemployment
WILLEM THORBECKE
2004/1

The Future of the Dollar: Has the Unthinkable Become Thinkable?
KORKUT A. ERTÜRK
2003/7

LEVY INSTITUTE MEASURE OF ECONOMIC WELL-BEING

Economic Well-Being in U.S. Regions and the Red and Blue States
EDWARD N. WOLFF and AJIT ZACHARIAS
March 2005

How Much Does Public Consumption Matter for Well-Being?
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
December 2004

How Much Does Wealth Matter for Well-Being? Alternative Measures of Income from Wealth
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
September 2004

Levy Institute Measure of Economic Well-Being: United States, 1989, 1995, 2000, and 2001
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
May 2004

Levy Institute Measure of Economic Well-Being: Concept, Measurement, and Findings: United States, 1989 and 2000
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
February 2004

PUBLIC POLICY BRIEFS

The Fed and the New Monetary Consensus
The Case for Rate Hikes, Part Two
L. RANDALL WRAY
No. 80, 2004 (Highlights, No. 80A)

The Case for Rate Hikes
Did the Fed Prematurely Raise Rates?
L. RANDALL WRAY
No. 79, 2004 (Highlights, No. 79A)

The War on Poverty after 40 Years
A Minskyan Assessment
STEPHANIE A. BELL and L. RANDALL WRAY
No. 78, 2004 (Highlights, No. 78A)

The Sustainability of Economic Recovery in the United States
The Risks to Consumption and Investment
PHILIP ARESTIS and ELIAS KARAKITSOS
No. 77, 2004 (Highlights, No. 77A)

Asset Poverty in the United States
Its Persistence in an Expansionary Economy
ASENA CANER and EDWARD N. WOLFF
No. 76, 2004 (Highlights, No. 76A)

STRATEGIC ANALYSES

How Fragile Is the U.S. Economy?
DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA
March 2005

Prospects and Policies for the U.S. Economy: Why Net Exports Must Now Be the Motor for U.S. Growth
WYNNE GODLEY, ALEX IZURIETA, and GENNARO ZEZZA
August 2004

Is Deficit-Financed Growth Limited? Policies and Prospects in an Election Year
DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA
April 2004

Deficits, Debts, and Growth: A Reprieve But Not a Pardon
ANWAR M. SHAIKH, DIMITRI B. PAPADIMITRIOU, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA
October 2003

WORKING PAPERS

Asset Ownership along Gender Lines: Evidence from Thailand
RANIA ANTONOPOULOS and MARIA S. FLORO
No. 418, February 2005

Determinants of Minority-White Differentials in Child Poverty
YUVAL ELMELECH
No. 417, February 2005

Occupational and Industrial Mobility in the United States, 1969–1993
ERIC PARRADO, ASENA CANER, and EDWARD N. WOLFF
No. 416, January 2005

Measuring Capacity Utilization in OECD Countries: A Cointegration Method
ANWAR M. SHAIKH and JAMEE K. MOUDUD
No. 415, November 2004

This Policy Note and all other Levy Institute publications are available online on the Levy Institute website, www.levy.org.

To order a Levy Institute publication, call 845-758-7700 or 202-887-8464 (in Washington, D.C.), fax 845-758-1149, e-mail info@levy.org, write The Levy Economics Institute of Bard College, Blithewood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000, or visit our website at www.levy.org.

The Levy Economics Institute of Bard College
Blithewood
PO Box 5000
Annandale-on-Hudson, NY 12504-5000

Address Service Requested

NONPROFIT ORGANIZATION
U.S. POSTAGE PAID
BARD COLLEGE