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US deficit a ticking time-bomb

Idea of a New Bretton Woods system is flawed, but an effective defusing requires simultaneous actions on many fronts

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THE sustainability of the US current account deficit and its resulting implications for the US dollar is the dominant global macroeconomic concern in 2005, just as it was in 2004. One might quite legitimately ask why the deficit has become such a headline-grabber in recent times.

After all, the deficit has been there for most of the 1990s - quadrupling between 1995 and 2001 - without any significant backlash on either the US dollar or the US economy as a whole. Indeed, the latter half of the 1990s was a period of general robust growth in the US economy and secular appreciation of the US dollar.

There is, in fact, a school of thought that argues that the global macroeconomic situation - whereby the deficit is partly financed by the reserves accumulated by Asian countries which have maintained undervalued exchange rates - is a perfectly normal state of affairs.

Proponents of such a view point to the Bretton Woods system of fixed exchange rates that was initiated in 1944 with an agreement between the war-ravaged Western European countries and the US that the latter would keep its borders open for exports from the former. Thus, while the US acted as the 'importer of last resort', the European countries pegged their respective currencies at undervalued levels to the US dollar to remain cost-competitive.

The currency undervaluation and resulting foreign exchange market intervention allowed Western Europe to acquire reserves which were in turn used to finance the US current account deficit at a low cost. There was no immediate or obvious pressure on the US to check its excessive spending. This system of global fixed exchange rates pegged to the US dollar lasted until 1973.

This US-Western Europe axis (with Japan joining in in the 1960s) seems to bear an uncanny resemblance to the current relationship between the US and vendor financing by Asia, leading some to suggest that a New Bretton Woods has emerged since the 1990s. Proponents argue that the current arrangement of international settlements ought to be able to persist for a long time to come as many developing Asian countries (China, in particular, but also others in South-east Asia, and India and South Korea) are attempting to grow rapidly by exporting to the US via an undervalued currency. In turn, the Asian central banks are perfectly happy to hold US sovereign paper as a necessary condition to sustain the export-led growth.

Asia will not stop financing the US on a large scale as that will lead to a marked rise in US long-term interest rates, which in turn might trigger a collapse in US property and equity prices and a concomitant fall in US consumer spending on all goods and services, including those from Asia. Going by this logic, the global macroeconomic imbalances are structural and inherently stable; fears of instability are grossly overstated.

However, the New Bretton Woods notion runs into major problems when matched against the facts.

The rapid build-up in reserve in Asia really took place after the Asian crisis of 1997-98, and escalated from 2000 onwards, largely because of capital account surpluses (as foreign investors have been anticipating Asian currency revaluations and resulting capital gains). Pre-1997, many developing countries in Asia actually ran current account deficits.

The conventional wisdom then was that Asian economies were growing and industrialising rapidly and needed high levels of foreign capital to spur their development, and the current account deficits would eventually be self-correcting.

Thus, unless there has been a significant and conscious change in the growth strategies in Asia post-crisis, one would be hard-pressed to argue that the ongoing imbalances are part of some sort of grand bargain or implicit global understanding which can persist ad infinitum.

More likely, at least in the case of South-east Asia and Korea, the current account adjustments (from deficit to surplus) was forced on the region by the crisis and it has persisted partly because domestic demand - investment demand, in particular - has not fully recovered from the shock of 1997-98.

As such, while many South-east Asian countries continue to be high savers, they are not nearly as high investors as they used to be in the 1980 and 1990s. The resulting surpluses in the private sector financial balances in Asia have in turn been recycled to the US to finance that country's national dissavings.

But even if we accept the New Bretton Woods hypothesis, the conclusion that the current pattern of international settlements is stable does not automatically follow. While the official sector dominated capital flows in the pre-1970s period, international private portfolio flows are much more significant nowadays.

Thus, there is no reason to expect private sector's assessment of relative attractiveness of US assets to be influenced by any such global understanding among governments.

Concerns about the US dollar are understandable in view of the relentless deterioration of the US current account deficit (over 6 per cent of GDP with projections that it could easily reach 8 per cent by 2008 without any adjustments or change in economic fundamentals).

The yawning US current account imbalance has in turn been caused largely but not solely by acute fiscal profligacy in the US (re-emergence of the so-called 'twin deficits').

Worse still, there appears to be a total lack of commitment on the part of the current US administration to take remedial actions against the ever-worsening national dissavings position. The recent statement by US Treasury Secretary John Snow, that the administration is concerned about the fiscal deficit and is committed to halving it in the next four years, is good news. However, financial markets are looking for these words to be backed up by action.

All of this explains the acute bearishness against and therefore persistent secular weakness in the US dollar. Asian central banks which hold significant amounts of US sovereign debt are caught in a conundrum. Assuming they remain convinced about the need to maintain an artificially undervalued currency (despite its potentially inflationary side-effects), should they aggressively diversify their reserves away from the US dollar to euros and other assets?

If any single central bank with large US dollar holdings does diversify on a large scale, that will

lead to a self-fulfilling prophesy as the US dollar will fall steeply, hence eroding the capital values of their existing reserve assets. But if central banks do not sell off their US dollar reserves, while their counterparts do, they face significant financial losses which may be unpalatable.

Many market watchers and policy analysts quite rationally fear that the US dollar is treading too close to the edge of a cliff and is being precariously held back by an informal - and inherently unstable - cartel among Asian central banks.

Will these central banks be willing to finance ever-larger shares of the US external imbalance as private agents decrease their holdings of US dollar-denominated assets? Thus far, it appears that Asian and other central banks have chosen to maintain past reserves in US dollar assets, and gradually diversifying their new reserve flows away from the US dollar.

This ongoing gradual portfolio rebalancing in turn has further contributed to the slide of the US dollar, which will probably persist as long as the US administration does not take substantive steps to enhance fiscal discipline.

What should Asia do? Mere shifting of reserves by Asian central banks into euros cannot be a sustainable strategy as it is unlikely that Europe will be prepared to passively accept a perpetual strengthening of the euro and the relentless erosion of their price competitiveness.

Asia therefore needs to focus on introducing greater exchange rate flexibility in a graduated manner (particularly true for China), while simultaneously taking other steps to revive domestic demand (particularly true for South-east Asia, Korea and India).

Europe, for its part, needs to eschew any protectionist pressures that might emanate from its domestic manufacturers, while at the same time persisting with needed structural reforms to enhance factor market flexibility to better withstand currency market pressures.

Orderly resolution of the current global macroeconomic imbalances requires actions on many fronts at the same time.

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