

Dollar devaluation cannot right the US economy

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Well-known international economist Barry Eichengreen has taken issue with the views of those he calls “congenital optimists” who maintain that the fall of the US dollar will bring about a smooth “rebalancing” of the world economy. Writing in the *Financial Times* on Monday, Eichengreen noted that at current exchange rates the US current account deficit was on an “explosive path” and set to widen from its current level of between 5 and 6 percent of US gross domestic product (GDP) to 8 percent by 2008 and 12 percent in 2010.

Eichengreen noted that deficits of this magnitude could not continue to be financed indefinitely through the inflow of foreign capital. At some point foreign investors “would pull the plug, and the dollar and the US economy would come crashing down.” While a moderate decline in the dollar and a narrowing of the US balance of payments deficit would be preferable to a “sudden and catastrophic fall later,” Eichengreen wondered whether it was already too late for such a smooth adjustment.

A large fall in the dollar would lead to upward pressure on interest rates, bringing about a “significant fall” in consumption and investment in the US and a consequent recession. While markets were not yet anticipating a recession, foreigners, who view the US current account deficit as unsustainable, would continue to sell dollars until interest rates began to move upwards. This meant that a slowdown in the US economy, or more likely a recession, was unavoidable.

“The question is whether there is anyone to take up the slack. For the world economy to avoid a serious downturn, less consumption and investment in the US will have to be offset by more consumption and investment elsewhere. But where? Europe is stagnant ... China is cooling off, and it will cool off more as it

allows its currency to strengthen. Japan’s modest recovery will disappoint now that it has to raise taxes to control its own spiralling debt. Countries outside the Group of Four nations (the US, the UK, Japan and Germany) are simply too small to make a difference.”

In other words, he concluded, the “correction” of the US current account deficit will mean a recession, not just for the US, but for the rest of the world as well.

Eichengreen’s warnings come in the wake of the latest figures from the US Commerce Department, which show that the current account deficit grew to a record \$164.7 billion in the third quarter, up from \$164.4 billion in the previous quarter.

While the payments deficit was less than the predicted \$171 billion, it was still described as “very worrisome.” Wells Fargo Bank chief economist Sung Won Sohn told the Agence France Presse news agency that he expected the outlook would get worse. “I don’t see this trend changing any time soon despite the sharp dollar depreciation. My worry is that we could see the dollar not only falling further but also we run the risk of a plunge in the value of the dollar at some point as it becomes more and more difficult to attract foreign investors.”

Sohn is one of a growing number of economists who point out that dollar depreciation alone will not be enough to reduce the US balance of payments deficit and that the main problems are the record budget deficits and low savings rates.

Lehman Brothers senior economist Ethan Harris warned there was a limit to how far foreign investors were prepared to finance US deficits. “We’re saying to the world as a nation: ‘Lend us more money.’ And every quarter we’re sending out a bigger request. We have also seen in the last years that ... preventing a bigger drop in the dollar has required massive

interventions by Asian central banks, buying tons of US assets and filling the hole left by private investors hesitating to lend money to the US.”

As the payments crisis deepens, attention has turned to the so-called Plaza Agreement of 1985 (named after the Plaza Hotel in New York where the discussions were held) in which the major capitalist powers agreed to joint action to lower the value of the US dollar in order to cut the American trade deficit.

Recalling the agreement, an article in last Sunday’s *New York Times* noted that while the problems facing the Bush administration were not identical to those confronted by President Reagan in 1985 “some economists suggest that the process of policy coordination formalised at the Plaza provides a map that Mr Bush may want to follow.”

But as with generals who fight the last war, this may well be a case of economists reliving the previous economic crisis. The situation confronting the US economy is vastly different from that which prevailed in 1985. The most significant difference is the level of debt. Twenty years ago, despite the growing budget and trade deficits, the US was still a net creditor nation. Today it is the world’s biggest debtor, with external liabilities now amounting to more than \$3 trillion, equivalent to about 30 percent of GDP.

Furthermore, there is some doubt about the effect of the Plaza currency realignment in bringing down the US deficit. Even after the agreement, the US trade deficit continued to expand and only started to fall towards the end of the decade as a result of slowing economic growth and a recession in 1991.

According to an analysis by economic commentator Kurt Richebacher, the source of the trade deficit was not the overvalued dollar. Rather it lay in the low levels of savings and capital investment. Richebacher noted that in the years 1989-93, when the trade deficit declined, total credit in the US grew by \$819 billion per year. However, during the four years to mid-2004, it grew three times as fast—\$2.4 trillion a year, with no letup in sight.

This credit growth is the result of the expansionary monetary policy pursued by the US Federal Reserve, which reduced interest rates 13 times between January 2001 and June 2003. But according to Richebacher, monetary and fiscal stimulation has now largely spent itself without producing a self-sustaining investment

recovery. As a consequence, the imbalances and dislocations “make a normal, sustainable economic recovery flatly impossible” and render the US economy “highly vulnerable to a sudden downturn.”



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