The Dollar Problem

Time for East Asia to expand aggregate demand.

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BY RONALD I. MCKINNON

The sustainability of the huge U.S. current account deficit depends on the continuance of the world dollar standard. If the United States as center country maintains a stable price level, countries with trade surpluses are loathe to let their currencies appreciate against the dollar for fear of losing mercantile competitiveness in the short run while risking deflation in the long run. If private capital inflows are insufficient to fund the U.S. current account, then foreign central banks step in to buy dollar assets to prevent their currencies from appreciating. Thus, the deficit could continue indefinitely with no well-defined upper bound on America's net international indebtedness.

However, this uneasy equilibrium could be upset if the Federal Reserve loses monetary control by some "accidental" domestic event, say, pumping too much liquidity into the economy to avoid a cyclical downturn—as might be the case with the current subprime mortgage crisis. Alternatively, if U.S. protectionists succeed with bashing China or Japan to force the dollar down, then foreign holders of liquid dollar assets would again become nervous. There could be a tipping point where investors in Asia or the Persian Gulf so fear the loss of the dollar's international purchasing power that they jettison their dollar holdings—despite the short-run pain of letting their own currencies appreciate. Such a deep and general dollar devaluation would then cause massive inflation in the United States itself.

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More positively, as the old literature on the transfer problem would suggest, the United States can reduce its current account deficit without devaluing the dollar. If spending falls in the United States (the silver lining in the housing crisis?) matched by an increase in spending in trade-surplus countries, then the American trade deficit diminishes without a dollar devaluation turning the terms of trade against the United States or provoking a flight from dollar assets.

Should we worry about a deficiency in global aggregate demand when American households reduce their spending? In the longer run, the overdue righting of the financial imbalance in American households is both opportune and necessary to reduce the huge American current account deficit. But, in the near term when American households are no longer "consumers of last resort," how can this be accomplished without falling into a pit of deficient aggregate demand at the global level?

Instead of nattering about the dollar's exchange rate, which is the wrong variable to adjust, the U.S. Secretary of the Treasury should now approach his counterpart finance ministers in East Asian countries and possibly Germany to expand aggregate demand jointly. In China, for example, household consumption has been lagging behind the very rapid growth in GDP; and China's recent success—not fully anticipated—in collecting taxes could be generating an as-yet-unrecognized fiscal surplus. Similarly, Japan has actually been running public sector surpluses over the past four years. So these governments, and Germany's, can afford to be fiscally expansive over the next two years or so as part of a worldwide countercyclical policy. Apart from international altruism, each of these countries has an individual incentive to expand fiscally because their exports will decline as the American consumer is forced to retrench. And further American fiscal expansion (government dis-saving) is not desirable if the U.S. current account deficit is to be reduced.

If foreign governments with surplus saving act jointly to become more expansionary fiscally, the United States can better avoid another unwise round of unduly easy monetary policy—like that following the collapse of the high-tech bubble in 2001. In concert with European Central Bank, the People's Bank of China, and the Bank of Japan, the U.S. Federal Reserve can then more easily ensure that the foreign currency value of the dollar remains stable in the transition between less aggregate spending in the United States to more in Asia and Europe. ◆

Ronald I. McKinnon is the William D. Eberle Professor of International Economics at Stanford University.