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Europe must prepare for fall in US dollar

Like the dog that didn't bark in the Sherlock Holmes mystery, the most striking feature of the global economy in 2005 may not have been so much what happened as what didn't happen.

Another year went by without any sign that the long-awaited adjustment in global current account imbalances, especially the huge US current account deficit, was about to begin.

On the contrary, 2005 saw the US external deficit - which is mainly due to US imports being much greater than its exports - continue its rise, propelled in part by higher oil prices and a rebound in the dollar.

Will 2006 be the year that adjustment begins? It might well be, and if so, the performance of the global economy this year will depend critically on how the adjustment process evolves.

Since 1997, the US current account deficit has ballooned to unprecedented levels, driven by a dramatic deterioration in the trade balance.

The current account deficit is estimated to have widened to a record 6 per cent of GDP in 2005 and shows no signs of bottoming out.

An overvalued dollar and robust economic growth in the United States relative to the rest of the world have boosted US imports and depressed US exports. As a result, US imports are now roughly 70 per cent larger than US exports.

Deficits of this size are not sustainable.

Put simply, the US is living beyond its means. To finance ongoing current account deficits, the United States must borrow from the rest of the world.

This adds to US net external liabilities, which have risen from less than 3 per cent of GDP in 1990 to an estimated 25 per cent of GDP in 2005.

This trend of rising US net external liabilities relative to GDP cannot continue forever.

As Herbert Stein, chairman of the Council of Economic Advisers under Presidents Nixon and Ford, famously remarked, "That which cannot go on forever won't."

A continuously rising ratio of net external liabilities to GDP would eventually see the burden of servicing these liabilities becoming unbearably large. As my

former boss, Alan Greenspan, has pointed out, at some point foreign investors will balk at further financing.

We know that the US current account deficit must narrow eventually. We also know that this process will almost certainly involve a drop in the dollar.

Given that the responsiveness of US exports and imports to changes in the exchange rate is relatively small, substantial dollar depreciation, perhaps in the range 20-40 per cent, will be required to shrink the US trade deficit.

From an Irish perspective, a 20-40 per cent fall in the value of the dollar against the euro would leave one euro worth between $1.50 and $2.00! Wonderful for the hoards of Irish shoppers jetting to New York and Boston, but disastrous for Irish firms exporting to the United States.

Worryingly, the longer current account adjustment is delayed, the more pronounced will be the depreciation of the dollar. Perhaps ironically, a weakening dollar will probably have relatively benign effects on the US economy, at least if the correction is orderly. US exports will increase and the Fed will respond to contain any effects on inflation.

The consequences of adjustment for the rest of the world, however, will be much more problematic. As one US official said to a foreign visitor, "It's our currency, and your problem!"

For starters, if adjustment were to start today, a narrowing of the US trade deficit to about zero would imply a contraction of US net exports of roughly $700 billion at an annual rate.

The flip side of this adjustment is that the rest of the world's trade surplus with the United States would necessarily shrink $700 billion. It is not clear that many countries are growing robustly enough to be able to withstand such a sizable decline in exports.

How much of the heavy lifting could, say, Germany do without plunging into recession? Or Italy? Or Japan? The answer is, "Probably not much."

For example, let's assume that the burden of adjustment is shared equally among Asia, Europe, and the major oil exporting countries. This would imply a decline in European net exports of $233 billion, equivalent to about 2 per cent of EU-15 GDP.

For the currently anemic European economy, this decline in exports would represent a significant blow, even if it were spread over several years.

The Irish economy would appear to be particularly vulnerable. US imports from Ireland account for nearly 2 per cent of total US imports. Therefore, Ireland's

"fair share" of adjustment would imply a drop in Irish exports of around $14 billion, equivalent to about 8 per cent of Ireland's GNP.

For a manufacturing sector that is already losing competitiveness because of faster growth in wage costs here compared with our main trading partners, the effects of adjustment could be devastating.

To make matters worse, Ireland may be disportionately affected by the drop in the dollar, given our role as an export platform for many US multinational firms. The fall in the dollar will push up the dollar cost of wages in Ireland, making it attractive for these firms to shift some production back to the United States.

A related issue revolves around what will happen to the value of sterling when the dollar weakens. An appreciation of the euro against sterling, as well as the dollar, would compound the damage to Ireland's competitiveness.

Moreover, it's hard to see how Ireland's frothy property market could withstand the resulting deterioration in confidence, given the rosy expectations of future income growth that are implicit in the rapid expansion of credit in Ireland.

Current account adjustment will also affect the global economy through financial channels. When adjustment eventually occurs, holders of dollar assets in the rest of the world (that is, outside of the United States) will suffer negative wealth effects.

The rest of the world held about $9,300 billion of gross dollar assets at the end of 2004. The euro area's holdings amounted to nearly $3,000 billion, equivalent to about one-third of euro area GDP.

If adjustment started today, depreciation in the dollar of 30 per cent would imply a loss of wealth for the rest of the world equal to nearly 10 per cent of rest-of-the world GDP. The hit to euro area wealth would be of a similar order, relative to GDP.

These numbers assume an orderly adjustment. The wealth effect of a disorderly adjustment would be even greater.

Such a scenario would not only involve an abrupt drop in the dollar, but would also see surging US interest rates, falling US stock prices, and weaker economic activity in the United States.

The effects would probably spill over into financial markets in other countries, dragging down asset prices in Europe and elsewhere.

What should policymakers in Europe do to prepare for global current account adjustment? The domestic macroeconomic consequences of adjustment will be less severe if policies aimed at creating more flexible markets are introduced, especially in the services sector.

Fiscal policy can cushion some of the shock to aggregate demand that will accompany adjustment. To facilitate this, European governments should now be striving to improve fiscal positions.

In this regard, Ireland might be well-advised to aim for sizeable fiscal surpluses, not the moderate deficit projected in December's budget. Spending could then be boosted or taxes cut to boost economic activity, if necessary.

Irish policymakers should also be more proactive in managing the risks associated with the property market.

Finally, the ECB should make it clear that it would respond to deflationary pressures by easing monetary policy significantly, thus avoiding the risk of deflationary expectations that might raise the cost of adjustment even further.

By following these recommendations, European policymakers will be taking out an insurance policy that will help Europe avoid a major downturn should the United States experience abrupt current account adjustment.

Prudent people buy insurance. Given the magnitude of the imbalances, policymakers in Europe need to act quickly.