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The Dollar Is Down, but Should Anyone Care?

By EDMUND L. ANDREWS

WASHINGTON, Nov. 15 - It sounds eerily like the worst economic nightmare for President Bush's second term.

Bogged down in a costly war that shows no sign of ending, the United States faces a gaping budget deficit and ballooning foreign indebtedness. The dollar plunges against other major currencies, while turmoil in the Middle East sends oil prices soaring. The rest of the decade is plagued by rising inflation, increased joblessness and sky-high interest rates.

But the president under fire was Richard M. Nixon - not George W. Bush. The war was in Vietnam, not Iraq. And the dollar crash was in 1973 rather than 2005.

Could it happen again? With the dollar down more than 40 percent against the euro since 2002, and hitting new lows since Mr. Bush's re-election, economists are debating whether America's foreign indebtedness could lead to a collapse in the dollar and a global financial crisis.

The United States is spending nearly $600 billion more a year than it produces, almost 6 percent of its annual gross domestic product. Much of that spending has been financed by Asian governments, which bought more than $1 trillion in Treasury securities and other dollar assets in the last two years to help keep the dollar strong against Asian currencies.

Many analysts expect the financing gap to widen and the dollar to decline further. But there are at least three schools of thought on whether a dollar collapse is likely and, if it happens, what it would mean.

One group, which includes the Federal Reserve chairman, Alan Greenspan, contends that global financial markets are awash in so much money that the United States can borrow much more than seemed possible 20 years ago.

The dollar may well decline in value, according to this view, but the decline would be gradual and would help reduce American trade imbalances by making exports cheaper and imports more expensive.

The Bush administration goes one step further, arguing that America's huge foreign debt simply reflects the eagerness of others to invest here.

"Productivity has been remarkably high in the last few years," John Taylor, deputy secretary of the Treasury, said at a recent conference. "Foreigners want to invest in the United States. That's what that gap illustrates."

A second school of thought holds that foreign governments like China and Japan will continue to finance American borrowing and keep the dollar strong because they are determined to sustain their exports and create jobs.

But a third school, which includes officials at the International Monetary Fund, worries about a collapse in the dollar that would send shock waves through the global economy.

That group argues that the dollar needs to depreciate another 20 percent against the other major currencies but warns about a run on the dollar that could reduce its value by 40 percent.

A collapse of that size would severely affect Europe and Asia, which have relied heavily on exports to the United States for their growth.

A steep drop in the dollar could lead to higher interest rates for the federal government and American private borrowers, as foreign investors demanded higher returns to compensate for higher risk. And it could expose hidden weaknesses among financial institutions and hedge funds caught unprepared.

"There is a school of thought that the U.S. can keep borrowing forever," said Kenneth S. Rogoff, professor of economics at Harvard University and a former chief economist at the I.M.F. "But if you add up all the excess saving being thrown out by the surplus countries, from China to Germany, the United States is soaking up three-quarters of it right now."

For Mr. Rogoff and several other economists, the question is not whether the dollar declines - but how fast and how far the fall turns out to be.

The United States current account deficit, which encompasses annual trade as well as the balance of financial flows, has gone from zero in 1990 to nearly $600 billion this year. The United States' accumulated debt to foreign investors is $2.6 trillion, or 23 percent of the annual output of the economy.

But where foreign investors in the 1990's poured trillions of dollars into American stocks and corporate acquisitions, investment from abroad now comes mostly from foreign central banks and goes heavily to buying Treasury securities that finance the federal deficit.

Catherine Mann, a senior economist at the Institute for International Economics in Washington, said today's financing gap could be expected to widen. Part of the problem lies with Europe and Japan, which grow more slowly than the United States and import less than they export.

Higher costs of imported oil will aggravate the trade deficit even more, Ms. Mann said, and the federal government will be paying foreigners higher interest rates on its rapidly growing debt.

"You have a dynamic that links government deficits to current accounts deficits more than has been the case before," Ms. Mann said. "We are going to have a lot of government securities out there, and a very high share of those Treasuries are owned by foreign investors."

But where Mr. Rogoff predicts that the dollar will slide sharply over the next two years, Ms. Mann predicts that Asian countries will continue to subsidize American imbalances to keep their economies growing. A decline in the dollar may be likely, but not a panicky flight by foreign investors.

The American dollar has been through several ups and downs in recent decades. In 1973, it fell sharply against Japanese and European currencies - the major industrialized countries had already abandoned the system of fixed exchange rates adopted at Bretton Woods after World War II.

The dollar rebounded strongly in the early and mid-1980's in response to higher American interest rates, but then plunged 40 percent after leaders from the United States, Japan and Europe reached the so-called Plaza Accord in 1986 to nudge the dollar back down. The plunge after the Plaza Accord caused few disruptions for Americans, and foreign investors did not demand higher interest rates on securities.

"One theory is that investors were simply irrational," said J. Bradford DeLong, a professor of economics at the University of California, Berkeley. "Others said it was the result of what Charles DeGaulle called the 'exorbitant privilege' of being able to repay your debts in your own currency."

Some economists contend that the United States can postpone its day of reckoning for years. Richard N. Cooper, a professor of economics at Harvard, said the global pool of savings was about 10 times the United States' appetite for foreign capital last year and growing fast enough to easily finance $500 billion a year.

The wild card is that most of the money is coming not from private investors but from foreign governments, led by Japan and China. Rather than profits, their goal has been to stabilize exchange rates and keep their exports from becoming more expensive.

Many economists contend that the Asian central banks have created an informal version of the Bretton Woods system of fixed exchange rates that lasted from shortly after World War II until the early 1970's.

The system collapsed after the imbalances between Europe and the United States became impossible to reconcile. Rapid growth is putting similar pressure on China, which has kept its currency, the yuan, pegged at a fixed rate to the dollar.

The growing imbalances, in both China and the United States, is one reason Mr. Rogoff is bracing for a jolt to the dollar and the American economy similar to the one that occurred in the early 1970's.

Then, as now, the United States was running large budget and trade deficits. Then, as now, the United States was bogged down in a war costing billions of dollars a year. And in 1974, a few months after the dollar plunged against the German mark and Japanese yen, oil prices soared.

"It's striking how many parallels there are between today and the early 1970's," Mr. Rogoff said. "The loss of the anchor of the dollar and fixed exchange rates contributed to the inflation we saw in the 70's. It was the worst period in growth we have had since World War II."

Business Day

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The New York Times

Nov 16, 2004

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a From Ex-Boeing Official

Michael Sears, left, the former chief financial officer of Boeing pleaded guilty to a felony conflict-of-interest charge. He acknowledged that he secretly offered a job to an Air Force official, Darleen A. Druyun, while she was overseeing billions of dollars in contracts and,
lmission, favoring Boeing. [C2.]

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The Dollar Is Down: Is It a Cause for Concern?

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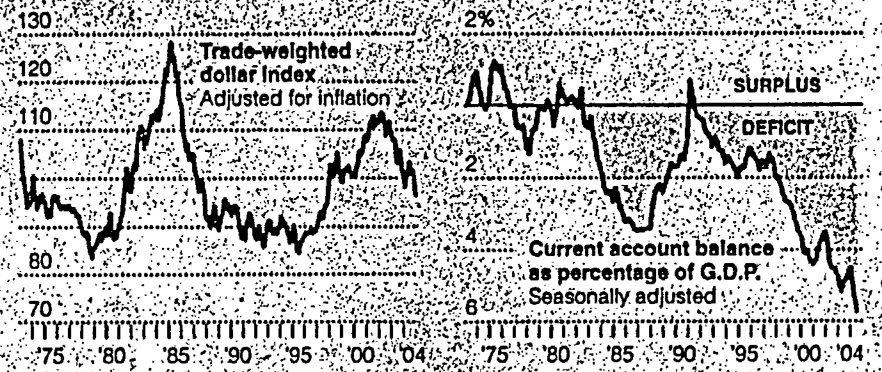
Growing Gap

The value of the dollar has fallen for more than two years, but so far that has done little to narrow the current account deficit, which measures the money the United States needs to attract from foreign investors to cover its trade gap and financial transactions with the rest of the world.



Sources: Federal Reserve; Bureau of Economic Analysis; Haver Analytics

The New York Times

The 2 New 'Must Haves' of Auto Safety

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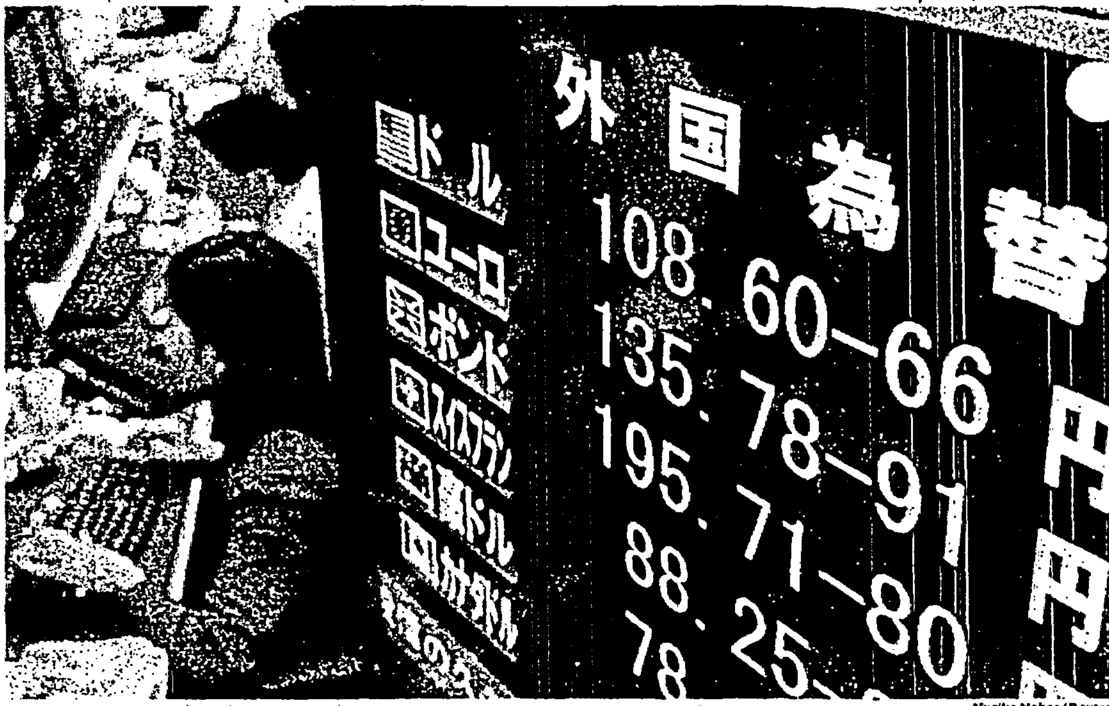

Yuriko Nakao/Reuters

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