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Crisis, Imbalance, and Prospects for the Dollar

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Crisis, imbalance, and prospects for the dollar

One positive aspect of the financial crisis was the boost to the dollar. However, global imbalances have put further pressure on the future of American finance.

BY SERGIO DA SILVA

The ongoing financial crisis is linked to the U.S. current account deficit, although not ultimately caused by it. Reducing the American external deficit will require further decreases in the value of the dollar, which will in turn boost net exports.

Nevertheless, the end of the greenback as the world’s reserve currency is not in sight. The dollar has, in fact, benefited from the financial crisis, and a current account crisis is not likely at the present time. However, foreign reliance on American financial markets will fade, which presents the U.S. with the pressing task of resolving both problems.

A glimpse of the financial crisis

Since the 1940s, the amount of equity held by a bank as a percentage of its assets, such as profit-generating loans, typically remained below 10 percent. This low equity-capital rate allowed banks to lend generously. Before the summer of 2006, the rate hit 10 percent. The three-month LIBOR-overnight index swap (OIS) spread, which measures investor perceptions of potential bank insolvency, also remained stable until the autumn of 2007.

In August 2007, investors became scared after learning that highly leveraged financial institutions were holding high-risk securitized subprime mortgages. Investors thereafter demanded a larger capital cushion. The historical equity-capital rate below 10 percent was no longer viewed as secure, and the LIBOR-OIS spread started to increase.

After the default of Lehman Brothers on Sep. 15, 2008, the banks, responding to investor demands, began to fear for their solvency, and stopped lending. In December 2008, former Federal Reserve chairman Alan Greenspan estimated investors now required a 14-percent equity-capital rate (“Banks Need More Capital,” The Economist).

To fulfill the banks’ need for more capital, temporary government credit is currently the only alternative. However, assuming the extra capital necessary to put an end to the crisis cannot rely on sovereign lending on a permanent basis, new sources of private capital must be found.

Deficits that finance profitable investment are not necessarily ruinous, but the American deficit reflects increasing consumption rather than increasing investment.

Greenspan suggests the restoration of the $30 trillion global stock-market value wiped out in 2008 could do just that. Higher global stock prices would lead to equally higher levels of equity, making it easier to issue debt and recapitalize financial institutions.

Capital gains can restore balance sheets but cannot finance physical investment, which is related to the imbalances in the U.S. current account. Between 2000 and 2008, the U.S. received foreign investment equivalent to more than 40 percent of its 2007 GDP. The financial system had the job of recycling the money to borrowers. Bad incentives were thereafter introduced. Credit became cheaper and savings declined from around 10 percent of disposable income in the 1970s to 1 percent after 2005.

The economic growth of the past 25 years was partly dependent on the current account deficit, which indicates that Americans were becoming prosperous at a pace beyond their resources.

Global economic imbalances before the financial crisis

The U.S. current account has been in the red every year since 1992. Until 1997 this was not so troubling, but in 2006 the deficit reached 6 percent of GDP, a level at which the exchange rate of a currency begins to be affected.

The deficit is financed by foreign capital inflows. The U.S.
The current account balance

The current account is the trade balance plus the services balance. The trade balance measures the exports and imports of goods. The services balance measures the exports and imports of services, including those attributed to factors of production, such as payments and receipt of interest and profits.

The U.S. has been a net importer since the mid-1970s. Excluding 1991, the U.S. has operated with a current account deficit each year since 1982. The resulting debt is then funded by the issuance of U.S. Treasury securities — T-bonds, T-notes, and T-bills — many of which are purchased by foreign countries. The largest foreign owner of U.S. treasury securities is China, which according to the U.S. treasury held $739.6 billion worth of U.S. Treasuries at the end of January.

Table 1 shows the U.S. current account deficit in billions of dollars as well as in percentage of GDP since 1992 according to the International Monetary Fund's (IMF) World Economic Outlook Database. Relating the deficit to annual GDP shows how much the country owes compared to how much it produces.

To put this into perspective, assume a person making $50,000 per year spent the same percentage of his annual income as the U.S. has spent of its GDP since 1992. Without considering interest, or accounting for any payments on his debt, in those 17 years he would have accrued a $29,308 debt. As of March 18, the U.S. total public outstanding debt was more than $11 trillion.

— Currency Trader staff

Table 1 — Current Account Balance

<table>
<thead>
<tr>
<th>Year</th>
<th>$ (billions)</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>-50.079</td>
<td>0.79%</td>
</tr>
<tr>
<td>1993</td>
<td>-84.816</td>
<td>1.27%</td>
</tr>
<tr>
<td>1994</td>
<td>-121.612</td>
<td>1.72%</td>
</tr>
<tr>
<td>1995</td>
<td>-113.571</td>
<td>1.54%</td>
</tr>
<tr>
<td>1996</td>
<td>-124.773</td>
<td>1.60%</td>
</tr>
<tr>
<td>1997</td>
<td>-140.396</td>
<td>1.69%</td>
</tr>
<tr>
<td>1998</td>
<td>-213.532</td>
<td>2.44%</td>
</tr>
<tr>
<td>1999</td>
<td>-299.819</td>
<td>3.24%</td>
</tr>
<tr>
<td>2000</td>
<td>-417.429</td>
<td>4.25%</td>
</tr>
<tr>
<td>2001</td>
<td>-382.37</td>
<td>3.78%</td>
</tr>
<tr>
<td>2002</td>
<td>-461.271</td>
<td>4.41%</td>
</tr>
<tr>
<td>2003</td>
<td>-523.413</td>
<td>4.78%</td>
</tr>
<tr>
<td>2004</td>
<td>-624.999</td>
<td>5.35%</td>
</tr>
<tr>
<td>2005</td>
<td>-728.994</td>
<td>5.87%</td>
</tr>
<tr>
<td>2006</td>
<td>-788.115</td>
<td>5.98%</td>
</tr>
<tr>
<td>2007</td>
<td>-731.214</td>
<td>5.30%</td>
</tr>
<tr>
<td>2008*</td>
<td>-664.125</td>
<td>4.63%</td>
</tr>
<tr>
<td></td>
<td>*Estimate as of March 20.</td>
<td></td>
</tr>
</tbody>
</table>

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The current account balance

The current account balance.

Borrows from abroad or sells assets — stocks, bonds, and property — to pay for the deficit. Deficits that finance profitable investment are not necessarily ruinous, but the American deficit reflects a decreasing savings rate, which implies increasing consumption rather than an increasing investment. As a result, the deficit has been wasted. The deficit also implies growing foreign ownership of American capital stock and increasing American debt to foreigners.

However, despite the fact the U.S. is a net debtor, American net investment income has remained positive because Americans commonly earn far higher returns on their investments abroad than foreigners do on their American assets. This is a result of the dollar’s special role as the international store of value.

Considering all these facts, are current account deficits bad? Two concerns argue global imbalances must ultimately be tackled. First, because the deficit has been wasted on consumption, foreign borrowing has not been used to expand production capacity, and thus borrowing may not enhance the ability of the U.S. to service an increasingly larger foreign debt. Eventually, foreigners may become less willing to lend to the U.S. Greenspan once warned that there is sure to be a limit beyond which foreigners will resist holding dollar-based assets. This can be extended to the dollar reserves held by the central banks of surplus countries, notably China.

Second, the current account deficit is partly responsible for the ongoing financial crisis because it introduced misaligned incentives. The inflows of foreign money raised government bond prices, lowered interest rates, and increased housing prices. Low interest rates helped feed the housing boom and encouraged Americans to continue spending.

Who is ultimately to blame for the continued on p. 20
global imbalances — profligate consumers and the government that runs deficit budgets or the central banks of emerging markets? The current account deficit enabled consumers and the government to spend more than domestic savings. This was made possible by the surpluses of the emerging countries, which before 1996 had also been living beyond their own means (in terms of their current account deficits), as diagnosed in 2000 in an International Monetary Fund (IMF) pamphlet “The IMF and Human Development: A Dialogue with Civil Society,” authored by then-Managing Director Michel Camdessus.

Throughout the decade after 1996 — the year before the beginning of the Asian financial crisis — the deficits became surpluses, with China and the oil exporters accounting for almost all of the increase in recent years. These countries accumulated large amounts of international reserves because of strong exports.

Federal Reserve Chairman Ben Bernanke, then a Fed governor, argued in 2005 that neither consumer spending nor budget deficits were the primary cause of the current account deficit. A low level of savings in the U.S. was a passive response to the global savings glut caused by the foreign reserves of emerging markets.

The counterargument is that demand always comes first and supply is its immediate consequence. The emerging countries just wanted to make good use of their surpluses. It was profitable for them to export capital to the U.S., where there are broad and liquid markets for securities. However, if there had been no demand for their loans, they would have had to be creative and find a better use for the surpluses at home. Therefore, it’s up to the U.S. to resolve the crisis and reduce its use of foreign financing.

**FIGURE 1 — U.S. DOLLAR INDEX**

As the financial crisis intensified in October 2008, the U.S. dollar index (DXY) posted its largest monthly gain in 17 years.

![Graph](source)

**FIGURE 2 — U.S. DOLLAR/RUSSIAN RUBLE**

Russia’s insufficient reserves led to a 53-percent slide in the ruble vs. the dollar from July 2008 through February 2009.

![Graph](source)

**FIGURE 3 — U.S. DOLLAR/JAPANESE YEN**

Japan’s currency reserves helped protect the yen against depreciation.

![Graph](source)
deficit posed the No. 1 risk to the world economy. Nonetheless, the predicted crisis has not materialized. The No. 2 risk, a financial crisis in the aftermath of the dotcom and subprime bubbles, arrived first.

Ironically, the current account deficit, by itself, became less of a problem after the financial crisis struck. In the depths of the crisis in October 2008, the dollar rallied against most currencies, and the U.S. was not cut off from external funding. Figure 1 shows the monthly moves in the U.S. dollar index (DXY), which gained 7.8 percent in October, the index’s largest monthly gain since October 1991. As foreign demand for dollar assets will continue to be high, America will continue to attract foreign capital and the flows of savings from emerging countries is expected to persist.

The emerging countries’ strategy of accumulating reserves proved right for them after the financial crisis. Countries with insufficient reserves to insure their financial systems, such as Russia (Figure 2), India, and Korea, suffered greater currency crashes during last year’s turmoil, whereas the currencies of countries with high reserves, such as Japan (Figure 3), China, Hong Kong, Thailand, Israel, and Sweden, did not depreciate; some even rose. The crisis has since spurred some countries to seek further self-insurance in reserves.

Even if there was insufficient motivation for the U.S. to reduce its current account deficit before the crisis, it remains vital for the U.S. to tackle external imbalances to prevent future financial crises.

Prospects for the dollar
Three factors have contributed to making the current account deficit less of a problem during this crisis. First, only a fraction of the capital that flows into the U.S. is used to finance the current account deficit posed the No. 1 risk to the world economy. Nonetheless, the predicted crisis has not materialized. The No. 2 risk, a financial crisis in the aftermath of the dotcom and subprime bubbles, arrived first.

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account deficit; much of it finances the purchases of foreign assets by American residents. Because American investments abroad perform better than foreign investments in the U.S., it softens the burden of the deficit.

Second, the role of the dollar as an international reserve currency alleviates the burden of the U.S. deficit. American liabilities are all dollar-denominated, whereas 70 percent of the holdings of nonresident assets are denominated in the currencies of other countries. The U.S. enjoys the unique privilege of owing debt in its own currency and receiving payments in the currency of its creditors. This leads to the third factor softening the burden of the current account deficits: dollar depreciations.

Dollar depreciation benefits the U.S. because the dollar-denominated assets held by foreign investors and central banks lose value. In a sense, there is “international seigniorage,” in which the dollar’s depreciation creates profit as debts are paid back. These “revenues” derived from dollar depreciations are similar to an exchange-rate tax levied on American creditors. Between 2002 and 2004, more than 75 percent of the growth of U.S. foreign debt provoked by the current account deficit was offset by changes in the values of nonresident assets because of the dollar’s decline.

Of course, the deficits themselves also put pressure on the dollar to decrease. Research suggests when current account deficits reach 5 percent of GDP, the exchange rate starts depreciating and the current account begins to react (Freund, Caroline L., “Current Account Adjustment in Industrialized Countries,” International Finance Discussion Paper No. 692, Board of Governors of the Federal Reserve System). Considering the U.S. current account deficit is already above this threshold, a current account recovery is overdue. Although, as the dollar started to decline gradually from 2002, the current account deficit grew.

How deep does a decrease in dollar value have to be to eventually balance the U.S. current account? There is a wide scattering of estimates, partly because of the lack of consensus over an appropriate model. Estimates range from 14 percent to as high as 56 percent. Whatever the extent of dollar depreciation needed, American investors with assets held abroad will continue to win.

A persistent dollar decline may, however, threaten the currency’s role as the international reserve currency. To escape the exchange-rate tax, foreign investors and central banks may be willing to reduce their demand for dollars and increase demand for the Euro, for example. There were signs this was beginning to happen before the financial crisis. However, the crisis has reversed the trend.

China has been selling American agency bonds (those issued by government agencies other than the Treasury), such as those offered by government-sponsored enterprises (GSEs), since Fannie Mae and Freddie Mac, both GSEs, flirted with default in mid-2008, and buying Treasuries instead. Saudi Arabia has increased its share of funds held in gold, deposits, and cash. After suffering large capital outflows, Russia and South Korea have been buffering their reserves with risk-free liquid assets, preferably in dollars. Other surplus countries have been adjusting their portfolios to less-risky assets. As the emerging countries become more risk-averse in the wake of the financial crisis, international demand for the dollar is expected to increase. In addition, demand for the Euro will likely decrease because the effects of the financial crisis in the Eurozone have put the Euro at risk of extinction.

The role of the dollar as a world reserve currency depends on the belief the U.S. is a beacon of financial stability. The ongoing financial crisis has undermined that perception. Nonetheless, for the moment, the dollar has benefited from the global escape from risky assets and the unwinding of bets made with borrowed cash. As yet there are no signs the role of the dollar as world reserve currency has become threatened by the financial crisis — the facts indicate quite the contrary. The crisis has reemphasized the centrality of the dollar as a currency.

For information on the author see p. 6.

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