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# The falling dollar sets a test for Asia and Europe

Recent statements by the Group of Seven industrial nations and the International Monetary Fund underscore the growing pressure to reduce the massive US international deficit. Doing so will require both a higher national saving rate in the United States and a more competitive value for the dollar. Neither alone would be sufficient.

The US current account deficit reached an annual rate of \$900bn at the end of last year, an amount equal to 7 per cent of gross domestic product. This enormous imbalance reflects the fact that US investment (including business plant and equipment and housing) exceeds US saving by 7 per cent of GDP. Cutting the US trade deficit to a sustainable level therefore requires a substantial increase in US national saving.

The good news is that the saving rate of American households is beginning to rise and is likely to gain momentum during the coming year. The household saving rate has been negative for the past four quarters, an abnormal level that has not been seen in the US since the 1930s.

The saving rate began falling in the early 1990s as households increased consumption in response to their rising level of wealth – initially a rising stock market and, more importantly, double digit increases in house prices. More recently, this wealth effect was reinforced by the rise in mortgage refinancing that was induced by falling interest rates.

Households extracted trillions of dollars of spendable cash from the value of their homes and a substantial part of that cash found its way into consumer spending.

The forces that lowered the US saving rate are now being reversed. House prices nationwide are down from the peak reached in the middle of last summer. The Federal Reserve has reversed its low interest rate policy, causing mortgage interest rates to rise by

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nearly a full percentage point over the past year. The volume of mortgage refinancing is down by 20 per cent from a year ago. It will only be a matter of time until the household saving rate is at least back to the 2.4 per cent level of 2002.

To convert this higher saving to a reduction in the current account deficit requires increased exports and a shift in Americans' spending from imports to domestically produced goods and services. A lower dollar will provide the necessary incentive for both of those changes to occur.

Natural market forces are already causing the dollar to fall against the euro, the yen and other currencies. The dollar's fall is responding to the narrowing gap between US interest rates and those in Europe and Japan. It also reflects a shift in the market's focus from short-run cyclical conditions to the fundamental trade imbalance.

Past experience shows that a more competitive dollar can substantially reduce the trade deficit. The last big fall of the dollar, a 37 per cent decline in the mid-1980s, was followed by a 40 per cent fall in the trade deficit.

A lower US trade deficit will of course mean a decline in the exports of our trading partners around the world.

Countries that lose exports need to adopt policies to stimulate domestic spending in order to prevent a decline in their GDP and employment levels.

Where this all ends will depend not only on market forces but also on the policies of the governments and central banks of Europe and Asia. It will be tempting but wrong for them to resist the decline in the US trade imbalance by using a combination of monetary policy and exchange market intervention to prevent the dollar's shift to an appropriately competitive level.

Without that competitive dollar, the higher saving rate in the US will mean slower US growth and rising unemployment. If that happens, the American political process is likely to turn to protectionist measures to shrink the trade imbalance and maintain employment.

It would be far better to allow the natural market forces to bring about the needed currency realignment. Instead of seeking to resist the dollar's shift to a more competitive level, governments in Europe and Asia should focus on developing policies to maintain aggregate demand in their individual economies as their export sales decline.

Resolving the massive trade imbalances without a global cyclical downturn can be achieved, but only if countries approach this challenge in a constructive way.

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