Global transmission of US economic woes

It is a policy mistake to downplay, let alone ignore, the seriousness of the implications of the unsustainable current account deficit of the United States, both within and without. The US current account deficit has continued to soar without respite in recent times, at the rate of roughly US$ 2 billion a day, setting an all-time record close to 6% of gross domestic product (GDP) in 2004.

It is simple arithmetic that the reverse side of the balance-of-payments current account deficit of the United States comprises the surpluses of some of its trading partners. Thus, the United States accounts for about 70% of the current account surpluses of other countries, notably China, Japan and Germany.

This simply means that the US current account deficits cannot be reduced unless other countries are willing to reduce their own current account surpluses. Thus, the burden of adjustment will have to fall on both sides of the equation. This calls for the depreciation of the deficit country's currency and the appreciation of the surplus countries' currencies. A cheaper dollar would reduce the US trade gap by encouraging the country's exports and discouraging its imports. The reverse would indeed be the case for other countries that currently enjoy large surpluses with the United States. In other words, by definition, the US trade deficit can fall, only if America's trading partners are prepared to have their surpluses slashed by allowing their currencies to appreciate.

Thus far, the brunt of the currency adjustments has fallen on the euro. The dollar has already depreciated by 17% against a broad basket of currencies since early 2002, but the extent of dollar depreciation vis-à-vis euro has been the sharpest with a 35% drop. There have not been much currency adjustments in East Asia, despite the fact that the region accounts for a large chunk of the US deficit. The Chinese yuan, the Hong Kong dollar and the Malaysian ringgit are all tied to the dollar one way or another, with virtually no exchange rate adjustments against the dollar for many years. Other East Asian currencies, including the Japanese yen, are on a "controlled float" which some would describe bluntly as "dirty float". To put it differently, a more flexible exchange rate policy in East Asia, if implemented soon enough, would help mitigate, if not avert, a global economic disaster of tsunamic proportions in 2008.

However, there is a growing consensus among analysts that exchange rate changes alone will not be sufficient to correct the US imbalance. This observation calls for expenditure adjustments, as well, on the part of the United States. The massive current account deficit incurred by the United States is a clear indication that the US is living beyond its means, consuming more than what it earns, by simply borrowing. To plug the hole, the United States must increase its domestic saving. The most effective way to augment domestic saving would be for the US government to cut its budget deficit, which now exceeds 5% of GDP, and to restrain consumer credit growth.

The US current account deficit is so large that it needs both expenditure cuts and currency depreciation. If nothing is done on the expenditure side, it is projected that the

US dollar would fall to 1.80 against the euro by 2008. Many analysts are thinking of the unthinkable, which smacks of another 30% depreciation of the dollar. The smaller the expenditure adjustment, the bigger the exchange-rate depreciation needed to correct the current account imbalance.

Needless to say, all this is no music to the ears. It will be painful not only for the United States but also for the rest of the world. Expenditure adjustments will cause US growth to decelerate vehemently, exacerbated by the negative wealth effect emanating from the depreciation of the dollar, although this will be offset partially by the positive impact of cheaper dollar on US exports. To be sure, the net upshot will be slower growth in the United States in the short term.

A slowdown in the US will, no doubt, hurt the exports of other countries to the largest market in the world. The US economic woes will thus be transmitted to other economies, especially those with close links with the ailing US economy, like the ones in East Asia. A slower global growth in 2005 may get increasingly sluggish before culminating into a full-blown recession in 2008. This scenario makes palpable sense especially in the wider framework of global cyclical waves. East Asia will not be spared, although the impact may be cushioned to some extent by the growing importance of intra-Asian trade, which now accounts for over 40% of its total trade. Seen in these terms, a recession for the Malaysian economy in 2008 is more than just a theoretical possibility.

There is no insinuation that East Asia is oblivious to the writings on the wall. The main measure taken thus far by some East Asian economies, including China and Japan, to ward off this impending threat, has been largely to help finance US current account deficits by buying US bills and bonds. What's wrong with this strategy is that it only helps the United States "manage" but not "solve" the deficit problem. East Asia only seeks to buy time, unwittingly delaying the adjustment process, which in turn would make matters worse beyond the near term. East Asia must do more by allowing their currencies to appreciate as well.

In the absence of a more flexible exchange rate system, the prognosis would be frightening. The current East Asian formula of financing US deficits will not work for long. Creditor nations bear the burden of rising currency risks on America's huge gross liabilities, which now stand at US$11 trillion. This concern alone will make many creditors less willing to finance future deficits at current interest and exchange rates. The chances are that the US current account deficit will increase to 8% of GDP and its net debt would exceed 50 % of GDP in 2008. The US interest rates will then have to rise sharply and the US dollar must depreciate substantially.

With the dollar rapidly losing its lustre as a store of value, its importance as a reserve currency will also decline. The dollar's share of global foreign-exchange reserves has already fallen to 65% in 2004 from 80% in the mid-1970s and this trend is likely to accelerate, with the euro increasingly replacing the dollar as the reserve currency.
For East Asia, all this means an appreciation of regional currencies, too sharp and too fast for its own good, a recipe for disaster, come 2008. An economic crisis of this kind would

be far more difficult to handle than the one experienced in 1997/8 when regional currencies experienced a sharp depreciation. A better strategy for East Asian economies would be to opt for a more flexible exchange rate regime now and allow their currencies to appreciate gradually without subjecting their economies to sudden exchange-rate adjustment shocks with painful consequences later on. In any case, East Asian economies will have to pay a price for their current account surpluses, but the price would be considerably smaller under flexible exchange rates.

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