THE SAGA OF THE SHRINKING DOLLAR

Finally, the inevitable is beginning to unfold, with the US dollar climbing down from dizzy heights. There has been a consensus among the analysts for quite a while that the strong dollar was neither sustainable nor desirable, given the huge budget and current account US deficits. The external imbalance, in particular, amounting to nearly 7.0 per cent of gross domestic product (GDP) of the United States, has long been very worrisome. Projections show that this will rise to 8.0 per cent of GDP by 2008.

To be sure, the strong dollar has not been in the long-term interest of the US economy, as it tended to hurt US exports and impede adjustments. The dollar could stay strong, despite many weak fundamentals, thanks mainly to massive capital inflows into the United States, lured by high interest rates which were necessary not only to combat inflationary pressures in the United States but also to finance its twin deficits. Between June 2004 and June 2006, the Federal Reserve had raised interest rates by 425 basis points to 5.25 per cent, while interest rates were hovering around zero in Japan and 3 per cent in Europe.

According to some estimates, the dollar has remained overvalued by as much as 25-30 per cent. A sharp correction of such magnitude would certainly have disastrous impacts on the global economy, given the pivotal role the greenback plays internationally. It is therefore important to ensure that the dollar glides down gracefully without plummeting. Seen in these terms, the recent downtrend in the US exchange rates is a good thing, as it signals a soft landing for the dollar.

A nightmare scenario for the dollar would be to stay stubbornly strong until the breaking point, in which case it would have to crash, with dire consequences not only for the United States but also for the rest of the world. The world can now breathe more comfortably, as the dollar is seen to be depreciating in an orderly manner.

One wonders why it took the greenback so long to start its correction. Interest rate differentials may have much to do with it. The general consensus is that the US interest rates have peaked and that there is a 30 per cent chance of a cut in US interest rates in the first quarter of 2007, while the European Central Bank and the Bank of England have begun to tighten their rates. Such considerations tend to drive down the demand for the dollar.

There is no suggestion, however, that a weak dollar is a panacea for the US imbalances. Even a 30 per cent depreciation of the dollar cannot eliminate the current account deficit of the United States. After all, there is only a need to trim down the US current account deficit to a sustainable level of around 3 per cent of GDP, without having to erase it altogether. Besides, the problem lies as much with the saving-investment gap as it does with the exchange rate misalignment. For the US current account deficit is attributed largely to the fact that the Americans are living beyond their means, saving too little and spending too much, an observation that calls for expenditure adjustments in addition to exchange rate adjustments on the part of the United States.

In other words, the situation warrants slower GDP growth in the United States ***and*** weaker US dollar. It is hard to predict how these adjustments will play out. One thing seems certain: if the dollar depreciation does not go far enough, the economic slowdown would turn out to be far more severe than otherwise. The chances are that the dollar will shrink sufficiently to avert a severe slowdown in the US economy. There are two palpable reasons behind this expectation. The first relates to the possible diversification of global foreign exchange reserves, which stands at US $4.7 trillion, away from the dollar. China, Japan, Taiwan, South Korea, Russia and Singapore account for two-thirds of these reserves. China, which is said to hold 70 per cent of its reserves in dollars, is likely to reduce if not minimise risks by distancing itself from the dollar. Russia, Switzerland, Italy and the United Arab Emirates have already announced plans to reduce their dollar holdings. All this would serve to lower the demand for the dollar.

The second reason why the dollar will continue its downslide is that there are signs that East Asian countries are now more willing to let their currencies appreciate than they have been previously. Until recently, the brunt of the adjustment had fallen on the European Union with the euro appreciating significantly, while East Asian currencies could strengthen only modestly. It is noteworthy that the euro had peaked at above US$1.36 last December and is likely to hit new highs. The dollar may decline to US$1.40 to the euro by mid-2007, a cause for grave concern to the euro-zone countries as this would hurt their economies. China, whose foreign exchange reserves have recently breached theUS$1 trillion mark, seems more willing to let its yuan appreciate a bit more freely. East Asia in general appears to be more confident, buoyed by rising reserves and growing intra-regional trade, which may translate into more flexible exchange rates regimes in the near term.

In any case, it is incorrect to look at the external deficits as an American problem per se. The truth of the matter is that it is a global problem. Current account balance is a zero-sum game in the sense that the US deficits are indeed the surpluses of some of its trading partners. The United States cannot reduce its external deficits unless its trading partners are willing and able to reduce their surpluses. In this equation, the overvalued dollar is matched by the presence of undervalued currencies elsewhere. In the same vein, to reduce the saving-investment gap, it is not good enough that the US saves more and spends less, as the surplus countries must also do their part by spending more and saving less.

Be all that as it may, the US dollar has depreciated 3.4 per cent against the British sterling, 3.1 per cent against the euro, 2.5 per cent against the Malaysian ringgit, 1.7 per cent against the Korean won and 0.9 per cent against the Japanese yen between November 16 and December 11. It is unlikely that the slide will continue at this pace all the way until the dollar finds a new stable equilibrium. The correction in exchange rates is likely to be punctuated with fluctuations, pauses and even temporary reversals of sorts, depending on the movements of feel-good factors. All indications are that the secular trend for the dollar is clearly downward.

Emeritus Professor Mohamed Ariff is the executive director of the Malaysian Institute of Economic Research