Asia Looks Forward: The Decline of the US Dollar

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Joergen Oerstroem Moeller
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This is certain to happen. The uncertainty is when and whether it will be an orderly and controlled adjustment under the aegis of the authorities or imposed by a market that finds policy makers not up to the task of restructuring and rebalancing the world economy.

The basic problem on the agenda is not a reform of the global monetary system or more regulation in the financial sector. Although something has to be done in these areas, the real problem is much more daunting.

The US economy needs to be rebalanced. For years, demand has outstripped production leading to a deficit on the balance of payments resulting in debt weighing the economy down. As the US accounts for almost one quarter of global Gross Domestic Product, a realignment of demand and supply supplemented by a reduction of debt cannot be executed by the US alone. The effect will ripple through the globe and affect everybody else, so it needs to be orchestrated by all the major economic powers. The entire global economy will enter a cataclysmic decline in the absence of a concerted effort at opening the door for countries to adopt divergent, and in some cases contradictory policies.

What is called for is a burden sharing arrangement not only inside the US among the various classes, but also globally between countries. This is something the world has not seen since the early 1930s, when endeavours to tackle a similar problem failed abysmally.

It is almost pathetic to read President-elect Obama talk about creating new jobs to stimulate the American economy by injecting up to one trillion US dollars. The money is simply not there. In good times, the US spent lavishly instead of preparing for weathering a storm many observes were predicting, albeit not on the scale that was recently witnessed.

If the US goes on to print money, and that seems to be the plan, debt will escalate. Some people say that increasing debt will not be a problem, but how can they say that knowing that it has to be serviced, putting an extra load on an already overburdened federal system? It can only be done if spending results in increased production and income, thus enlarging the size of the economy, and even this presumption cannot be taken for granted. Ironically, there are considerable risks that further spending will keep the economy in a stalemate.

Fiscal policy may prove ineffective, dovetailing Keynes' observation in the 1930s that monetary policy in a heavy recession is ineffective. Keynes saw that irrespective of low interest rates, corporations did not invest because demand was not there (the liquidity trap). Now we may see that irrespective of fiscal stimulus packages, people will not spend because they do not trust anyone.

Monetary policy has been used intensively over the past 12 months and rightly so. It has probably saved us from the worst, but it has not managed to turn the economy around. There is very little that monetary policy can do to stimulate demand. The interest rate is low, but nobody wants to invest. The liquidity is there, but nobody wants to lend, preferring to hoard money instead.

So the only realistic policy instrument available is to depreciate the US dollar. The caveat is that although the US dollar may fall, but the Asian economies, through improvements in productivity will wipe out much of the shift in competitiveness it should have brought about. If so, the global economy is back to square one, or even worse, if efforts to improve productivity entail keeping domestic demand in check, the foot may be on the brake instead of the accelerator. The end result would be a ceiling for global demand and growth, keeping the world on a low growth pattern for years.

A falling US dollar will depress real US incomes making the US poorer, transferring purchasing power from the US to other parts of the globe. A more competitive US will stimulate American exports and reduce imports, gradually putting the US economy back on a growth pattern, although not like the one we have seen the last few decades. Keeping in mind the need for a higher savings rate in the US, it is unlikely that domestic demand will improve.

Whichever way we turn the spotlight, the answer to where demand and growth will come from is the rest of the world, and that will be primarily in Asia. It is a misconception that increased demand in the US will bail out the world. On the contrary, demand in the US needs to be kept in check to allow a rebalancing to take effect. The global economy will only start to grow if domestic demand and private consumption begins to climb in countries like China and Japan.

The only way out of this policy dilemma is a coordinated policy response where the US brings its house in order gradually without disturbing the global economy including its own. In tandem, China and Japan acquiesces a real shift in competitiveness to their detriment, while at the same time beefing up domestic demand. Quite simply, the rest of the world must spend more while the US should spend less and save more and production in the US must go up, without boosting domestic consumption.

Such burden sharing would in the medium and probably long-term result in a visibly lower US share of global Gross Domestic Product and a larger Chinese one. The US will start to save and China will consume more. The accumulated US dollars held by China (and Japan) will – at least some of them - be spent, and both the US and Chinese economies will become more balanced.

Joergen Oerstroem Moeller is a Visiting Senior Research Fellow at the Institute of Southeast Asian Studies, and an Adjunct Professor at the Copenhagen Business School.