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# A more competitive dollar is good for America

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The dollar has finally begun its long overdue correction. Its recent decline is just a prelude to the much more substantial fall needed to shrink the US current account deficit, running at a nearly $800bn (£393bn) annual rate, about 6 per cent of gross domestic product.

If the dollar remained at its current level, the US trade deficit would continue to expand because Americans respond to rising incomes by increasing imports more rapidly than foreign buyers raise their imports from the US. Although a faster growth rate in the rest of the world would raise US exports and reduce the US trade deficit, experience shows that even substantially faster foreign growth would have only a very small impact. A lower dollar has to do most of the work of reducing the global trade imbalance.

America's trade deficit must be financed by a capital inflow from the rest of the world. Since foreign investors are no longer buying significant amounts of US stocks or direct investments in US businesses, the vast bulk of that capital inflow must take the form of purchases of US bonds.

Even an unchanged trade deficit would require the rest of the world to buy $800bn of additional US debt over the next year, an amount that would grow in future years because of the rising interest payments on our external debt.

The largest purchasers of this debt are foreign governments and their related investment funds. A big uncertainty hanging over the dollar is how long those governments will be willing to keep adding to their dollar holdings, knowing that they will eventually incur losses as the dollar falls. Even if governments are prepared to do so, private investors may drive the dollar down as they try to shift from dollars to euros and other currencies.

Although any individual government or private investor can shift from dollar bonds to other currencies, they can do so only if someone outside the US is willing to buy those bonds. The total foreign holding of US bonds can decline only if the US has a trade surplus, something that clearly will not be happening any time soon. If foreign buyers do not want to keep acquiring US bonds at the current exchange rate, the dollar must fall enough to convince investors that it is unlikely to fall further or US interest rates must rise enough to compensate investors for the risk of holding dollar bonds.

The falling dollar should not be seen as a problem for the US economy. A more competitive dollar will raise net exports, reducing the probability that the current weakness will turn into an outright recession. Looking further ahead, as the US household saving rate rises from its current low of nearly zero to a more normal level, consumer spending will slow, driving down aggregate demand. A declining dollar will then help to maintain growth and employment by raising exports and causing American consumers to shift their spending from imports to domestically produced goods and services.

Nor should the falling dollar be a problem for our trading partners if they take the appropriate measures to offset the reduction in demand that will be caused by their declining exports and rising imports. The best way for foreign governments to stimulate demand would be by revenue neutral fiscal changes (such as tax-financed increases in investment incentives) or by regulatory changes to facilitate increases in consumer spending and construction.

If foreign central banks were instead to lower interest rates or foreign governments to engage in exchange market intervention, the result would be to weaken their currencies and prevent the dollar's decline. If that happens, US exports will not increase, causing the current US economic weakness to get worse and potentially leading the future rise in household saving to precipitate a US economic downturn. Any perception that foreign economic policy is responsible for US economic weakness would exacerbate the current protectionist mood in the US Congress.

Since a falling dollar raises the cost of imports and increases the export demand for US products, a dollar decline by itself

puts upwards pressure on the US inflation rate. But the overall inflation rate need not rise if the Federal Reserve sticks to its goal of price stability. Instead, relative in-creases in the prices of tradable goods would be offset by lower inflation in other goods and services.

Markets must look beyond the slogan that a strong dollar is good for America to recognise that a more competitive dollar will help sustain US growth and is necessary to correct America's trade deficit. Governments of our trading partners must recognise that the dollar's decline will weaken demand in their economies and should use fiscal and regulatory measures to maintain their growth and employment. With appropriate policies, the dollar's decline will correct the imbalances that threaten the global economy without higher inflation in the US or decreased growth in the rest of the world.

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