The Wrong Call: The Euro is no match for the Dollar

Ricardo J. Caballero[1]

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Pundits and intellectuals have made up their mind. Central Banks are next in line. The dollar has only one way to go, and that is down. Global imbalances must come to an end, the sooner the better. I beg to disagree.

The arguments for doom are textbook in style. The dollar once danced in the 1980s, and the conditions are here again, twin deficits and all. There is an extra twist in this round, since no one is on the other side, certainly not Germany or Japan, to absorb the US adjustment and its impact on the world economy. To remedy this costly gap, advocates of the dollar demise call for an expansion in global demand ex-US – investment and consumption must rise in Europe and Japan.

But this position seems to ignore that Japan has spent the last decade trying to do just that, and that Continental Europe is against the Maastricht constraint and bogged down by, unfortunately, well founded pessimism.

If the textbook solution is not at hand, what else? The answer may be in the path that took us where we are. There is an enormous demand for saving instruments in the world, and the US is the most efficient producer of such instruments. No other place combines the volume from new opportunities and ability to generate trustworthy saving instruments from each unit of physical investment put on the ground. By the way, this is the reason the corporate scandals in the US could have been so devastating for global equilibrium and why the nearly quixotic ventures of Mr. Eliot Spitzer, the tenacious New York Attorney General, are to be praised.

Granted, the aforementioned corporate scandals, the many shocks hitting the US economy since 2000, and an episode of fiscal recklessness, temporarily weakened private investor confidence, but this is in the mend. Moreover, the much repeated claim that three quarters of the current account deficit in the US is being financed by foreign central banks, to imply that only them have any interest in US assets, only shows how misleading net flows can be. Foreign private capital inflows dwarfed official capital inflows even at the worst of the draught, and are now in full recovery mode aiming at their 1990s level. Of course, the other side of it is that capital outflows by US nationals are also on the rise, as American companies, with their great ability to generate savings-assets and spread corporate governance, borrow cheap from abroad and return to the source through win-win FDI.

This is not to say that the US current account deficit needs not be reduced, but only that the problem is more one of composition than of level. In the good path, fiscal deficits

[1] Ford International Professor of Economics and co-Director of the World Economic Laboratory, MIT.

gradually fall, consumers decelerate slightly, both of which have begun to happen, but the current account does not fall equally as investment picks up.

Who can finance this continuous deficit? This is not hard to figure out, the same that have done it up to now. If fact, over the next two decades the bottleneck is less not more than in recent times. The high saving economies of East Asia are growing fast, at rates significantly higher than current interest rates. This means that in the years to come their financing of the US will grow enough to fulfill the US needs but decrease relative to their wealth. Things get easier not harder as time goes by. Unlike the 1980s, the persistent US current account deficits have come with extraordinarily low not high interest rates.

What about the Eurozone and its currency? Would not this be a better deal for big savers? Please, Continental Europe is barely afloat, and an appreciation of the Euro brings titanic-style images to mind. The Yen is probably a more serious contender for the East Asian economies, but that too needs to wait until Japan is once again ready for prime time.

In summary, unless US corporations begin to issue claims in Euros in concert, which I doubt very much, the dollar is probably the currency not only of the past but of the future as well. Working on strengthening the foundations of the current system, through zealous enforcement of sound corporate governance standards and fiscal retrenchment, is a much surer bet than forfeiting the dollar in herds for clearly inferior substitutes.