The Euro Is Our Currency, and the Dollar Is Your Problem

The dollar is falling and falling. The exchange rate of 1.32 $/€ at the end of November was the lowest ever in the still young history of the euro. And an end to the fall of the dollar is not in sight. Alan Greenspan has made one thing very clear, however: the Fed is not going to intervene in favour of a stronger dollar. Why should it? The devaluation of the dollar has been expected for quite some time. There are good reasons for a weaker dollar. So what good would intervention by the central banks do? None!

Exchange rates are prices. There is a supply of, and a demand for, foreign currencies. A currency becomes weaker if the supply exceeds the demand. Goods markets and financial markets both determine simultaneously the supply of, and demand for, dollars. The balance on current account and the balance on capital account are Siamese twins. They are inseparable. A current account deficit has to be covered by a capital account surplus. The exchange rate is the mechanism which brings the two sides together. It changes until they are exactly the same size and is the outcome of an iterative adjustment process determined simultaneously by international trade and capital flows.

What consequences result from the interdependence of current account and capital account for the further development of the dollar? First, it is apparent that two forces will interact. One is the impact of the large and still increasing US current account deficit. The other is the future of the capital account surplus. The US current account deficit reached about $500 billion in 2003. In 2004 it will increase further to about $620 billion, which is about 5½% of the US GDP. A current account deficit, even of this size, is not a problem as long as the capital account shows a surplus of the same size. This was the case for the USA in recent years. The strength of the US economy and the comparably high returns on investments attracted capital from all over the world. International investors brought their liquidity to the USA by buying government bonds or shares in American firms. Day for day more than one billion dollars in foreign capital flowed into the USA. In 2003, altogether about US $450 billion were invested in the USA from abroad. Most of the capital came from Japan and China. Japanese and Chinese investors have financed the American current account deficit almost on their own.

Where do the Japanese and Chinese get the capital to buy American bonds and shares? The answer is easy: from the sales of goods to American customers. What the Japanese and Chinese have earned by selling goods to the Americans, they have returned by buying bonds and shares from the Americans. By exporting goods and services to the USA, Japan has accumulated a stock of foreign currency reserves of about $800 billion, and China has about $500 billion. This was a win-win situation for everybody. The US customers were happy to get cheap products from Asia. This has increased the purchasing power of American wages, which has also led to an increased demand for domestic goods and services and has thus stimulated the growth of the American economy. Japan and China were positively affected by their strong exports to the USA. This has allowed them to increase their production significantly, to employ more people and to grow faster. For that reason the Japanese and Chinese central banks were very eager to keep the dollar strong and their own currency weak. Since 1995 the Chinese renminbi yuan has been strongly fixed to the US dollar even although the real value has spoken for a quite substantial revaluation of the yuan.

At this point the second force becomes important. What will happen if the international investors in Japan, China and the rest of the world are unwilling to keep their American shares and bonds? What will happen if they sell their dollar investments *en masse* to buy euro, pound or Swiss franc investments instead? This might be the case if investors expect that the return on investments outside the USA will exceed returns in the USA. More and more people all over the world are sceptical about some recent developments and trends in the US economy. The public deficit continues to increase. Total public debt has accumulated to about $4300 billion. It is growing by about $400 billion per annum. The savings of the private sector are modest. The savings rate is low, i.e. less than 1% of disposable income. The social security system is not fully financed. Public education is facing many severe problems. The public health system is extremely expensive but not very efficient. The prices of medical treatment and medicines are increasing. No other industrialised country is hit as hard as the USA by poor nutrition and obesity. More and more Americans cannot afford private health insurance. In his election campaign President Bush promised financial aid for the poorest without saying how he is going to finance this support. The uncovered cheques of the future in the fields of the public pension system and health system may amount to more than US $1000 billion.

In view of these problems more and more international investors are starting to sell off dollar investments. As a result the capital account surplus is diminishing. Consequently, the current account deficit has also begun to decrease. This is the time for devaluation. Devaluation helps automatically. It makes imports more expensive and exports cheaper. This brings down the US current account deficit. But it presents a challenge to the rest of the world. For the world economy a weak dollar means that the driving force of worldwide growth (i.e. exports to the USA) becomes weaker. Firms from abroad become less competitive – not only on the US market but also in their home markets. Thus, a weak dollar is good for the US economy but bad for Asian or European exporters. A weak dollar might help President Bush a little to solve some of the problems of the US economy, especially because the devaluation of the dollar will increase import prices, which will fuel inflation, making nominal public debts less severe in real terms.

The devaluation of the dollar forces Europe to change the horses that pull the economies. The weaker the dollar, the more important it becomes to have stronger European legs to push ahead economic developments. What is needed is a strengthening of the dynamic factors to bring Europe onto a steeper path of growth. The Lisbon declaration was not much more than rhetoric. What is needed is a return to the old principle of more self-responsibility and fewer public activities. This also means that interventions by the ECB to strengthen the dollar would be completely false policy. The weakness of the dollar is the logical consequence of current trade and capital flows and changes in the expectations of international investors. Neither political action nor intervention by central banks could make a fundamentally weak dollar strong. Of course the devaluation of the dollar has a negative influence on European export sectors or the European tourism industry. However, the strong euro lowers import prices and makes daily life for European customers cheaper. Furthermore, it allows European investors to buy bonds, shares and firms from all over the world more cheaply. Finally, a strong euro means an increase in European wealth. Each revaluation of the euro makes Europeans wealthier. This is definitely positive for a region with an ageing society that more and more has to be financed by wealth and capital income.

The weakness of the dollar is for Europe not only a challenge but also a chance to reverse the understanding of international dependencies. The old American saying is still valid: “The dollar is our currency, but your problem.” Europe should do everything to turn the saying around: “The Euro is our currency and the dollar is your problem.” The opportunities for Europe to achieve this turnaround are not too bad. The eastward enlargement of the EU has provided the single market with some fast growing economies. They will increase the demand for European products. Furthermore, many European firms have used the difficulties of recent years to make themselves fit for the future. They have reorganised themselves, their profiles and production. They are ready for an economic take-off. To learn where the trip will go Europeans do not necessarily have to look to the USA. It was Europeans that made America into the most powerful economy. Risk-taking, pioneering and entrepreneurship are not foreign to Europeans. They are well-known and well-developed European characteristics. However, they were smothered by a rather naïve belief in the goodness of state activities. It is time to wipe away the dust of history. It is time to rely on old European traditions. It is time to rely on our own strength. It is time to make the euro our currency, and the dollar the problem of others.

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