THE WAY WE LIVE NOW: 3-13-05; Our Currency,

Your Problem, By NIALL FERGUSON (NYT) 1532 words, Published: March 13, 2005

Every congressman knows that the United States currently runs large "twin deficits" on its budget and current accounts. Deficit 1, as we well know, is just the difference between federal tax revenues and expenditures. Deficit 2 is generally less well understood: it's the difference between all that Americans earn from foreigners (mainly from exports, services and investments abroad) and all that they pay out to foreigners (for imports, services and loans). When a government runs a deficit, it can tap public savings by selling bonds. But when the economy as a whole is running a deficit -- when American households are saving next to nothing of their disposable income -- there is no option but to borrow abroad.

There was a time when foreign investors were ready and willing to finance the U.S. current account deficit by buying large pieces of corporate America. But that's not the case today. Perhaps the most amazing economic fact of our time is that between 70 and 80 percent of the American economy's vast and continuing borrowing requirement is being met by foreign (mainly Asian) central banks.

Let's translate that into political terms. In effect, the Bush administration's combination of tax cuts for the Republican "base" and a Global War on Terror is being financed with a multibillion dollar overdraft facility at the People's Bank of China. Without East Asia, your mortgage might well be costing you more. The toys you buy for your kids certainly would.

Why are the Chinese monetary authorities so willing to underwrite American profligacy? Not out of altruism. The principal reason is that if they don't keep on buying dollars and dollar-based securities as fast as the Federal Reserve and the U.S. Treasury can print them, the dollar could slide substantially against the Chinese renminbi, much as it has declined against the euro over the past three years. Knowing the importance of the U.S. market to their export industries, the Chinese authorities dread such a dollar slide. The effect would be to raise the price, and hence reduce the appeal, of Chinese goods to American consumers -- and that includes everything from my snowproof hiking boots to the modem on
my desk. A fall in exports would almost certainly translate into job losses in China at a time when millions of migrants from the countryside are pouring into the country’s manufacturing sector.

So when Treasury Secretary John Snow insists that the United States has a "strong dollar" policy, what he really means is that the People’s Republic of China has a "weak renminbi" policy. Sure, this is bad news if you happen to be an American toy manufacturer. But there are three good reasons that the administration is tacitly delighted by the Asian central banks' support. Not only is it keeping the lid on the price of American imports from Asia (a potential source of inflationary pressure). It is also propping up the price of U.S. Treasury bonds; this in turns depresses the yield on those bonds, allowing the federal government to borrow at historically very low rates of interest. Reason No. 3 is that low long-term interest rates keep the Bush recovery jogging along.

Sadly, according to a growing number of eminent economists, this arrangement simply cannot last. The dollar pessimists argue that the Asian central banks are already dangerously overexposed both to the dollar and the U.S. bond market. Sooner or later, they have to get out -- at which point the dollar could plunge relative to Asian currencies by as much as a third or two-fifths, and U.S. interest rates could leap upward. (When the South Korean central bank recently appeared to indicate that it was shifting out of dollars, there was indeed a brief run on the U.S. currency -- until the Koreans hastily issued a denial.)

Are the pessimists right? The U.S. current account deficit is now within sight of 6 percent of G.D.P., and net external debt stands at around 30 percent. The precipitous economic history of Latin America shows that an external-debt burden in excess of 20 percent of G.D.P. is potentially dangerous.

Yet there is one key difference between the United States and the countries south of the Rio Grande. Latin American economies have trouble with their foreign debts because those debts are denominated in foreign currency. The
United States' external liabilities, by contrast, are almost entirely denominated in its own currency.

It therefore makes more sense to compare the United States with other members of that exclusive club of countries that have produced -- and hence been able to borrow -- in international currencies. The most obvious analogy that springs to mind is the United Kingdom 60 years ago.

During the Second World War, Britain financed its wartime deficits partly by borrowing substantial amounts of sterling from the colonies and dominions within her empire. And yet by the mid-1950's, these very substantial debts had largely disappeared. Unfortunately, this was partly because the value of sterling itself fell significantly. Moreover, sterling's decline and fall did not reduce the U.K.'s chronic trade deficit, least of all with respect to manufacturing. On the contrary, British industry declined in tandem with the pound's status as a global currency. And, needless to say, the decline of sterling coincided with Britain's decline as an empire.

From an American perspective, all this might seem to suggest worrying parallels. Could our own obligations to foreigners presage not just devaluation but also industrial and imperial decline?

Possibly. Yet there are some pretty important differences between 2005 and 1945. The United States is not in nearly as bad an economic mess as postwar Britain, which also owed large sums in dollars to the United States. The American empire is also in much better shape than the British empire was back in 1945.

Even the gloomiest pessimists accept that a steep dollar depreciation would inflict more suffering on China and other Asian economies than on the United States. John Snow's counterpart in the Nixon administration once told his European counterparts that "the dollar is our currency, but your problem." Snow could say the same to Asians today. If the dollar fell by a third against the
renminbi, according to Nouriel Roubini, an economist at New York University, the People's Bank of China could suffer a capital loss equivalent to 10 percent of China's gross domestic product. For that reason alone, the P.B.O.C. has every reason to carry on printing renminbi in order to buy dollars.

Though neither side wants to admit it, today's Sino-American economic relationship has an imperial character. Empires, remember, traditionally collect "tributes" from subject peoples. That is how their costs -- in terms of blood and treasure -- can best be justified to the populace back in the imperial capital. Today's "tribute" is effectively paid to the American empire by China and other East Asian economies in the form of underpriced exports and low-interest, high-risk loans.

How long can the Chinese go on financing America's twin deficits? The answer may be a lot longer than the dollar pessimists expect. After all, this form of tribute is much less humiliating than those exacted by the last Anglophone empire, which occupied China's best ports and took over the country's customs system (partly in order to flood the country with Indian opium). There was no obvious upside to that arrangement for the Chinese; the growth rate of per capita G.D.P. was probably negative in that era, compared with 8 or 9 percent a year since 1990.

Meanwhile, the United States may be discovering what the British found in their imperial heyday. If you are a truly powerful empire, you can borrow a lot of money at surprisingly reasonable rates. Today's deficits are in fact dwarfed in relative terms by the amounts the British borrowed to finance their Global War on (French) Terror between 1793 and 1815. Yet British long-term rates in that era averaged just 4.77 percent, and the pound's exchange rate was restored to its prewar level within a few years of peace.
It is only when your power wanes -- as the British learned after 1945 -- that owing a fortune in your own currency becomes a real problem. As opposed, that is, to someone else's problem.