Project Syndicate

The Vise Tightens on the Dollar

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NEW HAVEN – The US dollar has now entered the early stages of what looks to be a sharp descent. The dollar's real effective exchange rate (REER) fell 4.3% in the four months ending in August. The decline has been even steeper as measured by other indexes, but the REER is what matters most for trade, competitiveness, inflation, and monetary policy.

To be sure, the recent pullback only partly reverses the nearly 7% surge from February to April. During that period, the dollar benefited from the flight to safety triggered by the "sudden stop" in the global economy and world financial markets arising from the COVID-19 lockdown. Even with the recent modest correction, the greenback remains the most overvalued major currency in the world, with the REER still 34% above its July 2011 low.

I continue to expect this broad dollar index to plunge by as much as 35% by the end of 2021. This reflects three considerations: rapid deterioration in US macroeconomic imbalances, the ascendancy of the euro and the renminbi as viable alternatives, and the end of that special aura of American exceptionalism that has given the dollar Teflon-like resilience for most of the post-World War II era.

The first factor – America's mounting imbalances – is now playing out in real time with a vengeance. The confluence of an unprecedented erosion of domestic saving and the current-account deficit – joined at the hip through arithmetic accounting identities – is nothing short of staggering.

The net national saving rate, which measures the combined depreciation-adjusted saving of businesses, households, and the government sector, plunged into negative territory at -1% in the second quarter of 2020. That had not happened since the global financial crisis of 2008-09, when net national saving fell into negative territory for nine consecutive quarters, averaging -1.7% from the second quarter of 2008 to the second quarter of 2010.

But the most important aspect of this development was the speed of the collapse. At -1% in the second quarter, the net saving rate fell fully 3.9 percentage points from the pre-COVID 2.9% reading in the first quarter. This is, by far, the sharpest one-quarter plunge in domestic saving on record, dating back to 1947.

What has triggered this unprecedented collapse in net domestic saving is no secret. COVID-19 sparked a temporary surge in personal saving that has been more than outweighed by a record expansion in the federal budget deficit. The Coronavirus Aid, Relief, and Economic Security (CARES) Act featured $1,200 relief checks to most Americans, as well as a sharp expansion of unemployment insurance benefits, both of which boosted the personal saving rate to an unheard of 33.7% in April. Absent these one-off injections, the personal saving rate quickly receded to a still-lofty 17.8% in July and is set to fall even more sharply with the recent expiration of expanded unemployment benefits.

Offsetting this was a $4.5 trillion annualized widening of the federal deficit in the second quarter of 2020 (on a net saving basis), to $5.7 trillion, which swamped the $3.1 trillion surge in net personal saving in the same period. With personal saving likely to recede sharply in the months ahead and the federal budget deficit exploding toward 16% of GDP in the current fiscal year, according to the Congressional Budget Office, the plunge in net domestic saving in the second quarter of 2020 is only a hint of what lies ahead.

This will trigger a collapse in the US current-account deficit. Lacking in saving and wanting to invest and grow, the US must import surplus saving from abroad and run massive external deficits to attract foreign capital. Again, this is not esoteric economic theory – just a simple balance-of-payments accounting identity.

The validity of this linkage was, in fact, confirmed by the recent release of US international transactions statistics for the second quarter of 2020. Reflecting the plunge in domestic saving, the current-account deficit widened to 3.5% of GDP – the worst since the 4.3% deficit in the fourth quarter of 2008 during the global financial crisis.

Like the saving collapse, the current-account dynamic is unfolding in an equally ferocious fashion. Relative to the 2.1%-of-GDP current-account deficit in the first period of 2020, the 1.4-percentage-point widening in the second quarter was the largest quarterly deterioration on record (dating back to 1960).

With the net domestic saving rate likely headed into record depths of between -5% and -10% of national income, I fully expect the current-account deficit to break its previous record of 6.3% of GDP, recorded in the fourth quarter of 2005. Driven by the explosive surge in the federal budget deficit this year and next, the collapse of domestic saving and the current-account implosion should unfold at near-lightning speed.

It is not just rapidly destabilizing saving and current-account imbalances that are putting downward pressure on the dollar. A shift in the Federal Reserve's policy strategy is a new and important ingredient in the mix. By moving to an approach that now targets average inflation, the Fed is sending an important message: zero-interest rates are likely to persist for longer than previously thought, regardless of any temporary overshoots of the 2% price stability target.

This new bias toward monetary accommodation effectively closes off an important option – upward adjustments to interest rates – that has long tempered currency declines in most economies. By default, that puts even more pressure on the falling dollar as the escape valve from America's rapidly deteriorating macroeconomic imbalances.

In short, the vise is tightening on a still-overvalued dollar. Domestic saving is now plunging as never before, and the current-account balance is following suit. Don't expect the Fed, focused more on supporting equity and bond markets than on leaning against inflation, to save the day. The dollar's decline has only just begun.

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