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Can the world economy be saved? The days of the dollar reserve system are numbered, says Nobel Prize-winning economist

BY: JOSEPH STIGLITZ

One of my predecessors as chairman of the Council of Economic Advisers once quipped that that which is not sustainable will not be sustained. The U.S. trade deficit - which now runs at about $900-billion a year - is not sustainable. The fact that the United States has been running huge deficits for a long time has given comfort to some who imagine that the U.S. is an exception and able to sustain such large deficits. But dollar optimists should remember that huge U.S. deficits in the past have resulted in serious dollar weakness.

It was only 35 years ago that Richard Nixon was forced to end the convertibility of dollars into gold and so brought into being the flexible exchange rate. Large U.S. deficits under Ronald Reagan were a major factor in the weakness of the dollar in the early 1980s.

All of this matters because countries around the world hold dollars in their reserves. They do this in order to bolster confidence in their currency and economy and as a way of assuring lenders that their loans can be repaid in dollars - which also bolsters their confidence.

But as America's total indebtedness increases, confidence in the dollar decreases.

Countries that hold a lot of dollars in reserve are seeing the value of their reserves shrink. They are probably wishing they had bought euros instead. After all, with trillions of dollars held in reserves, the losses are enormous. No one is panicking yet, but more and more central banks are adopting a simple principle, taught in every business school: diversification. They are selling dollars and buying other currencies, and that means the dollar is likely to continue to decline, perhaps steadily, but perhaps not.

America has been blaming China for its huge deficit - saying that, if only China did not undervalue its currency, the U.S. would not buy so much of its stuff. In fact, if China revalued, matters would be worse. Americans would still keep buying products from abroad but might end up buying them from countries that aren't willing to return the favour by buying U.S. treasury bonds. At the moment, China is effectively providing vendor finance to the U.S. for its purchases of Chinese textiles, apparel and consumer goods. Another exporter, such as Bangladesh or Cambodia, might prefer to reinvest its earnings at home or buy euros.

Who would then finance America's deficit? The nature of markets is that, somehow, they will be financed; but the process of adjustment can be disorderly, with economic slowdowns and even recessions. Because of the pivotal role of America in the global economy, this is of concern not just to America but also to Canada, America's largest trading partner, and to the whole world.

Many economists lecture the U.S. about its huge fiscal deficit - and they are right. But America's past mistakes have put it (and the world) into an unpleasant corner. If America's fiscal deficit were eliminated, say by a quick reduction in government expenditures, the decrease in aggregate demand could precipitate a recession - exacerbating the almost inevitable slowdown from the weakening of the housing market.

Clever fiscal policy - an increase in taxes on the rich matched by tax cuts on struggling poor and middle-income workers - could lead to an offsetting increase in total consumption. It is hard to see such a policy being pushed by an administration committed to tax cuts for the rich, at whatever cost to the economy. Moreover, with American households already consuming more than their income, the short-run gain would be at the expense of problems in the future.

Alternatively, in principle, a large enough decrease in the value of the dollar would stimulate net exports and keep the economy going. But the requisite changes in the global economy could be wrenching, with adjustments that are unlikely to be smooth. And erosion in confidence in the dollar and the dollar reserve system could be long-lasting.

What's clear is, the days of the dollar reserve system are numbered. Some in Europe welcome the opportunity of becoming a reserve currency, but they should reserve their celebration. If they become a reserve currency, they will find themselves in a similar position as the U.S., facing a trade deficit as they "export" euros for others to bury in the ground for safekeeping against a rainy day.

But exporting euros does not create jobs, as exporting machines or other goods do, so Europe's unemployment rate will increase even more. And with limited flexibility in their macroeconomic policies - a central bank focusing only on inflation, and a growth and stability pact that restrains government deficits - there will be little they can do to stimulate the economy.

The world needs a better global financial system. The instability is inherent: As more and more dollars - IOUs - are held by foreigners as reserves, it is almost inevitable that confidence will eventually crash. The question is not if, but when.

Equally, the hundreds of billions of dollars put away in reserves every year takes away from global aggregate demand. The U.S. deficit has offset this depressing effect of the reserve system, but it is simply not sustainable. Instead, a more permanent solution is needed. Almost 75 years ago, the great economist John Maynard Keynes saw these fundamental flaws in the global financial system and argued for the creation of a global reserve currency (he called it bancor). Though the world did not heed his advice then, Britain's problems, manifested in long-standing low growth, were solved as the dollar replaced sterling as the global reserve currency.

The world is far more globalized today than it was then. The need for reform is all the greater, and so is our understanding of the global financial and economic system - with some work, we could adapt Keynes's ideas to today's realities. The question is, will we turn to these ideas before, or after, the next crisis?

Joseph E. Stiglitz served as chairman of the Council of Economic Advisers under Bill Clinton, was chief economist of the World Bank from 1997 to 2000, and won the Nobel Prize in economics in 2001. He is the author of the recently published Making Globalization Work.