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Opinion

We must get ready for a weak-dollar world

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The two most significant structural consequences of the recent financial debacle are the massive deficits and debts of the US and the shift of economic power from west to east. There is only one effective way for governments to address the combined impact of both: press for a sea change in currency relationships, especially a permanently and greatly weakened dollar.

The roots of this situation are well known. The American budget deficit of this past fiscal year reached 10 per cent of gross domestic product, the largest since the aftermath of the second world war. Meanwhile, the net external debt of the US nearly tripled last year to $3,500bn and it is projected to increase by nearly $1,000bn every year for the next decade. All this underestimates the problems of a country where unfunded liabilities for baby boomer entitlements are in the stratosphere, infrastructure deterioration is scandalous and many large states are out of money. To close the gaps, taxes would have to be raised to sky-high levels and spending brutally slashed. It would take a miracle if America's political system – one rife with vicious partisanship and riddled with well-financed special interests – could do either, let alone both.

Washington will therefore have little choice but to take the time-honoured course for big-time debtors: print more dollars, devalue the currency and service debt in ever cheaper greenbacks. In other words, the US will have to camouflage a slow-motion default because politically it is the easiest way out.

There is another factor pushing America towards a weaker dollar: lacking the domestic consumer demand that came with the unrestrained credit of the past 15 years, the US is desperate to find buyers abroad, especially in emerging markets where the middle class is growing and infrastructure requirements are soaring. A cheaper dollar could make US products and services more competitive.

Meanwhile, in the coming decade, the big emerging markets of Asia will be growing twice as fast as the US and three times faster than the European Union. By 2020, China, India, Indonesia, Korea and Vietnam together could generate more wealth than the the US, Japan and the EU combined. China, India, and South Korea have all been amassing dollar reserves and will be looking to reduce them. While imports into leading industrial countries have slowed, intra-Asian trade is booming and need not be financed only in dollars. The bottom line: Asian currencies are likely to strengthen against the dollar.

A much cheaper dollar is a sad development for the US, even though it is inevitable. It will make the US poorer, since Americans will pay higher prices for everything they buy from abroad – clothes, computers, cars, toys, food, you name it. It will make the US military presence abroad more expensive, since the cost of contractors and local suppliers will escalate in dollar terms. It will slow imports, removing competition that is essential to hold down the general price level in America, thereby making inflation more likely. It will send the wrong price signals for a country that prides itself on creating sophisticated, highly valuable products, for a low dollar will encourage producers to compete on price more than quality. It will diminish the political influence and prestige that the US has had while the dollar has been king.

Moreover, the US dollar has been at the heart of the global economy for well over half a century. Its demise, if not smooth and gradual – hardly certain – could lead to an era of competitive devaluations and other mercantilist trade policies.

An alternative to a global monetary system that has been centred on the dollar is now imperative. That means a multi-currency framework including the euro, the yen, the renminbi and significant issuance of an IMF-backed currency called "special drawing rights". This regime will take time to devise, but it should start now.

That is why Tim Geithner, US Treasury secretary, should invite his colleagues in the UK, eurozone, Japan and China to meet secretly, perhaps between Christmas and New Year, to start discussions out of the public spotlight (to avoid spooking markets). The big question: what kind of monetary system will best serve the world given deep-seated changes in the balance of economic power, and what process can be followed to develop it?

Since the late 1980s I have believed that a strong dollar was in the US and world interest. Now, however, the context has fundamentally changed. The issue is no longer whether the dollar is in long-term decline but which of two options will be taken. Should Washington and other capitals calmly and deliberately manage the transition to a new era, or, by default, should they let the market do it, with the risk of massive financial disturbances. Today, governments have a choice. Soon they may not.

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