



## Wolfgang Munchau: The dollar has fallen enough

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Last autumn, there was heightened speculation that the US dollar would face another period of devaluation. The argument focused on the US current account deficit, which amounted to 5.7 per cent of US gross domestic product in 2004. This level is widely regarded as unsustainable. Economic models suggest that a sustainable current account deficit would imply a fall in the exchange rate in the long run.

The Europeans would have taken most of the brunt of a further dollar devaluation. Fortunately for them, the euro/dollar exchange rate has been relatively stable since last November at a little over \$1.30. Of course, the big adjustment could still happen. Those who predicted it wisely acknowledged that they had no idea when it would happen.

In view of this consensus, the economists Pierre-Olivier Gourinchas, of University of California at Berkeley, and H el ene Rey, of Princeton University\*, make two brave claims. First, they argue that the dollar's depreciation between 2002 and 2004 may have been sufficient to redress the imbalances in the US economy. Second, and most outrageously, they claim to have constructed a model that is better at predicting exchange rates than the "random walk" - under which the best forecast of the future exchange rate is today's exchange rate. It is no surprise that the latter result in particular has generated some excitement in the financial markets.

How do the authors come up with such different conclusions about the dollar's level? The US calculates the current account, including the trade balance, investment income and financial transfers, at historic cost. This calculation, however, may understate the return on net foreign assets - the difference between foreign assets held by the US and US assets held by foreigners.

Mr Gourinchas and Ms Rey undertook the task of disentangling the various classes of inward and outward investments and measuring their real rates of return. If these data were put into the current account, you would get a far more accurate measure of an economy's imbalance and, as it turns out, one that is far less dramatic.

A devaluation of the dollar worsens the terms of trade, the prices of US goods relative to foreign prices. Over time, this should improve US net exports. But a dollar devaluation also affects the wealth of foreign and US investors. One therefore has two channels through which devaluations can affect the economy: the first is the trade adjustment channel; the second is the financial adjustment channel, which works through profits on shares, bonds and direct foreign investments.

A rough calculation suggests that the second channel is potentially huge. US foreign liabilities run close to 100 per cent of GDP, almost all of it denominated in dollars. US foreign assets are about 70 per cent of GDP. Of those, about 70 per cent are held in foreign currencies. If the dollar devalued by 10 per cent, the net wealth transfer from the rest of the world to the US would be about 5 per cent of US GDP. This would more or less cancel out the trade deficit.

A more detailed analysis suggests that the trade adjustment channel is still more important than the financial adjustment channel. But the financial adjustment channel presently acts as a kind of automatic stabiliser. As long as foreign investors, especially foreign central banks, are willing to hold US assets, the dollar's exchange rate does not need to devalue by as much as would have been the case if all the adjustment had to come from trade alone. Put another way, the sustainable current account deficit may be higher than otherwise thought.

Changes in the financial adjustment channels occur primarily through the exchange rate, and it is therefore tempting to ask the question: can we predict future exchange rates by looking at the ratio of net exports and net foreign assets? Econometric analysis suggests that this may indeed be so.

No doubt some financial wizards will jump at this to construct a model to forecast short- and medium-term exchange rate movements. Good luck to them.

For the rest of us, the important point is that the much-predicted crisis in the euro/dollar exchange may already have occurred.

\* *International Financial Adjustment, CEPR discussion paper 4923*