Opinion **Global Economy**

The end of the dollar's exorbitant privilege

A crash is likely given the collapse in US domestic saving and a gaping current account deficit

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Stephen Roach 2 HOURS AGO

The writer, a faculty member at Yale University and former Morgan Stanley Asia chair, is the author of 'Unbalanced'

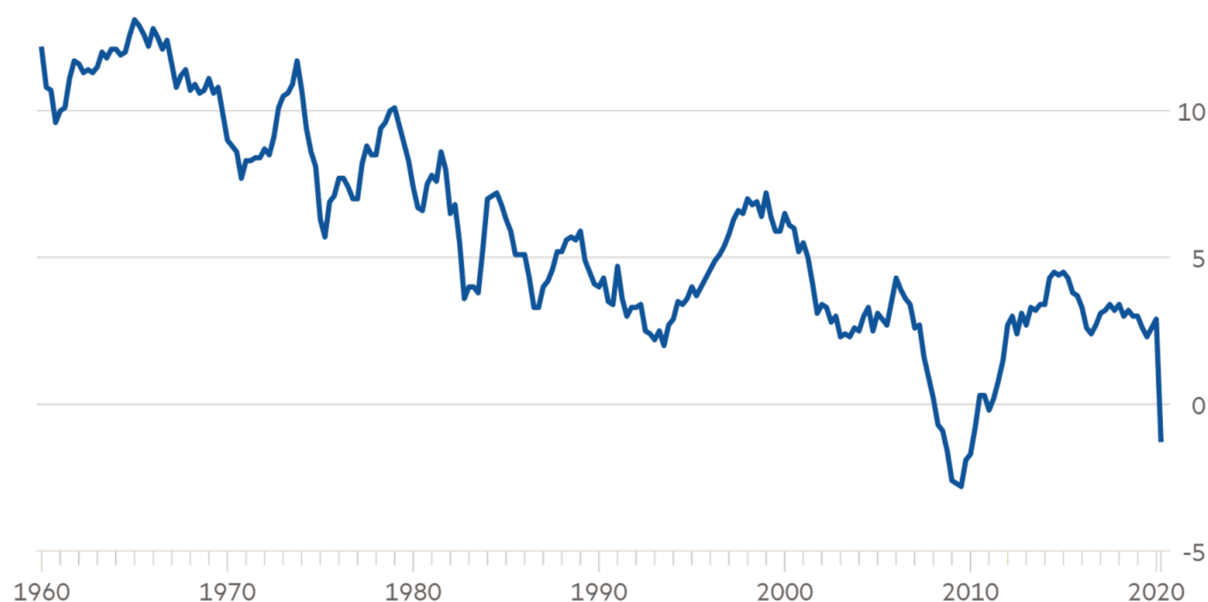
The riddle once posed in the 1960s by former French finance minister (eventually president) Valéry Giscard d'Estaing is about to be solved. Giscard bemoaned a US that took advantage of its privileged position as the world's dominant reserve currency and drew freely on the rest of the world to support its over-extended standard of living. That privilege is about to be withdrawn. A crash in the dollar is likely and it could fall by as much as 35 per cent by the end of 2021.

The reason: a lethal interplay between a collapse in domestic saving and a gaping current account deficit. In the second quarter of 2020, net domestic saving — depreciation-adjusted saving of households, businesses and the government sector — plunged back into negative territory for the first time since the global financial crisis. At -1.2 per cent in the second quarter, net domestic saving as a share of national income was fully 4.1 percentage points below the first quarter, the steepest quarterly plunge in records that go back to 1947.

Unsurprisingly, the current account deficit followed suit. Lacking in saving and wanting to grow, the US levered its exorbitant privilege to borrow surplus saving from abroad. That pushed the current account deficit to -3.5 per cent of gross domestic product in the second quarter — 1.4 percentage points below that in the first period and also the sharpest quarterly erosion on record.

A shortfall in US domestic savings has long been apparent

Net savings as a % of gross national income



Source: BEA

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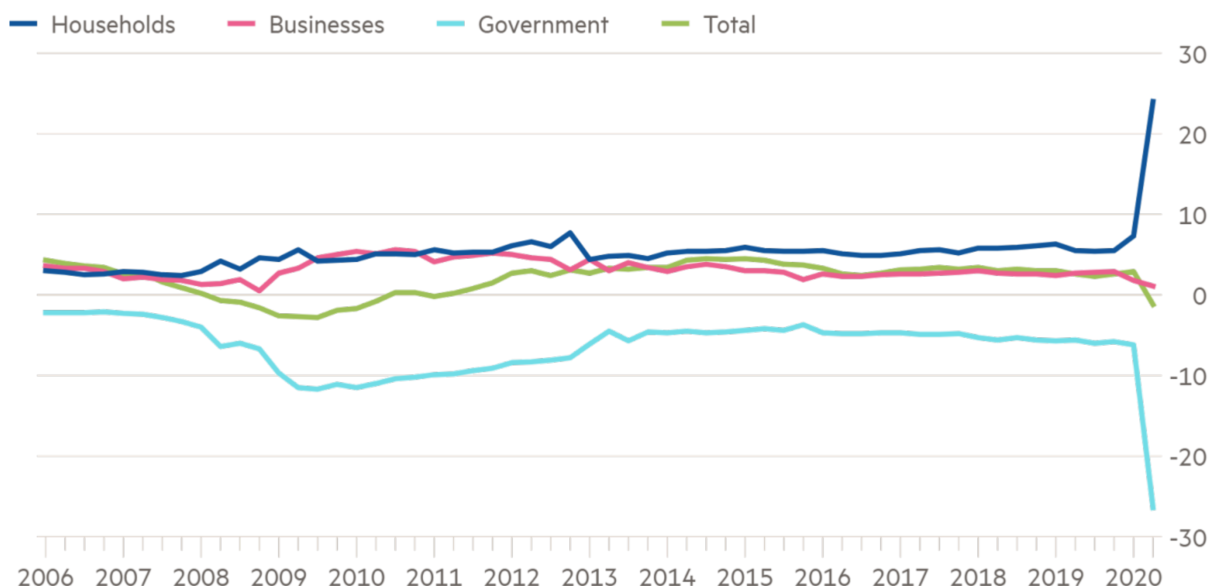
While a Covid-related explosion in the federal government deficit is the immediate source of the problem, this was an accident waiting to happen. Going into the pandemic, the net domestic saving rate averaged just 2.9 per cent of gross national income from 2011 to 2019, less than half the 7 per cent average from 1960 to 2005. This thin cushion left the US vulnerable to any shock, let alone Covid.

As budget deficits pile up in the years ahead, further downward pressure on domestic saving and the current account will intensify. The latest estimates of the Congressional Budget Office put the federal deficit at 16 per cent of gross domestic product in 2020 before receding to "just" 8.6 per cent in 2021. Assuming the US Congress eventually agrees to another round of fiscal relief, a much larger deficit for 2021 is likely.

US households have been saving this year but this has been outweighed by the fiscal expansion

US net savings by sector (% of gross national income)



Source: BEA
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This will take the US net saving rate far deeper into negative territory than during the global crisis That has ominous implications for America's future. After setting aside depreciation required of an ageing capital stock of buildings and infrastructure, the US is, in effect, liquidating the net saving required for the expansion of productive capacity. Without borrowing surplus saving from abroad, growth becomes impossible. The current account deficit will only deepen as a result.

That's when the dollar loses its special privilege. With America's position as the world's dominant reserve currency slowly eroding since 2000, foreign lenders are likely to demand concessions on the terms for such massive external financing. This normally takes two forms — an interest rate and/or a currency adjustment. The Federal Reserve has recently shifted to a strategy that takes into account an average of inflation rather than a specific target, and promised to keep policy rates near zero for several more years. That means the interest rate channel has effectively been closed. As a result, more of the current account adjustment will now be forced through a weaker dollar.

The US dollar's lofty value makes it especially vulnerable. Despite recent falls, a broad index of the dollar's real effective exchange rate remains some 27 per cent above its July 2011 low. That leaves the greenback as the world's most overvalued major currency, just as the US gets sucked into an unprecedented savings-current account vortex.

Currencies are relative prices. The dollar has always benefited from the seductive charm of TINA — that there is no alternative. Think again. The July 21 agreement on a Next Generation EU Fund of €750bn ($858bn) finally establishes a pan-European fiscal policy. That should boost the undervalued euro. The renminbi, gold and cryptocurrencies are also alternatives to the once invincible dollar.

The dollar index fell 33 per cent in real terms both in the 1970s and the mid-1980s, and another 28 per cent from 2002 to 2011. During those three periods, the net domestic saving rate averaged 4.9 per cent (versus -1.2 per cent today) and the current account deficit was -2.5 per cent of gross domestic product (versus -3.5 per cent today). With the US having squandered its exorbitant privilege, the dollar is now far more vulnerable to a sharp correction. A crash is looming.

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