OP-ED CONTRIBUTOR

When Weakness Is a Strength

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Suddenly all eyes are on a weakening dollar. In recent days, the American currency has fallen against the euro, the yen and most other currencies around the world. The renminbi is a notable exception; China has kept its currency firmly pegged to the dollar for a decade.

The fall of the dollar is not a surprise. It is the logical outgrowth of an unbalanced world economy, and America's gaping current account deficit - the difference between foreign trade and investment in the United States and American trade and investment abroad - is just the most visible manifestation of these imbalances. The deficit ran at a record annual rate of $665 billion, or 5.7 percent of gross domestic product, in the second quarter of 2004.

While a decline in the dollar is not a cure-all for what ails the world, it should go a long way toward bringing about a sorely needed rebalancing. With a weaker dollar, economic and even political tensions among nations would be relieved, helping to promote more sustainable growth in the global economy.

Still, a debate persists as to the wisdom of allowing the dollar to decline. The Bush administration seems to have given its tacit assent, and Alan Greenspan, chairman of the Federal Reserve, is finally on board. But outside the United States, where policymakers have long been vocal in their displeasure over America's deficits, officials are now objecting to America's cure. Europeans have referred to the dollar's recent decline as brutal. The Japanese have threatened to intervene again in foreign exchange markets. And Chinese officials have argued that global imbalances are "made in America."

In this blame game, it's always the other guy. Yet global imbalances are a shared responsibility. America is guilty of excess consumption, whereas the rest of the world suffers from insufficient consumption. Consumer demand in the United States grew at an average of 3.9 percent (in real terms) from 1995 to 2003, nearly double the 2.2 percent average elsewhere in the industrial world.

Meanwhile, Americans fail to save enough - whereas the rest of the world saves too much. American consumers have borrowed against the future by squandering their savings. The personal savings rate was just 0.2 percent of disposable personal income in September - down from 7.7 percent as recently as 1992. Moreover, large federal budget deficits mean the government's savings rate is negative.

Lacking in domestic savings, the United States must import foreign savings to finance the growth of its economy. And it runs huge current-account and trade deficits to attract such capital from overseas.

America's consumption binge has its mirror image in excess savings elsewhere in the world -

especially in Asia and Europe. For now, America draws freely on this reservoir, absorbing about 80 percent of the world's surplus savings. Just as the United States has moved production and labor offshore in recent years, it is now outsourcing its savings.

This is a dangerous arrangement. The day could come when foreign investors demand better terms for financing America's spending spree (and savings shortfall). That is the day the dollar will collapse, interest rates will soar and the stock market will plunge. In such a crisis, a United States recession would be a near certainty. And the rest of an America-centric world would be quick to follow.

The only way to avoid this unhappy future is for the world's major central banks to carefully manage a gradual but significant depreciation of the dollar over the next several years. America, and the world, would gain in several ways.

First, there would be a gradual rise in interest rates in the United States - compensating foreign investors for financing the biggest debtor in the world. That would suppress growth in those sectors of the American economy that are most sensitive to interest rates, like housing, consumer durables like cars and appliances, and business capital spending. The result: a higher domestic savings rate and a reduced need for foreign capital - a classic current-account adjustment.

Second, when the dollar falls, other currencies rise. So far, the euro has borne a disproportionate share of the change. That puts increased pressure on Asian nations - including China - to share in the adjustment by allowing their currencies to strengthen. Most currencies in Asia are now rising, but the renminbi has remained conspicuously unmoved.

Third, as the currencies of Asia and Europe strengthen, their exports will become less attractive to American consumers. This will force Asia and Europe to work to stimulate domestic demand to compensate - resulting in a reduction of both excess savings and current-account surpluses. This is easier said than done, especially since it may require painful structural reforms, like a loosening of domestic labor markets, to unshackle internal demand.

Fourth, a weaker dollar might defuse global trade tensions. Dollar depreciation will support American exports, and higher interest rates should slow domestic demand and reduce imports. That means the United States trade deficit should narrow - tempering protectionist risks. And with Asian countries allowing their currencies to fluctuate, Europe gets some relief and may be less tempted to resort to protectionist remedies.

What's certain is that a lopsided world needs to be put back into balance. The dollar is the world's most widely used currency, but its fall affects more than just foreign-exchange rates. A weakening dollar is an encouraging sign that the world's relative price structure - essentially the value of one economy versus another - is becoming more sensible. If the world can manage the dollar's decline wisely, there is more reason for hope than despair.

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