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## Dollar Plunge, Specter of the Crash

By Philippe Martin  
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The dollar is falling again and will continue to fall. The direction is not really in question, but the manner, brutal or orderly, with or without a financial crisis, has not yet been determined. Let's first review a few figures to get a good sense of the scale of the American problem. The current account deficit (the difference between what Americans import and what they export to the rest of the world) at a new historic record will represent about 5.4% of American income in 2004. Every year, the deficit must be financed by growth in net debt to the rest of the world. This now stands at around 2.6 trillion dollars, 23% of the United States' income. In comparison, France's net external position is a positive 7% of its income.



A current account deficit is not always a bad thing. It is also not always associated with currency devaluation. The nature of America's current account balance, however, changed profoundly with Bush's arrival in power in 2000. From the mid 1990s until 2000, the American deficit reflected a strong level of investment, particularly in the new economy, and a too weak level of American household savings. The productive American investment financed by the influx of foreign capital carried within itself the promise of reimbursement for the debts contracted. The deficit was not a synonym for the decline in the dollar because the world was buying dollars in order to invest in the United States. Starting in 2001, investment collapsed, but the external deficit has remained since there have been progressively worse public deficits that have had to be financed since then. The Bush era has generated the reappearance of the "twin deficits": the world no longer finances productive investment, but the American budget deficit attributable to the largesse offered to the richest taxpayers and to the increase in public expenditures linked to the war against terrorism and Iraq. So



while the influx of private capital flows dries up, financing the deficit today depends dangerously on Asian, particularly the Japanese and Chinese, central banks' purchases of American Treasury bills. These banks have accumulated close to 2.0 trillion dollars worth of American financial assets. That's the main reason why the dollar has not yet fallen sharply. For the moment, the Chinese government considers a loss of value in its dollar-denominated assets, in the case where the dollar would collapse in the future, to be less dangerous than a dollar fall today, which would slow down Chinese exports and endanger the objective of quasi-full employment and ultimately, the country's social stability. For the moment.

We can imagine the rosy scenario that would repeat the soft landing that followed the 1985 Plaza agreement between the United States, Europe, and Japan. Then, the dollar fell 40% in two years without causing a panic, a financial crisis, or a rise in protectionism. France's growth was not penalized either.

However the transatlantic ambiance is no longer really on track for multilateral agreements and the markets know it. It's enough to state what such an agreement would have to contain today to understand how difficult it would be to conclude. First of all, on the European side, a commitment to further reforms to re-launch economic growth and to increase productivity gains in the intangible goods sector and, consequently, to increase our imports. Recent experience in these areas is rather disappointing. A little less European cacophony over the dollar would be welcome. Then, an agreement by the Chinese and the Japanese to accept the revaluation of their currencies, an idea they have rejected up till now. Finally, and above all, a commitment from America to reduce its budget deficit, which can only happen through an increase in taxes. That is very unlikely, given the second Bush administration's ideological rigidity on the subject.

As with global warming, the Bush administration minimizes the risks so as not to have to take any action that might be politically costly. The chain reactions generated by a brutal freefall of the dollar, precipitated by the markets, might not, all the same, be very pretty. By pushing operators to sell American assets to avoid losses, such a dollar drop could precipitate a Stock Exchange fall, a brutal increase in interest rates, not to mention the failure of a certain number of financial institutions that had invested heavily in dollars. In cartoons, the hero continues along his trajectory above the abyss before suddenly falling straight down into it. In the same way, overvalued currencies have the tendency to stay that way until the day the markets consider that they are no longer sufficiently compensated for the risk of a crash. The probability of such a catastrophe scenario is perhaps low, perhaps as low as for a brutal global heating, but it is not zero. The absence of

international cooperation sends the markets a dangerous signal that for the moment, we are working without a [safety] net.

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*Philippe Martin is a professor at Paris-I and a researcher at the Centre d'enseignement et de recherches et d'analyses socio-économiques (Ceras-CNRS) [Center for Socio-economic Teaching, Research, and Analysis].*

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*Translation: **t r u t h o u t** French language correspondent Leslie Thatcher.*

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