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Testimony for the Committee on Financial Services on the Implications of a Weaker Dollar for Oil Prices and the U.S. Economy

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OIL, THE DOLLAR, GLOBAL IMBALANCES, AND THE U.S. ECONOMY

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Even as the housing collapse and related sub-prime crisis have slowed the real U.S. economy and weighed on the value of the dollar, oil prices have flirted with $150 per barrel and remain high despite recent downward adjustments. The resulting risks to the U.S. economy are serious. Other factors being equal, a falling dollar increases the prices of all imports, thus threatening more rapid inflation, and limiting the flexibility of the Federal Reserve to reduce interest rates. Meanwhile, higher oil prices drain U.S. consumers' wallets, and compound the impact of the credit crunch in slowing the economy and delaying recovery. The same higher oil prices also afflict other developed non-oil-producing nations, and thus could spread the economic slowdown around the world. In this regard, we should note that the price of oil has increased in Euros quite significantly, making clear that more costly petroleum is not only the product of our own weaker currency, but is driven by more basic supply/demand factors that will endure for some time. With these adverse but seemingly contradictory developments, monetary and fiscal policy makers the world over face a near-term balancing act to retain their hard-won credibility in maintaining price stability while avoiding a painful loss of economic output and employment.

Still, as difficult and as important as these near-term macroeconomic challenges may be, this nation and the world must maintain a focus on the longer-term fundamentals that will determine prosperity beyond the current slowdown. The oil price is a startling reminder of another potential crisis that was overlooked while everyone watched the financial meltdown: the continuing enormous imbalances in the global economy. While some progress was made in reducing the U.S. current account deficit in 2007 as a more competitive dollar gave a welcome boost to exports, the rising oil price has pushed these imbalances into growing again. So as I address the current economic environment, I want to guide your attention toward a longer-term challenge facing fiscal and monetary policymakers, both in the U.S. and in other countries.

Let us begin by taking a moment to review the large international imbalances that threaten longer-term economic stability and prosperity.

These imbalances have been most acute in the surpluses of Asian manufacturers, notably China and Japan, and the oil exporting countries, whose surpluses are now growing. On the other side of the fence has been the United States, with a persistent outsized deficit, along with certain other countries with large deficits relative to their GDP, such as the U.K., Australia and New Zealand.

It is understandable that the credit crunch and weakening economy have diverted attention from the global imbalances. The U.S. current account deficit, after growing painfully for a decade, has stabilized, at least for now. That deficit in the first quarter of 2008 was 5.0 percent of GDP, too large to be sustained, but below its peak of 6.6 percent at the end of 2005. For the United States, the adjustment process has begun to work as advertised: a dollar depreciation of 23 percent since mid-2002 and the slowing of U.S. growth relative to the growth of our trading partners brought a surge in exports and dampened the growth of non-oil imports. Indeed, the current account deficit may fall further relative to GDP if the economy slides into recession – although this is hardly a desirable means of adjustment.

Still, record oil prices show that this is not the time to declare victory over international imbalances. Indeed, in spite of a stabilized U.S. current account deficit, in absolute terms global imbalances remain extremely large. Because these imbalances are now overlaid on the crisis in U.S. and European credit markets and a weakening U.S. economy, the risks of global financial and economic disorder are increasing as well.

In September 2007, the Committee for Economic Development (CED) released a study entitled *Reducing the Risks from Global Imbalances*. The report argued that the large imbalances are unsustainable and, if not corrected, significantly raise the risks of financial and economic instability and the adoption of protectionist trade policies. This study noted, however, that market mechanisms were likely to reduce the imbalances, but this adjustment should be facilitated by sensible (and self-interested) policies by the major nations involved. The study outlined actions by the United States, China, the European Community, Japan, and the oil exporters that would help the process of global adjustment and a reduction of imbalances. These

measures would be most effective if adopted by all the countries contributing significantly to the imbalances.

The immediate problems of the worldwide credit crunch and economic slowdown have drawn attention away from the longer-term concerns about global imbalances and related economic pressures. The U.S. current account deficit has improved somewhat, and the direct increase in the current account surpluses of oil exporters has drawn less attention than the impact of the sharp rise in oil prices on economies dependent on oil imports. Unfortunately, we have yet to see any significant new adjustment policies being adopted by the major surplus and deficit countries, and certainly no coordinated international actions, with the modest narrowing of global imbalances more due to short-term market conditions rather than structural change. Unfortunately, the recent improvement in the US current account deficit has not been caused by reductions in energy and Asian exporting countries' surpluses. Rather, it seems more likely that we will witness a widening of deficits of the trading partners of these countries, just spreading the imbalance problem rather than resolving it. Thus, despite the thinning of a few nearby clouds, there is no weakening of the imbalances storm front on the horizon. In fact, there are important reasons to believe that the vulnerability of the United States, and increasingly other oil importing countries, to global imbalances may worsen significantly in the coming years. There are several reasons for this concern.

First, the U.S. federal budget deficit and our generally low overall national savings rate lead to a persistent current account deficit. At its historic peak, the current account deficit required the United States to attract roughly $2.0 billion dollars a day to finance this deficit. Due to the weakening of the U.S. economy, and the weakening of the dollar, this need to finance the current account deficit has now dropped to $1.5 billion per day, even with the higher price for imported oil. This amount may indeed go lower, but will continue to be significant for the foreseeable future. Exchange rate adjustment, including further weakening of the dollar, should eventually restore equilibrium, but policy actions would be desirable to facilitate adjustment and reduce the risk of a dollar crash in response to economic or financial shocks before the adjustment process is completed. I personally believe that the adjustment will be less risky and

less painful with affirmative and collective global policy action rather than leaving exchange rates alone to do the job.

Second, the growth of federal entitlement programs, particularly healthcare and social security, will lead to ever higher federal budget deficits without either restructuring the programs themselves, or paying significantly higher taxes, or a combination of the two. Failing to address this will contribute to still greater current account deficits, a larger need for foreign financing, and a weaker dollar.

Third, the current account deficit can be expected to climb further once the United States recovers from the current slow growth or recessionary period. I believe that we can expect such a recovery to begin in the second half of 2009. The impact of such a recovery on the dollar will be mixed, with the negative aspects for the dollar of a higher current account deficit offset by foreign investors finding the United States a more attractive destination for their funds.

Without policy change, therefore, the outlook is that total foreign indebtedness as a percentage of GDP will climb steadily in the future. This means that the cost of servicing this debt will be a growing burden on the U.S. economy and a weight on the dollar. Accompanying this, we can expect some increase in long-term bond yields over current levels, as the U.S. needs to attract more foreign capital but foreign investors face the prospect of receiving returns on such investment in depreciating dollars. Equally significantly, there is a question of intergenerational equity, as future generations must bear the debt burdens that result from the consumption of the current generation.

As just noted, the dollar can be expected to stay relatively weak in the long term unless we are willing to face somewhat higher interest costs to increase its attractiveness as an investment vehicle. A weaker dollar will "import" more inflation into the U.S. economy through higher prices for foreign goods and services. Offsetting this negative impact, exporting sectors of the economy will benefit by becoming more cost-competitive. In fact, exports now account for practically all the growth in GDP over the past several quarters. It is due to a weaker dollar and stronger exports that the current account deficit narrowed in 2007 for the first time in many

years. However, a wider deficit is expected in 2008, with a $261 billion increase in the oil import bill more than offsetting a $166 billion improvement in the rest of the current account.

The spread in foreign central bank rates versus the United States has also contributed to downward pressure on the dollar, especially relative to the Euro. This will be alleviated as the Fed begins to raise rates, probably in the beginning of 2009, reducing the now 2-1/4 percent gap between the federal funds rate and the European Central Bank's policy rate.

The weaker dollar has contributed somewhat in the short term to the high prices paid for oil and other imported commodities. As one factor, most Middle East oil exporters have continued to peg their currencies to the dollar and want, at a minimum, to maintain the real value of the prices received for their oil to finance their own imports from other regions of the world. However, as a trade-weighted basis, the Saudi Rial has only depreciated by 9% since 2005. The Saudis may have wanted higher prices for oil for other reasons, but the depreciation of their own dollar-pegged currency cannot be responsible for much of today's high oil prices. While the weak dollar can be a short-term contributor to higher prices for oil and other commodities, most of the recent price increases are a function of supply and demand. This can be illustrated by the increases in Euro prices for commodities. The price of oil in Euros has increased by about 175 percent since the beginning of 2005, which is not too far behind the 233 percent increase in dollars. So we should not assume that the value of the dollar is the main culprit or that an increase in the dollar would significantly reverse the pressure that oil and other commodities exert on the overall U.S. price level.

The current credit strains in U.S. financial markets, and foreign investor concerns about the risks associated with U.S. financial institutions and securities, also contribute to a weaker dollar. It is imperative that stability and investor confidence be restored in U.S. financial markets so that the United States can continue to attract foreign capital at reasonable rates – which is needed to finance U.S. deficits. Many of the government actions taken recently, such as Fed lending to securities firms, Fannie Mae and Freddie Mac, are appropriate and do contribute to restoring needed stability and confidence. However, it should be remembered that by these

actions, the federal government, which is already running a large deficit, has further increased its exposure.

In the past, the U.S. capital account has helped to offset the financing cost of the current account deficit. This is due to the fact that the United States earns more on its foreign investments than foreign investors earn on their investments in the United States, since much of the latter is in low-yielding U.S. Treasury securities. However, this U.S. advantage is shrinking and could disappear altogether in the future. One threat to this favorable margin is the establishment of sovereign wealth funds. Because of persistent imbalances, some $3 trillion in surplus dollars are held by other countries, and up to now, approximately $1 trillion of these funds have been placed in some 40 sovereign wealth funds. These funds, often handled by professional money managers, may not be content to recycle dollars into Treasury securities, but are likely to seek higher returns, both in the U.S. and elsewhere. Such trends will surely be negative for the dollar.

So what to do? First, and most immediately, the credibility of U.S. financial markets must be restored to attract the substantial foreign capital needed to finance the U.S. current account deficit without a steep rise in interest rates or an even lower dollar. All participants in the U.S. financial markets must address the impairments of the past, restore their capital bases, and establish better risk controls in their borrowing and lending practices. This must be done immediately, completely, and transparently and should be accompanied by more effective regulatory oversight. The steps taken thus far by many banks to write-off losses and obtain new sources of capital, both from U.S. and foreign sources have been helpful and necessary, but I believe more needs to be done.

To accompany such private actions, the Federal Reserve has appropriately provided additional liquidity to prevent recent financial problems from causing even deeper and long-lasting damage to financial markets and the real economy, which could cost jobs and income in the United States and abroad. The Fed's interest rate cuts of 325 basis points starting last September and recent liquidity facilities for financial institutions have been key. Appropriately, the Congress and the Administration moved quickly to put in place temporary fiscal stimulus in

the range of one percent of GDP. These monetary and fiscal actions have helped to put a floor under the economy, although the U.S. still faces a difficult period into 2009 now that most of the stimulus is behind us. Indeed, the economy still risks dipping into recessionary territory over the next several quarters.

Further action by policymakers everywhere will probably be needed to limit the depth and duration of the current slowdown. This will require the Fed, the European Central Bank (which raised rates earlier this month), and other central banks to make further difficult choices between limiting economic and social damage and controlling inflation. These choices must be made carefully, because the weaker dollar and higher oil and other commodity prices will sustain the threat of inflation, especially for the United States and countries with currencies pegged to the dollar. We cannot afford to sacrifice the strong central bank credibility, established slowly and painfully over many years, that has supported sustained economic growth with low inflation.

Along with the measures taken to support the U.S. economy, we must also address global imbalances. The U.S. fiscal stimulus, while certainly needed to counter the recession, will contribute to increasing the current account deficit. Further, as the U.S. economy recovers, the trade and current account deficits are likely to grow again. Mitigating this, the imbalances caused by high prices of oil and commodities should also fall at some point; commodities regularly go through such cycles as demand and supply shift. Oil prices should ease as world growth slows and new capacity is developed. However, upward pressure on oil prices is more likely to be sustained longer than in previous cycles, due to the current tight oil supply-and-demand balance, numerous barriers to supply growth and the relentless increases in China's energy consumption. Finally, and most fundamentally, whether the recent shifting of global imbalances is temporary or not, the United States cannot afford to ignore its large current account deficit. Persistent current account deficits have taken the U.S. net international investment position to well over $2 trillion, approximately 16% of GDP and climbing. As this U.S. net foreign debt grows in relation to the economy, and as the cost of servicing this debt increases, there certainly could be more downward pressure on the dollar. Just to summarize some key points:

- Even with an economic slowdown and a big drop in the dollar, the U.S. imbalance has only improved modestly because of high oil prices;
- The rise in oil prices means that the imbalance problem is spreading to additional countries, making the resolution of the global imbalance problem even more difficult;
- Coordinated international action to reduce imbalances would be desirable to facilitate adjustment;
- We must not ignore the need to cut the federal budget deficit and raise private savings over the longer-term, even though near-term actions are needed to stabilize the financial situation and deal with high oil prices.

As CED recommended some months ago, a sound agenda must include: a credible commitment by the United States to a ***long-term*** path of fiscal balance and increased national saving; accelerated financial sector reforms and domestic consumption growth in China; additional structural reforms in Europe and Japan; and further exchange rate adjustments or greater rate flexibility in Asian and oil-exporting economies. With the U.S. economy weak, countries with trade surpluses with the United States should stimulate their own domestic demand. This would both mitigate the effect of lower exports to the United States and contribute to the longer-term adjustment of global imbalances. And, needless to say, the United States must reduce its demand for oil, both through efficiency measures and the development of alternatives, as a matter of national and economic security. The United States has a key role to play in any program to reduce imbalances: It must put its own house in order – prominently including serious action to reduce the excessive federal budget deficits that exist now and under current policies will only continue to grow. The U.S. must also provide the leadership needed to encourage other countries to implement policies that will contribute to global adjustment. These key tasks should be high on the agenda of both the current administration and the next U.S. president.