Thanks to the Deficit, the Buck Stops Here

By Joseph E. Stiglitz
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Beware of deficit fetishism.

Last week we learned that the national debt is likely to grow by more than $9 billion. That's not great news -- no one likes a big deficit -- but President Obama inherited an economic mess from the Bush administration, and the cleanup comes with an inevitably high price tag. We're paying it now.

There are no easy options. When financial crises strike, economic growth declines and living standards drop, resulting in lower tax revenues and greater need for government assistance -- all of which leads to higher fiscal imbalances.

What really matters is not the size of the deficit but how we're spending our money. If we expand our debt in order to make high-return, productive investments, the economy can become stronger than if we slash expenditures.

There are other consequences, however, that we're missing in the debate over all this red ink. Our budget deficit, as well as the Federal Reserve's ballooning lending programs and other financial obligations, will accelerate a process already well underway -- a changing role for the U.S. dollar in the global economy.

The domino effect is straightforward: Higher deficits spark market concerns over future inflation; concerns of inflation contribute to a weaker dollar; and both come together to undermine the greenback's role as a reliable store of value around the world. Right now, with so much unused capacity in the American economy and so much unemployment -- likely to persist for at least another year or two -- the more pressing worry is deflation (a general decrease in prices), not inflation. But as the economy eventually recovers, the possibility of inflation will loom, and with forward-looking markets, worries about the future often play out in the present. Anxieties about future inflation can lead to a weaker dollar today.

So, are these anxieties justifiable? And what do they portend for the global financial system?

The worries are justified, even though Fed Chairman Ben Bernanke, recently nominated for another four-year term, assures us that he will deftly manage monetary policy to keep the economy on an even kilter. This is a tough balancing act -- move too quickly or too vigorously, and you plunge the economy into another downturn; too slowly or too weakly, and inflation can be unleashed. Anyone looking at the Fed's record in recent years will be skeptical of its forecasting skills and its ability to get the balance right.

In addition, international markets understand that the United States may face strong incentives to reduce the real value of its debts through inflation, which makes each dollar owed worth less. If market players are worried about inflation (or even if they are worried that others might be worried) that is bad news for the dollar. Holding dollars today represents risk without reward: The returns to U.S. Treasury bills are near zero, and even those most confident in the Federal Reserve must acknowledge the chance that things will not go smoothly.

For decades, other nations have held dollars in their central bank reserves, seeking to give confidence to their country and currency. But in a globalized economy, why should the entire financial system depend on the vagaries of what happens in America?

The current system is not only bad for the world, it is bad for the United States, too. In effect, as other countries hold more dollar reserves, we are exporting T-bills rather than automobiles, and exporting T-bills doesn't create jobs. We used to offset this drag on the economy by running a fiscal deficit. But going forward, we won't find it as easy to do this. And the Fed may not be able to do the trick -- as we have learned, expansionary monetary policy poses its own risks.

Like it or not, out of the ashes of this debacle a new and more stable global reserve system is likely to emerge, and for the world as a whole, as well as for the United States, this would be a good thing. It would lead to a more stable worldwide financial system and stronger global economic growth. The current system entails developing countries putting aside hundreds of billions of dollars a year -- only weakening global demand and contributing to our economic difficulties. Also, there is something a little unseemly about poor countries lending the United States trillions of dollars, now at an interest rate of close to zero.

Discussions on the design of the new system are already underway. The United Nations' Commission of Experts on Reforms of the International Monetary and Financial System -- a body I chaired and which included economists, former and current government officials, financial sector participants, central bankers, and business leaders from Asia, Europe, the United States, Africa, and Latin America -- has argued that a new global reserve currency system may be the most important reform to ensure the long-term health of the world's economy; it also suggested how to design an orderly transition from the dollar-based system.

In its interim report in June, the commission described a number of alternatives. Some involve building on the International Monetary Fund's "special drawing rights," or SDRs -- a kind of "IMF money" -- but making the issuance of this global reserve money annual and more predictable. (Currently, issuances of SDRs are small and episodic.) Other proposed reforms are more complex and ambitious, such as issuing new global reserves in ways and amounts that could be used to stabilize the world's economy or to invest in "global public goods," such as helping developing nations reduce greenhouse gas emissions.

The United States has resisted these changes, but they will come regardless, and it's better for us to participate in the construction of a new system than have it happen without us. The United States has seen great advantages with the dollar as the world's reserve currency of choice, particularly the ability to borrow at low interest rates seemingly without limit. But we haven't seen the costs as clearly: the inevitable trade deficits, the instability, the weaker global economy. The benefits to us are likely to shrink, and rapidly so, as countries shift their holdings away from the dollar.

It is happening already, and the process is likely to accelerate. Chinese authorities, for example, have openly expressed concerns about the value of the country's vast dollar reserves. Not surprisingly, China and other nations holding lots of U.S. debt support efforts to build a new system.

America should show leadership in helping shape this new structure and managing the transition, rather than burying its head in the sand. We may have preferred to keep the old system, in which the dollar reigned supreme, but that's no longer an option.

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