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Why the US cannot afford to abuse its haven status

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There is an equal and opposite formulation to Keynes's maxim "in the long run we are all dead". It is that the long run ultimately catches up with all fiscal profligates. Yet this rule, which has stood the test of history, appears to have been suspended for the benefit of the world's unique superpower. Likewise for the world's greatest currency brand name, the dollar.

The US has been conspicuous in its failure to set out a credible medium term strategy to address a huge budget deficit. It continues to espouse loose fiscal and monetary policy, which is traditionally a recipe for a weak currency. Yet the dollar, in the midst of Europe's sovereign debt crisis, remains strong. The reason is that there is no realistic alternative for the world's excess savers in northern Europe and Asia, who are piling up official reserves.

A month ago in this column I argued that the dollar would remain the world's pre-eminent reserve currency because US productivity and demographics were more robust than in stagnant Europe, while China would not be able to offer an alternative for the forseeable future. Yet as the weeks go by, the consequences of this strike me as increasingly disturbing. The reason is that safe haven status in a fiscal firestorm is a privilege that can too readily be abused.

In Europe the pressure from markets for fiscal retrenchment is palpable, while the only big country that is not under such pressure, Germany, is retrenching anyway. There is a strong possibility that both fiscal and monetary policy will be tightened prematurely. No such pressure exists in the US. And the dual mandate of the Federal Reserve to look after growth as well as the price level, together with recent rhetoric from Fed chairman Ben Bernanke, suggests that tightening is likely to happen later rather than sooner. It has always been politically difficult in the US to raise interest rates before unemployment is set on a downward path, by which time inflationary damage may be taking place.

In the short run this will be a boon for Europe, where a double dip in the eurozone economy will be less painful than it would otherwise be thanks to the devaluation of the euro and the import of stimulus from the US. As Fred Bergsten of the Peterson Institute for International Economics argued in the Financial Times last week, the US is taking the strain of continuing global imbalances. In the long run changing demographics and rising real wages in China and much of the rest of Asia will ensure a rebalancing of economies towards consumption. This will mitigate the imbalances, but the wait may be interminable.

The question is what happens to the US in between. Its position bears some similarity to that of the UK after the First World War. As the hegemonic power in the global monetary system it is acting as a safe haven despite being fiscally debilitated. This means that the haven will become progressively more unsafe as bolt-hole investors in short term dollar assets provide a constant reprieve to policymakers who find it difficult to undertake serious fiscal consolidation.

In effect, European weakness is increasing the threat of national decline and imperial overstretch in the US. Addressing that threat requires firm leadership and wise policy. Yet, especially since the Gulf of Mexico disaster, we have had populism and panic from the Obama administration, with BP acting as the punchbag.

In the aftermath of a bubble that leaves huge deficits and debts in its wake, investor perceptions swing between inflation and deflation. At present the fear of inflation is increased by the undermining of central bank independence in the US and now the eurozone as the central bankers have been coerced into a fiscal policy role to address the crisis. In addition, labour market pressure in China means that Chinese workers may put less of a lid on wages in the West. Nor should it be forgotten that inflation would provide a convenient means of defaulting on excessive levels of debt.

Where I disagree with Mr Bergsten is that it seems pretty clear that the world's biggest excess savers, Germany, Japan and China, are not going to take his advice and stimulate domestic demand in a way that would allow the G20 to announce an agreed strategy for global rebalancing, even if China is inching slowly in the right direction. Real default, in the form of debt restructuring, seems likely in parts of southern Europe. It follows that economic stagnation could prove a greater threat until the Asian *deus ex machina* puts in its tardy appearance, even if inflation is a plausible outcome for the US in the long run.

In such circumstances the question is not whether the dollar will retain its haven status, because it will, but how much damage will be done as global investors offer US policymakers the rope with which to hang themselves. That is the long and the short of it.

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