Dollar fears send tremor through markets

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Barely weeks after spokesmen for the International Monetary Fund and other global financial institutions declared that the so-called Asian financial crisis had run its course, world financial markets have been experiencing a new round of jitters. This time, though, the cause of the nervousness is not "emerging markets" but the situation in the United States.

The immediate cause of the turbulence, which saw significant falls on Wall Street and markets around the world, appears to have been the testimony of US Federal Reserve chairman Alan Greenspan to the US Congress last week. He hinted at possible further interest rate rises following the Fed's recent decision to lift rates by 0.25 percentage points.

In addition to the fears of interest rate increases, the instability is being fueled by concerns that the value of the US dollar could start to slide against major world currencies in the wake of continuing record US trade deficits.

The trade gap for May rose to a record $21.3 billion, a 14.8 percent increase on the previous month and the worst trade performance since monthly statistics were first collected in 1992. If present trends continue, and the indications are that they will worsen rather than improve, the deficit for the year will reach $225 billion, representing a 37 percent increase over last year's record trade gap of $164.3 billion.

In trading on currency markets earlier this week, the euro, after falling to near parity with the dollar at the beginning of the month, rose as high as $1.07. Overall, the US dollar fell by 5 percent against both the euro and the Japanese yen in the space of a week.

The drop in the dollar prompted statements by incoming US Treasury Secretary Larry Summers that the US remained committed to a strong dollar. Speaking to reporters after delivering a speech in Washington, Summers said: "As I've said many, many times a strong dollar is very much in the interests of the United States. That has been our policy and will continue to be our policy."

But the fear in international markets is that growing financial problems in the US economy, including the stock market bubble and the rising level of international debt, could overwhelm policy considerations and aims.

In his Humphrey-Hawkins testimony to the US Congress last week, Greenspan pointed to both these processes. While repeating his previous assertions that technological innovations had boosted the productivity of US firms, he warned that "the interpretation that we are currently enjoying productivity acceleration does not ensure that equity prices are not overextended.

"There can be little doubt that if the nation's productivity growth has stepped up, the level of profits and their future potential would be elevated. That prospect has supported higher stock prices. The danger is that in these circumstances, an unwarranted, perhaps euphoric, extension of recent developments can drive equity prices to levels that are unsupportable even if risks in the future become relatively small. Such straying above fundamentals could create problems for our economy when the inevitable adjustment occurs."

During his testimony Greenspan again expressed a fear that the fall in US unemployment could lead to a push for wage increases, necessitating a tightening of monetary policy. But even if wages were held down there were other "imbalances" in the US economy, which could have "important implications for future developments".

One of these factors is the growth of indebtedness in the US economy. With US savings levels now at negative levels—a phenomenon not seen since the 1930s—investment has been increasingly financed by the inflow of capital from overseas. But this process cannot continue indefinitely.

As Greenspan put it: "As US international indebtedness mounts ... and foreign economies revive, capital inflows from abroad that enable domestic investment to exceed domestic saving may be difficult to sustain. Any resulting decline in demand for dollar assets could well be associated with higher market interest rates, unless domestic saving rebounds."

Questioned on whether the dollar could retain its strength in the face of the record trade deficit, Greenspan pointed out that the current account deficit was becoming "an increasingly larger proportion of GDP and we've asked ourselves how long that can be sustained without inducing

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imbalances to the structure of the economy.

"Theoretically that obviously cannot go on indefinitely, something has got to give somewhere. Where it apparently will give at some point in the future is a lesser inclination to hold dollar claims on the United States."

While Greenspan assured his questioner that this point had not been reached and the evidence was that capital was continuing to flow into the United States, there is growing concern among international commentators that a US financial crisis will erupt sooner rather than later.

In an article published last week on the Wall Street escalation, entitled "Bubbles do burst," *Financial Times* economics commentator Samuel Brittan repeated warnings he made in an earlier comment published in May that there was "an uncanny resemblance between the upturn of the 1990s and the upturn leading up to the 1929 crash.

"Strong growth in the money supply, a rapidly rising investment share within GDP, a widening current account deficit and a personal sector spiraling into deficit are all classic indicators of a domestic bubble. ... Although there is nothing wrong in a current account deficit as such in the right conditions, the rapid increase in the US deficit is one classic indicator of a bubble economy, especially when combined with rapid domestic money supply growth."

An article in the *Financial Times* of July 28 pointed to the "fragile balance" in the world economy and recalled remarks by former US Federal Reserve chairman Paul Volcker earlier this year in which he noted that the "world economy was currently dependent on the US consumer, who was dependent on the stock market, which was dependent on about 50 stocks, half of which had not shown a profit."

The article warned that a sharp fall in the US dollar could tip the US economy into recession. Under the best case scenario, a fall in the dollar would ease the US trade deficit, lower US growth and gradually let down the stock market bubble. But there are compelling reasons why such a gradual easing of the financial crisis is not likely to occur.

One of the main fears is that while a rise in US interest rates would, under normal conditions, sustain the inflow of foreign capital it could lead to a financial panic if it were feared that this was the prelude to a rapid fall in the dollar. In that case there would be an exodus from US stocks and financial assets by investors who feared that any interest rate gains would be overwhelmed by losses incurred as a result of shifts in currency values.

Another factor adding to the instability is the growing indebtedness of US corporations. According to a recent editorial in the British *Economist* magazine, American companies are now buying back as much as 2 percent of their outstanding equity every year.

"On the face of it," the editorial noted, "America is hugely profitable: the latest quarterly earnings reports ... will probably be pretty good. But they should be treated with caution. If American companies continue to buy back their own shares, anything that uses them as a denominator—such as earnings-per-share, or return on equity—will automatically rise, even if underlying profits are unchanged. Moreover, buying back shares by issuing more debt means that corporate America is becoming ever more exposed to risk."

And while concerns grow about the stability of the US currency and financial markets, this week's financial crisis surrounding the South Korean *chaebol* Daewoo makes clear that the Asian financial crisis is far from over, despite the optimistic forecasts of a return to economic growth.

The Daewoo conglomerate, which accounts for 5 percent of South Korean GDP, was only saved from financial collapse by a $3.3 billion rescue operation organised by the South Korean government and its 69 creditors. Daewoo has a total of $48 billion debt, some $5.5 billion of which falls due this year.

The Daewoo financial structure is by no means exceptional. In June 1998 its debt to equity ratio was reported to be 407 percent, compared with a ratio of 508 percent for Hyundai and 482 percent for LG. While the immediate Daewoo crisis has passed, it is far from resolved and could well be the indication of problems in the other *chaebols*.

Korea's stockmarket fell 3.5 percent last Monday on lingering concerns over the Daewoo debt moratorium, capping a 14.8 percent drop over a week. Regional share prices also fell during the previous week. The Indonesian market lost 10 percent, Singapore 8.4 percent, the Philippines 7.2 percent, Malaysia 6 percent and Japan 5.6 percent.

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