US dollar surge brings currency market turmoil

Nick Beams
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Global currency markets have been thrown into turmoil by the continuing rise of the US dollar, which saw both the euro and the Australian dollar hit record lows in trading at the end of last week.

Some 20 months after its launch at the beginning of 1999, the euro hit 85.34 cents—a loss of 27 percent—while the Australian dollar closed in New York at 54.4 cents, down more than 17 percent for the year. And in both cases, the fall may not be over with predictions that the euro will go to 80 cents and the Australian dollar to 52 or even 50 cents, with at least one market analyst warning that the currency remained “on the brink of a very serious crisis.”

The rapid decline of both currencies has perplexed central bankers. Asked to comment on why the Australian currency had followed the euro, when previously it had moved with the US dollar, the Japanese yen and more recently Asian currencies, Reserve Bank of Australia governor Ian Macfarlane said: “I'm afraid I can't provide a logical explanation for that.”

He rejected claims that financial markets perceived Australia as lacking technological innovation and so-called “new economy” characteristics, but could offer no reasons for the fall.

“Why markets are placing such a low valuation on the Australian dollar is not a question I can easily answer,” he said. “For my part, I think an important contributing factor this time is that markets underestimated, and are still underestimating, the Australian economy's underlying strength.”

Wim Duisenberg, the president of the European Central Bank, likewise has no explanation as to why the US dollar should be climbing in the face of an unprecedented current account deficit running at 4.3 percent of gross domestic product, while the currency of the EU, which is running a trade surplus, should be falling so rapidly.

Speaking to a European parliamentary hearing, Duisenberg said the US deficit was “unsustainable” in the long run but for the present “the Americans have no difficulty in having that deficit financed, basically by us, Europe.”

While the general weakness of the Australian dollar could be explained by its balance of payments deficit and foreign debt levels, the highest of the major capitalist countries in the OECD, this does not seem to account for the sharp decline in recent weeks. Since the beginning of the year, the Australian current account deficit has narrowed 1.2 percentage points of GDP, while that of the US has widened by 1.1 percentage points of GDP. According to conventional theory this should have meant that the Australian currency would rise relative to the US dollar.

The overall picture is compounded by the movement of the Japanese yen, which has held its own against the US currency despite the continuing problems of the Japanese economy.

An article by *Financial Times* columnist Barry Riley on September 8 reflected the general perplexity among financial analysts and commentators.

“The Japanese economy” he noted, “continues to languish after 10 years of stagnation, its financial system is fragile and its government borrowing predictions are terrifying—causing Moody's to cut the Japanese government's credit rating ... The US economy is overheating and generating inflation heading above four percent, while its current account deficit is near $400 billion a year. The euro-zone economy meanwhile is healthy and well balanced. But it is the ECB that faces a crisis.”

What seems to have overturned the previous relationships, in which currency values moved broadly in line with a country's balance of payments position, is the effect of global capital movements, particularly investments in hi-tech areas. The impact of capital movements on currency valuations means that the traditional means employed by central banks of lifting interest rates to bolster currency values seem to be no longer effective. In the case of the euro, its decline has continued virtually unabated despite the ECB having lifted interest rates over the past year.

And there are suggestions that interest rate increases could even have a perverse effect as they tend to slow down economic growth, reduce profits, thereby encouraging investment capital outflows, resulting in a further currency decline.

Figures on the US economy point to the capital flows, rather than trade, as the chief determinant of currency valuations.

It has been estimated that in recent months as much as $1 billion a day has been flowing into the United States in the form of foreign investment capital, much of it from Europe, seeking higher returns in the American market. The driving force behind this capital inflow is that returns on hi-tech investments are higher in the US than in Europe and that the gap in productivity levels may even be widening.

In a recent speech, US Federal Reserve chairman Alan Greenspan pointed out that given the fact that new technologies reduced labour inputs, the greater ease with which companies could sack workers in the US as compared to Europe made investments in the US more profitable.

These views have been echoed by Goldman Sachs/International vice chairman Robert Hormats. “The general view,” he said, “ is that the process of corporate restructuring and innovation, while certainly going on in Europe, is simply not as great as in the US.”

According to some calculations, despite changes in European business structures, the rate of return on business capital in the US is still 10 percentage points higher.

The International Monetary Fund (IMF), which has pointed to the dangers posed by the rising US balance of payments deficit, also seems to share the view that perceptions of high US productivity and profits are driving the capital inflow and pushing up the value of the dollar.

Answering a question on currency valuations and the risks posed by the rising US deficit at a September 11 press conference to release the IMF's International Capital Markets report, IMF economist Garry Schinasi claimed capital flows were now driving exchange rate movements.

“I would suggest that international portfolio managers see the US as offering the highest risk-adjusted returns for investments. And until that changes, it's difficult to see why the dollar would decline much in value.

“Now, at some point the current account may take over; that is, portfolio managers may think that the goods and services that are being purchased with foreign capital cannot be sustainably financed in the future. That sentiment may change. It's hard to say when.”

Other analysts maintain that when perceptions do turn, possibly because of a rise in inflation, a downturn in the stockmarket, or some unforeseen financial crisis, the US dollar bubble will burst, leading to a rapid outflow of capital, rising interest rates and the onset of a recession.

Whatever way the US dollar bubble does eventually come to an end, the international capital flows giving rise to it and the pressures they generate have once again underscored the incapacity of national governments to regulate their national currencies, with significant political consequences.

In Europe recent polls suggest that support for the euro has reached a new low in Germany, while the referendum to be held in Denmark later this month on whether to join the euro is said to rest on a knife-edge.

In Australia, while news of the plummeting dollar has been overshadowed somewhat by the Olympic Games, concerns have been raised about the long-term economic and political implications of the currency's collapse.

An *Australian Financial Review* article by political j Geoffrey Barker on Monday, for example, suggested that the dollar's demise highlighted the need for “international measures to bring accountability and responsibility to the operations of global financial markets.”

In somewhat desperate tones, he insisted that “a way has to be found to encourage international currency markets to acknowledge the social and even ethical consequences of their operations.” However, as Barker himself was forced to note, the insatiable demands of capital for profits, transmitted through the pressure of global financial markets, have resulted in a never-ending restructuring of the economy.

“Australia has done much to open itself to the world since the early 1980s. It has deregulated its financial institutions and, with some pain, significantly deregulated labour markets. But in achieving an impressive measure of global success, Australia has become a less equitable country. Individuals and corporations have been told to adapt or die: to be infinitely retrainable, infinitely mobile, and to focus solely on the short-run bottom line.

“Yet still the goal posts keep moving. Weighed in the balance by international markets, Australia is found wanting compared with the US; it is not perceived to be a sufficiently new economy.

“And so the dollar slides while economic managers and politicians scratch their heads and wonder how best to defend the laissez-faire ideology to which they give unquestioning fealty.”

Barker called for globally accepted frameworks to bring to international financial markets a measure of accountability similar to that demanded of national financial and political institutions. The “imperatives of democracy” he warned, could not continue to be subordinated to uncontrolled currency speculation “without continuing social disruption.”