US dollar’s "virtuous circle" may be turning vicious

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There are clear signs in financial markets that the long-predicted day of reckoning for the US dollar may be close at hand. Last week the dollar slid to a 17-month low against the euro, marking a decline of nearly 14 percent from the levels of last July. Stock markets around the world turned down with the Dow Jones Index dropping 3.4 percent for the week and markets in Europe and Asia generally reached their lowest levels since the immediate aftermath of the September 11 terrorist attacks.

Predictions of the dollar’s decline have been based on the implications of the unsustainable financial position of the US economy. With imports exceeding exports by about one third, the US has been running a balance of payments deficit of more than 4 percent of gross domestic product, requiring a foreign capital inflow of more than $1 billion a day to finance it.

That did not present immediate problems during the stock market boom of the late 1990s. As long as markets kept rising, funds poured in from the rest of the world to purchase shares, corporate bonds and treasury notes, financing the foreign debt and keeping up the value of the dollar. But the collapse of the share market bubble and concerns over the real financial position of corporate America in the wake of the Enron scandal have started to shake the confidence of investors, prompting fears that at some point there could be a massive capital outflow.

There are signs that the turnaround may have already started. Warning that the US dollar was “very vulnerable” to a change in sentiment about American assets, the *Economist* of June 14 noted that there had been a shift in the flow of funds to the US over the past year. “Foreign direct investment financed 91 percent of America’s current-account deficit in 1999. By last year, that had fallen to 43 percent, having been supplanted by more fickle capital flows. Foreigners own no less than two-fifths of American Treasury bonds, a quarter of corporate bonds and 13 percent of American equities.”

Long-time Australian economics analyst Max Walsh commented in an article in the *Bulletin* magazine of June 4 that while the US dollar was anywhere between 15 and 30 percent overvalued, this did not set the limits to the potential fall because in the current era of large capital flows, exchange rate movements developed a momentum that fed upon itself.

According to Walsh, foreign investors hold US corporate bonds with a value of more than $1.3 trillion, Treasury bonds of more than $600 billion on top of $1.5 trillion in corporate equities. “A high proportion of this capital is footloose, ready to take off if there is a more promising investment at hand, or if the value of US investment looks like contracting,” he wrote.

Some commentators have dismissed the prospect of a capital outflow from the US on the grounds that investment opportunities are no better in the rest of the world. That may well be the case provided the value of the dollar is sustained. However, if it starts to rapidly lose value, then investments may well be liquidated, not because there are better opportunities elsewhere, but in order to try to avoid massive exchange rate losses they would sustain by continuing to hold dollar-denominated assets.

Investor nervousness is also being fuelled by the continuing revelation that the much-vaunted strength of the US economy is far from what was claimed.

At the macro level, figures show that since 1997 profits as a proportion of GDP have steadily declined. Yet in that period S&P 500 companies have been reporting earnings growth in excess of GDP growth. This result has been achieved by a series of accounting practices designed to inflate profit results in order to boost share market values.

So rampant have been these practices that the *Wall Street Journal* recently pointed to a “growing awareness of how deeply flawed ... US financial markets really are.” One of the main problems, it said, was that the so-called watchdogs, charged with keeping the financial world honest, had lost credibility themselves. Outside auditors bent the rules to please corporate clients, analysts shaped stock recommendations to woo investment customers, while government regulators were “too timid or too overwhelmed to keep track of the frenzy.”

According to the WSJ: “Boasts about world-class corporate disclosure, bookkeeping and regulation of American financial markets have become laughable in the wake of the Enron and Arthur Andersen scandals.”

But such concerns have been blithely dismissed by US Treasury Secretary Paul O’Neill. Speaking after a meeting of the Group of Seven finance ministers at the weekend O’Neill said market fears about corporate governance in the wake of the Enron collapse were overdone and would eventually dissipate.

“The important thing is the fundamentals of what is going on in the real economy, which I continue to believe are quite good,” he said. The problem with this and other optimistic assessments is, however, that such is the state of accounting practice and the vast overstatement of profit results that there is no objective measure of one of the most important “fundamentals” of any capitalist economy—the real level of profits.

Brushing these issues aside, O’Neill said markets had placed too much weight on concerns over corporate transparency and accounting standards and in any case he did not “worry about things I can’t do anything about.”

Whether or not the present turbulence is the start of a sustained slide of the dollar, it is clear that the economic trends of the past period cannot be maintained, with major consequences for both the US and world economy.

The dollar began its ascent in 1995 after reaching a record low of 79 yen in April of that year. With Japanese manufacturers facing bankruptcy because the high value of the yen was pricing them out of export markets, financial authorities agreed to lift the value of the US dollar. While this resolved the immediate crisis it had longer term consequences. In particular the East Asian economies, whose currencies were tied to the dollar, now experienced a downturn in export growth, one of the factors that helped spark the so-called Asian financial crisis of 1997-98.

For the US, the turnaround in the value of the dollar resulted in a rapid inflow of foreign capital into its financial and equity markets. This financial boom sparked investment spending and the increase in US economic growth in the latter years of the 1990s. This increased US growth led in turn to a widening balance of payments gap, requiring an increased capital inflow from the rest of the world to finance it.

The hoopla over the “new economy” at the end of the 1990s served to mask an increasingly untenable situation in which world economic growth was becoming increasingly dependent on the expansion of the US economy, which, in turn, was going deeper into debt. Now the stage has been set for a violent financial adjustment.

Last March, US Federal Reserve Board chairman Alan Greenspan pointed out that for the past six years about 40 percent of US capital stock had been financed by foreign investment, requiring an ever-greater outflow of interest and other payments. “Countries that have gone down this path,” he said, “have invariably run into trouble and so would we.”

If the dollar does continue to fall and sets off a withdrawal of funds, this “trouble” will confront Greenspan in the form of a dilemma. On the one hand, maintenance of economic growth will require that interest rates be kept at their present low levels. On the other hand, confronted with an outflow of dollars and the threat of a run on the currency, the Fed will be under pressure to increase official rates.

Calculations are already being made as to the impact of a rapid fall. According to Morgan Stanley chief economist Stephen Roach, a “hard landing” of the US dollar, defined as a 20 percent loss of value by the end of the year, would have a “devastating impact on US financial markets” as foreign investors sought to move out of dollar-denominated assets and US investors likewise sought non-dollar assets. This movement would result in lower bond and equity values with “significant negative consequences for a wealth-dependent US economy.”

This will spell “serious trouble” for the world economy—more dependent than ever on an expanding US market—as what seemed to be a virtuous circle in the late 1990s, in which financial inflows into the US prompted still greater inflows, turns increasingly vicious.