Dollar decline accelerates as US Treasury abandons “strong” currency policy

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The potential for a major crisis in global financial markets has markedly increased over the past few days amid growing concerns that the Bush administration has adopted a policy of allowing the US dollar to fall.

With the US balance of payments deficit running at around 5 percent of gross domestic product and the budget moving rapidly into deficit as a result of the administration’s tax cuts to the wealthy, the US dollar was destined to fall. Indeed, since January 2002, it has declined on a trade-weighted basis against all currencies by 22 percent, dropping by more than 8 percent over the past two months.

But now a new factor has come into play—the perception that the Bush administration, fearful of the political consequences of rising unemployment, deflation, and low growth rates, is encouraging the decline of the dollar to try to boost the US economy.

Since 1995, when the US currency hit a record low of 79 yen, the US has pursued a “strong dollar” policy. That has now been virtually abandoned. In comments following the meeting of the G8 finance ministers in France over the weekend, US Treasury Secretary John Snow described the recent decline in the dollar as a “modest realignment” and redefined a “strong” dollar in a way that did not include its value against other currencies. According to Snow, the dollar was a “strong” currency because people had confidence in it and it was difficult to counterfeit.

Coupled with the fact that the G8 meeting did not even discuss the dollar, let alone make any decision on a coordinated currency policy, financial markets interpreted Snow’s remarks to mean that the Bush administration was prepared to let the value of the dollar slide, if not actively encourage its decline. Consequently in trade this week, the euro has reached its issue value of $1.17 with predictions that it could soon go beyond $1.20. Some analysts have even warned that if the dollar undergoes a long term downturn as it did between 1985 and 1995, the euro could go as high as $1.40.

While a lower dollar is seen as providing welcome relief from deflationary pressures in the US and a fillip to growth, it carries with it the potential for a financial crisis. If the downturn becomes too rapid, there is a risk that foreign investors, who have financed the widening US balance of payments gap, could start withdrawing their funds.

With foreign investors holding around 45 percent of US government bonds, 35 percent of corporate bonds and 12 percent of equities, such a withdrawal would have a severe impact.

The two-edged nature of the dollar’s decline was highlighted in an analysis prepared for the *Australian Financial Review*. On one scenario, a gradual depreciation of around 10 percent would improve the competitiveness of US exports and could boost the American economy to the tune of a 0.7 percent increase in the growth rate for the rest of the year.

On the other hand, if the decline in the dollar reflected a loss of confidence by investors in the US economy, it could spark a “stampede of foreign capital out of the US” leading to falling stock prices, rising interest rates and a negative impact on growth.

With the US balance of payments deficit at a record high of around $500 billion and global external imbalances—deficits and surpluses—equivalent to a record 1.5 percent of world gross domestic product, there is a recognition that the conditions have been created where currency realignments have the potential to set off a major financial crisis.

Well-known Chicago-based economist David Hale writing in the *Financial Times* on Monday described the circumstances confronting the US economy as "unique in the modern era".

He pointed out that while the dollar's fall began more than a year ago, it had been accelerated in recent weeks by concerns that the Bush administration's fiscal policy could boost the budget deficit to as much as $500 billion and lead to a balance of payments deficit of $600 billion.

Furthermore, the markets "are concerned that the US is embarking upon an imperialist foreign policy that will have unknown consequences for its fiscal position, foreign trade and relationships with other countries. In the heyday of empire, the UK ran large current account surpluses. There is no precedent for a country playing the role of global superpower with a large external payments deficit."

Such are the political tensions generated by the US invasion of Iraq that there is speculation in some quarters that the weaker dollar may have been initiated by the White House as a form of retribution against France and Germany for their opposition to the war.

However, according to Norbert Walter, chief economist at Deutsche Bank, there was no basic change in the outlook of the US. Its policy, he explained somewhat caustically, had always been "the dollar is our currency and your problem."

And a major problem it is turning out to be. Matthew Wickens, an economist with ABN AMRO in London told the *International Herald Tribune* the loss of competitiveness for European exporters caused by the rise in the euro's value was "extreme". The surge in the currency was "basically taking growth away from Europe and redistributing it elsewhere."

Official estimates already put growth in Europe this year at only 1 percent, with every 10 percent rise in the euro's value cutting the rate by between 0.5 and 1 percent. The dependence of the eurozone on exports is highlighted by the fact that around 75 percent of last year's growth rate of 0.8 percent came from external demand.

Japan, already experiencing deflation and recession, is also under pressure from the falling dollar and financial authorities recently revealed they had spent the equivalent of more than $20 billion in the first three months of this year, in an attempt to prevent the yen rising above 115-120.

European monetary authorities have so far expressed little concern about the rise in the euro. But if the dollar continues to plummet, the eurozone will be severely affected. This could see currency markets wracked by a three-way competitive devaluation conflict in which the world's three major economic regions—the US, Europe and Japan—all try to keep down the value of their currencies in order to maintain their position in the increasingly bitter struggle for global markets.