Currency upheaval could have major consequences

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Since the disintegration of the system of fixed exchange rates at the beginning of the 1970s, there have been four major upheavals in international currency markets—all with far-reaching economic and political consequences. The fifth such upheaval, which has seen the slide of the US dollar against the euro, looks likely to prove no less significant.

The collapse of the Bretton Woods system in August 1971, when President Nixon withdrew the previous guarantee to redeem the dollars circulating in the international financial system with gold, at the rate of $35 to the ounce, was sparked by a steady worsening in the relative economic position of the United States.

Throughout the 1960s the US balance of payments deficit was growing as a result of an outflow of dollars to finance foreign investment and increasing military expenditure, especially on the Vietnam War. But the situation was compounded when, by 1971, the balance of trade began to move into deficit as well.

In a unilateral decision, Nixon removed the dollar's gold backing and imposed a 10 percent tariff against imports. While there were attempts over the next 18 months to prop up the old order, the system of fixed currency exchanges was doomed. Floating exchange rates were inaugurated in February 1973.

The US administration actively worked for the scrapping of the old order, recognising that its maintenance would require a cut in the American balance of payments position by reducing investment outflows and overseas military spending—something no administration was prepared to do. Moreover there were short-term advantages to be gained by floating rates. A fall in the value of the dollar would improve the position of US firms in the battle for global markets.

At the same time, the US could still enjoy the advantages that accrued from the dollar's role as an international currency, even after the removal of its gold foundation. The sheer weight of the US in the international economy meant that no other currency would be able to take its place and other countries would be forced to hold dollars as the major component of their international reserves. It was around this time that the now well-known phrase "It's our currency, but your problem" was first coined.

The US dollar maintained its downward trend during the 1970s as efforts were made to reflate the international economy following the major recession of 1974-75. But these efforts were largely unsuccessful, resulting in ever increasing inflation combined with low profit rates and high unemployment.

In 1979, President Carter's appointment of Paul Volcker as chairman of the US Federal Reserve Board constituted a major turn. Volcker initiated a high interest rate regime on the grounds that it was necessary to force inflation out of the economy. His policy reflected the demands of the dominant sections of finance capital, which had been hard hit by high inflation and the resultant negative real interest rates in the late 1970s.

Volcker's measures, coupled with a similar program initiated by the Thatcher government in Britain, had two major consequences: the value of the US dollar increased, encouraging a capital inflow into the US, while at the same time large sections of manufacturing industry were closed down as major firms undertook restructuring, introducing new job-cutting technology and/or transferring large amounts of their operations overseas.

Under Volcker, real interest rates went from -2 percent in 1979 to an average of 7.5 percent in the period between 1981 and 1985. Manufacturing output decreased by 10 percent between 1979 and 1982, investment by 8 percent—falling another 15 percent in 1983—and capacity utilisation dropped to a post-war low. [See Robert Brenner, *The Boom and the Bubble* p. 50]

The high-interest rate regime increased the value of the US dollar by 37 percent overall, with an increase against the German mark of more than 46 percent. But it had drastic consequences in the US. By the middle of the 1980s the so-called "hollowing out" of manufacturing industry had created a crisis, with major corporations demanding protection from the strong dollar policy.

In September 1985 at a meeting at the Plaza Hotel in New York, representatives of the five major capitalist powers, under pressure from the US, agreed to undertake joint action to reduce the value of the US dollar. The new policy was coupled with an increasingly aggressive stance by the US against imports, particularly from Japan.

The steady decline in the US dollar after 1985 boosted the competitiveness of US corporations but caused major problems for Japanese export industries. There were two major consequences. In order to cut costs, and thereby maintain profit margins in international markets even as the yen increased in value, Japanese firms increasingly set up manufacturing operations in South-East Asia where they could take advantage of cheaper labour. This shift of capital played a major role in fueling the Asian investment boom of the late 1980s and early 1990s.

Meanwhile, in order to cushion the domestic economy from the impact of a higher yen value, the Japanese government pursued an easy money policy—a program that was accelerated after the stock market crash of October 1987. While these policies helped stabilise the international financial system in the short-term, they had significant long-term implications. The conditions were created for the Japanese sharemarket and land bubble, which saw the Nikkei index reach almost 39,000 (compared to its present level of less than 9,000) and the value of a square mile of real estate in Tokyo rising to the equivalent of the entire state of California.

Although it was not apparent at the time, the collapse of the Japanese bubble in the early 1990s led to the slide of the economy into on-going stagnation, and then outright deflation, from which it shows no signs of recovery.

The low dollar policy continued in the early 1990s as the Clinton administration aggressively pursued US economic interests, insisting on the opening of markets.

In April 1995, a new crisis erupted. Japanese financial authorities warned their US counterparts that, with the dollar at a record low of only 79 yen, Japanese firms could not continue to function. A major crisis in Japan, they pointed out, would see the large scale liquidation of Japanese holdings of US financial assets, particularly Treasury bonds, thereby inducing an increase in US interest rates and most likely sparking a major recession.

Faced with this prospect, US authorities, with Treasury Secretary Robert Rubin playing the key role, agreed to undertake joint action to bring down the value of the yen and push the value of the dollar upwards. The Reverse Plaza Accord, as it has become known, was the starting point of the "strong dollar" policy that characterised Rubin's conduct of US financial policy under the Clinton administration.

The increase in the value of the dollar created an apparent virtuous circle. Money flowed into the US and boosted the financial markets—leading to a rise in equity values and easing pressure on interest rates. The financial boost helped spark an investment boom, leading to higher growth rates and increased US demand. The "boom" conditions of the late 1990s, in turn, attracted more funds into US markets, further increasing the dollar's strength.

While there were certainly increases in productivity due to the introduction of new technologies, the boom was based on increases in debt—corporate and household—and ever-more dubious accounting methods aimed at boosting stock values.

Furthermore, the financial bubble created major imbalances within the US financial system. The balance of payments went ever deeper into deficit and is now running at around 5 percent of gross domestic product.

To put it another way, the current balance of payments deficit of around $500 billion means that the US is increasing its external debt at the rate of $1 million per minute—all day, every day.

While the bubble continued and money kept flowing into the US, this widening payments gap presented no major problems. But with the ending of the financial boom three years ago and the subsequent stagnation, the US economy has become increasingly vulnerable to a sudden outward flow of capital.

The past year has seen a significant decline in the dollar, promoted in recent days by the Bush administration's apparent abandonment of the strong dollar policy. US financial authorities would like to see the dollar fall in order to boost exports and improve the balance of payments, but not so far or so fast as to provoke a major withdrawal of foreign capital, thereby sparking a crisis in financial markets.

But the new lower dollar regime is producing severe strains in the rest of the world. Japanese financial authorities, together with their counterparts in the rest of East Asia, are spending their currencies in order to try to stop them from rising too rapidly.

The Japanese authorities have outlaid tens of billions of dollars in the past few weeks, fearing that a rising yen will hit exports and push the economy even deeper into recession and deflation.

These efforts by Asian authorities have meant that the falling dollar has impacted most heavily in Europe, with the euro now above its post-launch rate of $1.18 in January 1999. A rising euro, however, spells deeper recession for the already stagnant European economies, as export demand falls.

Recent statistics provide an indication of the strength of the impact if present trends continue. It is estimated that the more than 15 percent rise in the euro against the dollar since December last year is equivalent to the European Central Bank lifting interest rates by one percentage point. Such an increase could possibly be absorbed if it were a one off occurrence. But there are predictions that the euro could soon rise to over $1.20 and even to $1.40 in coming months.

Germany will be among the hardest hit. According to figures published in the *Financial Times*, between 1997 and 2001, when the dollar was "strong", US exports rose by 11.3 percent while German exports increased by 30.4 percent. Now this trend will be reversed.

Eurozone companies are already reporting falling profits. Volkswagen said the rise in the euro had cost the company $460 million in the first quarter, with pre-tax profits dropping by 67 percent. The *Financial Times* predicts the impact could be even more severe on small and medium-sized export-dependent engineering companies, forced to compete with firms based in China where the currency is linked to the dollar.

Estimates are now being made of the effect of the rising euro on profits. According to Deutsche Bank, a 10 percent fall in the dollar/euro exchange rate, compared to its average level in 2002, will see the continent's 350 largest companies lose an average of 4.7 percent on their earnings before interest and taxation (Ebit).

But the average figure covers up some major falls. Semi-conductor companies, for example, are expected to suffer a 42.5 percent decline in their Ebit. Aerospace and defence companies could see a decline of 28.6 percent, the engineering sector 13 percent, and the auto sector more than 10 percent.

What these figures point to is a broader process, where the US "exports" deflation—characterised by lower profits and prices—to the rest of the world, and Europe in particular.

However, as the IMF warned in a recent report on deflation, if the dollar falls too far and too fast it could rebound on the US itself. "If the dollar decline were severe enough," it noted, "foreign balance sheets could come under significant pressure, aggravating deflationary pressure there with effects that can rebound on the United States."

In other words, if the dollar's fall induces an international recession, the result could be a repeat of the 1995 situation, when Japanese authorities warned that money would have to be withdrawn from US financial markets to repair balance sheets at home. Given the US economy's even greater dependence on foreign sources of financing today, the impact of such a withdrawal would be even more serious.

The present currency realignment is in its early stages. But already there are signs that its consequences will be even more far reaching than those that preceded it. This is because none of the previous four currency realignments resolved the problems in the world economy. Like all short-term measures aimed at trying to alleviate a crisis, they merely created the conditions for its re-emergence in an even more violent form.