Dollar fall adds to global turbulence

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The sharp drop in the value of the dollar in money markets last week has pointed to the underlying instability of the international financial system and the ever-present possibility of a major crisis. The dollar's decline followed a meeting of the Group of Seven (G7) finance ministers in Dubai which called for exchange rates to reflect "economic fundamentals."

The G7 ministers declared they would "monitor exchange rates closely, cooperating as appropriate", and emphasised that "more flexibility in exchange rates is desirable for major countries or economic areas to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."

This was taken to mean that the major capitalist powers and their central banks wanted to see a fall in the value of the US currency, especially against Asian currencies, and international markets reacted accordingly over the next few days.

However, for all the reassuring words about "smooth adjustments" and "global recovery" the world economy is beset by a series of contradictions. The basic imbalance arises from the fact that the maintenance of world growth depends on the US going deeper into debt.

The combination of recessionary conditions in Europe—the German economy has barely grown over the past three years—and the deflationary environment in Japan means that these regions provide little global stimulus. Under these conditions, the chief source of world economic growth is the US economy. But as long as the US grows faster than the rest of the world it continues to incur a balance of payments deficit. At present this stands at around $500 billion a year, requiring a capital inflow of almost $2 billion a day from the rest of the world to finance it.

So far, this capital has been provided with one of the major sources being Asian central banks. Eager to maintain export markets, they have purchased dollar-denominated assets to ensure that their own currencies do not rise against the US currency, thereby accumulating vast currency reserves.

According to the International Monetary Fund, so-called "emerging economies" in Asia held about $1,000 billion in official foreign exchange reserves out of a global total of $2,500 billion, with Japan holding a further $500 billion. It is estimated that foreign central banks increased their dollar reserves by $220 billion last year and financed nearly half the US current account deficit.

This is an unprecedented situation in which the world's leading economy is being financed by the accumulation of debt.

The "orthodox" method for unravelling this situation and ensuring global "rebalancing" is a reduction in the value of the US dollar, thereby cutting the balance of payments deficit and lessening the dependence on foreign capital inflows, coupled with increased growth in Europe and Japan in order to ensure alternative sources of world growth US.

That appears to have been the thinking behind the remarks on currency rates contained in the G7 statement. However, the rapidity of the dollar's fall in the subsequent days ignited fears that too rapid a loss of value could spark an outflow of capital from the US, leading to a jump in interest rates and a fall in equity markets.

These fears were expressed in a number of articles in major newspapers.

Last Wednesday, the *Washington Post* noted that the Bush administration "has embarked on a high-stakes effort to reduce the value of the dollar in Asia, hoping to stimulate exports and jump-start the US job market" but ran the risk of "a sudden spike in interest rates and an eventual slide on the stock market."

According to critics of the policy, the *Post* article

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continued, “the risk ... is that currency traders will dump dollars on the market, pushing it to dangerously low levels and eventually lowering the international value of other American investments, such as stocks and corporate bonds. If international investors lose money on dollar-denominated securities because of the currency exchange rates, they might reduce their purchases of US securities. That means that United States would have to offer higher interest rates on its bonds to attract international buyers...”

An editorial in the *Financial Times* pointed to potential conflicts in the implementation of a lower dollar policy. It noted that while the G7 statement called for “greater flexibility”—interpreted by US officials as meaning a higher value for the Japanese yen and the Chinese yuan—Japan appeared to be continuing with its policy of depressing the value of the yen while Chinese authorities had given no sign of introducing flexibility into the yuan-dollar rate which has been pegged at 8.3 since 1994.

“Unsurprisingly,” the editorial noted, “markets have interpreted this disarray as troubling, perhaps presaging rounds of acrimonious competitive devaluations. There will be no winners in this game; but the biggest loser would almost certainly be the US economy. The dollar’s decline would accelerate, forcing foreign investors to dump their US assets, raising interest rates and probably strangling the nascent recovery.”

An article by economist and money market analyst Avinash Persaud, published in the September 24 edition of the *Financial Times* noted that “the US current account deficit of 5.2 percent of gross domestic product is approaching the same level as Mexico and Asian countries before their financial crisis.”

While the US has been running a payments deficit for some time, Persaud pointed to a basic difference between the situation at the end of the 1990s and today.

“In the late 1990s, US overspending had a lot to do with investment in the technology sector and was partly financed through the sale of equities to foreigners. Today there is even greater overspending in the face of low corporate investment and a fast-growing public sector deficit. This over-consumption is being financed through debt. While equity-financed investment may be sustainable, debt-financed consumption is not.”

Furthermore, the previous virtuous finance circle of the 1990s—which fuelled the claims of a “new economy”—could be transformed into a vicious one.

When interest rates were still relatively high, but coming down, capital was attracted to the US by the prospect of still relatively high yields and the potential for capital gains on bonds. Interest rates and bond prices bear an inverse relationship, meaning that as interest rates fall bond prices rise giving rise to the possibility of a capital gain. At the same time, the “strong” US dollar created the conditions for foreign investors to secure a capital gain.

Now financial conditions have been reversed, increasing the risk that foreign capital may rapidly shift out of the US. Interest rates are low, with the prospect of rising, meaning that the yield on bonds is low while at the same time investors run the risk of suffering a capital loss, either as a result of increased interest rates or because of a fall in the value of the dollar.

It is a measure of the depth of the contradictions within the world capitalist economy that the devaluation of the US dollar, regarded as necessary to effect a global “rebalancing,” could in turn set in motion processes leading to a major financial crisis and a US and global recession.

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