Whither the US dollar?

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Will the fall in the value of the US dollar proceed gradually or will there be a financial crisis sparked by a rapid exit of funds from American financial markets? This is a question that is being asked more frequently in world financial centres as US indebtedness reaches new highs.

Last week the US dollar hit a record low of almost $1.20 against the euro in the wake of news that investment inflows into the US in September had fallen to their lowest level in almost five years.

The reason for the nervousness can be seen from the figures on the US current account deficit and its external debt. This year the current account deficit rose to more than 5 percent of gross domestic product (GDP), the level the Federal Reserve Board has identified as signifying potential problems for US economy. Running at more than $500 billion a year, the US requires a capital inflow of more than $2 billion every business day to finance its payments gap, with predictions that this figure will rise to $3 billion some time next year.

This is why the news that net inflows of foreign funds had plunged from $50 billion in August to just $4 billion in September—the lowest level since the crisis caused by the collapse of the hedge fund Long-Term Capital Management in October 1998—sent a tremor through financial markets. Stock markets experienced a fall, and the price of gold, which tends to rise in times of financial uncertainty, hit a seven-year high of $400 per ounce.

On Monday, a column by the *Financial Times* Asia news editor, Daniel Bogler, nominated the decline in the financial inflow as the "scariest statistic of the month". Bogler warned that the downturn could be the start of moves by Asian central banks to shift their funds out of the US. "For the past few years, Asian nations have been buying dollars to keep their currencies down and then investing those greenbacks in US assets, largely Treasury bonds. If Asia were to switch its money elsewhere, that would have a serious impact on the dollar, US bond yields, and the real economy."

There is a lot of money to switch. According to the latest figures, the foreign exchange reserves of Asian central banks were $1.8 trillion last month, much of it held in the US. If this money starts to move elsewhere then US financial markets will be severely affected. It is estimated that foreign investors now own 40 percent of the US government's tradeable debt, 26 percent of US corporate bonds and 13 percent of US equities.

Besides the decline in investment inflows, another reason for the financial market nervousness appears to have been the decision by the Bush administration to impose quotas on textile and garment imports from China.

This decision brought some stinging criticism from the *Financial Times* in an editorial published last Saturday. It began by pointing out that while the fall in the dollar from the "stratospheric heights" it achieved in recent years, especially against the euro, was welcome, "the question is whether the slide will be gradual and manageable, helping to rebalance global demand, or rapid and precipitate, spreading fear among investors. And while movements have so far been largely benign, the Bush administration seems bent on stress-testing the markets' resilience to destruction."

Quotas against a small proportion of Chinese textile imports would have little impact on international trade, it continued, but the markets would be alarmed by "yet more evidence of ham-fisted politics from the US administration" which "appears to be conducting international economic policy on the principle that bashing south-east Asia will play well in the Midwest next November."

The protectionist measures of the Bush administration were also the subject of some unusually critical comments by the Federal Reserve Board chairman Alan Greenspan. In an address on the US current account deficit to a Cato Institute monetary conference last week, Greenspan pointed out that while the external US deficit receded during the 2001 recession it had rebounded to a record 5 percent of GDP this year. This was a matter of “growing concern” because it added to the stock of outstanding debt that could be increasingly difficult to finance.

However, Greenspan, who, as Morgan Stanley chief economist Stephen Roach recently noted, “has a special knack of being creative in rationalizing financial imbalances”, concluded that if the processes of globalisation were allowed to proceed and create a more flexible international financial system, then “history suggests that current imbalances will be defused with little disruption.”

However, Greenspan concluded his remarks with “one major caveat.” Without referring directly to the Bush administration’s measures, he noted that, “some clouds of emerging protectionism have become increasingly visible on today’s horizon.”

“The costs of any new such protectionist initiatives,” he continued, “in the context of wide current imbalances, could significantly erode the flexibility of the global economy. Consequently, it is imperative that creeping protectionism be thwarted and reversed.”

Greenspan is clearly concerned that under conditions where US financial stability has never been more dependent on what could well be called “the kindness of strangers”, the Bush administration’s imposition of protectionist measures, first on steel and now on Chinese textiles, could spark some form of retaliation from both Europe and Asia, thereby destabilising financial markets and provoking a serious crisis.