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US dollar slide continues

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29 November 2004

The US dollar went down to a record low of $1.33 to the euro at the end of last week amid signs that foreign central banks, which have invested heavily in US treasuries and other forms of debt, are looking to shift some of their resources out of US financial markets. Besides recording an historic low against the euro, the dollar reached a four-and-a-half year low against the yen, a nine-year low against the Swiss franc, a 12-year low against the Canadian dollar and a 16-year low against the New Zealand dollar. In another indication of the growing loss of confidence in the US currency, the gold price hit a 16-year high of $455.

The latest fall in the dollar's value was touched off by a report in the Shanghai publication *China Business News* that China had reduced its holding of US treasuries. China, which has some $515 billion in foreign currency reserves, has been one of the key purchasers of US financial assets and any withdrawal from the market could see a rapid exit by other central banks and foreign investors.

The slide was only halted when Yu Yongding, a member of the monetary policy committee of the central bank, issued a statement saying that his remarks to a seminar had been misrepresented by the newspaper. As of the end of September, he explained, the total of US treasuries held by China's monetary authorities had increased but the proportion of US treasuries in China's total foreign exchange reserves had decreased.

The most recent figures indicate that China's holdings of US treasuries increased by 11.3 percent from January to the end of September, compared to an increase of 21.5 percent for the same period last year. This means that while still purchasing US dollar assets, the Chinese monetary authorities are stepping up their purchases of gold, euros, Swiss francs and other strong currencies in order to lessen their risk exposure in the event of a rapid dollar fall.

Nervousness over China's position was not the only factor. Earlier last week, Alexei Ulyukayev, first deputy chairman of the Russian central bank, indicated that the bank was looking to increase the proportion of foreign currency reserves it held in euros. "Most of our reserves are in dollars, and that's a cause for concern," *Bloomberg News* quoted him as saying. "Looking at the dynamics of the euro-dollar rate, we are discussing the possibility to change the reserve structure."

The Bank of Japan has also indicated that it is looking to shift its mixture of foreign currency reserves and has been virtually absent from the US foreign exchange market over the past six months, with purchases of US treasuries falling during September.

So far this year, despite the growth of both the fiscal and balance of payments deficits to record levels, the US bond market has remained firm, thereby keeping interest rates low. But all that could change if the Asian central banks, whose purchases of US treasuries have largely sustained it, decide to withdraw. Last year, for example, foreign central banks bought $441 billion of treasuries, equivalent to 83 percent of the US current account deficit.

While there has yet to be a major withdrawal from the US market, there is a limit to the investment by foreign banks because of the ever-increasing risk of over-exposure to a fall in the dollar. Quantifying this risk, the New York Federal Reserve Board noted in a recent paper that a 10 percent appreciation of the Singapore dollar against the US dollar would bring a capital loss equivalent to more than 10 percent of the island-state's gross domestic product (GDP). A similar loss would also be experienced by Taiwan, with China and Korea facing losses equivalent to 3 percent of GDP.

Given the massive losses they could incur, all the players in the US market keep a nervous eye on each other. They all want the inflow of funds to continue in order to maintain the value of their assets. But at the same time, they are all looking to reduce their own dollar holdings in order to lower their risk exposure. Consequently in these conditions, even a relatively minor movement out of the US market by one of the major players could provoke a “rush to the exit”, setting off a collapse of the dollar and a consequent escalation of US interest rates.

As the risks of a dollar collapse and the onset of a global financial crisis mount, there have been calls for a new Plaza accord, along the lines the September 1985 agreement in which the major powers agreed to joint action to lower the value of the US dollar.

Writing in the *Financial Times* of November 17, New York financial consultant and author Peter Bernstein recalled that within two years of the accord, the dollar had dropped by 30 percent and by 1991 the US current account was roughly in balance. But he acknowledged that the situation today was “far more complex”.

In 1985, the US current account deficit was 2 percent of GDP compared to 5 percent today, foreign asset holdings in the US were a fraction of what they are today and in 1986 the oil price dropped by 50 percent, in contrast to the sharp rises of the recent period.

There are other significant differences, which militate against any viable agreement. In the mid-1980s, Europe and Japan were experiencing higher growth rates than the US—in effect the Plaza accord was an agreement to boost US growth by lowering the value of its currency. Today, the situation is the reverse, with the US experiencing higher growth rates than either Europe or Japan. Another major change is the rise of China, which is now a major player in global financial markets, with its holding of more than $515 billion in foreign currency reserves. Above all, the most significant difference is the growth of the financial superstructure of global capital, far above what existed nearly 20 years ago.

A recent article published by the online magazine *Asia Times* pointed to the deep structural problems besetting the US economy. Drawing an analogy with the collapse of New York’s twin towers, the author, W Joseph Troupe, editor of the *Global Events Magazine*, asked whether the apparent strength and imposing size of the US economy “deceptively mask[ed] an imminent collapse” and whether events which would bring about a collapse of the “towering US economy” might have already begun.

He noted that the US economy has been built around the strength of the US dollar “and the apparently firm and virtually unbreakable international support it enjoys.” But in the aftermath of the Bush re-election “international support for the dollar and for related US economic and foreign policies is noticeably weakening, at a time when it is most needed to support an unprecedented and mushrooming mountain load of debt.”

The numbers involved have been described as “nothing short of frightening”. US government debt is now well over $7 trillion—Congress had to lift the ceiling earlier this month—total consumer debt is more than $8 trillion, and the government deficit is running at more than $400 billion.

Towering over all these is the figure for derivatives, the financial instruments involving interest-rate futures, and currency swaps and options, described last year by financier Warren Buffet as “financial weapons of mass destruction”. The derivatives market now totals $180 trillion, equivalent to around 17 times US GDP. Any rapid movement in the US dollar, and consequent shift in interest rates, could well see the collapse of this vast financial superstructure.

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