US dollar slide to continue after G20 meeting

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The US dollar is set to continue its fall on money markets around the world following the meeting of central bankers and finance ministers of the Group of 20 (G20) held in Berlin over the weekend. While the fall of the dollar has been one of the main topics of discussion in banking and financial circles over the past months, it was not on the agenda at the meeting because of disagreements between the US and Europeans.

While the European powers are concerned that the falling dollar will hit their exports, resulting in slower economic growth, the US is insisting that no co-ordinated action need be taken on exchange rates and that they should be determined by market forces. The Europeans maintain that the falling dollar is caused by the record US fiscal and balance of payments deficits and that the Bush administration should put its economic house in order. The US, on the other hand, declares that the imbalances in the world economy, reflected in the US deficits, are caused by low European growth rates which need to be overcome through "restructuring" and greater scope for the operation of "market forces".

Answering critics of the Bush administration, treasury secretary John Snow said the US was committed to cutting the budget deficit in half over the next four years, insisting that all countries were responsible for boosting growth and correcting trade imbalances. "Growth among our trading partners—including those here in Europe—also needs to increase and that requires addressing structural barriers in the way of better performance."

Earlier German chancellor Gerhard Schroeder had rebuffed US criticism by pointing to the record American deficits. "You can hardly demand from the Europeans to constantly carry out structural reforms—which we are doing—without addressing your own needs," he said.

As a result of the conflicts, the communiqué which emerged from the meeting committed nobody to anything. "We underscored the importance of medium-term fiscal consolidation in the United States, continued structural reforms to boost growth in Europe and Japan, and, in emerging Asia, steps towards greater exchange rate flexibility, supported by financial sector reform, as appropriate," the statement said.

The G20 may have decided to sit on its hands, but the problem is not going to go away. In an address to a European banking meeting on the eve of the G20 meeting, US Federal Reserve chairman Alan Greenspan explained that at a certain point the inflow of funds needed to finance the American deficit will dry up, prompting a rise in interest rates.

Posing the question as to how long the US current account deficit, now running at around 5 percent of gross domestic product (GDP) could continue to be financed from foreign sources, Greenspan offered the reassurance that at present there was only limited evidence of problems with inflows. But the US could not continue to accumulate foreign debt indefinitely, he warned. "Net debt service costs, though currently still modest, could eventually become burdensome. At some point diversification considerations will slow and possibly limit the desire of investors to add dollar claims to their portfolios."

At a certain point, he continued, the dollar holdings of foreign investors would become so large that they would represent "an unacceptable amount of concentration risk", leading to a withdrawal of foreign funds along with increased interest rates in the US.

The structural imbalances in the US and global economy have also been highlighted by former US treasury secretary Lawrence Summers. In a lecture delivered on October 3, he noted that running at more than $600 billion annually and in the range of 5.5 percent of GDP, the US current account deficit

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represents more than 1 percent of global GDP and absorbs almost two-thirds of the cumulative current account surpluses of the world's surplus countries.

"All these figures are without precedent. The United States has never run such large current account deficits and no single nation's deficit has ever bulked as large relative to the global economy," he said.

Summers explained that even if the global economy grew in a balanced way, with imports and exports rising in proportion to the size of the global economy, the US balance of payments deficit would continue to grow. This is because US imports are around 16 percent of GDP while exports stand at 11 percent. Furthermore, the US has a higher propensity to import than its trading partners. This means that even if the US and its trading partners grow at the same rate, US imports will increase at a faster rate than exports, thereby widening the balance of payments deficit.

Noting the increasing role of the East Asian central banks in financing the US deficit—they currently hold around $1.8 trillion in foreign currency reserves—Summers drew attention to what he has previously described as the "balance of financial terror" that maintains the world financial system. On the one hand the US depends on an ever-larger inflow from the Asian banks to finance its deficit, while on the other the lenders, despite incurring losses on their investment and exposing themselves to greater financial risk, are afraid to withdraw their funds lest they set off a financial crisis.

Summers, who was involved in setting up the G20 in the late 1990s, said it would be the appropriate forum to consider issues of global economic coordination and the development of a global economic strategy for sustained growth.

With a membership covering countries that embody 90 percent of the global economy, the G20 would appear, on the face of it, to be the body where such coordination would be developed. But judging from the results of last weekend's meeting, the divisions between the major economic powers mean that such co-operation is impossible. Indeed, the conflicts appear to be deepening.

In an analysis of the G20 meeting, an article in the *Australian Financial Review* noted: "Squabbling at the weekend's G20 finance ministers' meeting and unusually candid comments from ... Alan Greenspan can only mean one thing: America's unilateralism under President George Bush has extended beyond foreign policy to economic policy. Having lost hope that market-opening reforms on Europe and Japan that will boost exports and reduce its current account deficit, the US is taking matters into its own hands."

The US, the comment continued, would pursue its own agenda through a lowering of the dollar and higher interest rates, forcing governments and central banks around the world to accommodate themselves to its demands. "The US knows what it needs, and Japan and the Europeans can moan all they like."

Signs of increased tensions were clearly in evidence in the wake of the G20 meeting. In an interview with the *Financial Times* published today, the deputy governor of the People's Bank of China, Li Ruogu, made it clear that China would not be rushed into revaluing its currency—a central demand of both the US and the European powers.

Ruogu warned the US not to blame other countries for its economic difficulties. "China's custom is that we never blame others for our own problem. For the past 26 years, we never put pressure or problems on to the world. The US has the reverse attitude, whenever they have a problem, they blame others," he said.

China's trade surplus with the US was more than $120 billion last year and has been increasing at a record rate, rising by more than $15.5 billion in September and $15.4 billion in August. The US has been demanding that this imbalance be addressed through an upward valuation of the yuan and eventually full currency flexibility. But Chinese authorities fear that if the present regulatory regime is abandoned too quickly this will lead to a crisis in the banking system where some estimates put the level of bad loans at 40 percent of China's GDP.

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