US dollar slide increases global tensions

Nick Beams
18 November 2004

The recent sharp fall in the value of the US dollar and its implications for the stability of the world economy will be the chief topic of discussion at a meeting of the finance ministers of the Group of 20 at the weekend. The dollar is now down to $1.30 to the euro, a decline of 30 percent since Bush took office, with predictions that it could even hit $1.50. But no agreement is expected to emerge from the meeting, comprising finance ministers from the G7 as well as other countries, including China, Russia, Korea and Turkey.

The main division is between the United States and so-called “old Europe”, principally France and Germany. Last week the president of the European Central Bank Jean-Claude Trichet described the recent currency movements as “brutal”, hinting at the need for coordinated intervention by major central banks. But the US does not regard the recent currency market movements as excessive, with one Treasury official telling the *Financial Times* that markets were “operating very well” and displaying a “great deal of orderliness.”

This is not the view in the major eurozone countries where the decline of the dollar is seen as a major threat to export markets and consequently to European growth prospects. European governments maintain that the record deficits run up by the Bush administration have played a major role in the dollar’s fall.

In an interview with the weekly magazine *Der Spiegel*, Germany’s deputy finance minister Caoi Koch-Weser warned that US trade and budget deficits were “unsettling markets” and called for action to ensure “sustained, medium-term budget consolidation”. He criticised the Bush administration’s tax cuts saying they were too heavily weighted to the rich, did little to boost the economy and worsened the budget deficit.

The French finance minister Nicolas Sarkozy has made similar comments, warning that markets would only regain confidence in the dollar if the US cut its deficits. “This is the unanimous message from the Europeans and the International Monetary Fund that we send to the United States,” he said.

These criticisms will get short shrift from the Bush administration. According to Treasury Secretary John Snow, now visiting several European capitals prior to the weekend meeting, the problem is not the US deficits but the lack of growth in the European economy. Briefing reporters ahead of Snow’s departure, a Treasury official said one of the reasons for the pressure on the dollar was subpar growth in a number of US trading partners.

“If the US is growing more rapidly than other countries, then exports from the US are growing less rapidly than they otherwise would. So if you get more rapid growth in Germany or in other countries not growing as rapidly as they should, that will be beneficial to our exports and help with the reduction in the trade deficit.”

The official went on to urge greater efforts to press China to adopt more flexible currency policies, leading to an upward movement of the yuan and easing pressure on the dollar.

However, these policy prescriptions, rather than offering solutions, only serve to highlight some of the contradictory features of the global economy. While economic growth is held out as the solution, the chief source of European growth is the expansion of export markets, which depend in turn on the value of the euro remaining competitive against the US dollar. In other words, there is a vicious circle at work. Growth in the European economy requires the maintenance of the value of the dollar, but a high dollar leads to a widening US trade deficit, thereby worsening the financial imbalances in the global economy.

Similarly, greater flexibility in the yuan and the Asian currencies more generally is also fraught with dangers. This is because the Asian central banks have spent hundreds of billions of dollars purchasing US financial assets in order to keep the value of their currencies low relative to the US dollar, thereby ensuring that their exports remain competitive in the American market.

Asian banks at the end of last year held an estimated $1.89 trillion of foreign reserves, most of it in US dollars. If the Asian currencies were revalued, significant losses would be incurred on these holdings. According to calculations by the New York Federal Reserve if the yuan were to appreciate 10 percent against the dollar, China would suffer a capital loss equivalent to almost 3 percent of its gross domestic product (GDP). If the won rose by 10 percent, South Korea would experience a similar loss. For other economies the blow would be even more severe. Singapore would experience a loss equivalent to 10 percent of GDP and Taiwan 8 percent.

Commenting on these calculations, the *Economist* noted: "To avert such an appreciation, Asian central banks would have to amass ever greater holdings of dollars. But this would only expose them to greater capital losses down the road. Alternatively, they might seek to avoid the consequences of a dollar fall, by diversifying into other reserve currencies, such as the euro. But that would only bring the dollar crashing down all the more quickly. In other words, Asian central banks are caught in an awkward dilemma: either they try to break the dollar's fall, or they try to escape from underneath its collapse."

The growing concern over the dangers to the world financial system posed by too great a dependence on the US dollar was reflected in a major speech by the Governor of the Bank of Japan, Toshihiko Fukui, last week.

Addressing a symposium in Tokyo on the theme "The euro: five years on—implications for Asia", he said the emergence of a clear rival to the US dollar as a key global currency would have a stabilising effect on the global financial system.

Fukui told the seminar that since its launch the importance of the euro had already increased considerably. More than 50 countries now linked their currencies to the euro, it comprised 20 percent of foreign currency reserves and nearly a third of cross-border bonds were denominated in euros. In a thinly veiled reference to the US, he pointed to the dangers associated with allowing any single currency to dominate global commerce.

In such a situation, the government of the key currency country was "easily tempted to focus its economic policy on domestic considerations," he said.

"In today's globalised economy, this could lead to undesirable ripple effects on the rest of the world, through the fluctuations of the external value of the key currency." If there were two competing currencies, "competition between them could lead to more attention to the external value of key currencies" and this could have a "positive effect on the stability of the global financial system."

Such remarks will not be welcomed in the Bush administration for, together with the unease of the Europeans, they point to the fact that the other major capitalist powers are growing increasingly resentful of the enormous advantages which the dollar's role as the major world currency gives to the US and may start to promote alternatives.

That search could well be stimulated by conflicts over foreign policies. Within two weeks of the election, it is clear that the second Bush administration is going to intensify the unilateralist foreign policy approach which created such conflict with Europe. This means that economic measures may be used where diplomatic and other means have failed.

In his first press conference after the election, Bush insisted that he earned "political capital" in the campaign and that he intended to spend it. But with the US needing an inflow of around $2.6 billion a day to finance its trade and budget deficits, and with 92 percent of the $1 trillion increase in debt over the past four years financed by foreign lenders, whether he has the economic capital may prove to be another question.