Financial markets shaken by US dollar scare

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The fragility of the international currency and financial markets has been underscored by the turbulence which followed reports that the Bank of Korea might be looking to lessen its holdings of dollar-based financial assets.

Stockmarkets dropped on Tuesday and the US dollar fell sharply—losing 1.3 percent against both the euro and the yen—following a parliamentary report by the Bank of Korea that it would increase investments in high-yielding non-government debt and diversify its holdings into a variety of currencies.

In the wake of the market plunge, Asian central banks mounted a rescue operation. The Bank of Korea issued a statement declaring that, while it was planning to shift more of its reserves into higher-yielding non-government bonds, it was not planning to sell existing dollar holdings.

Treasury officials in Japan, which holds $841 billion in foreign currency reserves, the world's largest stock, insisted that there was no move to sell dollars—remarks which were echoed in Taiwan, which has $243 billion in reserves.

While the immediate crisis has passed, the underlying imbalances which produced it continue to worsen. As the *Financial Times* (FT) commented in an editorial on Wednesday: "If the mighty dollar can be rocked by a single paragraph in a report to the Korean parliament then something is sorely amiss. That something is the dependence of the dollar on a handful of Asian central banks, which between them control $2,400 billion reserves."

These reserves are getting larger by the day and as they grow so does the incentive to shift out of the dollar to guard against any capital loss caused by its depreciation. Of course, if all the Asian dollar holders move out, they will set off a plunge in the dollar's value and suffer major losses (in some cases up to 10 percent of gross domestic product). But individual central banks may be able to shift out of the dollar at a good price. The problem, however, is that others will be tempted to follow, setting off a collapse.

Moreover, as the FT editorial pointed out, even if central banks do not withdraw funds, the US currency is still far from safe. This is because, with private capital inflow having fallen off markedly since the end of the 1990s, the US depends on increased purchases of its financial assets by foreign central banks to fund its growing balance of payments deficit.

These imbalances were the subject of a speech by the managing director of the International Monetary Fund, Rodrigo de Rato, on Wednesday evening. The IMF chief began by noting that global growth in 2004 had been the strongest for some time and the prospects for 2005 remained good. But within these positive signs there were "serious threats and challenges" stemming from the imbalances in the world economy—the US current account and fiscal deficits and the growing surpluses in Asia.

Global growth, he continued, was "unduly dependent" on the United States and China, while the euro area and Japan, which together make up one quarter of global output, continued to underperform. "If this trend persists, it will further widen existing imbalances, and increase the risks for abrupt disruptions of global growth."

The extent of these imbalances has been highlighted in a paper prepared earlier this month by Nouriel Roubini and Brad Setser, who take issue with claims that the present system, in which US deficits are funded from Asia, can provide continuing financial stability.

Noting that the US currently absorbs 80 percent of the savings that the rest of the world does not invest at home, they point to a number of sources of instability. These include: the tension between the increased US need for finance and the large losses lenders will suffer as a result of a fall in the value of the US dollar; the burden that funding the US is imposing on Asian financial systems; and the danger of a lending boom and asset bubble in China, adding to the weakness of its banking system.

Central banks in Asia are being increasingly exposed to large losses from their holdings of dollars. For example, a 33 percent revaluation of the Chinese currency against the US dollar (not a large amount considering the 50 percent fall in the dollar against the euro in the past three years) would result in a capital loss to China equivalent to 10 percent of its gross domestic product (GDP). And the capital loss could exceed 20 percent of GDP by 2008.

The report warns that if the US "does not take policy steps to reduce its need for external financing before it exhausts the world's central banks' willingness to keep adding to their dollar reserves—and if the rest of the world does not take steps to reduce its dependence on an unsustainable expansion in US domestic demand to support its own growth—the risk of a hard landing for the US and global economy will grow."

This would involve a sharp fall in the value of the dollar, a rapid rise in US interest rates, leading to a fall in US asset prices, including equities and housing, resulting in a "severe slowdown in the US" and a "severe" global slowdown, if not outright recession.

The authors point out that there is a fundamental contradiction at the heart of the current international monetary order. "The US is currently financing itself by selling low-yielding dollar debt, which offers foreign investors little protection against a future fall in the dollar. Yet the United States' large trade deficit and rapidly rising external debt to GDP ratio imply that a large future fall in the dollar will be needed to reduce the US trade deficit to more sustainable levels. The longer foreign investors finance the US on current terms—particularly investors from countries whose currencies have yet to fall at all against the dollar—the larger their likely capital losses on their dollar assets."

A rebalancing of the world's financial system would require a large increase in growth in the rest of the world. But there is no sign of that with Japan, the world's second largest economy, falling back into a recession and Germany, the key economy of the euro zone, remaining stagnant. Rebalancing, the report's authors maintain, would require a combination of stronger growth in world demand and slower growth in overall US demand. But there is a contradiction in this scenario as well. Lower growth in US demand would adversely impact on the rest of the world, which has become increasingly dependent on the US market. In other words, slower US growth, which is seen as necessary to correct the present imbalances, would not lead to a restoration of global equilibrium, but rather to the onset of a global recession.