US dollar fall raises questions on global stability

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Was it US Federal Reserve Board chairman Bernard Bernanke's first bungle or are we seeing the start of a major shift in international currency markets? That was the question being raised in financial circles last week as the dollar underwent a fall against all major currencies.

The dollar went to a three-month low against the yen and a near one-year low against the euro following remarks by Bernanke which indicated that the Fed may halt its moves to lift interest rates after an expected rise of 0.25 percentage points when its policy-making committee meets later this month.

Speaking to the Joint Economic Committee of Congress last Thursday, Bernanke said: "At some point in the future, the committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook."

Since the start of its rate tightening policy in June 2004, the Fed has increased the base rate 15 times, lifting it from 1 percent to 4.75 percent. If the Fed does undertake a further increase to 5 percent it will mean that the base rate will be around 3 percentage points higher than the underlying rate of inflation. A real base rate of 3 percent is considered to be neutral, provoking neither inflation nor an economic slowdown.

Even before Bernanke's comments, it was clear from the minutes of the Fed's policy meeting last March that the policy of rate tightening did not have long to run and several members "expressed concern about the dangers of tightening too much."

While the dollar has been steadily losing ground since the start of the year—following an increase in value against most major currencies last year—Bernanke's comments set off an increase in the rate of decline.

As one strategist for a New York currency broker put it: "Bernanke buried the dollar this week. If the dollar's interest-rate support is taken off the table there is very little to prop it up."

These views were shared by the global head of currency strategy at ABN Amro, Tony Norfield. "I think this is it," he told the *Sunday Times* in London. "The dollar has been supported by high yields but markets are saying that is no longer enough. The question for policymakers is going to be how to manage the dollar's decline."

The impact on the dollar of possible monetary easing in the US is being compounded by the general interest rate tightening in the rest of the world. Last week the Chinese central bank announced an increase in its basic lending rate by 0.27 percentage points to 5.85 percent. At the same time the Bank of Japan, which has indicated that will try to shift away from its zero rate policy of the last few years to a more normal regime, issued a statement indicating that it viewed inflation, rather than deflation, as more likely in the coming period.

The European Central Bank and the Bank of England are both set to increase interest rates in the immediate future rather than bring them down.

Higher interest rates in the rest of the world mean that funds will tend to move out of US assets to seek increased yields elsewhere. But such a movement has the potential to create major financial instability because of the massive US current account deficit. The latest figures show that in 2005 the US current account deficit rose to $804.9 billion, equivalent to 6.4 percent of gross domestic product (GDP), up from a deficit of $668.1 billion in 2004, equivalent to 5.7 percent of GDP.

With the deficit continuing to rise, Bernanke has warned that there is a "small risk of a sudden shift in

sentiment that could lead to disruptive changes in the value of the dollar."

The size of the problem is indicated by the fact that in the last quarter of 2005, the US payments gap reached an annual rate of $900 billion, which is an amount larger than the GDP of all but nine countries in the world.

In a recent address to the Reserve Bank of India, former US treasury secretary Lawrence Summers pointed out that the transformation of the United States, the world's greatest economic power, into the world's greatest borrower has resulted in a number of economic processes that are "without historical precedent". Instead of supplying capital to the rest of the world, the US is in fact the greatest absorber of global savings in order to finance its balance of payments deficit.

Overall, the deficit—the excess of US international spending over income—is equivalent to about 2 percent of global GDP. This means that if the payments gap were substantially reduced without a compensating increase in demand elsewhere, the world would suffer a major recession.

So far the US deficit has been sustained by the inflow of funds from so-called "emerging markets". But, according to Summers, their reserves have risen from half a trillion dollars in 1999 to more than two trillion dollars today—around one and a half trillion dollars in excess of what is needed to provide currency stability.

Summers described the US current account deficit as "unsustainable and dangerous" and warned that managing its decline would require "substantial adjustments in other parts of the world if a recession is to be avoided." There had to be a "global strategy for managing the US current account deficit downwards without excessive risk to global growth."

Such a strategy would call for global economic co-ordination and collaboration on a scale far beyond anything which has existed in the past. But rather than moving towards greater co-operation, the conflicts among the world's major powers are intensifying. The meetings of the G-7 and G-8 major industrial nations are increasingly little more than photo opportunities, protectionist sentiment is on the increase in both the United States and Europe, and trade tensions are rising as evidenced by the failure to reach agreement on the Doha round of trade talks.