Currencies

Competitive sport in Boca Raton
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Europeans think the dollar is in danger of becoming too weak; Americans disagree. Who is right?

ALAN GREENSPAN and John Snow, respectively the chairman of America's Federal Reserve and the secretary of its Treasury, will be challenging their European counterparts to a game of tennis when the finance ministers and central-bank governors of the G7 group of rich economies meet in Boca Raton, Florida, on February 6th and 7th. But the swing of their rackets will be less on the minds of American and European finance officials than the swings in their currencies.

The euro has risen by 50% against the dollar since its trough in July 2001. European officials are frustrated by America's lack of concern for the dollar's slide and the disproportionate burden this is imposing on the euro. In the run-up to the Boca Raton meeting, some European policymakers were calling for a joint statement to stabilise the dollar. But this seems likely to have fallen on deaf ears. As John Connally, a former treasury secretary, told the rest of the world in 1971: “The dollar is our currency, but it is your problem.”

Although the dollar has strengthened against the euro over the past two weeks—thanks to slightly more hawkish comments about interest rates from America's Fed and efforts by the European Central Bank to talk its currency down—its slide has quickened since the G7's previous meeting in Dubai last September. Then officials called for “more flexibility” in exchange rates, but they have since disagreed about what that really meant. John Snow initially described the statement as a “milestone change”, sending out a general signal that the dollar needed to fall further.

Others interpreted it as a veiled message to China and Japan to stop intervening in the foreign-exchange market and let their currencies rise. If indeed that was the message, both countries chose to ignore it.
China's currency, the yuan, remains rigidly pegged to the dollar while the Japanese continue to buy dollars galore in order to hold down the yen.

A new agreement on exchange rates at this weekend's meeting seems unlikely given that the G7 members (America, Britain, Canada, France, Germany, Italy and Japan) have such different goals. The Americans do not see any problem for the moment in letting their currency fall, while the Europeans want action to stabilise it. Japan, meanwhile, is single-mindedly continuing its massive intervention in the currency markets.

A level playing court

When the dollar first started to wobble, in early 2002, America's economy was weak. Today, however, it is growing far faster than the economies of the euro area and Japan. So why is the dollar still sickly?

The obvious answer is that investors are less eager to finance America's vast current-account deficit than they once were. Given that stronger growth in America than elsewhere could cause that deficit to swell still more this year, a fall in the dollar is both inevitable and necessary to reduce the deficit by making imports dearer and exports cheaper.

Nevertheless, European policymakers complain that the euro has borne a disproportionate share of the dollar's decline. The Australian dollar has actually seen the biggest gain against the dollar among the main currencies (see chart 1). But since January 2002 the euro has risen against the greenback by roughly twice as much as the yen, sterling or the Canadian dollar. The currencies of emerging Asian economies other than China have also moved only a little, while the Mexican peso has even fallen against the dollar. (Mexico is America's third-biggest trading partner.) Overall, the dollar has fallen by a modest 15% against a broad basket of currencies.

There is also a deeper policy rift between Europe and America over a different sort of burden sharing. America accuses the euro area of running overly tight economic policies and hence not pulling its weight in supporting global growth. Europeans, on the other hand, fret that America's lax monetary and fiscal policies, by depressing domestic saving, are perpetuating its current-account deficit. They fear that American policymakers' belief that the dollar and the deficit will adjust smoothly is overly complacent.

Who's winning?

For at least a decade, American treasury secretaries have preached the virtues of a strong dollar. Yet today America is thriving on a weaker dollar. The lower exchange rate is already boosting exports and profits: export volumes rose at an annual rate of 19% in the fourth quarter of 2003, while imports grew by 11%. Moreover, by making manufacturers more competitive, the weaker dollar should create jobs before the presidential election in November.

Better still, there seems little imminent danger that a sliding dollar will cause inflation to surge. The
economy has ample spare capacity; inflation is, if anything, currently too low. As yet the weaker dollar has not pushed up import prices. Foreign exporters tend to fix their prices in dollars, and fierce competition has encouraged them to hold these down. Instead, they have trimmed their profit margins. One bizarre result is that some top-of-the-range German cars are now almost 30% cheaper in America than they are in Europe. But there is a limit to how much firms can squeeze profits; eventually a falling dollar will push up prices, so reducing imports.

If the cheaper dollar is benefiting America, is it hurting the euro-area economies? Surveys suggest that European firms are not yet panicking about the strength of the euro. An index of German business confidence tracked by Ifo, a German research institute, has risen to its highest level for three years. However, another survey by the institute found that 90% of larger German manufacturers would have problems exporting at a euro-dollar exchange rate above $1.30.

The current "strength" of the euro (at around $1.25) is often exaggerated. As recently as 1995 the currency (as calculated from a basket of the national currencies that preceded it) was trading much higher, at the equivalent of $1.37. The euro's trade-weighted value today is roughly the same as it was at its launch five years ago. In 2002 the European Central Bank (ECB) examined 16 different studies into the fair value of the euro. Most said it lay in the range $1.10-1.20, which explains why European policymakers have only recently got nervous about the euro's rise.

The ECB needs to worry about the strength of the euro only to the extent that it affects inflation. In January, the average inflation rate in the euro area was 2.0%, just above the central bank's objective of "less than but close to 2%". In theory, a stronger euro could be beneficial if it helps to hold down inflation and allows the ECB to cut interest rates. But, as in the United States, currency movements appear to have a more muted impact on European inflation than in the past. This is largely because importers have changed their pricing behaviour. They tend to keep their prices fixed in euro terms, thereby enjoying an increase in profit margins as the euro climbs rather than an increase in market share.

If the euro continues to rise, the ECB could intervene in the foreign-exchange market and buy dollars in order to signal that the currency is no longer a one-way bet. But that would probably not succeed unless America were to join in—which currently seems unlikely. If the ECB is really worried about the impact of a rising euro, then its best weapon is to cut interest rates. Most economists, however, do not expect it to act until inflation falls below 2% and there is firmer evidence that the euro's strength is hurting business.

For its part, Japan cannot cut interest rates because they are already at zero. Instead, the Ministry of Finance has been intervening in the foreign-exchange market on an unprecedented scale. After $175 billion-worth of purchases in 2003, it spent another $67 billion in January this year, a monthly record. That has not, however, prevented the dollar from falling to a three-year low of ¥105.2. Now the ministry is seeking more ammunition in its battle to hold down the yen. It has asked for authorisation from parliament to increase the funds available for intervention in 2004 to ¥61 trillion ($580 billion).

These efforts to hold down the yen are annoying European policymakers because it will then require an even bigger rise in the euro to reduce America's current-account deficit. A year ago, when Japan's deflationary economy was still flat on its back, there was a strong case for intervention to hold down the yen. But many economists are now forecasting that Japan's GDP will grow by 2.5% this year, following 2.4% in 2003. As recently as May last year the consensus forecast for both 2003 and 2004 was a mere 0.7%.

The good news about Japan's economy is increasingly broad. The unemployment rate fell to 4.9% in December from 5.4% last May, and the ratio of job offers to applicants rose to its highest level for more than ten years. In December, Japan's export volume was 13% higher than a year earlier, and the trade surplus was 40% bigger. Even deflation has eased.
Goldman Sachs, an investment bank, argues that a strong yen is less likely to derail Japan's recovery today than it was in the past because firms' output and profits have become less sensitive to swings in the dollar. China is an increasingly important market for exporters, and investments in America (such as car plants) have helped insulate firms from a rise in the yen. Many analysts reckon that Japan's big exporters could cope with a dollar rate of ¥90.

So why is the Japanese government intervening on such a vast scale? One reason may be concern about the possible impact on equities if the yen were to dip below a supposed psychological threshold of ¥100. A relapse in the stockmarket would erode the capital of Japan's shaky banks.

**The ball in China's court**

But Japan is not the only one trying to resist market forces. The Chinese yuan, the Malaysian ringgit and the Hong Kong dollar are all pegged to the greenback. Other Asian currencies officially float, but their central banks have also been intervening heavily to hold them down. The total reserves of the big four—China, Japan, South Korea and Taiwan—have more than doubled over the past three years (see chart 2), to $1.5 trillion, most of it held in American government securities.

It is hard to judge the correct value for the Chinese yuan, but there are tell-tale signs that it is undervalued. One is China's rapidly rising reserves; another is its large surplus on its "basic balance"—the sum of its current-account surplus and the net inflows of long-term capital, such as foreign direct investment. Its basic balance currently stands at around 4% of GDP.

In a free market the yuan would surely rise, helping to spread the burden of the dollar's adjustment. But the Chinese government's priority is to create new jobs as unprofitable state firms are closed down. For that it needs to maintain the currency's competitiveness. Furthermore, until China's shaky banks are shored up, it would be foolhardy to let its currency float.

Until then, any currency adjustment is likely to be modest. At best there might be a small widening of the yuan's band against the dollar or a shift to peg the yuan to a basket of currencies, but without any significant appreciation. So long as the yuan remains more or less pegged to the dollar, other Asian economies will resist appreciation too.

Stuffing reserves under the mattress is not without cost. The return on American Treasury securities has been poor. There is also a limit to how long this policy can continue. Large inflows of foreign exchange are creating excess liquidity in China. Some economists worry that rapid money growth is fuelling asset-price bubbles (in the property market, for instance) and causing the economy to overheat.

**Where does the buck stop?**

Most economists expect the dollar to fall further. Taking the average forecast of seven American and European banks, the euro is expected to trade at $1.32 in 12 months' time, and the dollar to be at ¥101. Even if they are right, the buck is unlikely to stop there. For it would still not have fallen by enough to make a significant dent in America's current-account deficit.
The maths behind America's trade deficit is daunting. The gap between merchandise exports and imports is now so large that, according to J.P. Morgan, exports need to grow almost twice as fast as imports merely to keep the trade deficit constant. Yet the dollar is still far from cheap: in real trade-weighted terms it remains close to its 30-year average (see chart 3). If the deficit is to shrink, then America's domestic demand has to grow more slowly than that of its trade partners, or the dollar needs to fall further, or a combination of the two.

Deutsche Bank argues that America does not need to eliminate its current-account deficit. The German bank reckons that it could probably sustain a deficit of around 2.5% of GDP, half its current level. Using the OECD's economic model, the bank first assumes that the dollar falls to $1.45 against the euro by 2005 and then roughly stays there. This would reduce the current-account deficit to a still hefty 3.6% of GDP by 2008. To reduce the deficit to 2.5% of GDP would, according to Deutsche Bank's simulation, require the dollar-euro rate to fall to $1.98 by 2008, supposing that the dollar falls evenly against all currencies and nothing else changes.

But this assumes that all the adjustment has to come through the exchange rate. The current-account deficit basically reflects America's lack of saving, by both households and the government. Not only is the government's budget deficit set to soar to a record $520 billion (almost 5% of GDP) this year, but the personal saving rate fell to only 1.3% of income in December, thanks to rampant consumer borrowing.

Another way to slim its external deficit is for America to save more. Suppose the government were to reduce its budget deficit to 1.5% of GDP in 2008. Deutsche Bank calculates that the dollar would then have to fall to $1.64 against the euro by 2008 in order to reduce the external deficit to 2.5% of GDP. If the Asian currencies continue to cling to the dollar, the euro would have to rise by even more.

This is only a crude simulation; other factors may change at the same time. However, many other economists agree that, even if the American government were to trim its budget deficit (and thus dampen growth in domestic demand), the dollar would need to fall by another 20% in trade-weighted terms in order to achieve a sufficient reduction in America's current-account deficit. To put that figure into context, remember that the dollar fell by over 50% against the D-mark between 1985 and 1987, when America's current-account deficit was smaller (at only 3% of GDP). This time the dollar has fallen from its high point by just over 30% against the euro.

In an ideal world, America would now tighten its monetary and fiscal policies in order to boost saving, curb domestic spending and reduce imports. This could be offset by looser policy in other countries. But big budget cuts do not happen in election years. So it could take an even bigger fall in the dollar to correct America's current-account deficit.

The problem facing the dollar, therefore, is not that it is too weak, but that it remains too strong. In propping it up, the policies of Asian governments are delaying the necessary adjustment of global imbalances. America is being encouraged to remain profligate for longer. Unlike private investors, Asian central banks care little about the financial return on their dollar reserves. Their sole concern is to keep their exchange rate stable in order to bolster domestic economic growth.

No discipline from bonds
This is distorting financial markets: the dollar remains too high and America's cost of capital is artificially low. Previous falls in the dollar's exchange rate have pushed American bond yields up as foreign investors have demanded a bigger reward to compensate for the increased exchange-rate risk. This devaluation, however, has so far been painless with bond yields staying remarkably low. Ten-year Treasuries, for example, are currently yielding 4.1%, slightly less than the yield on comparable German bonds.

In 2003, Asian central banks financed well over half of both America's current-account deficit and its budget deficit. At their recent pace of intervention, Japan and China could buy enough Treasury bonds this year to more than cover the American government's new borrowing needs. This would allow America to continue borrowing recklessly without the usual warning sign of rising bond yields.

President Clinton's campaign manager, James Carville, once quipped, "I used to think if there was reincarnation, I wanted to come back as the president or the pope...but now I want to come back as the bond market. You can intimidate everyone." Thanks to the appetite of Asian central banks, however, the bond market has lost much of its bark. It is subsidising rather than punishing American profligacy.

Not only do artificially low bond yields appear to offer false signals that America's budget deficit is no cause for concern, but by holding down mortgage rates (which are linked to bond yields) they are also prolonging an unsustainable boom in consumer spending and borrowing. This benefits America in the short term, but allows even bigger imbalances (in the shape of domestic debt and foreign liabilities) to build up in the long term. To contain these debts will eventually require a far sharper collapse in the dollar, a steeper rise in bond yields, and a harder economic landing. Anyone for tennis?