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New Developments on the International Financial Scene Affecting the Credibility of the Dollar (II)[1]

Hajime Shinohara

Managing Director

Institute for International Monetary Affairs

The previous article was based on the premise that the turmoil caused by the subprime mortgages, which began to spread last summer, could shake the international monetary markets in a fundamental way and lead to questioning the credibility of the US dollar. It focused on the possible beginnings of de-dollarization. This article will expand on the questions that were introduced in the previous article while taking the developments around the subprime problem into account. Let me begin with the analysis of the current economic position of the United States.

1. The current situation of the subprime issue

There have been many articles on the causes and the problems brought on by subprime loans. Since readers would be familiar with such articles, I will not bore you with repetitions but only say that we are not seeing a light at the end of the tunnel yet. Let us see the various aspects of this problem more closely.

Subprime problems began with securitized products. Mortgage-backed products were hit especially severely and the market for such products is still in serious confusion with the situation becoming more and more serious. The value of not only residential mortgage-backed securities (RMBS) but also of major securitized products such as collateral debt obligations (CDOs) is deteriorating rapidly in the markets, and as an inevitable result, the difference in the yield (credit spread) between such products and government bonds is spreading gradually.

Furthermore, the corrosion of the securitized products has, in effect, frozen the normal

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function of the asset backed commercial paper (ABCP) market (stop of issuance), and the ABCP market is shrinking with the redemption of the existing CPs.

Complexity of the situation is compounded by what is called the monoline insurance. If the credit ratings of the monoline insurance companies should be downgraded even further, even the existence of the industry could be in jeopardy. This would indeed be a serious blow, which could lead to the collapse of the financial transaction framework that depends on the insurance provided by such specialized companies. The freezing of the functions of various markets would lead to a credit crunch that would affect the whole financial market framework.

Malfunctioning in the short-term financial market is already inhibiting the smooth exchange of capital among financial institutions due to over-cautiousness on the side of the lenders to avoid risks. (I am sure many readers remember how a similar situation occurred in Japan in the autumn of 1997.) Once it is clear how far the current downward spiral will continue, the markets would begin to function again by bouncing back from the perceived bottom of the spiral. However, under the current situation, market participants still cannot see with any confidence where the bottom line is.

Financial institutions are applying more severe criteria in loan provisions, and this attitude is not only affecting the inter-bank market but also hitting a harsh blow to general monetary demand. A stricter standard is now applied to prime house financing loans as well as the subprime ones. Consumer loans, such as credit card facilitated loans and auto loans, go through a more rigorous processing as well, considerably decreasing the number of credits granted in such markets.

Such tendencies are slowly bringing stricter standards to commercial real estate loans and general commercial and industrial loans. This is as if the whole of the financial industry is cutting off lending, which is reminiscent of the situation in March of 1998 in Japan when there was capital injection of public funds. According to research by the European Central Bank, stricter lending standards are beginning to be applied in Europe as well and there is a real possibility of a credit crunch in Europe which needs to be paid attention to.

There is no predicting what burden (amount of loss) financial institutions would have to pay since the bottom prices in markets are still impossible to see. Just when there is an announcement of a reconstruction plan for one major financial institution there is a new focus on another institution, and there seems to be no light at the end of the tunnel. Financial institutions seem to be trying to rid themselves of the high-risk assets and to improve their capital adequacy, but it is becoming more difficult to deal with the demand for new loans due to the deterioration in their capital account.

This is the quick view of the problems suffered by the American financial markets. The inevitably macro economic logic coming out of the overview is that there will be a major

slowdown in growth. And the situation could be relatively long-term, not short-term as many economists are predicting. It may not last as long as ten years as it did in Japan because the country was going through a deflation simultaneously where the increase in prices was lower than zero. But in the United States there is no concern for deflation for the time being.

However, there are many factors that could lead to inflation, and the authorities will have to balance their policies in three areas; managing the financial markets, countering inflation and managing capital inflow to deal with the current account deficit. If the policies in these three areas are conducted in a stop-and-go manner, an unexpected amount of time would be necessary for them to take effect.

That would lead the idea that the dollar would suffer even more seriously and many would think it a serious challenge to stop a nose-dive of the dollar exchange rate. However, that would probably not be the case. That is not what most people would like to see happening, and I will expand on this issue in the next section.

2. The US dollar problem as seen from a macro-economic perspective

Let us first remind ourselves of the financial crisis that hit the Latin American countries in the 1980s and how it was dealt with. These countries fell so easily into a current account crisis as a result of the government's populist policies which eroded their fiscal situation, over-consumption by the general household (the other side of the coin to distrust in their home currency), and capital flight abroad.

All the prescriptions written by the international financial authorities including the IMF seemed to come from text books. They consisted of (1) restoring the savings-investment balance, (2) improving the fiscal balance, and (3) improving the trade balance (ultimately restoring the current account balance). A huge interest rate increase was necessary to achieve (1), decrease in expenditure and increase in revenue to achieve (2) and a considerable devaluation of the home currency in the foreign exchange market to achieve (3). These were the core of the policies.

When such arm twisting means were applied, it was not surprising that current accounts improved markedly, and as a result, there was a tremendous slowdown of the economy and a malignant seed of inflation was sowed. Such slowdown of the economy meant pressure on households and lowering of their living standards. So it would not be an exaggeration to say that such policies forced households to pay for the deterioration in the overall economy.

The improvement in the current account balance resulted in net income of foreign currencies, which was used for the repayment of external debts. (It must be remembered that foreign financial institutions (private institutions) were not necessarily paid in full, but had to share the burden through a partial write-off.) So the macro economic logic was that the public paid the price to repay foreign debt.

What are the differences between the situation in the Latin American countries where they experienced current account crises and the United States where the problem had long been understood to be a structural one which resulted in a massive amount of foreign debt? The main characteristic of the American situation is that 90% of its foreign debt is denominated in its home currency. The total US external debt is 16.3 trillion dollars and 90% of this is denominated in US dollars. (Total external claim is 13.8 trillion dollars, about half of which is denominated in US dollars. The difference of 2.5 trillion dollars between this and total external debt is the net foreign debt)

Whereas the Latin American countries were only able to borrow in dollars, the United States is able to conduct most of its borrowing in its home currency. This could be seen as the key difference between the two situations. If the United States were to be urged to repay in foreign currencies and if they had to raise funds in foreign currencies to refinance its current account deficit, it would not have been possible to accumulate such an enormous amount of net external debt.

It may have been only after the turn of the century that a chill began to go down the spines of those watching how the current account deficit and external debt continued to increase in the United States. But, in fact, the informed observers had long shared their concerns for the problems created by the economic structure.

Many in Asia suggested urgently applying the prescriptions used for Latin America in the 80s. But American experts normally argued that the vibrant US demand was lubricating the global economy, that by opening up the US financial markets to capital inflow from abroad, it was providing ideal investment opportunities, and that there were no major problems because there was a smooth flow of funds.

It would not be fair to say that the United States did not apply some policies to counter the situation. There was a time when it achieved considerable success in decreasing its fiscal deficit, one side of the twin deficit. There was also a time from the late 80s to the first Clinton administration when the US government seemed to put the cart before the horse and defended a weak dollar, saying that regarding the improvement of the trade balance, domestic balances would improve to the same extent if the current account deficit would decrease.

Such an attitude brought about the considerable weakening of the dollar and confusion in the foreign exchange market in 1995, and therefore the government was forced to turn its policy 180 degrees. Since then "a strong dollar is good for both the global economy and for the United States" has been the official comment coming out from the American government.

In all these years, one area where nothing was done was the improvement in the basic savings and investment balance. The American economy has long based its growth on private

consumption. In addition, the economy grew even faster in the past decade or so, based on the myth that the real estate value would forever continue to increase (which is exactly the same as what was said in Asia in the late 90s) while creating an abnormal situation where household savings were zero or even in the red.

If all conditions were the same, increasing savings would mean lowering the standard of living. Even the IMF did not dare to openly demand such a change of course by pointing out the problems. Needless to say, the leaders in the United States could not adopt such a policy easily.

Looking at the situation from the point of view of the providers of funds to cover the American deficit, the key concern is unmistakeably the devaluation of the dollar vis-à-vis their home currency, especially when the financing was in the form of investing their foreign exchange reserves. The problem is evident. For example, if Japan lent a dollar at the rate of 120 yen but received only 80 yen when the loan was repaid, it would lose out not only on paper but in real terms.

"A strong dollar" is crucial and the lenders had been watching the erosion of basic balances in the United States with a lot of concern. The subprime problem occurred under these circumstances, and the credit crunch is its consequence.

It is unclear how serious it will become or how long it will last. But it is clear that consumption will fall because the credit crunch is most likely to hit the financial activities related to household consumption. The situation will, with some time gap, inevitably call for an improvement in the household savings ratio.

If consumption should decrease, investment related to consumption will surely shrink. As a result, it is logical to expect the basic macro-economic balance to improve. In which case, there is more than a small chance that this would shrink the current account deficit to a considerable degree. The so-called housing bubble had already entered the adjustment period before the subprime mortgage problem surfaced, and as a result, last year's current account deficit had decreased to a 5% level. It is now possible that it will drop to a 3% level. (Though even this is not a small deficit)

As I pointed out in my previous article, markets around the world would welcome the improvement of the current account balance and cheer the restoration of the primacy of the dollar. When this should happen, it will be important to note that the reason for the improvement in the current account is not a forced devaluation of the dollar nor over-savings in the fiscal sector but improvement in the savings and investment balance as a rational policy development to deal with the situation the American economy found itself in. Such a turn of events would bring about several by-products, which I will enumerate below.

First, the American public would have to endure a relatively long period of slow growth, recession, worsening employment conditions and lack of income growth (the same problems as are being suffered by Japan). They would have to bear the lowering of the living standard similar to that experienced by the Latin American countries in the 80s. For Asia, this would mean that they would not be able to depend on the insatiable American consumer demand. How to overcome the situation where it is no longer possible to depend on the sales to the United States would be the major problem to overcome.

At the same time, excessive funds that had circulated back to the United States would have to find other investment opportunities. This would include reinvesting part of the accumulated dollar assets. Such change of directions could be said to be the beginning of a major structural reform, which could be defined as the multipolarization of the global economy.

Multipolarization has been discussed over the years, but was not realized for various reasons. This time, however, progress could be made in concrete ways as the United States, which is the key to the issue, tries to cope with the economic situation it faces and pursues certain measures as a logical answer to its problems.

3. Reactions of the Asian countries to multipolarization

One fundamental lesson of the Asian monetary crisis of ten years ago was the instability of the dollar-centric mono-polar situation. I had focused on this point, long before the crisis, and had made proposals based on this premise. For a while, Asian countries had seriously considered leaving the dollar-pegged foreign exchange system. However, in the ten years since the crisis, especially in the more recent years, foreign currency policies (currency of denomination in trade and capital transactions) and foreign exchange rate policies have shifted back to being dollar-centric, just as they were before the Asian crisis. The evidence of the situation can be seen in how most foreign exchange markets are still only against the US dollar.

The current environment that the United States faces and the measures that the country is likely to logically choose, will result in a huge decline in domestic consumption and slowing of economic growth. It is highly possible that the dollar will weaken temporarily until there is improvement in the basic domestic economic balances. International commodity prices are said to be vastly inflating as the international short-term funds that have lost their destination flow into various commodity exchanges. If that is the case, the prices should settle down in the not too distant future.

We must also remember that the inflation of commodity prices is due partly to the weak dollar, as oil producing countries continue to emphasize. Asian countries must analyze and understand such diverse factors. If a country continues to pursue a dollar only, mono-polar system, it is possible to fall into an unwelcome situation where the home currency weakens unnecessarily,

sales to the United States become more difficult and imported goods become more expensive (inflation due to imports).

If the United States changes gear to a multipolar world, whether willingly or unwillingly, then the Asian countries would have to respond in kind. Domestic economic management could become more complex. The situation in individual countries would vary, which I will not touch on here. However, as far as international monetary response is concerned, the outcome would be the diversification of currencies in use. Such diversification of currencies would be seen in two different ways.

One is the diversification in the use of major currencies that are in international circulation. Instead of using only the dollar, efforts would be made to use, for example, the Euro to denominate certain goods exported from or imported to a country. Trade transactions with Japan, which is one of the major trading partners, could be denominated in yen. Some will say that such decisions have to be taken by both sides of a trade, but means could be found to overcome the hesitancy of the counterpart to a deal (except for the United States which is less likely to purchase), if they understand that we are all facing international financial diversification.

The other way in which it will be realized is the bilateral use of local currencies in the region. Technically there could be difficulties in developing this scheme fully. Another lesson from the crisis is that internationalization of home currencies should not be rushed. But it is still a major goal that should not be forgotten as a means to realize direct foreign exchange between local currencies.

Diversification of currencies would immediately mean that the way in which the value of the home currency would be reflected would change. The home currency was always evaluated in the US dollar in a dollar-only environment. Once diversification is achieved, there will be situations where a home currency cannot be evaluated by the dollar. Here the author would like to re-emphasize the importance of an Asian Basket Unit (ABU), a basket of equally weighted dollar, euro and yen, which has been mentioned repeatedly in this column, as the new unit of evaluation to replace the dollar. If such a unit were to be adopted, it would be the first time that a foreign exchange policy could be formed based on the inherent stability of the unit.

At a recent gathering of the East Asia Community, ASEAN members reportedly expressed the feeling that they are “being forgotten by the United States.” I could not help feel that this was a very fortunate situation. It is easy to understand that the United States is absorbed in domestic and international problems unrelated to Asia, and is unable to pay much attention to what is happening in the region.

This means that for the time being, Asia can make a big shift in policies without being

bothered by the United States. We should remember that Japan proposed the Miyazawa Initiative to Asia in 1998 when the United States wanted to concentrate on the north-south American problem. Asian countries are hoping Japan will make a similar, large-scale and comprehensive proposal based on long-term observations.

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Address: 3-2, Nihonbashi Hongokucho 1-chome, Chuo-ku, Tokyo 103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町 1-3-2
電話：03-3235-6934（代）ファックス：03-3231-5422
e-mail: admin@iima.or.jp
URL: http://www.iima.or.jp