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# Newsletter

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## New Developments concerning the Credibility of the Dollar (I)[1]

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The subprime storm that suddenly attacked American markets last summer is hitting countries around the world at an unpredicted speed. Authorities of countries that were hit have taken measures in the early stages, and at least for the time being, a situation which has to be called a crisis, bringing devastating blow to markets in the United States and around the world, has been avoided. However, there are as yet no assurances from commentators that the situation will calm down and be back to normal.

One of the issues that monetary authorities and market participants around the world are watching with intense concern is whether the subprime problem would have any negative affect on the credibility of the dollar in an unforeseen way. This is actually a structural problem of the American economy and has long existed since before the subprime rate problem. The course of the issue will have an extensive impact so it should be handled with the utmost care. This paper will analyze the issues concerning the credibility of the dollar including the views from East Asia.

### I. Uncertainties of the dollar

#### Past debates

I will avoid using statistics since they are available anywhere and including a lot of figures in writing only makes it clumsy to read. However, it is well-known that the US current account deficit and foreign debt as a direct result of the current account deficit have accumulated at a breath-taking speed. Economists, government officials and politicians around the world all agree that such a situation just cannot continue. Most American commentators would agree, when they do not have to take politics into

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consideration, that this is a situation that cannot continue.

More recently, a few people have made more optimistic comments saying that the current account problem is beginning to be solved. This is based on the fact that the deficit which had been over 6% of GDP has declined in the past year to the range between 5 and 6%. But we should not forget that it was said to be unsustainable when the deficit first reached 5%.

Along with the current account deficit, foreign debt is growing at an incredible speed. At the beginning of the 80s, the United States had a net credit of 500 billion dollars, but 25 years later, it has a net deficit of 2.5 trillion dollars. So a current account deficit of 3 trillion dollars had been accumulating in the meantime. That such a situation would never occur in other countries is evident. The Asian monetary crisis of ten years ago began when it was found and publicly pointed out that "the short-term debt that had to be repaid exceeded the amount of the foreign currency reserve on hand." The American foreign payment reserve is in its home currency, so the moment they are asked to make the payment in a currency besides the dollar, the credibility of the dollar crumbles from the bottom.

How is it that the structure had somehow lasted this long? One reason is that the dollar has been the only international currency as well as a key currency. There was hardly a doubt that the United States was the last port of call because of the size of its economy, strength of technology, military and diplomatic capabilities, and attraction of its culture and strength of its ideology. Besides, even those who might have had some doubts about the United States did not really have any alternative. These factors had supported the dollar as the key currency and continued to allow the dollar to play the role. The United States has continued to be the only country in the world that can buy from other countries on credit in their home currency.

It is also true that in the last ten to fifteen years, many other major countries suffered from one economic problem or other, and the US economy, in comparison, had shown steady growth. Japan and other developed countries tried to shift from a growth economy to a mildly growing economy, using social change and structural reform as leverage. Developing countries, on the other hand, were trying various measures to put their economies on a high growth path. For all these countries, exports to the United States were the key growth factor because the United States was a huge and dependable market with consumers that have an insatiable appetite for consumption. In other words, the strong economic growth and consumption of the United States had supported the global economic growth. Some point out that the US market is an example to others, free from regulations and full of competition. That is completely true in one sense. But it can be seen as a clever mechanism for the United States, which lacks the capabilities to supply its huge consumption market adequately, to buy goods from around the world most effectively.

When a country continues such over-consumption while, by necessity, accumulating a huge current account deficit, it runs short of liquidity in payment reserve and faces a liquidity crisis, then a monetary crisis. (We saw this pattern more times than we care to in Latin American countries and others.) However, such a situation has not developed in the United States. What has been happening is that the United States has been distributing US dollars around the world equivalent to its deficit. If nothing had been done, then the dollar would have gone on a free fall from over-supply in the foreign exchange market. But since this would have created a huge problem for all monetary authorities, except the United States, since they have the US dollar as foreign currency reserve, the other countries were forced to support the dollar through purchasing operations in the market. This led to the accumulation of foreign currency reserves in these countries on the one hand and of foreign debt for the United States on the other. The decisions of these countries are partly justified by the thinking that there was no alternative. There is also the wishful thinking that “things have worked until now, so they should continue to do so in the future.” So the oversupplied dollar in the global market has been financing the US deficit by flowing back to the United States in huge amounts as the last port of call with no other choice.

The discussion on global imbalances began at the IMF about two years ago, and the United States and major creditors began discussing the issue. No one expects any brilliant measures that could solve the issue to come out of these discussions. The major objective of the effort by the major economic players at the IMF is to continue sending the message to markets around the world that the issue is not being ignored and hopefully to stop any critical movements that might lead to the collapse of the dollar from happening. There is no way of knowing whether or not some concrete measures would be announced from the gathering. It is most likely that they are figuring ways to gain more time without putting an unfair burden on certain countries. The United States will make efforts to improve the balance between savings and investment. Creditors will accept a gradual depreciation of the dollar. By slowing the speed in which the US foreign debt accumulates, they hope to stop a further fall of the dollar. I would think this is a good guess of what they are trying to achieve.

**Developments of the Last Few Years**

Living in Japan and dependent on what information the Japanese media brings to us, one becomes ignorant of developments that the media is not interested in. This tends to be true especially regards international financial issues.

On the foreign exchange front, the value of the yen had continued to be steady for about three years until last summer at a relatively cheap level. To indicate how steady the value had been, the yen was able to ignore the foreign exchange risks against the dollar (which means against other currencies as well), which was unthinkable previously, and investors were able to benefit directly from the cheap funding cost of the yen, i.e. to raise funds in yen and manage them in other currencies. (This is, as is well known, called the yen carry trade). This may remind some people of the kind of transactions that were conducted with Asian currencies during the dollar-peg years. The big difference is that in those days the monetary authorities of affected countries were telling the markets that their currencies were "de facto dollar-pegged" and tacitly allowed the notion to prevail that foreign exchange risk was limited. What has happened with the yen carry trade, on the other hand, is that those initiating the trade assumed the yen would remain cheap and maintain a steady exchange rate, and ignored the exchange risk. The value of the yen was that steady against the dollar. When the yen-dollar exchange rate was that constant, the media and commentators tended to put foreign exchange issues to one side, giving just a fleeting impression that the euro was gaining.

A gradual depreciation of the dollar is already beginning here and there. Its value against the Canadian dollar and against the Australian dollar has dropped notably in the past two years. The value of the dollar against the euro hit the ceiling in 2001 and the real effective rate index, which is one of the foreign exchange rate indices, has been following gradually in the case of the dollar since then. In other words, depreciation of the dollar against the euro and other currencies that are not necessarily so evident from Japan has been slowly but surely occurring.

The currencies that maintained relatively cheap foreign exchange rates despite this tendency have been the Chinese yuan, some of the East Asian currencies and the yen. Various messages have been directed to China from the United States concerning the exchange rate of the yuan in the last three to four years as China's trade surplus expands and foreign currency reserves accumulate. Judging from China's export structure to the United States, appreciation of the yuan would have a direct impact on her exports, and China may not be able to meet the American requests since its social stability is dependent on high economic growth.

Concerning the yen, the explanation by the Japanese government that the country's economic recovery is not yet on a steady course seems to have gone a long way for the Japanese monetary policies to be accepted by the United States. Exchange rate guidance towards a cheaper dollar (higher yen) that has been tried a number of times since the Nixon Shock has not improved the trade imbalance between the two countries. These past experiences are perhaps casting a shadow and there have not been any strict demands by the United States on Japan. The yen's exchange rate against the dollar which had been stable and low may have to change with the surfacing of the subprime problem.

I will put aside a full analysis of the subprime problem for another occasion, but would like to touch briefly on a very interesting issue that comes through when reading various arguments on the cause of the problem. They tend, first of all, to point out "the misperception that real estate prices will continue to increase" as the biggest cause of the problem. This is to say that such misperception stopped investors from having concerns for the risks involved. Second, technicalities of securitization are said to have developed to such an extent that neither the final investors nor the supervising authorities could appropriately judge the risks, and as a result there was no way of measuring the portion that turned into non-performing assets. So the FRB, which should have applied the brakes in a timely fashion by taking the potential risks caused by the increase of subprime loans into consideration, was not able to do so. Market practices could not catch up with the speed of securitization and could not demand necessary disclosure.

What I found amusing is that if we put aside the development of the securitization technologies, which is very much an issue for America that leads in market developments, all the other aspects are the same as those that were pointed out as the causes of the collapse of financial institutions when the Asian monetary crisis erupted ten years ago. Was it because of the lessons learned from that experience that the damage to the Japanese financial institutions was relatively small in the current crisis? Some say that the American economy will not take long to recover because of its potential for growth helped by the natural increase of population and flow of immigrants. But if it should take time, there is no denying that the subprime issue will cause unpredictable consequences.

## II. Detaching from the dollar

There is an opinion that the global economy has been supported by trade and current account deficits of the United States. Paul Einzig called this the "dollar's dilemma" with a grain of salt. He meant that under the fixed exchange rate regime of strict exchange rate regulations, the rest of the world would suffer from the lack of dollars unless the United States was in deficit. On the other hand, if the deficit was too large, then there would be an overflow of the dollar in the markets and the credibility of the dollar would suffer. The Nixon Shock was the US acknowledgement that the basis of the dollar's credibility was suffering. The United States, of its own accord, severed the relationship between the dollar and gold because it no longer had enough gold to cover its foreign debt.

We could say that it was de Gaulle who began the move away from the dollar by asking to convert France's dollar holdings into gold. In the following 50 years, how much of a debate was there about detaching from the dollar? And what measures actually were taken to move away from the dollar? As those who have been involved in international finance for a considerable time know, not so much action has been taken to move away from the dollar as noises may have suggested. So despite the predictions that there will now be a real shift away from the dollar because the US external balances are not sustainable, there is no urgency because past experience suggests that once again, the dust will settle.

Though the talk about detaching from the dollar has come and gone over the years, it is possible that the energy towards such a shift is accumulating deep down in the financial system. In that case, a small incident could serve as a trigger for a significant change, and there could be a shift in the international financial paradigm. I could not be the only one to think that the international financial system is about to face a fundamental change.

The current move away from the dollar is appearing in various ways.

- On a light note, a certain Brazilian model, who is active around the world, announced that she will receive her pay in euros from now on. Do not think that she is just a model. Some say her personal asset exceeds 170 million dollars equivalent.
- On a more serious note, at the OPEC meeting in November 07, there was serious consideration to changing the denomination of oil from the dollar to some other currency or method. One possibility was to denominate it in a unit of a basket composed of the dollar, euro, pound, yen, etc.
- It has been well known for the past twenty or so years that Singapore created a specialized institution for asset management. It manages her foreign exchange reserves except for the amount equivalent to that of the issued home currency and for the amount that was deemed necessary as payment reserve. The portion of the reserves that is being managed is larger than what is not. In the past few years other countries, such as China and the Gulf states, have followed the example of Singapore. The total of what is called the Sovereign Wealth Fund (SWF) is said to be in the 2-3 trillion dollar range.

The case of the Brazilian model is just an amusing story but it could be remembered as the showcase for the current development.

SWF could have a huge ripple effect depending on what may happen from now onwards. Until now most of the funds accumulated as foreign currency reserves were held in the form of government bonds. Government bonds were chosen for an orthodox reason -- as payment reserves, the form of asset has to be the least vulnerable to risks and at the same time be highly marketable so that it could easily be converted into cash. The SWFs that have been created in the last few years seem, for the time being, happy with increasing the outlets for fund investment. They are testing the ways in which investment could be diversified from American government bonds to other means, such as equity and real estate investment, public and corporate bonds, and even speculative investment in the commodities future markets. Such investments aim for an effective use of the dollar holdings beyond the amount necessary as payment reserve, and are not likely to directly affect the credibility of the dollar. As long as the funds are directed to investments in the United States denominated in the dollar, transactions would not lead to the selling of the dollar.

The operations in Singapore are well known not to be limited to the above. It was 30 years ago that the country began using part of its currency reserves to invest in the equities market. Its activities slowed in the first half of the 80s but with the establishment of a new organization, fund management became a serious operation. Government of Singapore Investment Corporation (GIC) seems to have started its activities by investing in non-dollar denominated stocks and bonds, then expanded to investment in real estate development including in accompanying shares and to salvage investment in neighboring countries that were suffering from the aftermath of the Asian crisis. GIC’s funds invested in the construction of huge buildings in Japan and in China as well as in multiple industrial complexes in ASEAN. The denomination of such assets must be in currencies besides the dollar. If the SWFs use their abundant funds to invest in such areas, that should start the move away from the dollar. I believe it is only a matter of time before such developments occur.

One of the lessons of the Asian monetary crisis was the need to effectively invest East Asia’s savings in the region. This led to the proposal for the Asian Bond Market Initiative. An investment fund capitalized by the central banks has also begun its activities. If dynamics were to be created with the example of Singapore, and sovereign investment funds from various countries should participate in major programs with shared objectives in mind, then a dream-like plan could make a huge progress towards realization. Development in the Greater Mekong Subregion, which has been a pending issue since the time of the establishment of the Asian Development Bank, and other projects could come into the category. The larger the amount of funds that is required, the larger in volume the detachment from the dollar would be.

Changing the denomination of oil related trade is an issue that would more directly challenge the credibility of the dollar. There was no announcement about any consideration of changing the denomination or concern about the weakening of the dollar at the OPEC meeting of last November. However, Iran and Venezuela are said to have been the aggressive members (as would be expected). Their points of argument were as follows: 1) change of denomination, 2) adopting instead a basket of currencies including the dollar, euro, yen, and pound, 3) announcing concern for any further depreciation of the dollar, 4) announcement of a shared understanding that the real culprit of the high oil prices in the last few years was the weak dollar.

It is difficult to imagine that Iran, who faces severe economic sanctions, would use the dollar for the settlements of oil exports. On the other hand, price setting is denominated in the dollar so there must be huge foreign exchange losses between price setting and receivables. No wonder their tone would be harsh. If all these items had been included in the joint communiqué as things to be acted upon, it is easy to imagine what a huge impact that would have had. The minute the news hit the waves, buyers of the dollar would have disappeared from the earth. So Saudi Arabia, which is the largest oil producer and a moderate Arab country as well as having close ties with the United States put its credibility on the line to maintain the communiqué within previous limits. But it does remain an important fact that such huge issues were proposed and discussed at the meeting. Depending on the exchange rate of the dollar in the future the same issue could be brought up every year. Pressure for change would be released through debates but it is always possible that at some stage, the situation could just begin moving towards change.

This has been an overview of the current developments related to the faltering credibility of the dollar. I had meant to touch on the relationship between the basket of currencies that has been mentioned as a possible denomination unit for oil prices and the basket (Asian Basket Unit) that I have been recommending for a long time, and denominating the oil imported to Japan in yen. In addition, medium term foreign exchange rate policies of China and Japan, and the role of Japan in dealing with the issues of East Asia are important subjects. I would like to discuss these issues in further publications.

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