

The Dollar Adrift

Europe's increasingly desperate call for currency 'stability' will define the debate in Boca Raton

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Feb. 9 issue - The seaside playground atmosphere of Boca Raton, Florida, will provide an ironic backdrop for this week's G7 summit of the seven major industrial nations, where the world's top finance ministers and central bankers will confront the most divisive issue in the world economy today: currency turbulence.

The war of words has been escalating in advance of the summit. In the past two years the dollar has fallen 40 percent against the euro and 24 percent against all major currencies. Though the Bush administration continues to publicly support a "strong dollar," it's clearly happy with a weaker one, which gives U.S. exports a competitive edge in an election year. Tokyo is openly worried about losing its edge, and has been buying dollars in huge amounts to slow their fall against the yen. Nowhere, however, is alarm as high as it is in Europe, where the euro is rising against both the dollar and the yen, and where top officials have used words like "brutal" to describe the impact of currency shifts on European companies. In recent days Europe's central bankers and finance ministers have issued calls for currency "stability," an apparently innocuous phrase that will be the lightning rod for behind-the-scenes debate in Boca Raton.

The drama will play out this week as U.S. Treasury officials, the summit hosts, send around a draft communique to the other six delegations. Most of the paper will be boilerplate, committing every country to pursue "sound policies"—which means, in plain English, to help correct the gross imbalances in a world economy that is now driven mainly by U.S. growth, and threatened mainly by U.S. debt. Washington will give lip service to cutting deficits, Europe will rehash its commitments to cut social spending and improve the climate for job creation and Japan will promise (again) to clean up its banking mess. But the real tussle will come over whether the communique emphasizes "stable" currency rates, as the Europeans and Japanese desperately want, or letting "market forces" determine exchange rates, as Washington prefers.

The release of the communique will be less important than how top officials spin the inevitably vague language in the hours that follow, says Daniel Tarullo, a law professor at Georgetown University and former special assistant, for international economic

affairs, to President Clinton. Currency markets will jump on every word. If the word "stable" appears, does that mean that Washington has agreed to slow the dollar's descent? Does it mean that the European Central Bank will either intervene in the market or lower interest rates to slow the rise of the euro? If the term "market forces" appears, does it mean that Japan will stop artificially depressing the yen with massive market interventions? Will it mean a side deal was struck with China to loosen the peg of its currency to the falling dollar, which effectively makes already cheap Chinese exports even more competitive?

Whatever the summiteers say, no currency shift will last unless the G7 quickly backs up its words with action, warns Jeffrey Shafer, vice chairman for international investment banking at Citigroup and former undersecretary of the Treasury in the Clinton administration. This action could take one of two forms. Governments could intervene in foreign-exchange markets in a concerted fashion to buy or sell currencies to achieve a jointly agreed target value for the dollar. Or they could change interest rates to make their currencies more (in the case of the United States) or less (in the case of Europe and Japan) attractive to investors.

Most likely, the G7 will muddle through after Boca Raton. The conflicts may be relieved in part by changing circumstances. The strong U.S. recovery may draw foreign investors to the dollar and slow its depreciation. This is likely to be a temporary phenomenon, but there are signs it's happening. In November, the last month of good statistics, non-American investors bought nearly \$90 billion of U.S. securities, compared with less than \$30 billion in October. Last week the U.S. Federal Reserve vaguely hinted that it was preparing to raise interest rates later this year, and this could also encourage more foreign investment in the United States.

For all its alarmed rhetoric, Europe is less vulnerable to global currency shifts than it once was. In the 1980s and early 1990s, before there was a euro, the soaring German mark caused painful disruptions in the tight network of intra-European trade. Today the rising euro has far less impact because 90 percent of Europe's trade is conducted between European Union members in their new common currency. Asked to gauge the pressure on governments to realign their currencies on a one to 10 scale, Princeton economist and former U.S. Federal Reserve vice chairman Alan Blinder says, "We are at about six now, but the heat is rising."

Exchange rates are signaling long-term anxieties about the underlying state of the world economy. The U.S. Congressional Budget Office last week released yet another upward revision of America's widening fiscal deficit, projecting an additional trillion

dollars of red ink over the next decade compared with the forecast it made just six months ago. Japan cannot sustain a strong yen and continue to grow, at least as the economy is now structured. Europe is not competitive enough to live for long with a superstrong euro, which threatens to raise unemployment rates still higher and stall economic reforms completely. And while China has become the second engine of global growth, its breakneck expansion is leading to bottlenecks and inflation, and its overvalued yuan only contributes to the threat of overheating.

At some point after this G7 conference, something will have to give. One possibility: after November, a re-elected George W. Bush begins to address the deficit, as President Reagan did in his second term. Alternatively, a new Democratic administration starts its first term by raising taxes, as President Clinton did when he came into office. Either move would moderate downward pressure on the dollar. Given the current level of concern about an upcoming fiscal train wreck, I give these scenarios a 25 percent probability. More likely, a rising euro will become too painful, and the European Central Bank will decide to lower interest rates to make its currency less attractive to investors. I give this a 75 percent chance, even before summer. A variant on this theme would be for the ECB and the Bank of Japan to team up and intervene in the market to keep both the euro and yen from rising.

In a third scenario, governments will continue to follow their current dangerous paths, forcing the markets to do their work for them. At some point—and no one can say when—there could be a huge sell-off of the dollar. Perhaps foreign investors will tire of financing Uncle Sam, and accumulating dollars that are falling in value. Perhaps oil-exporting countries will tire of being paid in increasingly depreciated dollars and ask to be paid partially in euros. Maybe one or two big investors will just get fed up with soaring U.S. deficits, to be followed by the rest of the financial herd. In response, the dollar will sink faster, the U.S. stock and bond markets will beat a hasty retreat and world markets everywhere will fall into serious disarray.

In that event, the next G7 summit could be an emergency meeting. This is a real possibility, and while none of the officials at Boca Raton will talk about it, the prospect will keep them from sleeping too well in their Florida suites.

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