

The Dollar Deluge

The Bush team signals that its 'strong dollar' policy will be a reflection of its military policy: ideological and unilateral.

By Jeffrey E. Garten
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Nov. 29 issue - There was one telling sign about U.S. Treasury Secretary John Snow's trip to Europe this past week. Everywhere he went he reaffirmed that the Bush administration supported a strong dollar. But while traders and investors from Wall Street, London, Tokyo, Hong Kong and elsewhere listened intently to Snow's every word, they weren't convinced by his mantra. Fact is, as Snow made his way from Dublin to Berlin, with interim stops in London and Warsaw, the greenback dropped against the euro, the British pound, the Swiss franc, the Polish zlotys, the Japanese yen, the South Korean won and the Canadian dollar. Meanwhile the price of gold, a classic hedge against the dollar, reached a 16-year high.

There are at least two ways to look at Snow's words and the global reaction to them. To begin with, no matter what the secretary says and how many times he says it, many investors and traders are skeptical, either of the Bush's commitment to a strong dollar, or of its ability to do what is necessary to achieve a strong dollar—namely restrain the U.S. budget deficit.

A second way of evaluating Snow's trip is that he left little doubt that the Bush administration would now behave in the international economic arena much as it has in the political and military sphere. It would speak confidently if not arrogantly, and it would not shy away from pressing its strong ideology around the globe. It would invite other countries to participate in its plans, but in the end it would move ahead with or without them. Its dollar policy will be a mirror of its Iraq policy. For a world hoping to see signs of a new, more diplomatic American approach in Bush's second term, these are disappointing signals.

Snow has been attempting a delicate balancing act on behalf of the Bush administration, and whether or not he is successful will be known only during the coming months. But the risks are mounting that world markets will not cooperate. In a speech to bankers in Frankfurt on Friday, Federal Reserve Chairman Alan Greenspan warned that foreign investors could soon decide that U.S. interest rates (and returns on their money) were too low, and that a depreciating dollar would continue to erode the value of their U.S. holdings; they might then reduce their exposure. His comments sent the dollar plummeting further, to record lows against the euro and the yen.

On one hand, officials like Snow are trying to convince global financiers that despite America's huge budget and trade deficits, Washington's policies are on track to achieve both strong economic growth and a narrowing of America's international borrowing requirements. Those requirements are nearing \$2 billion per day, which is about 75 percent of all the savings generated by countries in Asia and Europe from their trade surpluses.

On the other hand, U.S. officials are exhorting the world to work in unison to achieve a more balanced and robust global economy. Snow's plan, as outlined to an audience at London's Royal Institute of International Affairs last Wednesday: (1) increase savings in the United States so it can reduce its foreign borrowing; (2) expand growth in Europe and Asia, so that these regions can import more from America and take pressure off U.S. trade deficits; and (3) ensure that Asian countries such as China, Japan and South Korea do not hold their currencies artificially low by selling them in massive amounts to purchase dollars. Were Asian governments to allow their currencies to float upward, Snow's reasoning goes, the dollar would become weaker against them and stimulate more American exports. "The [U.S.] current account is a shared responsibility," Snow said.

Translation: the U.S. wants others to clean up the mess it has made. Indeed, since 2001, foreign financiers have seen federal projections swing from a 10-year *surplus* of more than \$5 trillion to a *deficit* of more than \$2 trillion, a swing of \$7 trillion. They see that Bush's plan to make permanent its substantial first-term tax cuts would add another \$2 trillion to the 10-year deficit. His determination to partially privatize Social Security could cost yet another \$1 trillion to \$2 trillion. Finally, traders and investors discount Bush's ability to cut spending in any meaningful way, since 80 percent of the budget is comprised of virtual untouchables such as defense, homeland security, legally mandated retirement and medical entitlements, and interest on the federal debt.

The markets are therefore betting that whatever the administration says, it is relying on a gradually depreciating dollar to narrow its current account deficit and take some of the heat off its foreign borrowing requirements and its \$3 trillion foreign debt. Indeed, most financial experts believe Washington wants a weaker dollar and will not stand in the way of its fall.

Last week Snow laid out the Bush administration's free-market philosophy in a quasi-moralistic tone that implied Washington was on the side of virtue. The United States was all about expanding liberty, he said, and pressing for higher economic growth and freeing up markets was the strategy. "Business growth, free markets and financial reforms lead to a better life for citizens of any country," he told the crowd at the Royal Institute. "And with a better life comes an increased esteem for fairness, liberty and equality, which is good for the human condition."

Snow praised Ireland and the European Union's new members, such as Poland and Hungary, for their energetic entrepreneurship and economic reforms, and he criticized France and Germany for their lack of both. He was gentler on China, but he implied that American pressure on Beijing to liberalize its exchange rate was continuing and would pay off.

Most significant, he poured cold water on international financial collaboration. In London, Snow was asked whether Washington would consider a currency agreement along the lines of the 1985 "Plaza Accord" between the United States, Germany and Japan—an agreement that succeeded in fundamentally realigning major currencies and is credited by many experts with stabilizing global financial flows and paving the way for a substantial expansion of global trade. He replied, "I think that the history of efforts to impose non-market valuations on currencies has at best been unrewarding and checkered."

The big question now is whether the administration will overplay its hand in trying to pressure others to push down the dollar. As Stephen Roach, Morgan Stanley's chief economist, has said, "Washington is depending on a new coalition of the willing—the Fed, other major central banks and politicians and policymakers from around the world."

If this coalition doesn't hold, a currency debacle could follow. Indeed, the greenback may have to sink another 20 percent for the current account to be sustainable. The events Greenspan warned of last week would force the Fed to jack up interest rates to make investing in America more attractive. That, in turn, could cause a recession in the United States, with worldwide repercussions. Asia and Latin America could be hit hard. Their exports to America would slow. And since oil is priced in dollars, if their currencies rise versus the greenback, their oil imports would become more expensive. Also, if U.S. interest rates rise, they will suck funds out of emerging markets.

The deeply unbalanced global economy, with the United States running such large deficits and Asia in particular running such huge surpluses, has had markets worried for several years now. There are nevertheless many officials who believe that this situation can continue for some time. They say the arrangement has allowed Americans to consume all they can and Asian producers to sell all they can—a mutually beneficial deal. In addition, given that the U.S. growth is solid and that its interest rates are rising, foreign investors may be willing to continue supporting the lopsided pattern for quite a while. Still, there are reasons for heightened concern, and they have to do with rising uncertainties in the global financial system, and the coarse nature of U.S. international economic diplomacy.

The efforts that China, Japan and South Korea have made to keep their currencies low and competitive is hurting Europe, which is being squeezed by both a lower dollar and a lower yen and renminbi. Indeed, the superstrong euro could soon become a significant drag on European growth and job creation, both of which have been lackluster to begin with. Looking ahead, the course of the European Central Bank is not clear. Will it lower its interest rates to take pressure off the euro? Will it intervene in markets to slow the descent of the dollar? Judging by the recent chorus of complaints about the weakening dollar from European officials—including ECB president Jean-Claude Trichet, French Finance Minister Nicolas Sarkozy and German Finance Minister Hans Eichel—the angst on the Continent is rising fast.

In Asia there are big unknowns, too. For the time being, Japan has ceased its massive purchases of dollars designed to hold down the yen, but recent economic reports show that the economy may be sputtering, raising prospects for a return to large-scale interventions. As China struggles to let the steam out of an overheated economy, markets expect some loosening of the tight link between the renminbi and the dollar, but when and how much is anyone's guess. Beijing has highly sensitive considerations to weigh, including threats that any change in the status quo will undercut its shaky banking system.

These uncertainties have to be seen in the context of another one—the behavior of global markets that have grown in size and complexity these past few years, and whose behavior simply cannot be confidently projected by anyone. Between April 2001 and April 2004, for example, daily global turnover in foreign-exchange markets increased 57 percent to \$1.9 trillion. At the same time, trading in complex financial

instruments called derivatives—instruments that have intertwined credit risks around the world in ways that no one could possibly understand in their entirety—grew 77 percent to more than \$1 trillion per day.

Last week there were some tentative indications that the foundations of global finance were moving to shakier ground. As Snow was winding his way across Europe, the latest statistics (for September transactions) were released, showing that Asian central banks, heretofore the major lenders to the United States, had slowed their lending. The slack seemed to have been picked up by private European investors and U.S. hedge funds, but both are prone to bail out much quicker than governmental and institutional investors.

Ultimately markets want to see ministers and central bankers backing their rhetoric with concrete policy measures such as interest-rate changes, budget cuts and currency interventions. They also want to see governments cooperating with one another, or at least not working at cross purposes. Despite everything Snow tried to do this week, there is little indication that either is happening.

This much does seem certain. During its first term, the Bush administration focused all its attention on fighting terrorism, on the wars in Afghanistan and Iraq, and on containing nuclear proliferation in North Korea and Iran. Odds are it will now have to broaden its international priorities to economic matters, and that currency and related trade issues will now compete for center stage in American foreign policy. Snow's trip was just Act I, but unless the script gets better, the ending could be as disappointing as in Iraq.

Jeffrey E. Garten is dean of the Yale School of Management.

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