Saga of the shrinking US dollar

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It has become increasingly clear in recent times that the US dollar, after all, is not as mighty as many had believed. The greenback has been falling against the euro and the yen with hardly any pause. The euro was worth just US$0.81 in July 2001. Now its value has surpassed US$1.24. This means that the dollar has shrunk by as much as 35 per cent. The dollar has also fallen against the yen by more than 25 per cent since March 2001 to 107 yen.

To be sure, the fall in the value of the dollar stems from its own weakness, for it has nothing to do with the strength of the euro or the yen. There is absolutely no reason why euro or the yen should appreciate on their own now, as the economies of the Euro zone and Japan are limping. It is estimated that these economies would manage to grow only by 0.5 per cent in 2003. In other words, neither the euro nor the yen are really strong, but the fact of the matter plainly is that dollar is unambiguously weak.

How come the dollar is weak at a time when the US economy is showing a strong turnaround? It is of relevance to note that the US economy posted a robust 8.2 per cent growth in the third quarter of 2003. Indeed, the dollar should be appreciating, not depreciating, if the phenomenon we are witnessing is purely cyclical in nature. But this is not so. On the contrary, the problem is essentially structural and systemic. The weakness of the dollar is a reflection of the serious structural imbalances in the US economy. The ballooning twin deficits, domestic and external, are a taking a toll on the dollar's exchange rates. The budget and balance-of-payments deficits to the tune of US$1 trillion a year is too heavy a burden to bear even for the world's largest economy.

It is readily obvious that such conditions are not sustainable by any stroke of imagination. To sustain such imbalances, these deficits will have to be financed. To finance them, the US will have to depend on a steady inflow of foreign funds. The US has been able to run huge deficits in the past, simply because it has also been the largest recipient of foreign capital. It is not sure if the US will be able to do so just as well in the years to come.

Already there are signs that the US is losing its attractiveness for foreign funds. Low interest rates are no more than a part of the explanation. The Middle East funds are steering away from the US in the aftermath of the 9/11 infamy and the ongoing so-called war on terror. Even the Japanese and European sources appear to be shying away from the US. It is not at all surprising that the dollar takes a beating under these circumstances. The falling dollar and the expectations that it will continue to fall provide an incentive for funds to be transferred from dollar-based assets to euro-based or yen-based ones, adding fuel to the fire.

How low will the dollar go? That would depend mainly on how much and how soon the US external payments situation will improve. The dollar depreciation is certainly good for the US economy. By making exports cheaper and imports more costly, the falling dollar will increase exports and reduce imports, thereby improving the country's balance of payments (BOP). Understandably, the US administration is gleefully doing nothing to arrest the decline in the external value of the dollar, notwithstanding its declared commitment to the strong dollar principle.

The fact however remains that, while a weak dollar would help redress the situation by reducing the US external deficits, exchange rate depreciation alone cannot eliminate the country's yawning BOP deficits for two important reasons. First, the brunt of the adjustments has thus far been on the euro, whereas the bulk of the trade deficits of the US are with East Asia. No doubt, the dollar has fallen against the yen as well, but the exchange depreciation against the yen has been somewhat muted by Japan's active interventions in the foreign exchange market to prevent the yen from growing too strong for its own good. For Japan is relying primarily on exports to breathe new life into its flagging economy, while a strong yen at the present juncture would dampen the economic recovery, which looks very fragile in any case.

The US bilateral trade deficits with China, hovering around US$100 billion a year, are particularly far more worrisome. It appears that China is enjoying an unfair trade advantage, as the external value of the yuan remains completely out of sync with the economy's growing prowess as shown by its high GDP (gross domestic product) growth rates and swelling foreign exchange reserves. Estimates have it that China's yuan is undervalued by 25-40 per cent. The yuan has been depreciating with the sliding dollar as the former is pegged to the latter within an extremely narrow band. There have been talks of international pressure being brought upon China to revalue its yuan, but to no avail. All indications are that China will resist such pressures and stick to its current exchange rate of 8.3 yuan to the dollar. For any revaluation at the present moment will slow down economic growth in China and might throw its debt-laden state-owned enterprises and weak financial institutions totally out of gear. Needless to say, any major economic convulsion in China will have far-reaching fallout elsewhere in the region, given its extensive regional linkages.

Instead, China is likely to bridge its trade gap with the US by other means, which include sending "buy American" trade missions. For China knows only too well that the huge bilateral trade deficits with the US is bad for Sino-US relations. There are also fears in China that the US might resort to unilateral actions to curb imports even if these fly in the face of the World Trade Organization (WTO). Hence the urgency to import more from the US. It is, however, pertinent to underline that China's trade surpluses with Europe and North America have been offset to some extent by its trade deficits with East Asia.

The second reason why the US deficit problem will persist, despite exchange rate changes, is that the US suffers from a systemic imbalance between production and consumption. To put it bluntly, generally speaking, the Americans are living beyond their means. Excess demand finds expressions in trade deficits and BOP shortfalls. The solution for the US then is to reduce consumption and increase production. This, however, would be bad news for the rest of the world. Undeniably, the profligacy of the US consumers and the US government has fueled the growth of the world economy. To put it differently, trade partners of the US should be grateful for the US deficits, as they have benefited from them. Put bluntly again, it is in the interest of the rest of the world that the US continues to register deficits, which the US might also enjoy doing provided that there is adequate capital inflows to finance its deficits.

Herein lies the crux of the problem. The trade partners of the US need to recycle their surplus in such a way as to funnel funds into the US economy. They have done it in the past. But will they do it in the future? One cannot be so sure. Much would depend on how appealing the US assets will be to foreign investors. If the current erosion of the dollar leads countries to dumb the dollar in favour of the euro, replacing the dollar with the euro as the main international reserve currency, it would further depress the demand for the dollar, the economic implications of which seem somewhat scary. This would indeed be the case, especially if the shift is rapid and substantial, although all this sounds like a self-fulfilling prophecy.

Without a question, all would suffer if the dollar were to experience a free fall, a worst-case scenario, which admittedly sounds farfetched. A more down-to-earth outcome will be one where the US deficits are significantly reduced through exchange rate adjustments not only in the US but also in other countries, with the surpluses of some countries financing the deficits of others, while the US strives to fix its structural problems.

Clearly, a soft landing for the dollar is good not only for the US but also for the global economy at large. As alluded to earlier, the burden of adjustment in recent times has fallen mainly on the euro. The Europeans are asking why should the euro go it alone in cushioning the fall of the dollar, although the European Central Bank (ECB) seems somewhat unperturbed, as the current exchange rate of $1.24 for the euro is not too far from $1.17 when the euro was first launched. Nonetheless, the euro zone is already paying a price for this by losing export competitiveness, with the strong euro hurting economic growth and undermining employment prospects. This observation calls for adjustments in other currencies as well, especially those that are shackled to the US dollar, such as the Chinese yuan, the Hong Kong dollar, the Malaysian ringgit and the Saudi rial.

It is unlikely that any of these currencies would budge any time soon, as they are quite comfortably saddled on the greenback as exporters of manufactures, except for the Saudi rial. But they cannot hold on for long, especially if the dollar continues to shrink with no respite. Some analysts are predicting that the dollar will fall to 1.30 against the euro in the near term. The prospects of the dollar diving to the 1.50 level against the euro in 2004 are more than a theoretical possibility. Should the dollar stoop so low, all currencies that are currently tied to the dollar, including the ringgit, will have to de-peg and run for cover.

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