EAST ASIAN CAPITAL FLOW
AND WORLD FINANCIAL STABILITY:
WILL THERE BE A FREE-FALL
OF THE U.S. DOLLAR?

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Introduction:

I would like to direct your attention to something of great importance to the Canadian economy, to a phenomenon of which one could ask---is it likely to have an abrupt dramatic effect on the value of the dollar? The matter is this. Latterly we’ve seen a massive accumulation of international reserves, one in which foreign Central Banks are buying U.S. dollar assets, U.S. treasury bonds, notes, and so on. We’ve seen an extraordinary amount of purchases in unprecedented magnitudes, by Japan, China, Korea, and other countries. I’ll argue today that there are special considerations driving these recent developments and limiting the appreciation of these Asian economies. This is a fragile situation and adjustments are likely to occur. One scenario, what I call the ‘firesale’ scenario, involves a very abrupt adjustment in the dollar.

The U.S. current account balance, which is shown in the graph above, was of an unprecedented magnitude in 2003, 5 percent of GNP, 531 billion U.S. dollars. Now, U.S. current accounts need to be financed, and what we’re seeing is a private financing, but
also most importantly now, a public financing of this. That is, foreign governments are purchasing dollar assets of a magnitude that’s unprecedented. When you have current account deficits, wherever the countries are, usually the private capital is coming into the country. And that’s been the case in the past history of U.S. current account deficits.

What’s remarkable about this year and last year is that $249 billion, about 45 percent, of the U.S. current account, is being financed by official capital flows in the United States. That is, by intervention in foreign exchange markets, meaning dollar purchases of assets. Now, this is the largest on record. As I said it’s unprecedented and it’s up from $113 billion in 2002. You’ve seen similar magnitudes continuing this year as last year, and the question is why? Why are governments suddenly changing their behaviour and purchasing U.S. dollar assets of such magnitudes? What governments are financing the deficit and why are they investing so much in U.S. dollar securities? That’s the topic that I want to address today.

Section 1:

The factual answer is very simple; we have good statistics on this, and the deficit is being financed by Asia. Asia has massive reserve holdings—$2 trillion in early 2004. We’re talking about a regional concentration and of a few countries holding massive dollar reserves. This is a big change from the past, when it was mainly industrialized countries—Japan obviously is an exception here—but mainly industrialized countries holding reserves and managing exchange rates of sizable magnitudes. Now, we’re seeing countries like China, which are playing a very predominant role. Let’s look at the top holders of foreign exchange reserves, which, you’ll remember are, simply U.S. dollar government assets being held by foreign governments.
The way a country gets such assets is by buying dollars in the foreign exchange market and investing them in dollar securities. For such countries—Canada, China, Japan—those U.S. dollar assets are their foreign exchange reserves. There’s nothing mysterious about it. But the question is, who’s holding them? 767 billion held by Japan, that’s the stock in February 2004, 430 billion by China, 225 by Taiwan, and by South Korea, somewhat less.
The graph above gives an idea of how international reserves have grown, and at its bottom is industrial countries. And you can see that reserves in industrial countries, that bottom yellow block, haven’t grown that quickly. They’ve grown, but it hasn’t been that extraordinary, compared to what you see in the red and the blue areas above them, which are essentially emerging markets. Of countries in this yellow block of industrial countries, it’s mainly Japan here. Japan has about 767 billion dollars; the total industrial countries only have about a trillion dollars, of which the majority, almost 80 percent of it, is held by Japan.

Now, of the other emerging markets, and the blue represents Asian emerging markets, [their size] means that you have emerging market economies—not rich economies, but emerging markets—that are purchasing, hand over fist, U.S. assets. The issues I want to raise and address are:

1. What are the motivations underlying this shift in behaviour?
2. What are the implications for world currency values, particularly for the U.S. and Asian countries, (though I also reflect a bit on Canada)?

3. Are these official financings of the U.S. current account deficits sustainable? How long can this go on and what are the implications for private financial flows and currency values if this public financing slows down? It could stop, but what if it just slows down, what are likely to be the effects?

Section 2:

I’m going to go through three arguments. I am an academic, so these are academic arguments, but they actually have real, concrete meanings. Of these three arguments, which I’m going to go through quickly, the first is trying to explain motivations. It could be called ‘Stabilization of Exchange Rates in the Short Run’; that is, is it possible that this huge accumulation is simply trying to manage and stabilize exchange rates. Second is what I’ll call ‘Precautionary Demand’; that is, that there’s so much uncertainty in the world economy that you want to build up a big ‘war chest’ in case you need it sometime, for example to protect your currency or economy from really big economic international shocks, such as the Asian Crisis of 1997. It would have behooved Korea, for example, at that point in time to have had massive foreign exchange reserves. The third explanation that I would like to put forward is a reference to the Financial Times article by a colleague of mine, Michael Dooley, and it is called ‘Sophisticated Mercantilism’. The argument there is simply that you want to maintain undervalued, fixed exchange rates for an extended period for development purposes, if you want export led growth and you want to do it by having and maintaining low exchange rates.
Let’s go through these three arguments. Consider the first view, that of holding large reserves to stabilize exchange rates. The motive here is to reduce short-term currency volatility. The Bank of Japan and other Central Banks usually highlight the value of intervention in order to try to maintain exchange rate stability. The Bank of Canada holds 17 billion dollars worth of reserves, U.S. dollar reserves, and they do that to intervene in foreign exchange markets and to try to dampen volatility. Now, new evidence, from work which examines intervention, and that one of my colleagues, Rasmus Fatum from the Business School at the University of Alberta, and I have done, [shows that intervention], especially if it’s coordinated, is effective in the short term. If we try to stabilize exchange rates, intervention can have an effect, but we’ve shown that it is a short run effect. If it’s against fundamentals for a sustained period, then intervention alone, just buying or selling currencies by Central Banks, will not be able to fix an exchange rate. And this work has been on Japan, Germany, and the Euro area. But more than that, this kind of analysis of the stabilization function of foreign exchange market intervention doesn’t explain the massive one-way buildup of reserves. If you’re really trying to stabilize a price, and that’s all you want to do, to stabilize or reduce volatility, then presumably you’re intervening in both sides of the market, i.e. you’re buying and selling the currency in order to try to dampen its movements, but not changing the trend of direction. But when you’re accumulating reserves massively in one direction, it suggests you’re trying to fix the price against the trend movement. So this argument, which I call the ‘Stabilization’ argument, doesn’t really address the issue.

The second argument, which is called the ‘Precautionary’ argument, is basically based on the idea that you want to smooth consumption. What I mean by that is that you
want your economy more stable, so that if you do have a serious recession, you want to be able to draw on your reserves to try to finance capital formulation and other government activities, as an insurance mechanism, basically. That’s why we call it precautionary. It’s the idea that Alberta, for example, has a large oil fund, so that when bad times come they can draw on that fund to help stabilize the public sector. That’s an argument for precautionary demand. And you can say international reserves are self-insurance against foreseen output declines. One of my colleagues in Santa Cruz, Joshua Aizenman, has done a lot of work in this area.

Now, if you look at each of these cases, each of these explanations, separately, this argument has some merit, in my view. You see that the 1997/98 Crisis had a huge impact on the Asian economies and their demand for precautionary reserves jumped. Suddenly, places like Korea decided they needed a lot of reserves to make sure they wouldn’t have to go to the International Monetary Fund in the future. As you can imagine, it was a humbling experience for Korea to be forced to go to the IMF and talk to the U.S. Treasury to get enough reserves to stabilize their exchange rate and get their economy moving. And as a consequence, Korea now has been on a path to try to build up reserves. I visited Korea in 1998, right after the crisis, and it was amazing how the whole country spoke of trying to avoid a collapse and of going to the IMF again by building up savings and reserves. That was an argument that seemed to work for a couple of countries.
I’ve just added above a chart from a paper I wrote showing that crises do have huge implications. Basically, this is just showing the output collapse at time $t$, where $t$ is the time for currency crisis for different countries. We’ve got Turkey, Mexico, Korea, and Indonesia at different points in time, and these sharp drops show that all these sharp collapses, currency crises, are associated with big output declines. In the vertical axis is output, and this negative movement here is just suggesting that you see very sharp output costs associated with currency crises. It’s not just hypothetical that this may be bad for the economy: when you have currency collapses and sudden stops in capital flows, you have big output losses. And these, in large part can be averted if you have a large enough ‘war chest’ of international reserves to avoid these problems. So that is one reason why you might want to build up reserves.
And in fact, the empirical evidence for Korea suggests this is a major motivation for accumulating reserves. This is based on empirical work; I’m referencing this article by Aizenman and Marion, a series of articles that would suggest that there are good reasons that Korea did this, and taken from a statistical point of view, it seems that uncertainty, more than the export receipts, drove the demand for reserves. Because export receipts fluctuate a lot, as a consequence they wanted more reserves. And you see that Korea has opened up its markets to much more risk sharing by allowing foreign investment in their firms, stock market, what have you. 40 percent of the equity in Korea now, of total market capitalization, is foreign shareholders, and it used to be closed almost entirely, so that’s a huge change. But, the big players, with really massive accumulation of reserves, are China and Japan. And precautionary motivations can’t explain that—they’re too large.

Precautionary motivations do not explain flat exchange rates. The Yuan has been absolutely flat against the U.S. dollar since 1994. What’s the motivation for that? This is where the argument for fixity and sophisticated mercantilism come to play. It’s just not China. What you see if you look at the Taiwan dollar, is that it’s been relatively flat, much more stable than you would expect. The Malaysian Ringgit and the Singapore Dollar are flat the whole time. And you see the Korean Won has been roughly stabilized over the last few years. All these smaller East Asian economies also have much more fixity of exchange rates vis-à-vis the U.S. dollar, combined with a rapid accumulation of dollar reserves. The fixity of exchange rates and the massive accumulation of reserves suggest that there is a conscious move to maintain undervalued exchange rates in the
Exchange Rates of KRW/USD, MYR/USD, SGD/USD and TWD/USD
also very stable against dollar since 2001

region. That is, we’re seeing much more of a U.S. dollar-fixed exchange rate system, or
very much fixity emerging in the region.

Emerging markets plus Japan, and I’ll talk about Japan in a moment, are
intervening in order to manage exchange rates, and China in particular stands out. It’s got
the largest current account surplus accumulation of reserves of any merging market and
it’s also got the tightest capital controls. That is, it’s very difficult to get money in and out
of China without regulations. Now, look at China’s current account balance in the ‘90s.
This is an emerging market, and classical economics or development economics would
suggest that what a poor country does in a development phase is to have current account
deficits, import a lot of capital, use that capital to increase their production facilities, and grow more rapidly. China isn’t following a “traditional” model, but following more of what you may call the “Asian” model, the model established by Korea and Japan. And so what you see is a series of current account surpluses together with very rapid economic development. Combined with those current account surpluses has been this growth in reserves that I spoke about. This is the accumulation that has led to the massive stock mentioned earlier.

This leads me to the third view, to explain what’s going on with China I think you need to look at the sophisticated mercantilism argument. This is a series of arguments that we’ve seen put across—most recently by Michael Dooley, Folkerts-Landau, and Garber, who have written a series of papers looking at the motivations for the accumulation of reserves in China. They call it ‘modern mercantilism’ and see it as based on export competitiveness as a development strategy. What you see is a heavy intervention and build-up of reserves, where they’re buying dollars massively to keep the
China won undervalued. Now, why might they do this? Their argument is that China is a very big country, with 1.3 billion people, and almost unlimited resources of unemployed labour. China today, by official estimates, has 115 million migrants moving from the countryside to urban areas. This is fueling industrial health. I was looking at a New York Times article last week on China, official estimates are suggesting—these are obviously wild estimates—but nonetheless official estimates are suggesting 115 million, and this could become 300 million by 2020. What we’ve seen in the last couple of decades in China is the largest migration in human history, in terms of magnitudes of people. To give an example, many people say that the Irish migration to North America was really massive. And it was, over 60 years you saw 4.5 million people moving. We’re talking today, in China, of 115 million people. This is recent, not over 60 years. The ability to move around in China as a worker really only emerged in the early ‘80s, when you were able to be given national identity papers that enabled you to move to the coastal, industrial zones, and so on. Against the juxtaposition of having large unemployed labour resources, the development strategy which had very rapid growth, based in turn on at least partly an undervalued exchange rate, makes good sense. And clearly China has also encouraged huge amounts of direct foreign investment, usually, with some kind of cooperative agreement, where there’s joint production or joint ownership or technology transfers. Virtually every exporter you speak to with respect to China has an agreement where there’s some kind of sharing of either profits, technology, or what have you.

But how do you know huge direct foreign investment in China won’t be confiscated? One way to give more confidence to foreign investors is to have a massive
build-up of reserves in the United States. The argument that you see by Dooley, Folkerts-Landau, and Garber, is that this is collateral. By the way, all these three individuals are investment bankers. Well, Michael Dooley is a part-time academic with me in Santa Cruz, but the other two work for the Deutsche Bank. The reason I’m saying that is that they’re trying to understand what’s going on from an investment perspective. And they believe that firms doing business in China putting hard cash in production facilities there feel much more confident that the Chinese government won’t tax them too much if they don’t need the cash, if they have these huge dollar reserves based in New York. They don’t need to get cash out of U.S. firms and other firms that are located in China proper. That’s their argument; it has two things: one’s the argument that it’s a development strategy from traditional mercantilism: exporting as much as you can will lead to faster growth. But they put additional wrinkles on it: because of the uncertainty of the legal
system and of public property rights in China, it’s good to have collateral. They call this
the collateral view. In summary, where you have unemployed resources, you also have to
have capital controls, restrictions on free movement of capital, because without that it’s
extremely difficult to maintain any kind of fixed exchange rate system

Section 3:

The so-called Bretton Woods system that lasted from the end of World War II till
1971 or 73 was based on extensive, pervasive capital controls as well as on large-scale
interventions in foreign exchange rates. And that system of fixed exchange rates was
viable, as long as you have capital controls. When capital controls were released, private
flows became so much that they overwhelmed the ability of Central Banks to intervene in
foreign exchange markets and to fix those rates. But China is still maintaining very tight
capital controls. Now, the question is, “Is this a new sort of Bretton Woods system, the
fixity in East Asia that we’re seeing, where the central country, the United States,
facilitates the process by having large current account deficits?” Some of you may have
heard of the so-called Triffin problem, where if the issue was to supply dollar reserves as
a world currency, then the United States needed to run current account deficits. That’s the
question that we are addressing here. And, in my view, this explains, at least in part, the
development strategy in China today. But it doesn’t fit Japan at all, and Japan is the
largest purchaser; it owns 767 billion dollars worth of foreign exchange reserves. The
Chinese story is great for development strategy, but it doesn’t fit the largest holder of
reserves in accumulation in Asia, and that is Japan.
Japan is a little more traditional in the sense that you can argue more generally that the massive intervention you see in Japan is really an attempt to moderate the exchange rate trend appreciation we’ve seen over many years. Remember, in 1971, the Yen value of a dollar was 360, a dollar would buy 360 Yen. Today, it’s 117. That is what you call a trend decline in exchange rate, an appreciation of the dollar. It’s gone up and down a little bit. This most recent intervention has been really a huge jump in 2003 and the first quarter of 2004, and served as an attempt to hinder further appreciation of the Yen. There’s no evidence of longer-term effectiveness, referencing the study I mentioned earlier. And capital controls are virtually absent in Japan. It’s not all that strange that Japan has trouble fixing its exchange rate or limiting appreciation when it has no capital controls and is part of an international financial system where it’s very difficult to fix a price when you’ve got massive amounts of private capital moving around, i.e. borderless capital.

Something interesting happened on March 16th of this year (2004), which is that
Japan stopped. It stopped intervening in foreign exchange markets. It started in January 2003 with no massive, big announcement, no news conference, and stopped on March 16th, also with no fanfare. In fact, when someone pointed out, “You’ve stopped intervening in foreign exchange markets,” the Ministry of Finance said, “Our policy hasn’t changed.” And they haven’t intervened since. They’re clearly not trying to make a big issue out of the largest purchase of foreign exchange in modern history, but nonetheless they started and stopped with no further discussion.

Japan’s current account balances, we know all about those, because it’s had the largest sustained current account surpluses of any country, sustained the magnitude. And this reflects the build-up of reserves I was talking about.

You can see where the accumulation in 2003 really jumped up. Japan, has been an enormous player in the build up in reserves, but they haven’t been able to slow the appreciation in the Yen, or at least it doesn’t look that way. They started intervening in 2003 and the Yen appreciated very sharply against the dollar during that period of time. This is the period they started intervening, and look what’s happened.
It obviously hasn’t been enormously successful, that’s the first thing, and secondly, it’s been very costly. Just ask yourself, what’s one percent of 700 billion dollars? What’s 10 percent of 700 billion dollars? And then you say, you have an asset, a dollar and it just appreciated 10 percent against your dollar, that means you experience, on your reserves, a 10 percent loss. It’s not realized yet, you haven’t sold the dollars, but on paper, that’s a 70 billion dollar loss. Those magnitudes make the Ministry of Finance rather nervous in Japan, as you can well imagine.

Section 4:

These are the three views and the academic sort of arguments as to why you have this large accumulation of reserves in Asia. And what are my views on it? I’ve already given you some hints. One is that we’re seeing a new dollar zone emerging in Asia and there is some merit for precautionary and mercantilist stories. But, the question is, will the build up continue? What could stop it? And if it were to stop, what are the risks and what kind of transition would we see to a new exchange rate regime?
I’d like to tell you why I think the system is not sustainable, that this build-up won’t last indefinitely. Let’s first go back to the Bretton Woods system for a moment. Why did that break down? Well, I mentioned capital controls, that some were relaxed, that there was more liberalization going on in the economies, but also important was that Japan, Germany, and France, in particular, got nervous about buying so many dollars. This is because when they were buying dollars, they were selling their home currencies. So for Germany, they were selling the Deutsche Mark, the French were selling the Franc, and the Japanese were selling the Yen. But that meant they had a lot more Yen in circulation in Japan, a lot more Deutsche Marks in Germany, a lot more Francs in France, and they were having inflationary pressures. Suddenly, Germany, in particular, said that because of the history of hyperinflation there, they didn’t want anymore of it. They said, “We’ve gone through hyperinflation which brought down democracy in Germany in the ‘20s, we’re not going to have that happen again.” So they pulled out and, as a consequence, once they stopped intervening, the exchange rate system unwound.

That’s one reason why the system could collapse. You could have, in Asia and elsewhere, the threat to financial stability when there is a build-up of reserves and more currency in circulation in your home countries. Also, as I mentioned, when you have an un-diversified portfolio, like Japan—767 billion dollars worth of dollar assets, that’s what you call an un-diversified portfolio—it’s not good, generally, from a risk management perspective. Also, it has a very low yield. We’re talking about a 70 billion dollar loss with the depression of the dollar—that’s called a very low yield, unless you’re looking at negative numbers as a benchmark.
In any case, a third reason is the domestic political economy. It could well be the case that U.S. investments are no longer viewed as favorably, for a variety of reasons, and there might be a movement towards an Asian-based system. There’s been a lot of discussions about an agreement called the Chiang Mai initiative. This is a move to have a greater zone of exchange rate stability within East Asia. In this context you have Central Bank swap agreements with China, Japan, Thailand, Korea, and elsewhere. And there have been some moves to try to put on the agenda for Asian countries the idea of having a fixed exchange rate zone, perhaps Yen based, perhaps a common currency. These discussions are in preliminary stages, but there have been concrete steps to move away from the dollar-based system. Once you have that, then you no longer need U.S. dollar assets, and those countries would start accumulating other assets. That’s another reason why you might suddenly see a drop in the magnitude of purchases.

There is also external U.S. political pressure. It’s well known that the U.S. Treasury has been quite nervous about Japan’s intervention in foreign exchange markets. The Treasury has stated that they think the market should be much more freely determined. In particular they’d like to see, at one stage at least, a dollar which would be lower. And they’re constantly pressuring China about allowing more flexibility in the exchange rate. From a U.S. perspective, more flexibility means, essentially, an appreciation of the Yuan. There are a number of reasons, both domestic as well as external, that will lead to a slowdown in accumulation of reserves.

I mentioned that three investment bankers are involved in the mercantilist story. And they’re telling their investors in their newsletters, “Don’t worry about it, this is a sustainable system.” Why? Because it’s in China’s best interest to maintain the system.
China has virtually unlimited labour and, without a rapid development, political instability could come to China very quickly. You have 115 million migrant workers around China without permanent residence, and without jobs you would have a very restless workforce. That’s what they’ll argue. Their argument is that this could go on for ten years or more. What are the implications of that? What I want to do here is consider this suggestion, and let’s ask what the implications are for a couple of minutes. The implication here, of course, is that if the massive buildup continues then the accumulation of reserves will actually surpass the U.S. monetary stock at some stage. Ownership of U.S. capital, particularly government debt, would shift largely from Americans to foreign governments. For this to occur you would still have huge trade surpluses in China and deficits in the United States, and China would have to maintain quite strict capital controls, despite liberalization in other parts of their economy. And political economic pressures would have to be held in check.

Now, what about a more gradual adjustment scenario? Let’s say you had three to five years. In that case, you could imagine a gradual adjustment in the U.S. current account deficit and the surplus of China and Japan; that is, you’d get exchange rate adjustments, similar to what you’ve seen in the last year and a half, where the dollar has depreciated rather significantly. You’d have higher absorption in Asia, absorption in the sense of more purchases of world goods and less export orientation, and an appreciation of their currency. The dollar would show depreciation without major or sharp movements. That’s a possibility; but this is rarely the way exchange rates work. They tend to work as asset prices, which mean that when news comes, they adjust very quickly. It’s like a stock price, where when you have news it’s incorporated into the price and
before you know it the price has adjusted to developments people expect in the future: not necessarily to what’s happening now, but to future developments. That’s the way exchange rate markets work for the most part and that’s why it would be very difficult to have a gradual adjustment process, one that was planned, and if you will, manufactured in some sense.

The crisis scenario that I’m going to talk about now is that you don’t get any adjusting of the U.S. current account balance. Surpluses continue at the same magnitude, but then you get some reluctance to accumulate reserves. Maybe there’s a political crisis, maybe there is a trade dispute between the United States and China, and suddenly there’s less purchases of these assets. Perhaps China decides to sell off some of its U.S. dollar assets. What would happen in that case? What I’m asking is, “What would happen if just the flow were to be reduced?” Not an outright firesale by these countries, China and Japan, but just a slowdown in how much they’re purchasing.

In this case one could well imagine a speculative run to buy the Yuan, resulting in an appreciation. You’ve seen China liberalize much of their business sector, but not the financial sector. We know that it’s very difficult to have an economy that’s very liberalized in one area but not in another—you tend to get encroachments. Over the next few years you can expect more market-driven liberalization on the financial side in China, exactly as what you’ve seen on the business side. This might be motivated by agreements China entered into in the WTO, with respect to financial liberalization, which is one of the platforms of the WTO entry process. This is similar in some respects to what happened to Spain, when people viewed it suddenly as a great investment country, where it had a great deal of difficulty stopping all the massive inflow of capital and appreciation.
of the Peseta. And this has happened before in different contexts, though not in this magnitude, but where you’ve seen sharp movements in the dollar. And once there is a speculative run, if you want to call it that, sharp movements in the dollar based on lack of investor confidence about monetary or fiscal policy in the United States could result.

In this case, i.e. with the ‘firesale’ scenario, how might this pan out? That’s in some sense the most interesting scenario and I think that it’s well worth taking seriously. Among academics we have a theory of exchange rates based on speculative and self-fulfilling prophecies and sustainability of exchange rate systems. What is a self-fulfilling prophecy? It’s where you are concerned about something happening, and as a consequence you change your behaviour, then your behavioural change causes it to happen. If you think of investment in this case, let’s say the investors are nervous about a fall in the dollar, so they stop buying dollar assets and as a consequence, their action of not buying dollar assets, in turn causes a fall in the dollar. That’s a self-fulfilling prophecy in this sense, and it is a major theory of abrupt movements in exchange rates. So, could this happen? Well, certainly it could happen. Just the first hint that the reserve accumulation is not sustainable could cause an abrupt depression of the U.S. dollar. Random or seemingly small events, in fact, could trigger very large movement of exchange rates and behaviour shifts. The idea is that if you think you’re looking for governments to instill confidence in their policies and let’s say they’re changing their policies or are just hesitant, then that in turn could move private markets to sell off dollars, which in turn would become a sharp fall in the dollar.

Do we have any signs yet of fragility? Well, Japan is not intervening anymore in the foreign exchange market. Very likely, in 2004, we’ll see much less financing. We had
a huge first quarter of dollar purchases, but virtually nothing in the second quarter. The financing of the U.S. current account deficit in the last part of this year, is not going to be coming from Japan, unless they dramatically shift policy. And there is a warning by the Asian Development Bank quite recently saying this accumulation of reserves was initially prudent, but now the accumulation is fueled by speculation. Over the last two years, reserves have become excessive and that could trigger another financial crisis. So what does this mean? The Asian Development Bank is analyzing and reporting on trends of what’s going on in the economies. They’re saying that this accumulation is a bad thing, that it’s excessive. Now, if you’re a private investor, you might hesitate and say, “Wait a second, maybe this accumulation won’t continue, maybe China’s policy will change.” That could make me change my behavior. And once this starts, then you would see a sell off of dollars in the market.

Section 5:

Let’s talk about the implications, because financial crises can have good and bad effects. The good effect is that international financial economists like me have lots of employment opportunities. As long as there are financial crises, there’s always lots of interest in studying them. Now, for China and Asia, what would the effects be? They’ll obviously have revalued their currency and I think that the Yuan would have appreciated dramatically under the circumstances. Of course Japan has already lost 70 billion in unrealized losses on their foreign exchange reserves, and a further depreciated dollar would mean other large fiscal losses. Those are real resources that Japanese tax payers have to put up. Now, this could be a hindrance to development strategy, or appropriate adjustment for these economies, and by contrast they may have more control over the
domestic economy. In other words, if you’re not accumulating these reserves, that would be less inflationary tendencies in your economy and your ability to control your financial system more. Obviously this would change the development strategy for some of these countries, but on the other hand they might have more domestic control than they do presently.

Now for the United States, this scenario calls for a sharply depreciating exchange rate, better trade competitiveness, which of course comes with a loss of purchasing power for U.S. consumers. Now, an interesting thing is that the United States has had quite low interest rates in the last few years. That’s at the same time that we’ve had some of the largest budgets deficits ever recorded. Capital flows coming into the United States are keeping interest rates down. What you’d see if this capital inflow stopped are higher interest rates. But, the United States, unlike some of the countries I showed you a moment ago, where currency crises were associated with very large drops in output, has a very stable banking system and has got a limited foreign currency denominated debt. In some sense the currency depreciation in the United States would have a relatively limited effect on the real economy. It would be a boost to the export sector, and industrial sector generally. It would be a loss to consumers, however. But in terms of a real financial blow, it probably would be quite limited. It’s always a great situation if you don’t have to worry about depreciation of your currency because foreigners are holding most of it! In this case, foreigners are accepting the risk of taking large exchange rate losses.

I’ll be somewhat provocative. Should we welcome the rapid adjustment scenario? In my mind, the biggest issue here will be the need then to really rethink China’s development policy. Japan has lived with the situation of high unemployment, by Japan’s
standards, for some years now. They’ve been in a situation where they’re coming to accept much lower growth rates than previously. They’re in a situation where high unemployment in Japan is just a couple of percent, which is enviable by North American or European standards. In the context of the Japanese economy, they’re not happy with it, but they’ve learned to live with it. But China is a different issue, and it would really necessitate rethinking development strategies on the part of China and other countries, moving away from what I would call an artificially low exchange rate. There might be positive elements in some parts of the world with a greater balance in trade and sustainable exchange rate arrangements, and in some sense, sooner would be better than later for the rest of the world and the United States, but clearly not for Asia.

Now, what is better for the rest of the world? Let’s just talk about Canada for a moment. Canada saw roughly a 20 percent appreciation against the U.S. dollar in 2003. That was very shocking; I think it went from 64 cents to 77 cents. Now, just imagine if it went up to 85, 90, or 95 cents. That’s not unthinkable under this scenario. However, I would argue that Canada and the United State’s economies are so linked that you wouldn’t get that kind of Canadian dollar appreciation. It would be more likely to see a 25 or 30 percent adjustment in the Asian economies, and much less for Canada, or for Europe, for that matter. But, that of course is speculation, and as I always tell my classes when I’m teaching them International Finance, “where any consultant can tell you what the exchange rate will be a year from now, get another consultant.”

Thank you.
Question Period

**Question:** Will the shortage of generating fuel affect China dramatically? Will it affect the American dollar?

**Response:** A shortage of generating fuel will definitely affect China. How that will affect the U.S. dollar, I can’t say. But it would probably boost the U.S. dollar. If you saw the Chinese economy in really dire straits because of fuel shortages, that likely would reduce investment in China, because China is drawing on world resources of fuel and energy in different ways. China is the fastest growing economy in the world, and it’s a big economy, and I’ve heard many times that steel prices in California, where I live, are influenced greatly by developments in China. We have an integrated world market and China is increasingly one of the biggest players in that market.

**Question:** Has the Euro been a disappointment? Why are Asian economies not going to the Euro?

**Response:** Well it’s a new currency; it’s only a couple of years old, so give it time. Of the Euro area, generally, there are serious issues of competitiveness in continental Europe. In Canada you’ve just negotiated a massive health care plan between the federal government and the provinces and, in this context, the question was, how much could you afford? The social services in Europe obviously are much higher and the costs of maintaining that system are very high, in large part borne by employers’ fees, so Europe has a competitiveness issue relative to Asia. And, I think direct foreign investment in Europe is significant but clearly has been much lower than it otherwise would be if you had a much more competitive base. Why go to Europe when you can go
to India or East Asia for production processes? Now, Europe is doing fine, if you look at it from a social welfare objective. European countries have very low birth rates and very low population growth rates. You wouldn’t expect rapid growth rates like you see in other parts of the world. It is all through productivity and careful investment that these economies grow. And that’s not necessarily a bad thing; you’re talking about mature economies with limited space. It is not surprising if there’s not massive investment in a high cost region of the world.

**Question:** What about using international reserves as collateral for foreign direct investment? Do you think it’s conceivable that the U.S. government would interfere with ownership of these reserves? There was an issue with Iran a couple of decades ago.

**Response:** How did the Euro markets begin? It was essentially that Russia had a lot of dollars and they didn’t want to invest in the United States because they were afraid that at some point there might be confiscation of those dollar assets. So they went to London, and said, “Will you take dollar deposits for us?” And London said, “Sure, we’ll take those deposits” and then London Bank invested those dollars in the United States. In this way, Russia didn’t worry about “political risk.” So, yes, at some point you might be nervous, if political tensions were to arise, and that’s not impossible. Now of course, the United States did this with Iran, under really drastic circumstances so I believe it would be unlikely, but obviously not impossible. Who knows how the political and other developments will go. Whenever you have a completely undiversified portfolio in dollar assets and U.S. government bonds, it’s going to be risky from a financial or a political perspective.
**Question:** What impact will U.S. fiscal deficits have on currency valuation?

**Response:** I said that the U.S. government is quite willing to supply these bonds to the market in unlimited amounts, apparently, and that was a reference of course to the surge in the U.S. government deficit. Now this is not because of hard times, obviously there’s more expenditures, and a very small recession; but at least half of it is because of very large tax cuts. In some sense, this is deficits by design. The United States, in about five years’ time perhaps, or maybe sooner, will likely pass another Gramm-Rudman amendment to restore fiscal solvency. And then you’ll see an uptake in the economy, and you’ll start getting more revenues and cut-back in expenditures and you’ll see a balanced budget. Remember, just 3 years ago we had the largest surpluses in U.S. history, so now we’ve got the largest deficits in many decades. These things turn around quickly, right now it’s a very odd period because people aren’t viewing deficit as much of a problem, but they would if interest rates were higher. So one argument I’m pointing out here is that you can finance a lot of debt at zero interest rates. If interest rates go up, suddenly there’s real cost, and also the Federal Reserve starts having concerns. Government debt is a budget constraint over a long period of time and, as you know, many countries have run deficits for decades. The question is, what size? What’s most amazing about the United States is not the size relative to GDP, but the switch from surplus to deficit, that’s the first thing, and the second thing is that the economy is so large so that, a deficit in the United States has a significant effect on the world economy. Right now you’re not seeing interest rates high in the United States or elsewhere in large part because of what I call the public financing of this foreign debt. You know it’s interesting, about the size. I was in an
OECD meeting once, where Belgium was criticizing the United States for the large deficits. Now this was in the early ‘80s, and there were very large deficits, and the Council of Economics’ advisor to the United States looked at the Belgian representative and said, “Thank you for that point.” And then he sort of noted a statistic that Belgium had been running 7 percent, as a percent of GDP, deficits for the last decade, and had the largest debt of any OECD country per capita. So he says, “And thank you for the advice.” But the Belgian had a point. When the United States runs large deficits, there are repercussions, not necessarily good. Belgium, by contrast, has no affect on the world economy.

**Question:** What role will the protectionism emerging in the United States play?

**Response:** This is one of the threats I believe threatens the sustainability of the financial system. All you need is for the United States to have a more populist legislation on trade. It is very unusual to have such a huge current account trade deficit without a stronger political backlash in the country than has occurred in the United States. Right now, there are a lot of people benefiting from really inexpensive imports, so I think that you’re seeing a balance of constituencies. But nonetheless, at some point, you could very well have a surge in protectionist pressure. My guess is that most countries would have already had it in a very strong way if they run deficits of the order of magnitude. The United States has been protectionist pressures in different areas, obviously, steel is one area, agriculture another, occasionally automobiles but since about half of the “foreign” automobiles are produced in the United States, there are constituents on both sides to balance out the political economy spectrum.
**Question:** If you’re looking for a trigger event, how does Mr. Greenspan fit in? He’s elderly and even if re-appointed, he cannot complete his entire term. What would be the effects of this?

**Response:** I’ve worked for the Federal Reserve System, and I think there’s too much emphasis on the magical ability of Alan Greenspan. Inflation has been low since the early ‘80’s. Maintaining low inflation is a totally different animal than reducing inflation. This was accomplished by Paul Volcker and Jimmy Carter. True enough, in the United States we have low inflation, but there has been no major shift in monetary policy. Fundamentally, the United States has had a very stable interest rate established by Volcker and continued by Greenspan. I was very disappointed when Greenspan supported the tax cuts because of the argument that he thought they were running down the U.S. debt too quickly, that they would be disruptive to financial markets. Today, he’s saying that we have to reduce government expenditure because the debt is rising too quickly. So he made, in my mind, a foray into fiscal policy which should well have been avoided. This was three years ago. I think his track record is pretty good, but still his track record of the fed, the political support for low inflation, I think is more important than any one head of the Central Bank; that you have to have a constituency that it maintains. And when you have the status quo as low inflation it’s much easier to maintain it than it is to reduce it if it’s high, like at the time under the Volcker regime.

**Question:** Don’t you think the Chinese government’s strategy of accumulating reserves is a good strategy for the long term?
Response: You’re suggesting that it is in the best interest of China to continue to accumulate reserves. And that seems consistent with their development strategy, of keeping a low Yuan and, stimulating export growth. This is the sophisticated mercantilist view. The question is: how much reserves do you need? China’s reserves are larger than we’ve seen in any emerging market ever, and this would clearly be sufficient under most cases. But still, at what point is enough enough? I read to you the quote by the Asian Development Bank, where they stated that reserve accumulation is now excessive and could lead to speculative movements. From the point of view of China, per se, it may well make good sense for another few years to continue the same development strategy, if they can manage it.

Question: A credible source has said that Saddam Hussein trading Euros has led to the depreciation of the U.S. dollar. How credible is this?

Response: Well, I’ve never read those stories. But I don’t think that has any credibility, because I don’t understand how trading some Euros by Saddam Hussein would have that much effect on the value of the dollar. Now, what would have an effect, is if he were able to influence all oil exporters in the Middle East, for example, to change all their pricing from dollars into Euros. Politically, if he had that kind of influence, if you think he was central in that, then that could have a big effect on the value of the dollar because suddenly no longer is it the price of invoicing of most of the world’s oil exports.
**Question:** Do you think it is a credible case that the American dollar will appreciate in the short term?

**Response:** You know, as I said at the very end, if you have a consultant who comes and wants to forecast the exchange for a year from now, they’re blowing smoke because we know that exchange rates are like stock prices—it’s very difficult to make any credible forecast. If you want to do these things by probability, I give this firesale scenario a 25 percent probability, of a 25 percent decline in the dollar. That means there’s another 75 percent of probabilities out there. But this is the most interesting story, because I think this has a lot of implications for Asia overall and you know the theme of this series is also sort of an Asian focus. But that would fit particularly well in this context. I think the dollar could appreciate over the short term, but I do not see it unless there is a significant change in fiscal policy. I do not see the dollar appreciating over a 3-year period. Week to week, if you’re in the market, if you’re buying and selling foreign exchange, you don’t care, you want to balance your books each night. Day-to-day fluctuations in foreign exchange markets, that’s not what I’m talking about. I’m talking about what’s going to be down here in the medium term. And the medium term of two to three years is far beyond the interest of most foreign exchange traders.

**Question:** In the short term, is there any credibility to the idea that as interest rates rise, this could create a short squeeze, causing a boom stage?

**Response:** Sounds good, I don’t know.
Question: As interest rates rise, you have argued in your lecture that there would be an increase in demand to pay back U.S. debt. Would this not cause a panic for dollars? An increase in demand for the U.S. dollar?

Response: Yes but even if that occurred, it would be a very short term phenomenon, most of the momentum would be to move out of the dollar because you might want to move into currency, but then from the U.S. dollar move out to foreign currencies. That could be a transitory mechanism, but clearly, in my view at least, the argument would be that you’d move out of the dollar eventually. And that would be a longer-term movement.

Question: Would the U.S. government, let the U.S. dollar drop and resist seeing interest rates rise? Is there any historical evidence to suggest that after a certain level of debt with respect to GDP is reached in an industrialized country, it might cause problems with international creditors?

Response: The majority of foreign reserves in the United States are short-term instruments. But the swap arrangement I was talking about earlier was actually in ten year government notes, so even in the Bank of Japan they do not issue the numbers on holdings of their assets. That is, you don’t know what the maturity or precise note that they are holding. Most of it is in the short term. Of the second question, I know of no precise trigger point when debt, do you mean government debt as a percent of GDP? [Audience member clarifies that he meant “total indebtedness to foreigners”] The reason I do not expect a simple relationship is because a lot of it has to do with what that debt is financing. I remember that before the financial crisis in Korea, a Latin American was
speaking to a Korean friend of mine and he said, “You know, you have all this foreign debt, but it doesn’t seem to have had an effect on your economy, while we hold dollars and repayment of that seems to be causing recurrent crises.” My Korean friend said, “Yes, but when we borrow dollars we use it for productive investments, we don’t just spend it on condominiums in Aspen.” That wasn’t a very pleasant thing to say, of course, and six months later there was, in fact, the Korean crisis. But I do think fundamentally, from an economic perspective, we know one of the most interesting things about Latin America is that they did not have large current account deficits most of the period they were accumulating foreign debt. It wasn’t net debt, it was gross debt. What you saw was a recirculation, you saw a lot of capital going into Latin America that eventually was guaranteed by governments and a lot of private capital going out to the United States. So the country, if you look at the net balance of the country in Latin America, didn’t look like it had a lot of debt. But in fact, the government had implicitly taken on a lot of government guarantees of foreign capital coming into the country while their private citizens were getting capital out as quick as they could. That is a problem. Now, by contrast, you can have debt that’s directly involved in productive investments that is going to generate yields which in turn will pay off the debt. The debt is just a financial instrument. What’s underlying it is more important than the actual magnitude. There are a lot of studies which are saying, from a purely arithmetic point of view, that there’s only a certain amount of debt that you can pay off, and its all based on what’s the underlying growth rate of the economy. If that debt was really helpful and productive in increasing the growth rate, then presumably you can hold more. That’s why I made a fleeting statement that it’s pretty easy to finance debt at zero interest rates, and basically if you
think that the debt you take on is more than compensated for by increases in productivity to the economy, then that debt is a very good investment.

**Question:** *The price of oil is denominated in U.S. dollars, how much does this prop up the dollar? What would happen in the denomination changed?*

**Response:** That’s interesting and I don’t think there’s a consensus. First of all, I don’t know the answer to the question. I understand the question, I just don’t know the answer. U.S. dollars are the currency of denomination and that is a transactions based demand for dollars. Similarly, most of the international invoices are based in dollars, but you don’t necessarily need large amounts of dollar currency to support those invoices. So as a consequence, I think there will be a short run implication on the dollar, but I don’t know if there will be a dramatic long run effect from just using a different invoicing currency. And, as I said, there’s not a lot of good empirical evidence one way or the other that it matters how you invoice your currency. For example, Japan does not invoice that much of its exports in Yen. It mainly invoices in dollars and other currencies. Does it matter for the value of the Yen? It’s not clear.

**Question:** *Do you think the lowering of the Yen is devious?*

**Response:** I don’t think there’s anything devious. As I said, Japan started this in 2003, January, and ended it in March 16th, 2004. I don’t really think they were devious, they were simply trying to lower the value of the Yen. Now, is that devious or not? It’s pretty clear what they were trying to do. When I say ‘lower the value of the Yen’ I simply mean trying to stop the further appreciation that was likely if they hadn’t done it. Its not
real clear, but I don’t call that devious. I think China’s development strategy is absolutely in the best interest of China. And I think that if you want to think of the world welfare point of view, it’s really good that China is developing quickly, that one of the poorest countries in the world in the last thirty years is becoming a rapidly developing emerging market. That was not the case thirty years ago, and the Chinese welfare has gone up enormously, despite social problems associated with 115 million migrants (and that doesn’t include their families.) You’ve got a lot of social disassociation going on in China right now. But, if you ask a person, “Would you like to be on a farm and starve or would you like to go to the cities and work in factories?” My guess is that they would choose the latter. Industrial development is very very good for China. And it’s clearly in their best interest. So is it devious? I don’t think so.

**Question:** The U.S. current account deficit becomes a problem if it keeps increasing. What if it goes up to 10 or 15 percent? How do you convince people it is a problem so that you can address it? Is it a matter of interest rates increasing?

**Response:** Economists are a little mixed about deficits, i.e. current account deficits. Are they a good thing or are they a bad thing? And it’s getting to the point that was raised here. A current account deficit means you’re taking on debt. The good thing in the United States is that it’s keeping interest rates very low. Now, the bad thing is that if this might be distorting competitiveness in the United States, and a lot of people are very much concerned about it. It just hasn’t reached the heightened political debate right at this point. But at different stages in the United States this has been a big issue. My guess is that there will be a lot more trade friction with China in the future, and the reason I
think this is because China is a huge exporter, a very competitive country. It has got huge reserves, and from the perspectives of the United States and probably other countries like Canada, it probably could use an adjustment, an appreciation of their own currency, to bring back their current account closer to balance.

**Question:** *I agree with the trade dispute part, but you won’t have a strong bargaining position if the other side of the table holds a massive amount of your currency. Couldn’t they threaten to dump U.S. treasury bills in order to force an agreement?*

**Response:** Some have suggested that Japan could threaten to dump their holdings, selling off their dollars in the event of trade disputes. But in fact it would be enormously costly for Japan, China, and elsewhere to do this since they would incur capital losses on those dollar assets. However, we know countries sometimes don’t act on purely short-term economic self-interest, and there might be some other driving issue. If you look at Canadian holdings of dollar reserves it is only 17 billion dollars. This seems like a small amount in the overall perspective, and so whatever Canada does, it will only have a limited effect in the market. But if China and Japan act simultaneously it would move the market in a big way. But remember, when you sell an asset, you have to sell it to someone—you have to find a buyer—so they would be taking large losses if they suddenly sold dollar assets. We’re talking about massive losses, and is that in the long term interest of the investing country? It would have to be really serious circumstances if they are trying to take that kind of action.