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The New U.S.-Asian Dollar Bloc

And why Europe could end up the loser.

BY MILTON EZRATI

It does not take deep analysis to see that February's G7 meeting was more than a little contentious and that economic relations between the United States and Europe are strained. The G7's official communiqué, though blandly written as always, nonetheless gave a hint of the problem, calling simultaneously for the vaguely contradictory objectives of currency stability and flexibility. Europe is desperate because the pricey euro threatens its export prospects and therefore its fledgling economic recovery. The United States, though paying lip service to a strong dollar policy, likes the improved export prospects promised by a cheap dollar. As if to underscore the differences, remarks by European Central Bank (ECB) President Jean-Claude Trichet about currency stabilization met a response from U.S. Treasury Secretary John Snow that he had no idea what Trichet was referencing.

In many respects, this is an old argument, but today it plays out against the backdrop of a relatively new presence in currency markets: a powerful, if informal, currency bloc has developed between the United States and most of Asia. Its currency links relieve U.S. financial markets of any adverse pressure from the dollar's slide. At the same time, they place an especially heavy burden on Europe and to a

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The European Central Bank's Jean-Claude Trichet

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—M. Ezrati

slightly lesser extent, Japan. The bloc for the time being gives America all the negotiating advantages.

This dollar bloc developed in the late 1990s after the Asian financial crisis and did so without the active engagement of the United States. Most of Asia simply took a page from Japan's development book, identified exporting to the United States as a primary engine of economic growth, and set out to ensure a price edge for their product in America by pegging their currencies at a cheap rate to the dollar. It might at first seem strange, given America's budget and trade deficits, that these dynamic Asian economies persist in such a connection, but on a practical level, the link should surprise no one. The United States is still the richest consumer market in the world. Asian exporters also can rely on American policymakers, in a way they cannot rely on European policymakers, to promote the consumer's interests. So the Asian states have tied their currencies to the dollar and have given little consideration to other exchange rates.

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In the late 1990s, when the dollar rose on foreign exchange markets, the formation of this informal bloc imposed little on Europe or Japan. Indeed, as the Chinese yuan, the South Korean won, the Malaysian ringgit, and others of these currencies floated up with the dollar's rally of that time, Europe and Japan found a measure of relief from the natural price advantages of Asian import competition. The cheap euro and yen of that time gave European and Japanese exporters price advantages over American competitors throughout Asia. Through it all, the developing Asian nations were content to maintain their favorable terms of trade with the targeted American market. Everyone's exports grew at America's expense.

But now that the dollar has fallen, the whole pattern has reversed. Since 2001, the U.S. dollar has led these linked Asian currencies down more than 30 percent against the euro and over 15 percent against the Japanese yen. Relative price advantages accordingly have shifted in favor of dollar bloc products. Europe and Japan have become much more vulnerable than previously to emerging Asia's natural price advantages. At the same time, they have lost their former price advantages over America when selling into the dynamic Chinese and other Asian markets.

International trade statistics do not yet show the effects of these price shifts, but the strain is certainly

evident in comments from European officials. Germany's finance ministry has voiced its lack of concern so many times that it is only reasonable to conclude that it is very concerned. German Finance Minister Wolfgang Clement complained that the world cannot expect Europe to do all the adjusting to the currency pressure. ECB Chief Economist Otmar Issing expressed concern over "excessive movements" in relative currency values, an issue he failed to notice when the dollar was rising and the pricing advantages lay on Europe's side. Italian economic and finance ministers have appealed for help to the European Union and the ECB, while ECB President Jean-Claude Trichet has hinted at the possibility of a cut in European interest rates and even direct intervention in foreign exchange markets.

While Europe suffers from the competitive pressure of this entire dollar bloc, the currency links between the United States and Asia free America of those financial and economic pressures that would typically accompany currency weakness. Usually, a declining currency, though it helps a nation's competitive position in the world, also drives investors away from its local financial markets. Interest rates frequently rise in response. A sometimes painful, if needed, economic slowdown can ensue until imports decline and the nation begins to live within its means—that is, no longer consumes in imports more than it produces. But America has little need to fear this kind of stress right now. China, India, and much of the rest of Asia, to keep their currencies from rising against the dollar, must buy dollars continually, and since they then need a repository for their dollar holdings, they must also continually buy American securities, mostly Treasuries. This ongoing flow of funds into America not only relieves any upward pressure on interest rates, but with Asian nations effectively lending America the money with which to buy Asian exports, they allow the United States to sustain its trade deficit.

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Figures on international financial flows speak loudly to the extent of this Asian support. According to the U.S. Treasury, capital inflows into the United States over the course of 2003 totaled $633 billion, up by over $140 billion from the same period in 2002. Almost all came from official sources, mostly in Asia. During the last six months, the Bank of China and the Bank of Japan alone bought the equivalent of the entire U.S. federal budget deficit.

And the United States can count on Asian nations to persist in these patterns for some time to come. The Asians, after all, follow their policies for their own, very long-term purposes. They realize that they risk losses on their huge holdings of U.S. securities, but they see such risks as a small price to maintain their export-led growth model. They are aware that Japan kept up these same practices for over forty years, mostly to that economy's ultimate benefit, at least in terms of much-sought development.

Nor will matters change even if China allows a modest appreciation in the yuan. As long as Asia maintains some kind of a peg to the dollar, even an adjustable one, America will retain these benefits. When Europe seeks help in stabilizing the currency situation, as it inevitably will, Washington will have the leverage to make serious demands in exchange for that help. Reforms long sought by this and previous administrations will surely enter the negotiations—the liberalization of European trade practices and of labor markets, and the promise from EU members to stimulate their domestic economies or try to shift their engine of growth from exports to domestic consumption. Because of this informal dollar bloc, the United States will be able to force all the adjustment to currency onto Europe and to a lesser extent Japan. ◆