

# JAPANECHO

Global Capitalism

# After the Fall

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# The Dollar Rides High Despite the Crisis

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**I**n October 2008, at a time when Western financial markets were totally paralyzed and stock prices were plummeting around the world, the US dollar rose sharply against currencies other than the yen. Over the two months from August to October, the US Federal Reserve Board's nominal dollar index, which tracks movements in the value of the dollar against other currencies, climbed 12%. Even though the financial crisis had originated in the United States, the dollar grew stronger. How is this paradox to be explained?

Changes in money flows to and from the United States provide a clue. Ordinarily the United States has a net outflow of foreign securities purchases, resulting in negative figures. In July, August, and September 2008, however, there was a net inflow, with money being brought back into the country. Many American investors, including hedge funds, which had run up heavy losses and faced pressure from requests to cancel contracts, were busily selling chunks of their foreign stock and bond holdings. When the statistics for October are released, they will probably show the same trend.

These transactions naturally entail the buying of dollars and selling of other currencies on foreign exchange markets. At the same time, private investors outside the United States were selling US financial assets, especially bonds of government agencies, and bringing the funds back home. These are deals that involve dollar selling. In this way, investors both in the United States and in the rest of the world were acting to repatriate capital. Though this leads to offsetting supply-and-demand moves of dollar buying and dollar selling, in fact the dollar gained strength (except against the yen). What this tells us is that in this financial crisis, the liquidity shortage facing investors and financial institutions has actually been a lack of dollar liquidity. We can understand why dollar buying has exceeded dollar selling on foreign exchange markets if we presume that when investors outside the United States have sold American financial assets, they have not converted all of the dollars into their own currencies. Some they simply brought home in the form of dollars to shore up their liquidity.

How about the yen? Why did it suddenly grow stronger? During 2008 the interest rate differential between the dollar and the yen has rapidly narrowed. As a result, investors and speculators engaged in the so-called yen carry trade, in which money is borrowed in yen at low interest rates and invested in dollar assets at higher interest rates,

have cut back on their yen-dollar dealing to lessen their exposure to a high dollar position. At the same time, however, there has continued to be a fairly large interest rate differential between the yen and such currencies as the British pound, the Australian dollar, and the euro, and this has persuaded market players to maintain their position on yen selling. In the summer of 2008, in fact, selling of yen was seen on a rising scale to build up positions. These position changes can be ascertained in the open interest trends on the Tokyo market for foreign exchange futures trading called Click 365. But when stock prices fell steeply in October, investors and speculators who suffered heavy losses moved en masse to cover their risky holdings. In order to cut losses, they scaled back their yen selling and joined a yen-buying stampede. This, we may reason, is what caused the yen to rise sharply against all the other major currencies.

## US EXTERNAL DEBT PEAKS

We are living in a world where financial institutions sometimes become quite frantic to secure dollar liquidity, where they are unable to lessen their dependence on the dollar even if they wish to do so. But what is the long-range outlook? If the net external liabilities of the United States go right on swelling, will there not come a time when the world's investors reach a limit to their willingness to hold dollar assets, causing the flow of capital into the United States to slow and the withdrawal of capital to pick up speed? And if that occurs, might not the dollar's position as the world's key currency collapse faster than has been expected? Here we find one of the classic arguments made by those who predict an American decline.

I myself do not entirely dismiss such a scenario, but I have long argued that we must not underestimate the solid structure that the dollar and the United States have established. It is true that US net external liabilities are following an upward trend. When measuring increases or decreases in net liabilities, however, we need to consider their relationship to the size of income or the scale of the economy. Such an examination reveals that the net external liabilities reached a peak of 19.5% of US nominal gross domestic product in 2002, after which they fell to 17.6% as of the end of 2007. As shown in figure 1, US net external liabilities have not been mounting as rapidly as has the deficit in the US current account.

If we total all the annual deficits in the current account starting from 1980, a year when the United States had net



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external assets of \$365.5 billion, we find that by 2007 they had built up to \$5.6 trillion. Net external liabilities, by contrast, stood at only \$2.4 trillion at the end of 2007 according to data from the US Department of Commerce. The difference between these two figures is a huge \$3.2 trillion (some ¥320 trillion). You cannot create riches out of nothing, so where did this \$3.2 trillion come from? Does it represent the profits of American financial imperialism? In fact, neither alchemy nor exploitation was involved. The United States may have more external debts than any other country in the world, but it also has more external assets—some \$17.6 trillion as of the end of 2007. The assets produce returns, while the debts incur costs. The returns and costs take the form of income, such as dividends and interest, or of capital gains or losses when the values of assets and liabilities rise or fall. Dividend and interest payments and receipts are included in current account statistics in the income balance. So we are left to conclude that the \$3.2 trillion represents capital gains on the assets and liabilities (denominated in dollars).

This raises the question of why the external assets and liabilities of the United States were able to produce capital gains on such a huge scale. Two answers can be posited. First, large currency exchange profits were realized from the weakening of the dollar. It is estimated that about half of the American external assets are denominated in foreign currencies and half in dollars. Using the \$17.6 trillion at the end of 2007 to represent the scale of the assets, we find that

a 5% drop in the value of the dollar (and rise in the value of foreign currencies) would lift the dollar-denominated value of the assets by \$440 billion. If the dollar's drop were 10%, the value would go up by \$880 billion. These are profits going to the United States in the form of capital gains from currency exchange profits. Meanwhile, it is estimated that about 90% of America's external liabilities are denominated in dollars. This means that when the dollar weakens, it is mainly foreign investors who incur currency exchange losses, with only light losses on the American side.

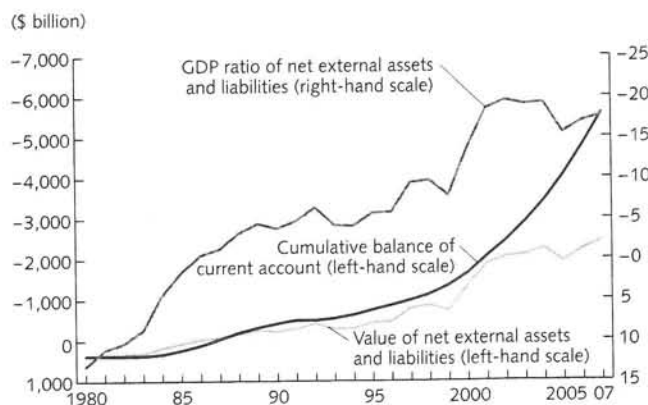
I might note parenthetically that having a key currency is a prerequisite for being able to hold external liabilities denominated in your own country's currency. In the case of smaller countries, developing economies in particular, external debts will be denominated in dollars, euros, yen, or some other major currency. If such a country's currency falls at the same time as its debts rise, the value of its debts measured in its own currency will swiftly swell. This will expose it to the threat of a currency and financial crisis.

Second, American external assets have been channeled into high-return assets, largely through direct investment and purchases of stocks. Direct investment and stock investment account for a large portion of these assets, 48.2% of the total, compared with only 26.2% in the case of the liabilities. The largest liability category at 36.7% is bond investment, which includes investment in US government bonds by foreign governments. Investors face risks from price movements when they place money in direct investment and stocks, but they have a chance to earn long-term capital gains. The overall returns are generally higher than those from investing in bonds with their fixed interest rates.

What, then, was the difference in the returns from the external assets and liabilities of the United States? Using Commerce Department data, the Institute for International Monetary Affairs found that over the 1989–2006 period there was a spread of 4.2 percentage points between the returns on assets and the costs of liabilities (see the table).

Stock markets around the world took a heavy beating in October 2008, and the plunge in stock prices means large capital losses on US holdings of external assets. It is possible to argue that as a result of this, the United States will find it increasingly difficult to perform the sleight of hand by which capital gains on external assets offset the deficits in the US current account. It is, however, long-term trends that count in this case, and one should not try to make predictions based on the results of short-term move-

**FIGURE 1. NET US EXTERNAL ASSETS AND LIABILITIES**



Source: US Department of Commerce.

ments. We need to note, moreover, that foreign investors hold a sizable share of the huge volume of US stocks, and though their share may not be all that large compared with that of domestic investors, the drop in stock prices will also reduce the external liabilities of the United States. In any event, judgment needs to take into account the changes in both assets and liabilities, and they cannot be ascertained until statistics for the end of 2008 become available.

It is to be granted that the snowballing of the US current account deficit cannot continue indefinitely. The relative size of the deficit has now begun to contract, however, following the general decline in the dollar's exchange rate since 2003. The scale of the deficit needs to be measured against the scale of the economy; and one suitable yardstick for this purpose is the ratio of the deficit to nominal GDP (figure 2). In 2006 the US current account deficit rose above 6% of nominal GDP, the largest level of red ink ever recorded, but in 2007 it contracted to 5.3%.

On average since 1980, there has been a time lag of about two years between a decline in the dollar's value and the resulting reduction in the deficit's size. High oil prices have recently been an impediment to deficit reduction, but now they have sharply declined to about half their peak level. If the dollar's real effective exchange rate continues to weaken by some 2%–5% per year, the downward trend in the deficit should continue over the medium term. A projection made with an estimation model I developed shows that even if the dollar's decline is relatively mild, the GDP ratio of the deficit is likely to fall to about 3% in the 2010–12 period.

If the level of the current account deficit moves down in this way, US net external liabilities should stabilize in the vicinity of 20% of GDP and, over the long run, begin to decline even if the spread between the returns on assets and the costs of liabilities narrows to around 2.0 percentage points from the 4.2 points of the past. In this age of globalized financing and investment, we can appreciate that a vast accumulation of national wealth can be acquired over the long term through efforts made to preserve the US financial structure, which is characterized by gigantic amounts of external assets and debts and a wide differential in investment returns favoring the home country.

#### ANNUAL RETURNS ON US EXTERNAL ASSETS AND LIABILITIES

	(%)
<b>External assets (returns to US investors)</b>	
Income returns	6.0
Capital gains	4.3
Total	10.3
<b>External liabilities (returns to foreign investors)</b>	
Income returns	4.5
Capital gains	1.6
Total	6.1
<b>Return differential (percentage points)</b>	4.2

Source: Calculated by the Institute for International Monetary Affairs based on data from the US Department of Commerce.

#### A LENGTHENING LAG

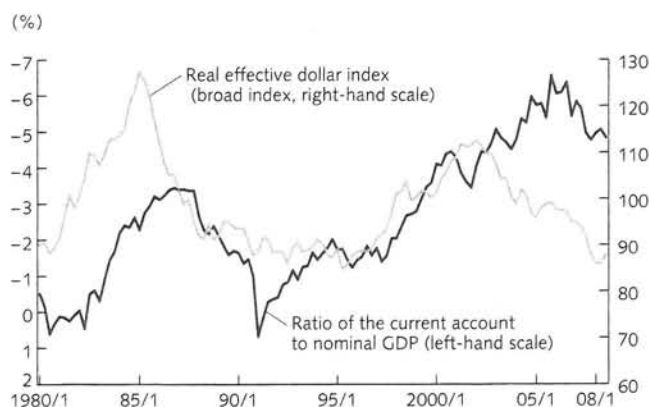
We nonetheless need to note that since 2003, there has been a lengthening lag or diminishing effect in the relationship between declines in the dollar index and declines in the current account deficit. Why should this have occurred? Some observers argue that the failure of the deficit to contract despite the fall of the dollar is a sign of the demise of financial imperialism in an age when the manufacturing industry has been hollowed out by the shift of production to other countries. This, though, is an old refrain, one we have been hearing from such people ever since the 1970s.

Today, when large corporations are moving down the road of globalization, they are constructing a more flexible division of labor within each corporate group so as to reflect such factors as production costs and exchange rates. In the case of the Japanese automakers building cars in the United States, periods when the yen weakens are times to lower the local content on American production lines and rely more heavily on parts imported from Japan. When the yen strengthens, conversely, local content is enlarged. Such fine-tuning has a direct impact on the trade balances of the countries concerned. The trade balances are adjusted by exchange rates.

Still, this does not explain why over the years since 2003 there has been a longer lag than in the 1980s between downward movement of the dollar and contraction of the American current account deficit. Two sets of developments appear to be involved, one in the United States and the other outside of it. On the domestic side, the first decade of the twenty-first century saw the inflation of a housing bubble. With the value of housing assets growing larger, an asset effect worked to boost consumption and reduce saving by American households. The downward trend in the saving rate pushed the saving-investment balance yet further in the direction of a saving shortage, and this caused growth—or delayed contraction—in the US current account deficit.

The development outside of the United States was the behavior of the country's major trading partners. They

FIGURE 2. THE US CURRENT ACCOUNT AND DOLLAR INDEX (QUARTERLY DATA)



Sources: Data from the US Department of Commerce and Federal Reserve Board.

sought to keep the dollar from weakening by intervening in foreign exchange markets, and they plowed the dollars they acquired through this intervention back into the United States in the form of investments. By acting in this way, they were able to realize a large expansion in their trade surpluses with the United States. This description applies to quite a few of the United States' trading partners, Japan included, but China is the prime example.

The upshot is that long-term US interest rates remained low over the 2004–6 period, a time when the Fed was tightening the monetary reins by lifting short-term rates. Alan Greenspan, then chairman of the Federal Reserve Board, found this inversion of long-term and short-term rates strange, even calling it a “conundrum.” It is widely agreed now, however, that one of the main causes was a vast flow of investment funds into the American bond market from foreign countries.

When we view the situation in this way, we can perceive the true nature of the adjustment phase, which was already underway in 2007. Since a domestic saving-investment imbalance equates with an external disequilibrium, the plus and minus signs reversed, what the United States needed to return to a balanced state was a rise in the saving rate (a decrease in consumption), accompanied by a trend of contraction in the current account deficit. And now, with the collapse of the housing bubble acting as a trigger, that is just what is happening.

The other side of this equation is the adjustment required among the trading partners that are running up huge surpluses with the United States. They need to get their surpluses on the path of contraction by increasing domestic consumption (and lowering saving) or by stepping up domestic investment. But in China, as in Japan, domestic demand has been slow to expand despite repeated calls for it from the government and other quarters. In such a situation, we find that demand around the world will fall to the extent that US domestic demand recedes. The inevitable result will be a global-scale slowdown and spread of business slumps.

People are inclined to label the financial crisis in the United States as the primary culprit behind the global slowdown and slide into recession. As long as we keep our gaze focused on adjustment of the disequilibrium in the real economy, however, we can see that the downturn in US domestic demand is to be welcomed. It is an inescapable element of the adjustment process. In this light, at least half of the blame for the slower global growth must be ascribed to the lack of progress in making adjustments by the countries with trade surpluses.

#### THE DOLLAR AND THE EURO

Finally, let us consider the relationship between the dollar and the euro. Will the rise of the euro lead to its replacement of the dollar as the world's key currency? I cannot say what may happen 100 years from now, but I am highly skeptical of such a possibility in the near future. To be sure,

the euro is the common currency in an area with a population exceeding 300 million and a GDP approaching that of the American economy. Naturally, then, it has become a major presence in terms of its share of the currencies used for trade and financial transactions. But this does not automatically confer on it the status of a key global currency. There is probably no way for it to replace the dollar as long as the euro zone lacks the capacity to take the initiative in political and military affairs as a sovereign state.

More than that, in this age of globalized financing and investment, is there not a more important requirement for a currency to serve by de facto standard as a key currency? This is the need for the currency to be accompanied by open money and capital markets, which function at the core of cross-border financial flows around the world. In this respect, we find that the euro has no international financial centers of its own comparable to New York and London.

A key currency, we need to understand, produces major benefits from the externalities of the networks in which it is used, with people making use of it because others are also using it. When this is considered, the predictions of those who assert we are moving toward an age of non-polarity appear very unlikely.

When people wish to provide proof of the euro's rise as an international currency, they frequently cite its share in the foreign currency reserves held by governments, a statistic released by the International Monetary Fund. In 1999, when the euro made its debut, foreign currency reserves denominated in euros had a share of some 18%. This share has now grown to 26% as of the end of 2007, while the dollar's share has declined from 71% to 64%. When we look at currency pairs in transactions on foreign exchange markets, however, we find that as of 2007 the dollar was involved in 86% of all transactions, including those in which the euro was the other currency. There has, moreover, been little change in this regard, with the dollar involved in 84% of all transactions in 1995. What this means is that the dollar is being used by traders as a medium for turning the yen and the euro into other currencies, and such use of the dollar as the key currency has changed little over the past decade.

In the arena of international politics, the United States and Europe need to work together on solving problems even when their interests are not identical. On the level of the dollar and the euro, similarly, there is more of a complementary relationship than one of rivalry or substitution, and this coexistence is likely to carry on into the future. At a time when there are signs of the rebirth of the Russian Empire, cooperation between Europe and America is all the more essential. At least over the near future, what we may realistically expect is a key currency setup in which the euro plays the role silver once did as a supplement to the gold standard.

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