Financial burdens will continue dollar's long-term decline

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The dollar is likely to be on a downtrend over the long term as the United States faces a massive fiscal burden from its efforts to recover from the financial crisis and to pay for its wars overseas, experts told a recent seminar in Tokyo.

The financial crisis has put in doubt the mechanism under which the U.S. economy has for so long attracted funds from abroad to make up for the shortage in domestic savings, and finance its investments and consumption, they said.

Eiji Ogawa, a professor of Hitotsubashi University Graduate School of Commerce and Management, and Jitsuro Terashima, chairman of the Japan Research Institute, discussed the global financial crisis and Japan's possible responses during the Feb. 13 seminar organized by the Keizai Koho Center.

Ogawa explained how the ongoing crisis is linked to the problem of global imbalances — or namely, the U.S. incurring current account deficits while East Asia, plus oil-producing economies in recent years, posted surpluses.

The U.S. current account deficits started to increase in the late 1990s amid excessive private-sector investment during the information technology boom, Ogawa said.

When the IT bubble burst, the U.S. government resorted to aggressive fiscal stimulus and easy monetary policies to make up for the fall in private-sector investment, sharply increasing the budget deficit in the early years of this decade, he said. The current account deficit increased further as the budget deficit expanded faster than the shrinkage of investments, he added.

Then came the housing investment boom of 2003-2005 — or the housing bubble — which is of course closely linked to the current subprime loan woes, Ogawa told the audience.

During the housing boom, money from East Asian countries like Japan and China financed the U.S. budget deficits — but mainly through investments in safe assets like government bonds, Ogawa said.

Meanwhile, European financial institutions, including those from the City of London, channeled abundant oil money from the Middle East and Russia into U.S. housing investments, he said. Therefore, the balance sheets of European banks were also hurt when the subprime mortgage problem surfaced in 2007 and following the September 2008 Lehman Brothers shock, he added.

This is why, according to Ogawa, the dollar's exchange rate did not collapse even though the financial crisis originated in the U.S. What happened instead was the sharp fall of the euro as European financial institutions had trouble securing dollars, he said.

Ogawa said several scenarios have been considered for the future course of the dollar's exchange rate.

A "crisis scenario" — often mentioned right after the Lehman shock of September — anticipated a dollar crash because the U.S.-originated financial crisis would ruin trust in the U.S. currency, but such a situation did not materialize, he said.

On the other hand, there is a "soft-landing scenario" under which shrinking housing investment, consumer spending and capital investment in the U.S. will pare excessive American consumption and investments, thereby reducing its current account deficit while having a relatively small impact on the dollar, he said.

The most realistic scenario, however, would be a long-term decline of the dollar's exchange rate, he said. Given that the huge fiscal cost of cleaning up the mess from the crisis would likely increase the U.S. budget deficit — perhaps up to 10 percent of gross domestic product — in coming years, the dollar would eventually have to fall over the long term, according to Ogawa.

Ogawa said that at least for the time being, the dollar-based system of international settlement will be maintained. But the question remains whether Asia can continue to rely on the dollar, and Asian countries will need to step up regional cooperation for financial stability, he added.

Terashima, also president of the Mitsui Global Strategic Studies Institute, pointed to the enormity of the fiscal burden to be imposed on the new U.S. administration of President Barack Obama.

Citing an estimate by Nobel Prize-winning economist Joseph Stiglitz that the U.S. would eventually have to spend up to $3 trillion to finish the wars in Iraq and Afghanistan, Terashima said the huge cost would weight heavily on the new administration also tasked with pulling the U.S. economy out of the crisis.

The total amount of the various commitments using public funds to stabilize the U.S. financial system — such as public loans and guarantees — has reached $8 trillion, he said. Although this does not automatically mean an immediate fiscal burden of this scale, the total potential risk to the federal coffers from these efforts and the wars — coupled with the cost of the stimulus package recently signed by Obama — is roughly equivalent to double Japan's annual GDP, he added.

Of the twin U.S. deficits, Obama last week forecast a $1.75 trillion budget deficit for fiscal 2009 — the biggest amount since World War II — and predicted the deficit would fall in fiscal 2010 but still remain huge at $1.17 trillion.

There are suggestions that the deficit would stay above $1 trillion for several years, Terashima said. The question is how to finance the massive deficit, and the U.S., due to its savings shortage, will have to rely on overseas sources — or namely, countries like Japan, China and oil-rich nations — to buy the U.S. government bonds to finance the deficits, he pointed out.

Despite the twin deficits, the U.S. economy has managed to survive because the capital account surplus more than made up for the current account deficit — namely, the inflow of funds from around the world through the New York financial markets, Terashima noted.

This inflow has long been attributed to a number of factors — including the dollar's role as an international currency, he said. But at least one of these factors — the interest rate differentials between the U.S. and other major economies — has diminished as the Federal Reserve rapidly cut its rates to as low as zero in response to the crisis since last fall, he added.

Also, people in the financial industry have often mentioned what they called the "maturity" of New York's markets, Terashima pointed out.

Even small credit unions in rural Japan are known to have invested in subprime loan-related financial products in the U.S., and the reason why they even managed their money in the New York markets in the first place is that they had been attracted to what was touted as a wide-ranging "lineup" of financial product options there that are not available in Japan, he said. But the reality was that such a lineup included the securitized products using the subprime loans, he added.

So what happened to the credibility of the markets? The result was that the capital account surplus in fiscal 2008 stood at $683.2 billion — not big enough to offset the current account deficit of $697.9 billion, Terashima said. This could mean the end of the structure that enabled the U.S. to continue consumption beyond its industrial power — like a bleeding patient kept alive on blood transfusions now suffering from anemia because he is losing more blood than is being given to him, he added.

Terashima noted, however, that the capability of the U.S. to present itself as a country full of new investment opportunities — and thereby attract money from around the globe — should not be underestimated.

In this sense, the so-called Green New Deal proposals for massive federal spending on clean energy technologies as a way to accelerate moves toward energy efficiency, renewable energy and a sustainable low-carbon economy should be closely watched to see if they have the potential to create a massive industrial-technological paradigm shift in coming years, Terashima said. And these are the areas where Japan has the technological edge and potential for greater industrial cooperation with the U.S., he added. (T.K.)