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Europe's Dollar Problem

By David M. Smick

We don't think of it much on this side of the pond, but European strategists had their policy world turned upside-down when George W. Bush was re-elected. Convinced that John Kerry would win, most were banking on a series of U.S. tax hikes as a "solution" to America's huge and growing current-account imbalance, which risks a further weakening of the already record low dollar. Indeed, the U.S. bond market and dollar were only being temporarily propped up, many Europeans argued, by Asian purchases of U.S. Treasuries aimed at helping re-elect a friendly president.

Yet so far the steady weakening of the greenback, especially since the election, has failed to produce the predicted bond-market nightmare. Time will tell, as Fed Chairman Alan Greenspan warns. But it may well be the U.S. doesn't have a dollar problem so much as Europe does. To be sure, the U.S. must eventually reduce its current-account and budget deficits, a phrase that has become a bit of a tautology in policy circles. But what has become increasingly clear is that this administration believes it has the option of relying more on slow and methodical exchange-rate adjustment (a weaker dollar, as the Bush team hints, "if based on the fundamentals") than on massive, potentially contractionary fiscal adjustments.

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A month or so ago, European Central Bank officials acknowledged that a dollar move to the 1.30 level against the euro would be "brutal" for European multinationals. Today we're beyond 1.30. A dollar approaching 1.40 was described as being "catastrophic" to European corporate balance sheets, despite the positive implications for oil, particularly if the dollar decline developed quickly. Europe's special problem is that the Asian economies are largely tied to the U.S. dollar and the one, sure engine for European growth has been exports to Asia. Further weakening of the dollar risks ruining that engine.

What is also clear is that European policy makers are essentially weaponless, unless of course the political leadership sees the light and implements new fiscal and structural policies that promote growth. Short of such a breakthrough, a standard solution for an overvalued currency, an interest-rate reduction, is not on the table. As ECB President Jean-Claude Trichet's recent hawkish remarks reflect, the central bank has missed its mandated 2% inflation target for the last five years with the rate now at 2.5%. Talk is that the inflation picture could worsen.

Central bank intervention is also a long shot. Intervention makes no sense without U.S. participation—and don't hold your breath. The latest G7 communique calls for intervention in the event of "disorderly" markets, which is hardly the case today. Besides, Washington—currently in the midst of its lip-service calls for greater global "flexibility" and reform to open up alternative investment opportunities for the world's capital—in the end only cares about one question in the event the dollar weakens further: Is the U.S. bond market holding up?

Some European strategists are tempted to attack the Chinese and other Asian economies for currency manipulation in tying to the dollar. Yet to many in the currency markets it is not altogether clear that, even if the Chinese tomorrow stopped intervening and allowed the yuan to strengthen, the euro wouldn't also strengthen in a largely global dollar system.

For most global-market strategists, the major surprise in this dollar drama has been the U.S. bond market. Why, despite the huge, growing current-account and budgetary imbalances, and steady dollar weakening since April 2002, has the bond market performed so well, rallying each time after the Fed's first four tightenings—something that hasn't happened since the 1960s?

Some at the Fed suggest the market is simply reflecting the U.S. central bank's brilliant performance in conquering inflationary expectations. Some Japanese analysts ominously suggest the U.S. today is where Japan was in the early 1990s, with interest rates low precisely because corporate credit demand has collapsed. Another emerging view is that bond yields have remained low because of the rapid aging of the U.S. population, which is forcing pension funds in asset allocation to shift from equities to bonds. U.S. corporate unfunded pension liabilities may also be contributing to this noncyclical shift.

> ***Pro-growth policies are the Continent's only weapon.***

But there's another, often overlooked, reason: The U.S. is the world's consumer of last resort. As such, many foreign buyers of the U.S. bond market in particular are being careful not to kill the goose that lays the golden eggs. After all, a serious chest cold for the U.S. economy brought about by abruptly skyrocketing interest rates would probably produce economic pneumonia in many other economies already suffering the effects of higher world energy prices.

Remember, too, that most of these high-saving economies seem to have one thing in common: They love to export, not consume. Thus, they may in the end not particularly enjoy a world without a strong, consuming, if not over-consuming, U.S. economy. Indeed, some analysts go so far—perhaps a bit too far—as to define the emergence of a sans euro Asian-dollar bloc where America's trade imbalance with China or Japan is about as relevant as California's trade balance with Texas or Connecticut.

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Where all of this leads is not totally clear and European policy makers probably have a right to be dismayed. It is hardly a certainty that further dollar weakness will successfully reduce America's current-account imbalance. At least for the next few years, European multinationals in the U.S. probably will resist raising prices despite a rising euro. Most are hedged some against currency risk. Almost all find the American market so incredibly lucrative and stable relative to the rest of the world that companies will likely squeeze profits down to virtually nothing simply to protect market share. The same goes for Japanese multinationals.

In other words, textbook 1980s foreign-exchange policy may no longer work. When all is said and done, the current-account imbalance may stubbornly persist. After all, a bulk of the U.S. imbalance is with the Asian economies, not Europe. In the end, Washington may eventually be forced back to the drawing board where perhaps serious measures to increase the savings rate will finally be considered.

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