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WHO WILL SUPPORT THE U.S. DOLLAR?

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There is a growing speculation that Japan may reduce its massive intervention in the currency market and allow the yen to appreciate. As Japan has spent nearly $300 billion on dollar intervention during the past fifteen months, such a possibility raises disturbing questions about how America will finance its $500 billion current account deficit.

The basic underpinning of the Bush administration's foreign and economic policies has been one statistical fact. The countries of East Asia now have over $2.1 trillion of foreign exchange reserves or 70% of the world total compared to only 30% ten years ago. The U.S. is able to run large fiscal deficits and current account deficits because these countries typically keep 85-90% of their reserves in U.S. government securities. If they ever sold the dollar or simply stopped supporting it, the exchange rate would fall sharply, driving up U.S. interest rates and forcing America to seek financing elsewhere.

Where could America turn for money? There is no simple answer. Many of America's traditional allies have shown little support for the dollar. The white dominions of the British Commonwealth, Australia, New Zealand, and Canada have reduced the dollar share of their forex reserves to less than 50% compared to a global overage of 66%. As the dollar has been declining in value, they are reluctant to purchase the currency.

If the dominions will not help America, where else can Washington turn? There is a former dominion which appears likely to be a candidate for large dollar purchases this year. It is South Africa. During the past two years, there has been a dramatic rally in the value of the South African rand because of the country's high interest rates (8%) compared to America, Europe, and Japan. South Africa's high relative yield has produced a carry trade of hot money driving the rand from nearly 14 in late 2001 to 6.35 recently. The hot money has allowed South Africa to eliminate the negative foreign exchange position which it had developed during the 1990s when it intervened to stabilize the currency during periods of crisis, such as the Russian default of 1998 and the transition to democracy during 1994. As South Africa still offers high yields, it is likely to continue attracting the world's surplus liquidity until American interest rates recover. The appreciation of the rand has done significant damage to the profit margins of South Africa's manufacturing and mining companies. As a result there is increasing pressure on the Reserve Bank to intervene and begin accumulating reserves. If it does, South Africa should be able to provide at least $20-25 billion of funding for the U.S. current account deficit.

The oil producing countries are likely to experience a large increase in forex reserves during 2004. Russia is likely to expand its forex reserves from $75 billion last year to $110 billion late this year. The Middle Eastern members of OPEC are likely to bolster their export income by $50-75 billion as well. Robert Woodward claims that Saudi Arabia will lower oil prices to help George Bush win re-election this autumn. The Saudis could also give Bush a boost by using their new reserves to buy U.S. government securities.

The great wildcard in the dollar outlook is the European Central Bank. Europe now accounts for only about 8.5% of global foreign exchange reserves compared to 40% during the late 1960s. In the late 1960s, France used its reserves to attack America by swapping dollars for gold. The Europeans have recently used moral suasion to slow the dollar's decline but the big question is would they fill an intervention void created by a Japanese withdrawal from the market. The ECB has often expressed disapproval of

intervention but if the dollar suddenly drops to 1.4 against the Euro there will be such great howls of protest from European industry that the ECB will either have to cut interest rates or intervene

The U.S. Treasury has been lobbying for dollar devaluation because it is unconcerned about how America will fund its current account deficit. If the East Asian countries cease their intervention, this complacency could turn into concern because of the sheer scope of the funding gap. But the good news is that countries other than Japan and Chine care about the dollar's value. In 2004, America will be able to find new dollar buyers in Africa, Russia, Latin America, and the Persian Gulf. If the currency falls far enough, there also will be intervention from Frankfurt. The only question is how far the dollar will have to fall to provoke buyers outside of East Asia to intervene.