

Why the dollar is almost past its sell-by date

Hot money flows into the US dollar may soon cool down. If so, expect foreign support for Wall Street to fall away, says Gerard Lyons. One warning from the Asian crisis: trade deficits matter.

Currencies rarely stay in fashion for long. The yen's performance in the 1990s demonstrates this. Once the star of the world's currency markets, the yen has fallen sharply in the last three years. By June this year it was clear it had fallen far enough. Intervention and new policy measures in Japan gave the yen support. Despite this, the financial markets remain negative on the currency and continue to look for an excuse to sell it. Everyone, it seems, dislikes the yen. By contrast the dollar is the currency in fashion.

When will this change? Probably sooner than the market expects. Soon it could be the dollar's turn to come under pressure and fall out of favour.

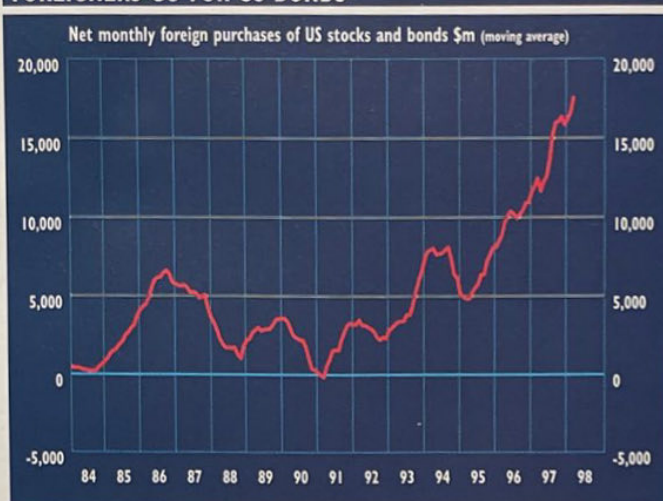
There are two reasons to be cautious about the dollar: hot money has helped keep the dollar strong, and the widening US current account deficit suggests problems ahead.

Hot money refers to liquid portfolio flows that move around the world quickly in search of a profit. Such short-term capital is attracted quickly into a currency when things look good, but leaves at the first sign of trouble. The performance of Asian capital markets in recent years shows how the benefits of hot money can soon turn sour. Behaving like sheep, investors poured money into Asian markets before last year's crisis. Once the crisis broke, the money left and sought safer havens elsewhere.

Foreign money is contributing to buoyant financial markets in the US, leading to asset price inflation. It would be wrong to suggest that money has only flowed into the US since Asia's crisis broke. It hasn't. Money has been flowing in for some time. It is just that the scale of the inflows to the US is now so sizeable that they should not be ignored, particularly if there is a shift in currency sentiment.

Foreign holdings of US bonds are at an all-time high. At the end of 1997, foreigners held 38%, or \$1.3 trillion, of the US Treasury market. British and Japanese investors account for half of the US debt held by foreigners. A surge in foreign holdings of US debt over the last year has been from private investors, not from official institutions. That is, the same type of investors who pumped money into Asian markets without

FOREIGNERS GO FOR US BONDS



question before last year's currency crisis are now investing heavily in the US.

Good economic fundamentals have driven both the US bondmarket and stockmarket stronger in recent years. But a key factor for foreign investors has been the attraction of the dollar. The dollar's attractive status has also spurred a buying surge by foreigners of the US stockmarket. More foreign money than domestic money is being attracted into US equities. The amounts fluctuate from month to month but the recent average has been sizeable, as the graph shows.

The amount of foreign money going into US stocks and bonds should be a concern, particularly in the wake of recent US intervention to help the yen.

Intervention to support the yen made sense. In recent years a weaker yen had acted as a safety valve for problems in Japan. But if the yen weakened further it would not have helped the Japanese economy, where a recovery in domestic demand is the key, and it would have exacerbated problems in Asia, increasing the risk of currency devaluations. Intervention stabilised the markets. Time will tell whether policy measures will support this. I think they will.

Intervention could also have a significant impact on US markets. And it is an impact that investors are either ignoring or unaware of.

Intervening to defend the yen sends an important policy signal that the US has shifted away from a strong dollar policy in favour of

dollar stability. The US does not want a weaker dollar. But if foreign investors no longer expect the dollar to appreciate they may not invest so much in US assets.

This could be a bigger concern for the US stockmarket than for the US bondmarket. If the amount of foreign money going into US equities stops, or falls sharply, this will remove one of the main recent driving force for the Dow Jones index. And if foreigners actually started to sell US assets the situation would be worse. The Dow could then fall, hitting US consumer confidence and slowing the economy. So an improvement in the prospects for the yen makes the dollar less attractive. And if the dollar loses its shine

then US assets become less attractive.

A second reason to be worried about the dollar is the US current account deficit. One lesson from Asia's currency crisis that a current account deficit matters. If more notice had been taken of current account deficits, investors may have been better prepared for Asia's crisis.

A large trade deficit means the economy is either growing too strongly, sucking in imports, or export performance is suffering, because of a lack of competitiveness. Or a trade deficit may reflect both, as in Asia before the crisis.

Public finances in many Asian economies were in good shape. This fed a false sense of security about Asia's prospects and allowed the market and policy makers to believe the trade deficit was not a problem. The reasoning was that if the government was in surplus then the trade deficit reflected behaviour in the private sector and should not be a concern for policy. The healthy state of US public finances could trigger similar complacency in the US.

In the past, large US trade deficits have eventually resulted in a weaker dollar. If the US trade deficit deteriorates, then it may require higher interest rates to compensate international investors for increased currency risk or the dollar will fall.

Changing currency fashions could soon leave the dollar looking past its 'sell-by date'. ●

Dr Gerard Lyons is chief economist of DKB International, the London-based subsidiary of the Dai-ichi Kangyo Bank.