Post-election, the US may choose to go for a weaker dollar

There were no political shocks from the US election. The key question now for global financial markets is whether the election outcome will trigger any economic surprises?

Ahead of the election there was a fear that a Democratic victory in Congress would allow organised labour to gain more influence and prompt a relaxed fiscal stance. This did not materialise. Instead the US voted for continued "divided government", with a Democratic President and Republican Congress. This should allow further fiscal consolidation, with the budget deficit falling, pleasing the US bond and stock markets.

But what about the dollar? In America, little attention outside of the financial markets is paid to the rate of the Deutschmark against the dollar. But US industry keep a very close eye on the dollar's movement against the yen.

Two factors have driven the dollar stronger during the last year – policy and Japan's declining trade surplus. Now, with weak growth and low yields at home, the Japanese need to obtain higher returns, and thus they are investing more money overseas. This points to a stronger dollar. The key issue is whether the Americans will tolerate this?

In recent months, US Treasury Secretary Robert Rubin has called for a stronger dollar. This gave the impression that, ahead of the election, administration officials would say anything to prevent the dollar from falling. If the dollar fell this could have weakened the US bond market, pushing long-term interest rates higher and, in turn, triggering a sharp fall in the US stock market, dampening consumer confidence and the feel-good factor.

Now, with the election over, the administration may be less keen to keep the dollar strong.

To see how policy may evolve it is important to put the ¥:$ in perspective. Throughout the 1980s various US Administrations tried to tackle America's large trade imbalance with Japan. President Reagan focused on the need for macro economic adjustment, forcing the yen stronger in order to make Japanese goods less competitive. The Bush administration focused on the removal of "invisible barriers" to trade in Japan.

President Clinton, meanwhile, combined both approaches. His Commerce Secretary, Micky Kantor, put strong pressure on Japan to deregulate and open its markets. This was also in Japan's best economic interests. They have deregulated, albeit slowly. Consequently import penetration into Japan has risen and Japan's trade surplus has fallen in recent years.

A strong yen was also central to the US strategy. In the first half of the 1990s the appreciation of the yen against the dollar was economically stabilising, helping to reduce Japan's trade surplus. But by spring last year this policy was sowing the seeds of its own downfall. The yen had appreciated too far, pushing Japan to the brink of recession and financial meltdown.

Consequently the major industrialised countries intervened to strengthen the dollar, against both the yen and mark. This policy proved successful, particularly against the yen.

The Bank of Japan played a key role in weakening the yen. Along with other central banks they bought dollars aggressively. Although the foreign exchange market is huge, one should not underestimate the potential impact of central bank intervention, particularly when their policy aims coincide with what is justified economically, which in this case was a stronger dollar. At the end of last year global foreign exchange reserves were $1.4 trillion.

At one stage it appeared the Bank of Japan was trying to stabilise the ¥:$ within a ¥:$105-110 range. But in recent months the yen weakened beyond this. This weaker yen, alongside low Japanese interest rates and increased government spending, has contributed to a recovery in the Japanese economy, which is now under way. But a weak yen is necessary for Japan's economic recovery to continue.

In view of this it is surprising that the comments about the dollar, since the US election, have come from the Japanese and not the Americans. The influential official Mr Sakakibara suggested the dollar's correction against the yen was about to finish.

In recent weeks, there have been two significant developments. Honda announced it was moving production of the Accord from the US back to Japan. Then Toyota announced that next year a new station wagon will be produced in Japan. In recent years, the trend has been to move production overseas. In both cases demand was cited as the reason, but the weaker yen must have played a key role.

US industry is also worried. Two weeks ago the "big three" US car makers asked for a meeting with Robert Rubin to discuss the dollar. They clearly want the dollar to weaken as Japanese car firms are now benefiting from currency moves during the last year. Hence the interest in whether there will be any shift in US policy towards the dollar. This is likely to depend on the performance of the US economy.

If the US economy continues to slow, and the likelihood is it will, then the US car sector will be badly affected. Thus financial markets will be wary of any US policy shift.

But if the dollar does fall against the yen or mark this will create problems again for the German and Japanese economies. A strong currency has become the old maid of the world economy. It is the card that countries least want to have. Thus it will be no surprise if the US election outcome prompts calls for a weaker dollar.

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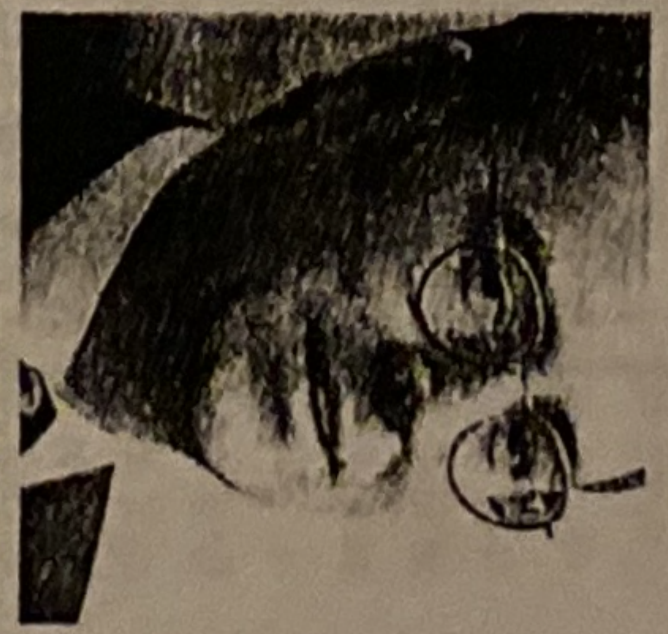

ECONOMICS WEEK

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