A mark of strength will weaken the union

As financial markets prepare for monetary union and the euro by 1999, it is important not to overlook the relationship between the big three currencies: dollar, Deutschmark and yen. This is also entering a critical phase. After the fall of the yen during the past year, it is now the DM's turn to weaken.

During the first half of the 1990s, currency movements were stabilising, helping to cure underlying trade and economic imbalances. The dollar fell sharply against the yen and was soft against the DM. The dollar's trade-weighted index was relatively stable, as the dollar was strong against the currencies of some of the US' major trading partners, such as Canada and Mexico. Thus, while most people talk of dollar weakness it is really a case of yen and Deutschmark strength. The question is, can this continue?

By the start of last year, currency movements had become destabilising. Then the yen appreciated too far, too fast. In the first three months of 1995, the yen appreciated from ¥:$99.8 to ¥:$80. This pushed Japan to the brink of another recession and financial meltdown. The Bank of Japan intervened aggressively, and the yen weakened. Alongside low interest rates and a huge fiscal stimulus, the weaker yen has triggered a recovery in the Japanese economy.

Just as the strong yen caused problems for Japan at the start of last year, the strong DM has squeezed German industry in recent months. Output has been weak, business confidence has slumped and job losses are widespread. Germany is on the brink of recession. Unlike Japan last year, Germany does not have scope to relax fiscal policy. Because of the Maastricht convergence criteria, German fiscal policy is tight, with plans for sizeable spending cuts next year. With growth weak, inflation low and fiscal policy tight the only option has been to loosen monetary policy, with interest rates now at record lows and the Bundesbank encouraging a weaker DM.

Are we seeing the first signs of a shift in the balance between the major three currencies? Is the dollar about to recover?

The dollar still has problems. The first is the shifting pattern of world trade. Higher intra-European trade has boosted the attraction of the DM, while higher intra-Asian trade has done likewise for the yen. Although the dollar remains *the* reserve currency, its influence has waned. Over the last 15 years the dollar has fallen from four fifths to three fifths of global currency reserves.

Second, the US still has a poor trade performance. Low national savings led it to run a current account deficit and run down its overseas assets; it moved from a net saver to a net borrower in the mid-1980s. Consequently, the US is dependent on foreign capital inflows. Just as sterling found during its exit from the ERM, such foreign capital can leave a currency just as quickly as it arrives.

Despite this, prospects for the dollar have improved.

Last week, one of Germany's six major research institutes, the IW Institute, released 1995 data on international labour costs. The hourly wage cost in the German manufacturing sector was DM45.5, in Japan it was DM35.48, but in the US it was only DM25.18. The UK was in even better shape, at DM20.96.

Such has been the appreciation of the yen and DM that the costs of Japanese and German goods are prohibitive. This has already encouraged Japanese and German companies to move production overseas. In Japan, this "hollowing out" is mainly to lower cost centres elsewhere in Asia. This year, Japan's manufacturing firms expect one fifth of their production and over one quarter of their investment to be outside Japan, a phenomenal jump from recent years. But it is not just Asia. There has been movement of production to the US, so much so that Japan now imports more Japanese than American cars from the US.

Recent surveys, however, suggest that Japanese firms can cope with a strong yen, as long as it does not appreciate too fast. Furthermore, just as the US is dependent on foreign capital inflows, the Japanese are current masters of the yen's destiny. Japan's huge savings mean that if Japanese investors keep their money at home the yen will remain strong.

By contrast, the DM appears at risk. Although Germany's quality capital goods exports are not so price sensitive and have helped underpin healthy export growth, particularly to Asia, there are problems elsewhere.

Germany has run a current account deficit for four successive years, during which its overseas assets have been halved. Another negative is capital flows. While Japanese capital flows may support the yen, flows in Germany will weaken the DM. As German competitiveness has suffered, there have been sizeable direct investment outflows from Germany. And, as German investors have become concerned that monetary union will result in the DM being replaced by a soft euro, there have been steady portfolio outflows.

Something has to give. In recent months it has been the economy, but now it is the DM. Just as the Bank of Japan last year had to intervene to keep the yen weak the Bundesbank may have to continue to encourage a weaker DM. If not, the consequences for the German economy and monetary union will not be good.

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Currency movements were destabilising in the last year, leading to a weaker yen and pointing to the need for a weaker DM, says **Gerard Lyons**

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