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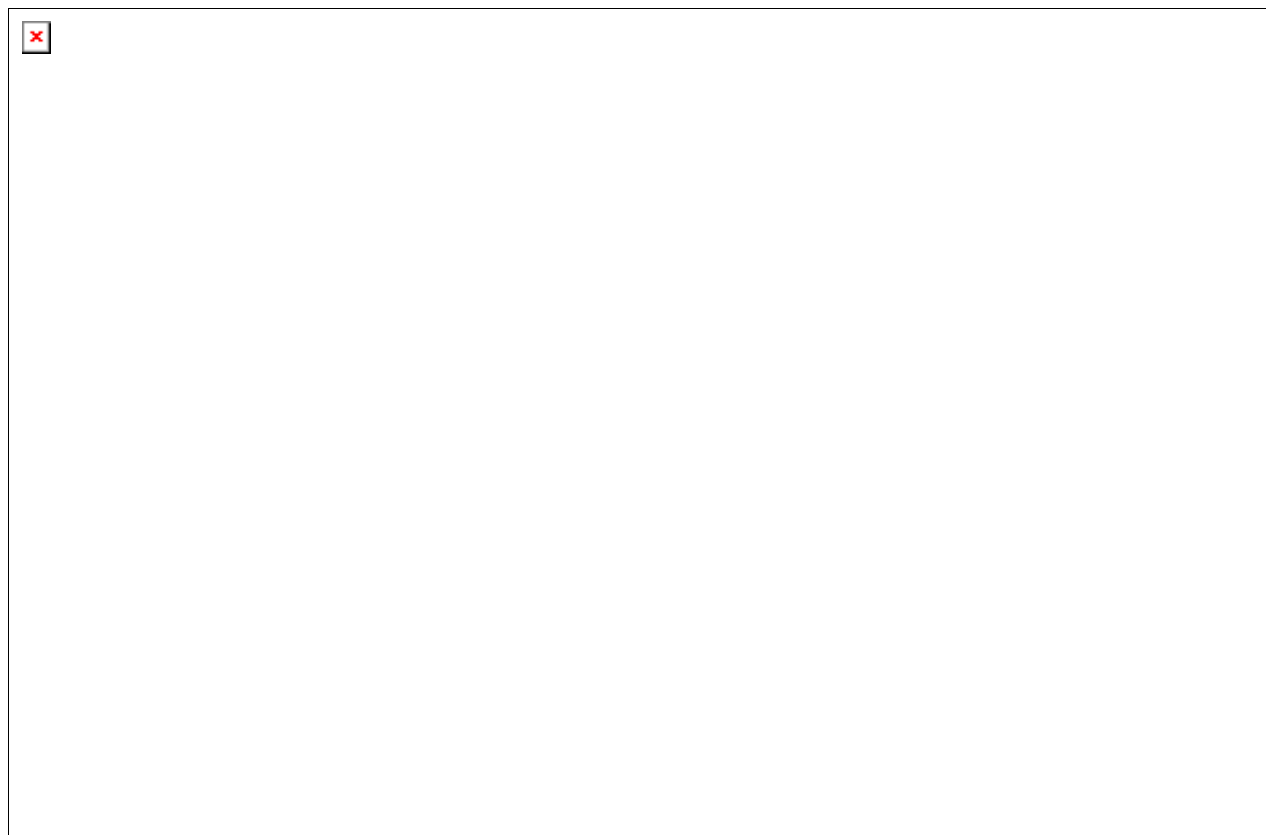
## Asia, its reserves and the coming dollar crisis

By Richard Duncan 21 May 2003

**Author of the new book, *The Dollar Crisis*, Richard Duncan explains why the dollar is the source of global deflation.**

*FinanceAsia: Posterity may remember it as a seminal book in the field of 21st century economics. Indeed, rarely has a book offered such a grim yet well argued view of the current economic situation facing the world and Asia. The author - a former Salomon banker, and World Bank staffer - is Richard Duncan and the book is called the Dollar Crisis. In this essay, the American explains why the US dollar is at the root of global deflation, and recent bubbles, and what it will mean for Asia.*

During the 30 years since the breakdown of the Bretton Woods International Monetary System, the global economy has been flooded with dollar liquidity. International reserves are one of the best measures of that liquidity. During the quasi-gold standard Bretton Woods era, international reserves expanded only slowly. For example, total international reserves increased by only 55% during the 20 years between 1949 and 1969, the year Bretton Woods began to come under strain. Since 1969, total international reserves have surged by more than 2000%. This explosion of reserve assets has been one of the most significant economic events of the last 50 years.



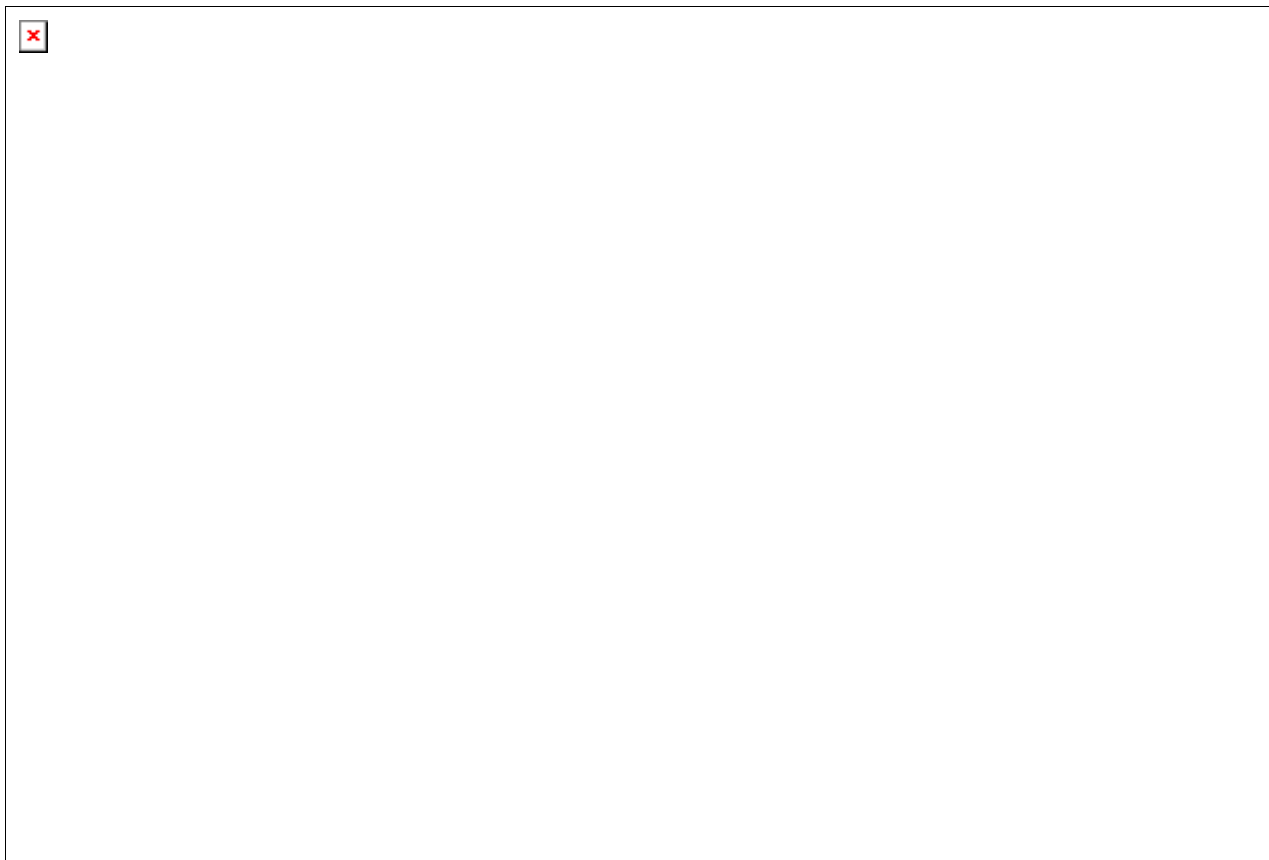
Today, Asian central banks hold approximately \$1.5 trillion in US dollar-denominated reserve assets. Most of the world's international reserves come into existence as a result of the United States current account deficit. That deficit is now \$1 billion *a minute*. Last year, it amounted to \$503 billion or roughly 2% of global GDP. The combined international reserves of the countries with a current account surplus increase by more or less

the same amount as the US current account deficit each year. So central bankers must worry not only about their existing stockpile of dollar reserves, but also about the flow of new US dollar reserves they will continue to accumulate each year so long as their countries continue to achieve a surplus on their overall balance of payments.

With the depreciation of the dollar rapidly gaining momentum, Asian central bankers are scrambling to find alternative, non-dollar denominated investment vehicles in which to hold their countries' reserves. Consequently, this is a topic that is attracting considerable attention in the press.

There is a related issue of much greater importance being entirely overlooked, however. The surge in international reserves has created unprecedented macroeconomic imbalances that are destabilizing the global economy. The global economic disequilibrium caused by these imbalances is the subject of this article. It is also the subject my recently published book, *THE DOLLAR CRISIS: Causes, Consequences, Cures* (John Wiley & Sons, 2003).

Since the breakdown of Bretton Woods, dollars have replaced gold as the international reserve currency. The international monetary system now functions on a Dollar Standard rather than a Gold Standard.



The primary characteristic of The Dollar Standard is that it has allowed the United States to finance extraordinarily large current account deficits by selling debt instruments to its trading partners instead of paying for its imports with gold as would have been required under the Bretton Woods System or The Gold Standard.

In this manner, The Dollar Standard has ushered in the age of globalization by allowing the rest of the world to sell their products to the United States on credit. This arrangement has had the benefit of allowing much more rapid economic growth, particularly in large parts of the developing world, than could have occurred otherwise.

It also has put downward pressure on consumer prices and, therefore, interest rates in the United States as

cheap manufactured goods made with very low-cost labor have been imported into the United States in rapidly increasing amounts.

However, it is now becoming increasingly apparent that The Dollar Standard has also resulted in a number of undesirable and potentially disastrous consequences.

First, it is clear that countries which built up large stockpiles of international reserves through current account or financial account surpluses have experienced severe economic overheating and hyper-inflation in asset prices that ultimately resulted in economic collapse. Japan and the Asia crisis countries are the most obvious examples of countries that suffered from that process. Those countries were able to avoid complete economic depression only because their governments went deeply into debt to bailout the depositors of their bankrupt banks.

Second, flaws in the current international monetary system have also resulted in economic overheating and hyper-inflation in asset prices in the United States as that country's trading partners have reinvested their dollar surpluses (i.e. their reserve assets) in dollar-denominated assets. Their acquisitions of stocks, corporate bonds, and US agency debt have helped fuel the stock market bubble, facilitated the extraordinary misallocation of corporate capital, and helped drive US property prices to unsustainable levels.

Third, the credit creation The Dollar Standard made possible has resulted in overinvestment on a grand scale across almost every industry worldwide. Overinvestment has produced excess capacity and deflationary pressures that are undermining corporate profitability around the world.

To understand how this unprecedented expansion of dollar-denominated reserve assets has created bubble economies, systemic banking crises and deflation around the world, it is first necessary to understand how the large inflow of dollar reserves affects the banking system in countries with balance of payments surpluses. Next it is necessary to understand how the central banks in those countries come to hold the dollars that enter their economies as a result of current account (or, less commonly, financial account) surpluses. Finally, an examination of the investment alternatives available to the central banks, and the economic impact resulting from each of those alternatives, makes it clear why central banks hold most of their reserve assets in dollars.

The United States is the major deficit nation. When exporters from surplus countries bring their dollar earnings home, those dollars enter their domestic banking system and, being exogenous to the system, act just like high powered money.



The affect on the economy is just the same as if the central bank of that country had injected high powered money into the banking system: as those export earnings are deposited into commercial banks, they sparked off an explosion of credit creation. That is because when new deposits enter a banking system they are lent and re-lent multiple times given that commercial banks need only set aside a fraction of the credit they extend as reserves.

Take Thailand as an example. Beginning in 1986, loan growth expanded by 25% to 30% a year for the next 10 years. Had Thailand been a closed economy without a large balance of payments surplus, such rapid loan growth would have been impossible. The banks would have very quickly run out of deposits to lend, and the economy would have slowed down very much sooner.

In the event, however, so much foreign capital came into Thailand and was deposited in the Thai banks that the deposits never ran out, and the lending spree went on for more than a decade. By 1990 an asset bubble in property had developed. Every inch of Thailand had gone up in value from 4 to 10 times. Higher property prices provided

more collateral backing for yet more loans.

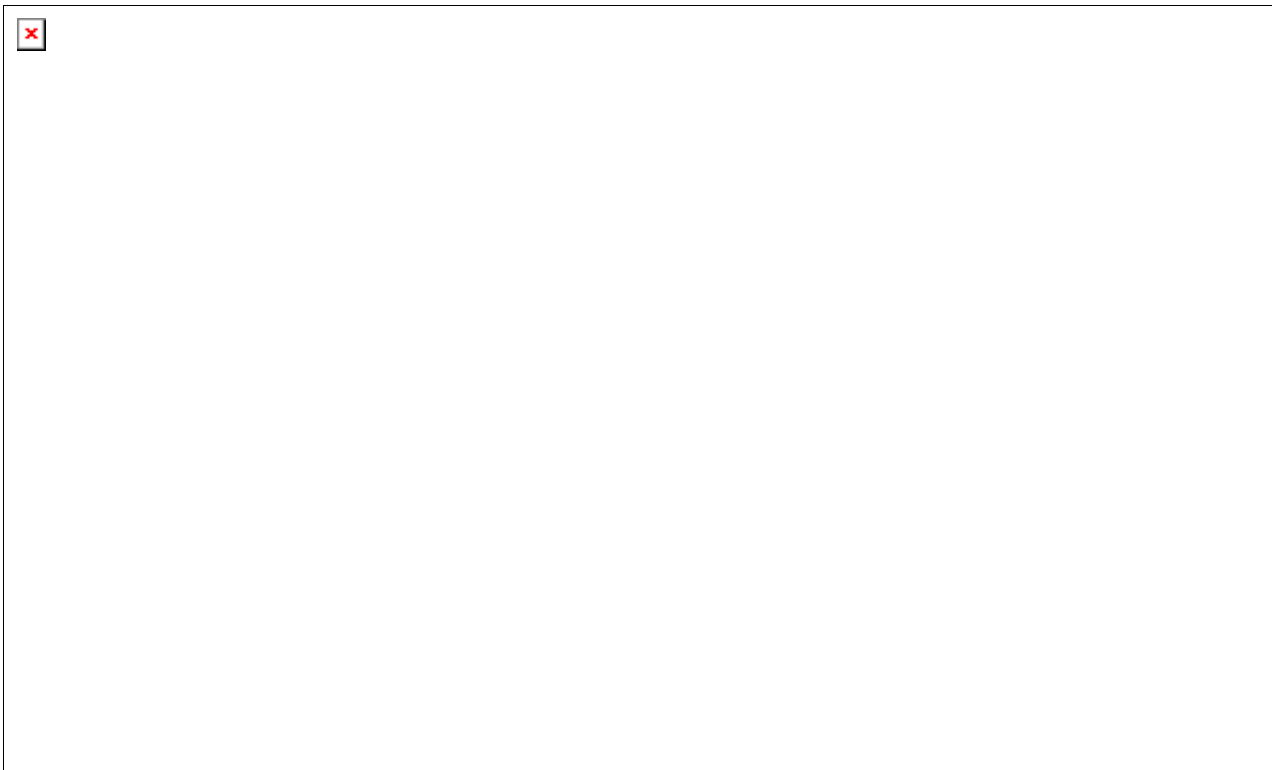
An incredible building boom began. A thousand high rise buildings were added to the skyline. All the building material industries quadrupled their capacity. Corporate profits surged and the stock market shot higher. Every industry had access to cheap credit; and every industry dramatically expanded capacity. The economy rocketed into double digit annual growth.

And, so it was in all the countries that rapidly built up large foreign exchange reserves: credit expansion surged, investment and economic growth accelerated at an extraordinary pace, and asset price bubbles began to form. That was the case in Japan in the 1980s and in Thailand and the other Asia crisis countries in the 1990s. It is also true of China today. Wherever reserve assets ballooned in a short space of time, economic bubbles formed.

Unfortunately, economic bubbles always pop. And when they pop, they leave behind two serious problems.

First, they cause systemic banking crises that require governments to go deeply in debt to bailout the depositors of the failed banks. Economic bubbles always end in excess industrial capacity and/or unsustainably high asset prices. Banks fail because deflating asset prices and falling product prices make it impossible for over-stretched borrowers to repay their loans.

During the Bretton Woods era, systemic banking crises were practically unheard of. Since Bretton Woods broke down, they have occurred on a nearly pandemic scale.



The preceding table lists 40 banking crises between 1980 and today and provides estimates of their high fiscal costs as a percentage of GDP.

The second problem economic bubbles leave behind when they pop is excess industrial capacity caused by the extraordinary expansion of credit during the boom years. The problem with excess capacity is that it causes deflation.

Japan is suffering from deflation. Hong Kong and Taiwan have deflation. Even China, where an economic bubble is still inflating, has been experiencing deflation since 1998. The rest of the Asia crisis countries only avoided deflation by drastically devaluing their currencies and exporting deflation abroad. Think of the impact that the over expansion of Korea's semiconductor industry has had on global chip prices.

Hopefully the preceding paragraphs have clarified how unprecedented US current account deficits have sparked off extraordinary credit creation in those countries with the corresponding surpluses, causing unsustainable economic bubbles which subsequently implode, leaving behind wrecked banking systems, heavily indebted governments, excess capacity and deflation.

Now consider how those US current account deficits end up being held as dollar-denominated assets by the central banks of the surplus countries.

There are several reasons why central banks accumulate international reserves. The most compelling reason - in Asia, at least - is the desire of the central banks to prevent their currencies from appreciating. When Asian exporters sell products in the United States, they earn dollars. When they bring those dollars back to Asia, they either exchange them for their domestic currency on the currency market or deposit them in their banks, in which case their banks exchange them for the domestic currency.

This process puts upward pressure on the Asian currencies. Asian policy makers do not want their currencies to appreciate since currency appreciation would cause a reduction in exports and, therefore, a reduction in economic growth.

Consequently, Asian central banks intervene in the currency market and acquire the dollars that the exporters and banks wish to sell. They pay for those dollars by issuing their own currency, whether Yen, Baht or Yuan. Asia's export-led economic growth strategy therefore requires that the Asian central banks build up their dollar reserve assets to prevent their currencies from appreciating. This process simultaneously expands the domestic money supply, which further fuels the domestic economy.

In theory, it is possible for the Asia central banks to absorb the domestic liquidity created through this process by issuing bonds to soak back up the currency they issued to acquire the dollars. However, sterilization on a grand scale is expensive as the central banks must pay interest on the bonds they issue. Judging by the size of the economic bubbles that have arisen across most of Asia during the past two decades, it is quite clear that if such sterilization was attempted at all, it occurred on too small a scale to be effective.

Once the Asian central banks have acquired dollars, they must either convert them into some other foreign currency or else invest those dollars in an interest bearing dollar-denominated asset in order to earn a return on those funds.

They must decide between holding those dollars in dollar-denominated investments that will generate a return, converting the dollars into some other currency, or else buying some other store of value such as gold.

Their options are fewer than they at first appear however. That is because the amounts involved are so large.

For example, China and Japan each enjoyed a trade surplus of more than \$100 billion with the United States last year. That is in addition to the hundreds of billions of dollar-denominated reserves assets they had accumulated in prior years.

Any attempt to convert even a small portion of that into gold would drive the price of gold wildly higher. Similarly, any strategy that attempted to convert a significant portion of those dollar holdings into Euros would cause a very sharp spike in that currency that the European Central Bank and other European policy makers would view as most unwelcome because of the negative impact it would have on Europe's exports.

It is quite probable that politicians and central bankers in Europe would call their counterparts in Asia and politely ask them to stop driving up the Euro. Or, imagine the response in Tokyo if China began converting its dollar hoard into Yen. Diplomatically, it would be unacceptable and, for that reason, it is not an option.

The fact of the matter is that Asia's dollar reserve holdings, both stock and flow, are so large that they only place they can be accommodated is in US Dollar-denominated assets such as Treasury Bonds; agency debt, such as Fannie Mae and Freddie Mac; corporate debt; equities; or bank deposits.

That is why it has been so easy for the United States to finance its enormous current account deficit. There is really nowhere else for that much money to go.

In other words, the US financial account surplus is actually merely a function of the US current account deficit. The surplus countries can't afford to convert those dollars into their own currencies because of the harm that would do to their exports, and other countries do not want the dollars converted into their currencies for the same reason.

Therefore, the dollar could be described as a boomerang currency. First it goes abroad as the export earnings of non-US exporters. Then foreign central banks send it back to be invested in US dollar-denominated assets because there is really no place else to put it.

It is ironic that not only has the US current account deficit fueled bubble economies in all the major surplus countries, it has also helped create the current economic bubble in the United States as the dollar export earnings of surplus nations come back into the US.

The investments by the surplus countries into US stocks, corporate bonds, and US agency debt have helped fuel the US stock market bubble, facilitated the extraordinary misallocation of corporate capital, and helped inflate the current US property bubble.

This year, the US current account deficit will be \$500 to \$600 billion. That means the surplus nations will have to find places to invest that sum of dollars in dollar-denominated assets. This is an annual task that is becoming increasingly difficult.

Which sector or sectors of the US economy can afford to issue and service \$500 to \$600 billion in additional debt - not only this year, but every year into the future so long as the United States continues to run such large current account deficits? The consumer sector has never been more indebted and corporations are going bankrupt in record numbers.

Neither the consumer sector nor the business sector can afford to take on any more debt. That leaves only the government sector.

Strangely, it is rather fortuitous - at least from the point of view of Asian central banks - that the United States government has once again begun to run such large budget deficits. At this stage in the business cycle, only the US government has the debt servicing capacity to issue and service the amounts of debt required to provide a safe home for the half a trillion dollars and more that the US current account deficit is adding to the world's stock of reserve assets each year.

This year, the US government deficit is well on its way toward \$400 billion. Foreign central banks will be more than happy to snap all that up and then some.

It is no coincidence that the worst of the bubble excesses took place in the United States between 1998 and 2000 when the government briefly achieved a budget surplus. During those years when the government stopped issuing new treasury bonds, the many countries experiencing a current account surplus with the US had little choice but to buy other, more risky dollar-denominated assets such as Fannie Mae, corporate bonds or NASDAQ stocks.

Those are the years of super easy credit when Fannie and Freddy dramatically expanded their balance sheets and sparked-off the US property boom. And those are the years when corporations found it so easy to raise and waste money. Finally, those were the years of the great NASDAQ blow-off.

Such excesses are unlikely to be repeated now that the Department of Treasury will be selling hundreds of billions of dollars of its debt at auction every few months now for years into the future. New US government debt will supply most of the dollar-denominated investment vehicles required to house the current account surpluses of the United States' trading partners. Fannie Mae and US corporates will be happy to supply the rest.

The United States' net indebtedness to the rest of the world is approximately \$3 trillion or 30% of US GDP. It increased by approximately \$500 billion, or 5% of GDP, last year and it will increase by a similar amount again this year and the year after and every year into the future until a sharp fall in the value of the dollar against the currencies of all its major trading partners puts an end to the gapping US current account deficit or until the United States is so heavily indebted to the rest of the world that it becomes incapable of servicing the interest on its multi-trillion dollar debt.

It is difficult to know which will happen first. However, it is certain that one of the two will eventually occur. Either outcome would put an end to the era of export-led growth that Asia has enjoyed for so long.

In the meantime, and here is the story that is of much greater significance than how much Asian central banks will lose as the dollar depreciates, so long as the US current account deficit continues to flood the world with US Dollar liquidity - in effect blowing up the global money supply - new asset price bubble are likely to inflate and implode; more systemic banking crises can be expected to occur; and intensifying deflationary pressure can be anticipated as falling interest rates and easy credit result in excess industrial capacity and falling prices.

In other words, so long as the US current account deficit persists, the global economic disequilibrium that it generates will continue to cause economic upheavals around the world. The costs of those upheavals will far exceed the foreign exchange losses Asian central banks will suffer as the dollar continues to weaken in the months and years ahead.

**If you wish to order a copy of the book *The Dollar Crisis* please call Randhir Prakash on (852) 21225228 or email him on [randhir.prakash@financeasia.com](mailto:randhir.prakash@financeasia.com) or click on the button to purchase online using PayPal:**

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