

PERSPECTIVE

## **'De-Dollarization' Has Run Its Course**

*MIKE COSGROVE*

Treasury Secretary Henry Paulson is meeting with the Chinese this week on the U.S.-China Strategic Economic Dialogue.

The U.S. has been pressing the Chinese to strengthen the yuan against the dollar at a faster pace ever since the Bush administration and members of Congress, notably Sen. Charles Schumer, lobbied the Chinese to break their dollar peg in July 2005.

The yuan has already gained 11% against the dollar, and bandwagon effects of China abandoning its peg to the dollar by moving to a basket of currencies are being implemented around the globe.

East Asia was in the process of dollarization early this decade, which meant that directly and indirectly a sizable proportion of global trade could eventually occur in dollars.

But breaking the peg sent a clear message to dollar holders. The U.S. government had no interest in encouraging such dollar-based trade. And, in addition, dollar devaluation was the objective in an attempt to close the trade deficit with China.

### **Falling Since '05**

Dollar holders had begun the rebalancing process in anticipation of the peg being broken by buying other currencies, as they knew the dollar was going to cheapen — hence the bandwagon effect of breaking the peg.

The price-adjusted broad dollar index has declined approximately 12% since July 2005, according to the Federal Reserve — about the same as the yuan has appreciated. Global portfolios are rebalancing in line with the yuan appreciation.

Members of OPEC also responded. Kuwait broke its dollar peg in May 2007. Saudi Arabia, however, indicated that it has no plans to shift to a basket of currencies, although the kingdom could revalue the riyal exchange rate to the dollar to offset the effects of dollar devaluation.

An expected monetary union for select Middle Eastern countries slated for 2010 may mean those countries opt for a peg to a basket of currencies instead of a dollar peg, following China's example.

Meanwhile, the Chinese have been able to cope nicely with the yuan appreciation, as dollar-denominated imported commodities such as oil are now 11% less expensive.

Chinese companies can maintain their profit margins or improve those margins with less expensive and more productive manufacturing technology imports from the West. Appreciation of the yuan may have even been a wash for many Chinese companies.

The balance of trade on goods and services with China was a negative \$48 billion in the second quarter of 2005. Two years later it was a negative \$60 billion for the second quarter of 2007.

A major slowdown in the U.S. means that the imbalance with China won't be

expanding as fast. But that is due to slower consumer spending growth, not an exchange-rate effect.

Policy decisions by the Bush administration and members of Congress in 2004-05 not only halted the move to East Asia dollarization, but also set in motion the effects of global de-dollarization. Instead of many countries conducting de facto trade in dollars under a dollar-yuan peg, countries are attempting to shed dollar assets.

But there is good news. Global portfolios may be close to completing their initial adjustments to the cheapening of the dollar vs. the yuan so that economic and demographic fundamentals will again become the focus.

Compared with the U.S., some Western European countries such as France, Germany and Italy are saddled with larger relative entitlement burdens.

### **Changing France**

In addition, Germany is facing a declining total population while France faces major labor rigidities in its economy. And France's immigrants don't appear able to assimilate into the indigenous population. As the size of that excluded segment of the French population grows, so will its power. That influence could begin to alter French economic and civil institutions.

For Japan, total population is expected to shrink by more than 8 million by 2025, according to the Population Reference Bureau. Japan has found itself in a subpar economic growth mode since the December 1989 Nikkei peak, with accompanying major outstanding debt, entitlement issues, bouts of deflation, an equity market caught in a long-term value trap, and major monetary and tax policy issues.

Issues in the U.S. may be sizable, but compared with the problems some Western European countries and Japan face, the longer term outlook for the dollar value is constructive.

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