Will Europe *Suffer* The Swiss Syndrome?

BY MICHAEL HUDSON

Confronting anew the problems if the world moves into euros.

Diversification of central bank reserves into larger holdings of euros is much in the news these days. Quite apart from the widening U.S. trade and payments deficit, the Iraq war has created a backlash that has led some Arab and Islamic politicians to urge OPEC countries to price and sell their oil in euros and shift their central bank reserves out of their present heavy weighting in dollars.

If this were the 1960s, central banks would be cashing in their dollar inflows for gold. But since the United States went off gold in 1971, a built-in market for U.S. Treasury bills has emerged as the only practical alternative to gold.

The question is whether this central bank market for U.S. Treasury securities is infinite. If it is, then the United States would find its interest to lie in a permanent policy of "benign neglect" for its federal budget deficit and the balance-of-payment deficit that helps finance the government deficit via foreign central bank recycling.

Michael Hudson is distinguished professor of economics at the University of Missouri at Kansas City. His most recent book is a new edition of Super Imperialism: The Origin and Fundamentals of U.S. World Dominance *(Pluto Press: 2003).*

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888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

U.S. officials have come to recognize that if OPEC-held dollars or U.S. Treasury bonds are exchanged for securities denominated in euros, these dollar securities simply will be passed on to the central banks of Europe. Oil-exporting countries would sell their U.S. Treasury bonds and buy those of European countries. This would oblige Europe's central banks to choose between lending their dollar inflows back to the United States by buying U.S. Treasury securities (financing America's federal budget deficit in the process), or seeing their currencies appreciate against the dollar, much to the disquiet of their domestic producers and exporters.

The fact that this problem persists more than thirty years since the United States went off gold shows how successful its economic diplomacy has been in turning seeming problems into unanticipated success. If matters continue on their present course, OPEC would solve its dollar problem by passing it on like the proverbial hot potato. A shift of dollars from OPEC or other countries probably would not reduce global central bank holdings of U.S. Treasury securities, but merely would shift these holdings out of OPEC and Islamic central banks to those of Europe.

Europe's dollar dilemma explains why today's currency markets are more volatile than at any time since the 1930s. The euro's roller coaster against the dollar has lifted its exchange rate to $1.20 and then pushed it down by 10 percent in the past few months. Put in its global context, the problem facing the currency markets—and central bankers—is as follows: If countries diversify their official reserves, the move into the euro may push matters to the brink of a political breaking point.

All things equal, the effect of a shift out of dollars into euros would force up the euro's exchange rate against the dollar. European exporters already are complaining that this threatens to price their products out of world markets. To prevent this from occurring, European countries are coming under pressure to hold down the euro's exchange rate by using these dollar inflows to buy yet more U.S. Treasury bills.

However, the more dollars presently they hold, the greater would be the book-value loss to central banks as the dollar's international value falls. By settling the payments deficit in Treasury securities since 1971, the United States has increased the costs to foreign central banks of withdrawing from the system.

As presently constituted, the international financial system thus provides the United States with a unique free ride. Whereas the war in Southeast Asia in the 1960s forced it to sustain military power by parting with monetary power in an epoch when this was measured in gold, the balance-of-payments constraint has now been removed, enabling the United States to run a trade-and-payments deficit some fifty times higher than the annual $10 million level that caused crisis conditions back in 1971. This deficit, now aggravated by additional U.S. military spending abroad, has been handled in such a way as to increase rather than diminish American financial leverage over the rest of the world, most of all over Europe.

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Under the gold-exchange standard that governed international finance prior to August 1971, a shift out of dollars would have led to a transfer of U.S. Treasury gold to Europe's central banks. America's loss would have been Europe's gain, without forcing up European exchange rates as surplus dollars were spent on importing gold. Today, thirty-two years later, the effect of a shift of dollars to euros would force up European exchange rates, imposing an economic cost that European industry and its employees would have to absorb as the dollar price of euro-denominated exports was forced up to uncompetitive levels (to the benefit of producers in countries whose currencies are tied to the dollar), through no fault of Europe's own policies.

This being said, how will U.S. military spending in the Near East, the rising U.S. trade and payments deficit,

and greater diversification of official reserves affect global geopolitics?

The answer is that it all depends on international financial diplomacy.

Those who expect America's present dollar glut to represent Europe's gain should ask the Swiss, whose currency has been a prime vehicle for capital flight. The Swiss Syndrome may be defined as a condition in which an autonomous capital inflow forces up a country's exchange rate to a point that threatens the competitiveness of its exports. In the late 1960s this became the almost chronic condition of Switzerland's franc as a result of that country's role as an offshore tax and capital-flight haven. The franc's appreciation caused problems for Swiss pharmaceutical companies and other exporters, shifting the economy's focus away from manufacturing to the favored banking sector. Europe is threatened with a similar effect as a result of other countries moving into euros.

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Some amelioration would occur on capital account as a falling value of the dollar relative to the euro would improve the capital balances of Latin American and Asian debtor countries. Their debts are serviced in dollars, whose relative value would fall. The effect on their trade account would depend on their ability to receive more for exports to Europe, relative to paying more for their imports from that continent, and on the relative weighting of exports and imports as between European and North American markets and suppliers.

Europe, China, and Japan have been the major regions building up dollar reserves and extending dollar loans. These creditor nations would experience a balance-sheet loss in proportion to the extent to which their financial claims are dollarized. They are beginning to ask themselves how much value these dollar claims will retain as their magnitude exceeds the U.S. willingness and even the ability to pay.

How then might the world debt and payments system be made more symmetrical and hence fairer?

STEPS TOWARD A COUNTER-STRATEGY

East Asian countries hold $1.6 trillion of dollars in their reserves. Measured against the euro, at one point during the spring they had lost over $100 billion in exchange value. Denominated in its own yen, Japan's central bank has suffered a capital loss in its reserves equal to the dollar's fall—which would have been much larger had it not been for heavy official purchases of Treasury securities. Russia also has lost by keeping its reserves so thoroughly in dollars, as have the leading oil-exporting countries.

These dollars swelling European and Asian central banks are an embarrassment of riches. Most attention is being placed on the Islamic countries, but Australia and New Zealand already have begun to diversify their reserves into euros, and Russia has noted that its major trading partner is Europe, after all.

But the squeeze is mainly on Europe itself, as the euro will be the major vehicle into which foreign dollar holdings will be converted. There seems little that the European Community can do as a practical matter. Repeating the foreign-exchange turbulence of the 1930s hardly seems to be an attractive alternative. It is difficult to see how Europe might adopt dual exchange rates, one for trade and another for capital movements, in a way that would not provide opportunities for financial arbitrage.

A simpler option is to do what the United States did in 1922 when it was threatened by low-priced imports from Germany as the mark's exchange rate collapsed under the weight of its reparations payments. Congress had put in place an American Selling Price (ASP) tariff system in 1909, replacing *ad valorem* tariffs based on invoice prices by tariffs

based on what the imported commodity would cost to produce in America. This confronted German chemicals and other exports with steep tariffs despite falling prices as the German mark depreciated. The policy denied all foreign countries a price advantage resulting not only from depreciation but even from superior efficiency. Then, in the 1960s, America even applied ASP tariffs against European steel and chemicals for purely protectionist purposes.

Might Europe adopt its own version or a variant of this policy by levying a floating tariff equal to the dollar's depreciation? Might it even take the further step of using its inflow of surplus dollars to subsidize its exports to offset the price disadvantage suffered by its exporters as a result of the depreciating dollar?

Such policies would be criticized as reversing the postwar move toward free trade, but this move was predicated on an assumed stabilization of capital movements and currency values. This assumption has been reversed in recent years as the dollar glut has led to a top-heavy volume of hot money leading exchange rates to zigzag.

Coming on top of a widening U.S. payments deficit, central bank movements out of the dollar may indeed prompt Europe to protect its manufacturers from the effects of euro appreciation. The problems of financial asymmetry that have been in the making since 1971 would be brought to a head in a less stable political context. It would be one in which U.S. military assertiveness becomes a catalyst for popular support for governments to create a new set of rules to prevent U.S. exporters from benefiting from the currency instability caused by America's own fiscal, financial, and military policies.

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One of the major concerns of Europe and Asia is to protect themselves from a loss in the value of their mounting dollar reserves as valued in their own euros, yen, and renminbi. A solution to this problem was proposed on the eve of America's 1971 dollar devaluation: The U.S. Treasury would provide foreign central banks with an exchange-rate guarantee. If the dollar declines against the currencies of central banks holding dollar reserves, the U.S. Treasury will make up the difference. (Private-sector ownership of dollar securities is voluntary and hence any risk rightly should be borne by their holders.)

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A related solution to protect foreign countries against the prospect of depreciating dollar reserves was proposed by France a generation ago: The U.S. Treasury would guarantee the gold-price equivalent of central bank dollar holdings. In view of the recent rise in the price of gold, the United States hardly can be expected to give so generous a protection to Europe. But the fact that gold is rising historically has been a harbinger for a declining dollar. Somebody must lose. But who, and by how much?

To have a practical effect, any such response would have to be structural, not merely marginal. And it would have to solve the disparity between an appropriate exchange rate for trade and that determined by capital transfers, which have become the major problem. Most important, it would provide a constraint, now missing from the financial system, on U.S. ability to run up deficits without limit. Such a mode of handling the capital transfer problem and that of international reserves would be the ultimate price that the United States may have to pay for running a widening payments deficit under today's geopolitical conditions. ◆