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# Slide in the US dollar: What it means for Asia

***As greenback boosts their wealth, Asian firms win competition to invest globally***

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THE sub-prime crisis hit the US economy when it was in the first stages of an adjustment process to redress the large deficits in balance of payments and public budgets. These disturbances would on their own have steered the economy towards a slowdown, but the coincidence in the timings raises the spectre of a recession while at the same time turning an American problem into a question mark on the solidity of global capital markets.

The US dollar is destined to bear the brunt of adjustment, but a dollar fall hides two obvious drawbacks. First, neither fiscal nor monetary policy in the US has been geared to suppress the purchasing power to bring it into line with the fundamental - weaker - economy. A falling US dollar means that real income is falling, but this way to realign demand and production capacity calls for more time than available to avoid a recession.

Second, the sub-prime crisis undermines confidence in the US financial system, luring countries and overseas financial institutions to convert US dollars into other currencies like the euro and the Japanese yen, thus starting a self-sustaining downward spiral for the US dollar.

As things are, the most likely outcome is a US recession whose depth and, more important, length is difficult to predict, especially because repercussions on global growth are uncertain. So far it seems that Europe is less hit than feared and Asia much less, but as time lags have shifted over recent years, it is too soon to come to a final judgment.

It looks a reasonable bet, however, that Asia largely has decoupled from the US economy, at least compared to previous business cycles in the United States.

An analysis of recent events calls for three observations.

The first is that currency rate changes do not any more influence flows of goods and services to the same degree as one or two decades ago. The reason is quite simple: goods and services competing on prices have been outsourced to China and other countries, primarily in Asia benefiting from a wage level often less than 10 per cent of what is the case in the US and Europe. Compared to that, a depreciation of the US dollar with 10 or 20 per cent is small money. Therefore, exports do not rise much and imports do not fall much to redress the imbalances by increased production, pre-empting a recession.

This is why growth forecasts continue to fall for the US and remain high for China, irrespective of the falling US dollar and the rising yuan.

As changes of relative prices are neutralised as a policy instrument, the adjustment process shifts from a price cycle to a volume cycle. A price cycle mainly works by restructuring the economy in countries out of tune (currently the US) from domestic to foreign demand, keeping growth at a high level and in most cases stimulating it. A volume cycle suppresses economic activity until demand is reduced sufficiently to match production capacity. The major snag is that during the process,

production capacity itself falls as the lower demand reduces incentives to invest.

**Demand and output**

Total demand and production capacity come to match each other at a lower level, and experience tells that it takes much longer for a volume cycle than a price cycle to do the job. This phenomenon is often seen in the property sector where prices can stay at a high level for a long time, irrespective of falling demand waiting for lower supply of new housing to reduce the surplus.

The lesson to learn is to prevent imbalances from arising by a much higher degree of economic policy fine-tuning. Economic globalisation and outsourcing have changed the rules of the game and even the US cannot, with a snap of the fingers, hope for a quick realignment of demand and production capacity.

Once in the hole, it may take quite a while for the volume adjustment to work its way through the system.

The second observation is that contrary to conventional wisdom, changing relative prices affect international capital markets for two reasons: countries having accumulated large currency reserves become interested in using these assets in a more profitable way than just running up cash or treasury bonds and multinational companies from emerging countries boost transnational mergers and acquisitions.

In both cases the price of the game is one of the determining elements and the fall in the US dollar implies that American companies or companies having most of their assets denominated in US dollars become cheaper in the eyes of the rest of the world. While a 10 or 20 per cent fluctuation of price is insignificant for goods and services, it is almost of phenomenal importance when analysing an international investment and/or merger and acquisition.

What has taken off in the course of 2007 is foreign purchase of American enterprises and/or enterprises linked to the American economy. Instead of selling more goods to stimulate production, the US is selling more of its productive assets to finance continued over-consumption.

The Europeans may be a bit reluctant to enter the game for various reasons, but the Asian countries are not. So we see a shift not only of production capacity from the US to Asia in these years, but also a transfer of wealth in the form of full or partial ownership of US companies in the goods and services sector. The purchase of minority shares by Asian investors in US financial institutions has been the most visible sign, but is far from the whole story. It was only recently that the news surfaced that Sinosteel intends to buy the West Australian mining company Midwest for about US$1.2 billion.

Alternatively, the Asian companies are winning the competition to invest in companies around the globe as the decline of the US dollar increases their wealth compared to that of American competitors. The Chinese insurance company Ping An is on the brink of taking a 4.18 per cent share in Fortis, a Dutch-Belgian-owned European giant in financial services, making Ping An the largest shareholder.

The third observation is the beginning of a strong concentration of global financial power. After the start of the sub-prime crisis the world has seen how several financial institutions have been bought or forced to welcome a determining minority shareholder in order to survive.

The most recent example is JPMorgan Chase's purchase of the investment bank Bear Stearns - once a rival. The deal will cost JPMorgan a fraction of Bear Stearns' value only a couple of weeks ago. It is even better for JPMorgan. The US Federal Reserve is taking off approximately US$30 billion of Bear

Stearns less liquid assets, thus actually helping JPMorgan (which by the way is paying with own shares removing any need for it to fork out 'real money').

**Bailing out banks**

The Fed has previously come to the rescue of banks, but this is the first time the umbrella is put up for a global investment banking, securities trading and brokerage firm. Apparently, the Fed deems justified bailing out financial institutions, which have chosen to take on risky operations instead of giving them a dose of their own medicine.

The only explanation is a conviction that default in one segment of the market would spill over and threaten the financial market as a whole. But if the Fed takes the view that segments of the financial market have been so closely weaved together, it spells the beginning of the end for specialised financial institutions.

It is not difficult to discern the future financial system as made up of fewer institutions with much higher capital. The new mergers come after years of consolidation with JPMorgan Chase and Bank One merging in 2004, Chase Manhattan's buy of JPMorgan in year 2000 for US$36 billion and Morgan Stanley's merger in 1997 with Dean Witter, Discover & Company.

For Asia, as a comparatively newcomer in the game, this offers unique opportunities. It should not be overlooked, however, that the rules of the game and the game itself is going through a tectonic shift.

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