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U.S. Push for Weaker Dollar Rattles Markets Around Globe

The Bush administration's push for a weaker dollar against the Japanese and Chinese currencies rattled global stock and bond markets, threatening collateral damage to the delicate economic expansions under way in both Japan and the U.S.

The call by the seven major industrial countries over the weekend for more-flexible exchange rates sent the dollar to a 33-month low against the Japanese yen and an eight-week low against the euro Monday. Implicit in the weekend call was the goal that major currencies would be allowed to rise in value against the dollar.

By **Aaron Lucchetti** in New York, **Greg Ip** in Washington and **Phillip Day** in Singapore

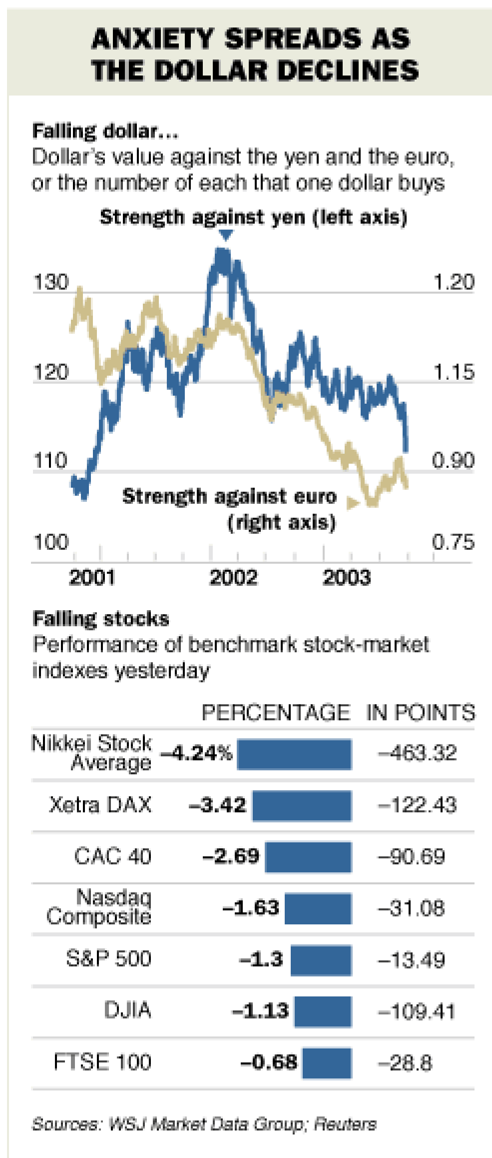
Fears that a stronger euro and yen would hamper both Europe's and Japan's export-led expansions sent stock market gauges down sharply in both places. While a lower dollar should enable U.S. manufacturers to compete better both at home and abroad -- a key goal of the Bush administration -- U.S. stocks also fell as investors worried that the lower dollar's benefits would be more than offset by rising interest rates as foreigners buy fewer Treasury bonds.

Despite the market turmoil, policy makers and economists generally agree that a lower U.S. dollar is essential to a better-balanced global economy. World growth in the last year has depended disproportionately on U.S. consumers' willingness to buy imported goods, especially from China and Japan, with money, in effect, borrowed heavily from foreigners. As a result, the U.S. deficit in trade and investment income is expected to hit a record 5.1% of economic output this year, according to the International Monetary Fund. A weaker dollar would make imports more expensive in the U.S. market and U.S. exports cheaper overseas, narrowing that gap.

The G7 statement "should be viewed as positive" for the U.S. economy, Goldman Sachs's chief U.S. economist Bill Dudley argued in a report Monday, but the ultimate result depends on the speed of the dollar's drop. Ideally, he said, it would fall gradually over several years. "A precipitous decline could harm the

economy by leading to a sharp rise in bond yields" and greater reluctance by investors to buy other U.S. securities.

Although it may yet prove to be a temporary bout of volatility, Monday's market action suggests investors are for now worried about a disruptive and precipitous decline.



In their statement, released at the close of their summit in Dubai Saturday, finance ministers and central bank governors from the seven countries said: "We emphasize that more flexibility in exchange rates is desirable." U.S. Treasury Secretary John Snow said the statement wasn't aimed at any country in particular. But his aides made it clear that it was drafted with the currencies of Japan and China in mind. Both countries hold their currencies at artificially low levels against the dollar through heavy intervention in foreign exchange markets. Japan and China sell their own currencies in the market in exchange for dollars, which depresses the value of the yen and yuan.

Monday, Japanese policy makers insisted the statement had changed nothing. Sadakazu Tanigaki, Japan's new finance minister appointed Monday, said Japan would stick to its policy of fighting sharp exchange-rate moves. "There will be no change in our fundamental policy," he said, adding that stable exchange rates are desirable and that Tokyo will act in the currency markets as the situation demands. (See related article[1].)

But many investors were betting that even if Japan continued to intervene, it would do so a little less strenuously, meaning that the yen will continue to creep higher against the dollar. "The Bank of Japan will continue to intervene, but the line in the sand will keep shifting to a stronger yen," said Ian Morris, U.S. economist for HSBC Securities. Some analysts now see ¥105 to the dollar as a level Japanese authorities may choose to make their new limit, after abandoning the earlier 115 level on Friday.

The statement also has implications for China, which Monday affirmed it had no intention of easing the peg of its currency, the yuan, against the dollar. The State Administration of Foreign Exchange issued a statement on its Web site in which it said China will "continue to keep the renminbi [or yuan] exchange rate basically stable." Japan's previous attempts to join the chorus of China critics were undermined by its own efforts to prop up its currency. But some of that was allayed by its willingness to let the yen fall. China may also find other Asian countries more willing to weigh in on its currency policy, since they also compete with China for exports.

The dollar, already enduring a lackluster year, suffered one of its worst trading sessions in months. In late trading Monday, the dollar was fetching ¥112.13, down from late Friday's level of ¥114.30 and ¥118 earlier this month. J.P. Morgan said the dollar's drop from noon Friday to noon Monday was its biggest since June of 2002. The dollar also weakened against sterling, the Swiss franc and the euro, which rose to $1.1474 from $1.1361 Friday.

The dollar's decline led world stocks down: The Nikkei average of leading Japanese stocks sank 463.32, or 4.2%, to 10475.10, its steepest one-day drop in both point and percentage terms since Sept. 17, 2001. Japan has recently shown signs of emerging from a decadelong economic slump, but should the yen continue appreciating, it could undermine the export boom that has laid the foundation for that expansion. Meanwhile, the Dow Jones Industrial Average sank 109.41, or 1.13%.

Ordinarily, U.S. investors welcome a lower dollar because it boosts the profits of U.S. multinational companies on overseas operations, when translated back from foreign currencies, and it enables U.S.-based producers to gain market share at home and abroad. Most economists still think that ultimately will be the result of its current drop. But the complexity of markets and the scale of cross-border financial flows today saddle any government-induced attempt to steer exchange rates with potential unintended consequences. For example, if the U.S. administration succeeds in its call on Asian governments to let the dollar fall, it could lose a major source of support for the U.S. bond market. Falling bond prices would send yields higher, undermining interest-sensitive sectors of the economy such as housing. The benefits of the falling dollar would then be offset in part or in whole by the harm of higher interest rates.

"If China were to protest U.S. foreign policy by selling the dollar for euros or gold, it could set the stage for a large correction which would drive up U.S. bond yields, weaken the housing market, depress American domestic consumption, and jeopardize the president's re-election," independent economist David Hale says in remarks he plans to deliver later this week to the Commission on U.S.-China Economic Security Review, a congressionally appointed commission that investigates the national security implications of trade and economic relations between the U.S. and China. If Asian central banks abandoned the dollar, bond yields could rise 0.5 to one percentage point, he earlier predicted.

Monday, those worries caused the 10-year Treasury note to fall $5 for every $1,000 face value, pushing the yield up to 4.24% from 4.17% Friday. "It's not a pleasant day to be a U.S. investor," said Joseph Balestrino, a bond-fund manager with Federated Investors, Pittsburgh. Mr. Balestrino says he may buy more European, Canadian and Australian bonds because he feels the U.S. current-account deficit is too large relative to the economy's health and because of the costs of securing Iraq.

The U.S. must sell hundreds of billions of dollars of assets every year to finance its gaping current-account deficit. Through most of the 1990s and early this decade, that was relatively easy because the U.S. appeared to offer more-attractive returns than other economies. But in the last year, with foreigners' appetite for U.S. stocks and other direct investments diminishing, the U.S. has relied to a striking degree on Asian central banks to finance that deficit. When those banks buy dollars to keep their own currencies down, they usually invest the proceeds in U.S. Treasury bonds and bills.

In the 12 months through July, foreigners purchased a net $233 billion of U.S. Treasury notes and bonds, and Japanese and Chinese investors -- primarily their central banks -- accounted for half of that, according to Treasury Department data. (Data on Treasury bills are unavailable.)

That means foreigners' net purchases accounted for almost the entire $257 billion in notes and bonds the Treasury issued in that period to finance budget deficits.

Some are skeptical that a reduction in buying by Asian central banks would have much impact, noting they primarily hold bonds and bills with a maturity of a few years or less, and those yields are being restrained by the Federal Reserve's easy monetary policy.

But Gerald Lucas, Treasury strategist at Bank of America, said over time 10- and 30-year yields, which heavily influence mortgage rates, do seem correlated with foreign central bank holdings of U.S. government

paper. The Japanese and Chinese aren't likely to sell, but if they merely buy less, it would tend to raise long-term rates, he said.

--Jason Singer in Tokyo contributed to this article.

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