

The Emerging Global

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Dollar Zone?

*A fleeting coincidence of events or
a powerful new underlying force?*

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This fall, China was included in the G7 deliberations for the first time ever. This was the occasion in which the G7 endorsed China's monetary formula "to push ahead firmly and steadily to a market-based flexible exchange rate."

Among policymakers in Beijing and Shanghai, "market-based flexible exchange rate" does not mean appreciation of China's currency, the renminbi. It means: "If we liberalize the RMB on capital account, the ensuing capital flight would collapse the exchange rate of the RMB; therefore, we'll only liberalize on capital account—we'll move to 'a market-based flexible exchange rate'—when our domestic financial markets are reformed sufficiently to moderate capital outflows."

To which U.S. Secretary of the Treasury John Snow, and the G7 with him, responded: This is fine by us, but we'd like to see it done a bit more quickly. Or, in more formal language: "Sustained, non-inflationary growth in China is important for maintaining strong global growth, and a more flexible and market-based renminbi exchange rate is an important part of achieving this goal. I have been encouraged by some of the advances that have occurred. Tonight, I underscored that I would like to see China move more quickly."

It is therefore a done deal that exchange rate liberalization will occur when the domestic Chinese

banking system has moved further along the lines of American "best practice" banking. It is not any specific level of exchange rate that has been negotiated. It is making the Chinese and American banking systems more compatible.

The formalities of a "dollar zone" are beginning to crystallize.

TWO YEARS IN THE MAKING

In the past two years, the economies of nine countries have been behaving as a quasi-integrated, de facto dollar currency zone. These are China, Hong Kong, Taiwan (these three together forming Greater China), Malaysia, Singapore, Thailand, Japan, South Korea, and of course the United States.

Their exchange rates are virtually unchanged since the beginning of 2002 (the yen and the won depreciated slightly against the dollar but all the others, and especially Greater China's, remained tightly pegged). Their domestic interest rates are at comparably similar low levels when adjusted for differences in local inflation rates. And their current account imbalances are being settled in the same way as between different districts of the U.S. Federal Reserve System—that is, by capital transfers from the surplus

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The conventional argument that capital flows into the United States in order to finance U.S. trade deficits is untenable. For a decade now, net foreign capital inflows have exceeded the U.S. trade deficit by an average of \$100 billion per year. For the same period of time, the conventional view that capital inflows finance trade deficits has been untenable and academic economic theory has done nothing to address its embarrassment. What is true respecting the United States' global capital flows and trade deficit position is even more true for its position *vis-à-vis* the Asian members of the de facto dollar zone: In 2004 so far, net capital inflows from these Asian dollar zone countries to the United States are \$232 billion, but the trade deficit is only \$150 billion. For 2003 and 2004 to date combined, net capital inflows and the trade deficit are \$494 billion and \$385 billion respectively.

Asia is sending far more capital to the United States than is needed to finance the U.S. trade deficit—about one-third more, in fact.

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These massive capital inflows (and their corresponding shifts in trade patterns) occurring under nearly uniform monetary conditions are strikingly similar to phenomena of resource reallocation or shifting divisions of labor within a

single currency system. Hence the emerging perspective of a dollar zone that encompasses these countries.

This de facto dollar zone has a combined GDP of \$18.5 trillion, which is growing at an annual rate of 4.6 percent. Half of the zone's growth rate, or 2.3 percent, is accounted for by the size-weighted contribution of the U.S. economy, another 1.1 percent by Japan's size-weighted contribution, and another 0.8 percent by China's. This dollar zone's exports account for 45 percent of world exports and its imports account for 50 percent of

world imports. Over half (52 percent) of these exports and imports are within the dollar zone and 48 percent are with the rest of the world (of which 12 percent are with the Eurozone).

The dollar zone's trade deficit with the rest of the world is \$325 billion (\$297 billion contributed by the United States and \$28 billion by the Asian members of the zone). This deficit is 1.7 percent of the dollar zone's GDP. The U.S. deficit with the world outside this dollar zone, \$297 billion, is 2.6 percent of U.S. GDP and 1.6 percent of dollar zone GDP. If NAFTA and OPEC are included in a somewhat looser definition of a dollar zone, then these deficits disappear.

In what way is it practical or useful to talk about a dollar zone? Can this way of analyzing the United States' international position tell us anything important or useful about the future course of the U.S. current account deficit, the dollar, interest rates, or the national rate of savings?

Discussion of a dollar zone can tell us a lot, especially in light of the impending fundamental reform of the U.S. tax system that is likely to reduce drastically—or even eliminate—the existing tax burdens on saved and invested income. Before examining these issues, however, the question that must be answered is this: How stable and resilient is this de facto dollar zone in the last couple of years? Is it just a fleeting coincidence of events coalescing to give the illusory impression of a dollar zone, or do we have powerful underlying economic forces at work that are bringing these economies together? ◆

De Facto Dollar Zone Members

United States

China	Singapore
Hong Kong	Thailand
Taiwan	Japan
Malaysia	South Korea

Combined GDP: \$18.5 trillion
Annual Growth Rate: 4.6%