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Foreign Exchange by David Goldman

The 'dollar bloc' crumbles

One curious side-effect of this collapse is that Taipei has become a leading supporter of the Treasury market.

With the most recent indications of American economic unraveling, the dollar now buys less than two German marks, against more than 3.3 marks in mid-1985, and its value is trickling away daily. Not since January 1981, before President Reagan took office, has the dollar bought so little; overseas, the "Reagan recovery" is priced in Jimmy Carter dollars.

But America's trade deficit appears to defy the laws of gravity, given that imports from America's biggest trading partners, e.g., West Germany and Japan, now cost 40% more than they did a year ago, and are likely to cost a great deal more soon, as the dollar continues falling below DM 2.00.

Part of the reason that the deficit has *not* declined, except for apparent shrinking of oil inventory-buildup, is to be found in the so-called dollar bloc, i.e., the group of America's trading partners whose currencies are closely pegged to the dollar. The increasing U.S. dependency on such sources has strained this arrangement to the breaking point, and caused one of the strangest financial side-effects on record: Taiwan this year built up the world's fastest-growing official net creditor position with respect to the United States.

Since 1985, one-fifth of America's total consumption of physical goods has come from the trade deficit, a worse dependency on foreign suppliers than that suffered by any major nation in history.

Japan's $40 billion or so trade surplus with the United States makes up the largest single portion of this subsidy. Taiwan may exceed a $12 billion trade surplus this year, huge for the size of its economy, but small by comparison. However, Taiwan belongs to what officials call a "dollar bloc," i.e., a network of trading partners whose currencies fluctuate closely with the dollar.

That resembles the old British "sterling bloc," the colonial arrangement by which the British bought raw materials from subject countries at cheap prices. Taiwanese export prices have not risen commensurately with the yen.

During the first years of the Reagan administration, high U.S. interest rates forced the dollar up, permitting American industries to buy materials and component parts—including about a quarter of the value of an "American-made car"—at a 40% discount. In West Germany and Japan, that discount is no longer available; the dollar may still be overvalued at DM 1.96, the current market rate, but by no more than 20% or so. (That is the amount the dollar has yet to fall, according to former West German Chancellor Helmut Schmidt, a leading advocate of an anti-dollar European currency bloc).

If the United States had to pay for its entire trade subsidy in expensive yen and marks, the trade deficit would be much more than the already horrendous $200 billion a year we now owe. The so-called "dollar bloc," including such diverse nations as Canada, Brazil, and Taiwan, provides us with a subsidy of physical goods at a still-affordable price.

Considering that Taiwan's dollar has held fairly steady against the American dollar, while the Japanese yen has appreciated by 40%, it should surprise no one that speculators want the Taiwanese dollar. It cannot remain so low forever, considering the enormous volume of trade between Japan and Taiwan.

The rush of funds into the Taiwanese dollar made the little island-nation the biggest single purchaser of U.S. Treasury securities during 1986. During the first nine months of the year, Taiwan invested $17.5 billion in U.S. government paper, helping the Federal Reserve to bring interest rates down, buying time before the financial structure came apart.

Taiwan is not the only major supporter of the U.S. Treasury; overseas government holdings of government securities rose $60 billion between January and September. The next-largest patron of the Treasury, Japan, accumulated $15 billion of U.S. debt paper. But Taiwan came in first.

Even for Taiwan, which has shown a consistent and growing trade surplus with the United States, that is a lot of money. In fact, it is more than its national product. So where did it get the funds to build up a $20 billion creditor position against the U.S. government in the course of this year?

The answer is that there has been a run out of the U.S. dollar, into the Taiwan dollar. Apparently, holders of U.S. dollars bought enormous amounts of Taiwanese dollars, and the Taiwan monetary authorities obliged by printing up their own currency, selling it to speculators for their unwanted U.S. dollars, and then investing the proceeds in U.S. Treasury securities.

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