Global Markets Research

Deutsche Bank

June 18, 2003

Dollars and Deficits: Where Do We Go From Here?

The view of the global monetary system that we propose here allows for some strong conclusions about the direction of financing flows and exchange rates. Among these are:

- Growing US current account deficits will be financed by official capital inflows from Asia and other Trade Account countries.
- Returns in the US will not have to rise to attract financing.
- Asia and other Trade Account countries will replace Europe and other Capital Account countries in US import markets.
- Europe and other Capital Account countries will have stronger currencies and intense deflationary pressures.
- Emerging markets will have to choose sides: either finance the US or sink with Europe.

Michael Dooley
Chief Economist,
Latin America

David Folkerts-Landau
Managing Director, Head of
Global Markets Research

Peter Garber
Global Strategist

Where is the International Monetary System Driving Us?

The intellectual currents pushing investment flows across countries have wrapped themselves around the two Ds: **deflation and deficits**. The conventional argument is that Japan and Germany are in deflation and the US, although not now, may join this unhappy club in the near future. The US suffers from a current account deficit that is getting harder to finance. So the dollar falls and passes more deflation to Europe. The US is in trouble but Europe is even more so and Japan's situation is increasingly depressed.

There is some truth to this picture. But there is a serious flaw. If investors are becoming reluctant to invest in the US in the face of a rising current account deficit, they have to be rewarded with rising returns. Yet yields and spreads are *falling* in the US, not rising. What is going on?

To explain this anomaly and to reckon what the recent past means for the future, it is helpful to step back for a broad look at how the international monetary system is organized just now. The view of the world monetary order that we assemble here allows for strong conclusions about where current global supply surpluses will be focussed, who is going to suffer, and who will gain. It especially allows us to understand what is going on in the emerging markets and Europe, which is where most of the negative effects will occur.

Trade Account vs. Capital Account Regions

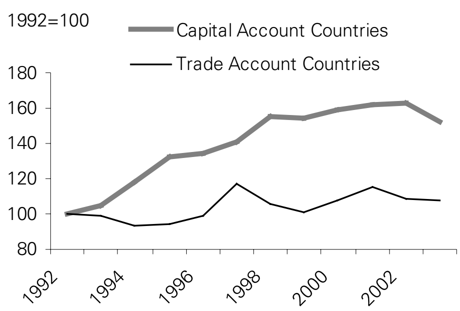
There are now three principal economic and currency zones in the world. Because these are generally concentrated by geographic region, it is tempting to think in terms of East Asia-US-Europe. But to get at a truly global picture, it is actually more illuminating to characterize the zones functionally: Asia is a **trade account region** and Europe is a **capital account region**.

- As a **trade account region**, exporting to the US is Asia's main concern. Exports mean growth. When their imports do not keep up, the official sectors are happy to buy US securities to finance the shortfall directly, without regard to the risk/return characteristics of the securities. Their appetite for such investments is, for all practical purposes, unlimited because their growth capacity is far from its limit.
- In their currency policies members of a **trade account region** manage their exchange rates. While nominal exchange rates have moved by large amounts following the Asian crisis in 1997 and macro shocks to Japan in recent years, central banks have consistently intervened to limit appreciation of their currencies.
- Europe, Canada, Australia, and now most of Latin America form, in contrast, a **capital account region**. Private investors in this region care about the risk/return of their international investment position and have recently become concerned about their US exposure.
- In their currency policies, members of a **capital account region** are floaters. Europe and Canada, for example, float against the USD; and the euro has fluctuated by 30% up and down against the USD since its introduction. Governments stay out of international capital markets. There has been hardly any change in official reserves in this capital account region.
- As for the third zone, the US is the central country and intermediary of the system. The US really does not care much one way or the other about the exchange rate. It does not cumulate official reserves, so its investment motivations make it a capital account country. But its own growth motivations make it a trade account country too. **It wants finance for its own growth and now for the war.** There have been complaints from industry about the strong dollar, but overall the US has been happy to invest now, consume now, fight the war and let others worry about its deteriorating international investment position. This explains the astonishing inconsistencies in statements about the US government's dollar policy: the

administration believes in a strong dollar but will do nothing to achieve it and is not concerned about dollar depreciation.

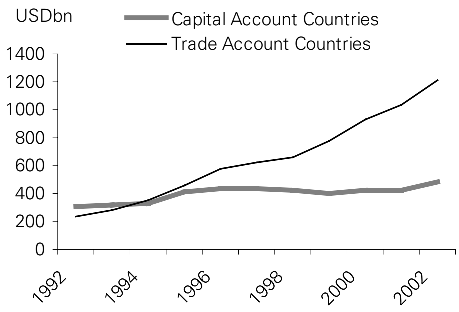
- The contrasting behavior of capital and trade account countries is summarized in the charts below. The first panel shows a trade weighted dollar exchange rate for each country group. The capital account countries show a substantial depreciation relative to the dollar from 1992 through the end of 2002, which as been partially reversed in the first half of 2003. Our interpretation of this is that, until recently, private investors in the capital account group pushed the dollar up and helped finance the US current account deficit. The trade account group's dollar rate has been essentially unchanged over the whole period. Private investors in the trade account group were not a factor; but, as shown in the second panel, official investors in the trade group helped finance the US current account deficit as reserves increased steadily, reaching about $1.2 trillion in 2003. Projecting this behavior forward, we would expect further strength in the capital account currencies, stability in the trade account currencies, and accelerated accumulation of international reserves by the trade account central banks.

Trade Weighted Dollar Exchange Rates



Source: DB Global Markets Research, BEA

International Reserves (USD bn)



Source: DB Global Markets Research, BEA

Differing Motivations for Financing the US Current Account Deficit

The US current account deficit (now about $500 bn, 4.7% of GDP) has been financed by **official inflows** from the trade account region and **private inflows** from the capital account region. This has been especially so for the last 5 years, with the US current account deficit surging from $130 billion in 1997 to $300 billion in 1999 to $400 billion in both 2000 and 2001. This US current account growth has been the engine for growth for the rest of the world.

- Asian countries in particular (China, Taiwan, HK, Singapore, Japan, Korea, Malaysia) manage their dollar exchange rates; and, as such, they float against the capital account region. Official capital exports finance growth-oriented trade surpluses. Policy is often effected through a system of exchange controls and administrative pricing. Some currencies are explicitly and rigidly fixed (RMB, HKD, MYR); others (JPY, KRW) "float" but still accumulate vast amounts of official reserves in USD.

- Since mid-1998, the JPY has moved from 120 to 105 to 135 and now back around 116. This has coincided with increases of Japan's foreign exchange reserves of $92 billion in the last year alone (vs. overall capital exports of $116 billion) and of $275 billion since 1998. China accumulated reserves of $56 billion in 2001 and $74 billion in 2002. Taiwan accumulated reserves of $16 billion in 2001 and $40 billion in 2002. These three official sectors alone financed 42% of the $489 billion US current account deficit in 2002. In Asia as a whole, a single-minded emphasis on export growth has been supported by a virtually unlimited demand for US financial assets in the form of official reserves. The current account surplus of Asia in 2002 was about $200 billion. The increase in reserves was a bit over $200 billion.

- Europe, and for now, Latin America constitute the bulk of the capital account region. European flows have been driven by private sector calculations for more than ten years. Private Latin American investors are now reversing capital flight, and their currencies have also been appreciating dramatically recently. Improving economic conditions in Latin America have clearly pulled funds into the region and limited capital flight from the region. But we think the push of funds into Latin America to escape low yields and uncertainty in the US has also been an important factor. As in Europe and Canada private capital flows have pushed currencies up across the board. Brazil and Argentina have already given back some of the improvement in their competitive positions following large depreciations in 2002 and 2003, respectively.

Is This System Sustainable?

In spite of the growing US deficits, this system has been **stable and sustainable**. The current account structure and asset accumulation have been consistent with the trade account region's preferences for official investments in the US and, until early this year, the capital account region's preferences for private financial investments in the US. But as US debts cumulate, US willingness to repay both Asia and Europe comes more naturally onto the radar screen, so the system that was previously stable could run into trouble.

- Normally, a nervous European investor would require a much higher return than before to keep capital flowing to the US. This could happen in both of two ways. Yields in the US would have to rise and the dollar would depreciate sharply so that an expected subsequent appreciation would further boost the yield to foreign investors.
- **But we think Asia will be pleased to displace Europe in sending exports to the US and accepting an even larger inflow of US securities. If so, yields in the US will not rise.**
- We see the start of this now in the form of euro appreciation. But appreciation of its currencies is the last thing that official Asia wants, so it should cumulate even more low-yielding US securities. A Europe that lets this happen will see its exports squeezed out and in the extreme may even start selling its claims on the US to be snapped up by Asia as the capital account region avoids what it sees as the potential collapse of the system.
- **As evidence for this combination of European and Asian actions, US yields have fallen and spreads have contracted. This has happened even in the face of a sharp depreciation of the dollar against the euro and other capital account region currencies and a sharp rise in the US current account deficit. Asian exchange rates have hardly moved by comparison against the USD.**

The Trade Account Region Is Underwriting the US in the Long Term

Asia's proclivity to hold US assets does not reflect some outsized affinity for the US. Trade account countries would export anywhere if they could and happily finance any resulting imbalances. But the US is open; Europe is not. Europe could not absorb the flood of goods, given its structural problems and in the face of absorbing Eastern Europe as well. Europe's growing reluctance to finance the US at current rates precludes its serving as an intermediary passing through low cost funding to the US if official Asia actually started to hold significant amounts of euro assets. So Asia's exports go to the US, as does its finance, notwithstanding the numerous arguments we all make to the official sector for the better diversification or risk/return available in euro assets. Otherwise, the US, if faced with financing difficulties, might similarly tend toward more stringent commercial policy. Asian officials are unlikely to shift toward euro assets because of the depressing effect this would have on trade with the US.

- The irony here is that concern of investors in the *capital account region* about the risk/return in an increasingly indebted US is misplaced. The US is being underwritten by Asia for the foreseeable future.
- The result is a bilateral US trade deficit with Asia and a balancing official bilateral capital inflow to the US from Asia. If Europeans and other capital account region countries want to sharply reduce their US assets, the euro and other capital account region currencies will appreciate much more. Then the US, but more probably Asia, will have to run trade surpluses with these countries roughly equal to the desired capital repatriation. **With a multilateral current account balance, the extra official financing from Asia, in effect, will finance everyone else.**
- It is useful to fit other countries, e.g. Mexico, Canada, Australia, Russia, into this three-color map of the world economy. The first three are floaters against the USD, and therefore, for now are in the *capital account* zone. As a result, their currencies will tend to appreciate; and their exports to the US will be displaced by Asia. Russia is and will be an oil exporter.
- More generally, **emerging markets now have a choice**: they can join Asia in the trade account region or Europe in the capital account region. If they follow the Asian model, they will do whatever it takes to limit exchange rate changes relative to the dollar and to keep their currencies undervalued to spur exports. The two tools available are controls and taxes on capital inflows and intervention in the foreign exchange markets to peg an undervalued currency.
- **Mexico** is the interesting case in point. A soon to be released study by the Banco de Mexico shows that of 128 products exported to the US by both China and Mexico, China's market share increased in 71 products while Mexico's share increased in only 21. Moreover, Mexico has lost market share in its most important product categories, including computers and other electronics. Mexico has started a very limited intervention program but will most likely stick to the free float.
- In **Argentina,** President Kirchner wants to keep the exchange rate around three pesos per dollar to encourage exports and growth. He has pressured the central bank to buy dollars and there has been talk of exchange controls. The central bank has so far resisted; central bank president, Prat Gay, believes in the floating rate system. Nevertheless, it seems to us likely that Argentina will join the trade account group.
- In **Brazil,** the same policy dispute is evident. So far the central bank has been very reluctant to limit exchange rate appreciation either through intervention or through a reduction in interest rates. We expect a compromise here, more intervention but relatively open capital markets.
- In **Europe**, emerging markets are committed to convergence with the euro, which will make them members of the capital account group.
- In **Asia,** the chance to capture the US market will not likely be missed. Even greater bilateral trade surpluses with the US will require even greater financing through official accumulation of US financial assets. This can be accomplished with little or no adjustment in real exchange rates, since they will merely be filling the vacuum created by Europe.

How Will These Capital Account Shifts Affect the Potential for Deflation?

For the **US** any propensity for deflation should be **unaffected** by these shifts in source of supply and finance—the same amount of foreign goods and finance will be forthcoming in any case.

For **Asia**, with an opening to displace European goods in the US markets, the **actual deflation** the Asian countries are experiencing **should be reduced**.

For **Europe**, now faced with a larger potential supply of goods and capital, the **potential for actual deflation must increase**. Until recently, the US market has served as a safety valve for the recessionary forces in Asia and Europe. If European finance recoils from the US, Asia can then drive European goods from US markets and refocus worldwide recessionary forces entirely onto Europe.

- The equilibrium where Asia runs a steady current account surplus vs. the US is the end game. In the foreseeable future, the growth requirements of Asia—with e.g. just under half of China's labor force still in the farm sector and only 15% in manufacturing—can keep this system going for another 20 years.

The Bottom Line

Our view of the current structure of the international monetary system has strong implications for where global surpluses will be focussed and which exchange rates will face pressures. Among these implications are:

- **The risk scenarios focus on the extent of euro appreciation.** If European investors, looking objectively at growing US debt alone, prudentially limit their US positions and demand better risk/return characteristics before supplying more capital to the US, the euro will appreciate dramatically. Local savings will stay in Europe, depressing yields there. Asia will grow even faster as it displaces European goods in the US; Europe will grow even more slowly.
- Yields in the US will not be forced up even as the US current account deficit grows, the dollar falls against the euro and private capital inflows from Europe and other capital account countries fall off.
- Shifts in financing from capital account countries to trade account countries should not affect any deflationary pressure in the US. Meanwhile, deflationary pressure should ease in trade account countries and intensify in capital account countries.
- Other emerging market countries will have to choose which way to go. In Latin America, those impatient for growth through exports will favor free trade, fixed, undervalued rates with the dollar, intervention and capital controls; in short, the Asian model of development. In contrast, central bankers and the IMF favor floating rates and capital mobility and therefore the capital account region; in short, the European model.
- As converging countries, emerging market countries in Europe must naturally follow the euro. Emerging markets in Asia are not likely to miss this opportunity to displace their rivals in US markets.

Michael P. Dooley (212) 250-7530
David Folkerts-Landau (44 20) 7545-5502
Peter M. Garber (212) 250-5466

Disclosure Checklist

For disclosures of our potential conflicts pertaining to analyses, recommendations or estimates made in respect of a security or issuer mentioned in this report, please see the most recently published issuer report or visit our global disclosure look-up page on our website at http://equities.research.db.com/cgi-bin/compose?PAGE=HOMEPAGE.*

The views expressed in this report accurately reflect the relevant quantitative research model(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. [David Folkerts-Landau, Peter Garber, Michael Dooley]

Global Markets Research Directory

David Folkerts-Landau
Managing Director, Global Head of Research
+44 20 754 55502

Stuart Parkinson, Chief Operating Officer, +44 20 754 57303

Peter Garber, Global Strategist, +1 212 250 5466

Regional Management

Asia	*Australia*	*Germany*	*Japan*
Michael Spencer Head of Global Markets Research +852 2203 8305	**Ivan Colhoun** Head of Global Markets Research +61 2 9258 1667	**Ulrich Beckmann** Head of Global Markets Research +49 69 910 31729	**Atsushi Mizuno** Head of Global Markets Research +81 3 5156 6316

Credit Research

High Yield Americas

David Bitterman
Co-head of US High Yield Credit Research
+1 212 250 2599

Andrew W. Van Houten
Co-head of US High Yield
Credit Research
+1 212 250 2777

Global High Grade

Marion Boucher Soper
Global Head of High Grade Credit Research
+1 212 250 0908

Anne Milne Head of Latin America Corporates +1 212 250 7568	**Nuj Chiaranussati** Head of Asian Credit Research +65 6423 5930	**Yoshio Shima** Head of Japan High Grade Credit Research +81 3 5156 6333

Credit Derivatives Research and Strategy

John F. Tierney, Global Head, +1 212 250 6795

Economic Research

Ciaran Barr Chief UK Economist +44 20 754 52088	**Ivan Colhoun** Chief Australian Economist +61 2 9258 1667	**Peter Hooper** Chief US Economist +1 212 250 7352	**Thomas Mayer** Chief European Economist +44 20 754 72884	**Atsushi Mizuno** Chief Economist, Japan +81 3 5156 6316

Emerging Markets Research

Marco Annunziata Chief Economist Emerging Europe +44 20 754 55506	**Marcel Cassard** Head of Emerging Markets Research, Europe +44 20 754 55507	**Michael Dooley** Chief Economist Latin America +1 212 250 7530	**David Sekiguchi** Head of Emerging Markets Strategy +1 212 250 8640	**Michael Spencer** Chief Economist Asia +852 2203 8305

Fixed Income and Relative Value Research

Jamil Baz, Global Head, +44 20 754 54017

Foreign Exchange Research

Michael Rosenberg, Global Head, +1 212 250 4776

Indices

Fergus Lynch, Global Index Development, +44 20 754 58765

Quantitative Flow Research

Robin Lumsdaine, Head/Global Econometric Strategist, +44 20 754 54858

Securitization Research

Karen Weaver, Global Head, +1 212 250 3125

Anthony Thompson, Head of CDO Research, +1 212 250 2087

Main Offices

London	*Frankfurt*	*New York*	*Hong Kong*	*Sydney*	*Singapore*	*Tokyo*
Winchester House 1 Great Winchester Street London EC2N 2DB United Kingdom +44 20 7545 8000	Grosse Gallusstrasse 10-14 60311 Frankfurt Germany +49 69 9100-0	60 Wall Street New York, NY 10005 United States of America +1 212 250 2500	55/F, Cheung Kong Center 2 Queen's Road, Central Hong Kong +852 2203 8888	Grosvenor Place Level 18,225 George Street Sydney NSW 2000 Australia +61 2 9258 1661	5 Temasek Boulevard #08-01 Suntec Tower Five Singapore 038985 +65 6224 4677	Sanno Park Tower 2-11-1, Nagatacho, Chiyoda-ku, Tokyo 100-6171 Japan +81 3 5156 6000

Subscribers to research via email receive their electronic publication on average 1-2 working days earlier than the printed version.

If you would like to receive this or any other product via email please contact your usual Deutsche Bank representative.

Publication Address:
Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America

Internet:
http://gmr.db.com
Ask your usual contact for a username and password.