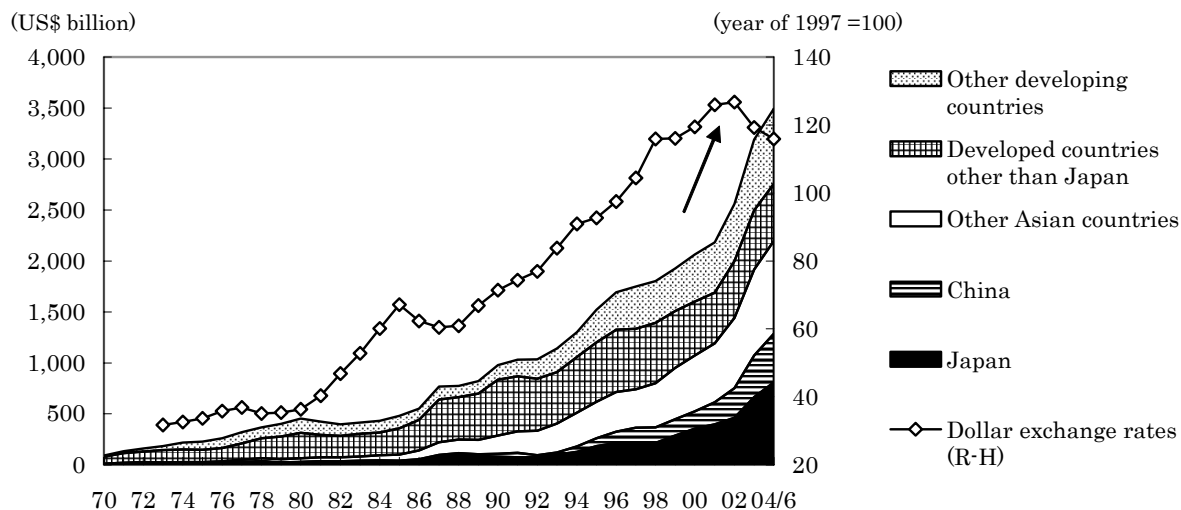


The Surge in Dollar Liquidity and its Risks

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Foreign exchange reserves held by monetary authorities have surged since 2002, as the dollar began to weaken. As of the end of June, 2004, they stood at 3.492 trillion dollars, a historical record. Asia, especially Japan and China, has increased its foreign reserves. Japan and China, among others, invest their reserve holdings in dollar assets. Dollar liquidity, the sum of the U.S. monetary base and the foreign official holdings of U. S. treasury and government agency bonds, has increased rapidly since 2002. As a result, it is assumed that changes in the amount of foreign reserves held by foreign monetary authorities will have a greater impact on the U. S. financial markets.

Foreign exchange reserves held in the world



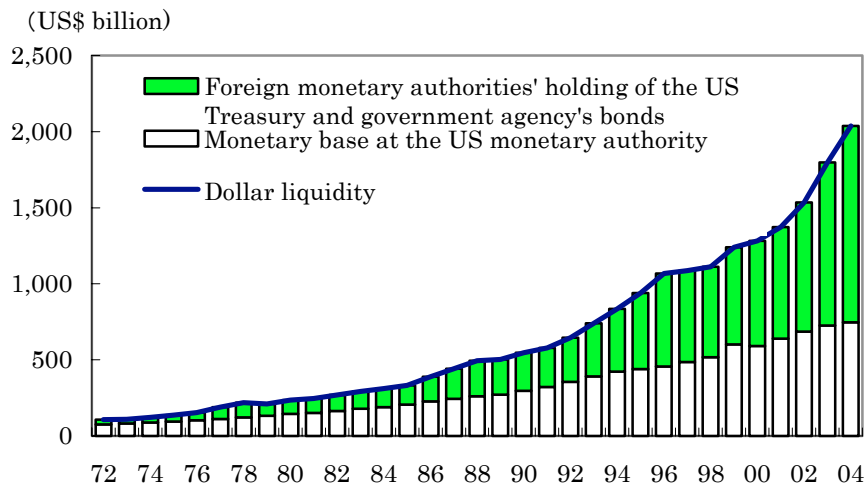
Source: IMF and own estimates.

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There are several factors which cause dollar liquidity to increase: First, the U.S. monetary authority has eased monetary policy aggressively in order to stimulate the economy, as it was affected badly by the burst of the IT bubble and the 9/11 terrorist attacks. Second, Asian countries, including Japan, have intervened heavily in the foreign exchange market by buying the dollar to prevent their own currencies from being strengthened, partly due to the easing of U.S. monetary policy.

The resulting surge in dollar liquidity has brought down long-term interest rates in the U.S., likely to cause an expansion in the U.S. current-account deficit, a rise in oil prices, and an increase in U.S. house prices.

The world dollar liquidity



Note: Figure for 2004 is that of end of August.
Source: Federal Reserve

According to our estimates, if the increase in Japan's foreign exchange reserve accelerates, the U. S. real GDP growth rate will be pushed up through an increase in the U.S. money supply and a rise in U.S. house prices. If Japan continues to intervene and buy the dollar as much as it did in fiscal year 2003, the U.S. real GDP growth rate will be higher by 0.3% points to 0.6% points, compared with the case of no intervention.

Nevertheless, a further increase in foreign reserves may affect a larger U.S. current-account deficit and higher oil prices, and ultimately destabilize the world economy. It is true that dollar-buying intervention by foreign monetary authorities will prevent the dollar from plunging in the short run. But such intervention may heighten the pressure to weaken the dollar in the medium and long term by causing the U.S. current-account deficit to bloat.

Estimates of the impact of Japan's intervention on the U.S. economy

		year	US money supply	US current-account balance	US real GDP growth rates	Oil prices	US house prices
			yoy %	US\$ billion	yoy %	yoy %	yoy %
Case 1	Without intervention	1st	0.02	-0.8	0.01	1.2	0.2
		2nd	0.01	-1.7	0.02	0.4	0.1
		3rd	0.02	-0.3	0.00	0.1	0.0
Case 2	Strong yen Intervention buying dollars	1st	0.53	-20.1	0.35	30.6	4.0
		2nd	0.24	-45.8	0.59	10.9	1.8
		3rd	0.59	-8.6	0.08	2.6	0.6
Case 3	Weak yen intervention selling dollars	1st	-0.07	2.8	-0.05	-4.3	-0.6
		2nd	-0.03	6.5	-0.08	-1.5	-0.3
		3rd	-0.08	1.2	-0.01	-0.4	-0.1
Difference between Case 2 and 1		1st	0.51	-19.3	0.33	29.4	3.9
		2nd	0.23	-44.1	0.57	10.5	1.8
		3rd	0.57	-8.3	0.08	2.5	0.6
Difference between Case 3 and 1		1st	-0.09	3.6	-0.06	-5.5	-0.7
		2nd	-0.04	8.2	-0.11	-1.9	-0.3
		3rd	-0.11	1.5	-0.01	-0.5	-0.1

Source: Own estimates.