ECONOMICS FOCUS

Economics focus

The resilient dollar

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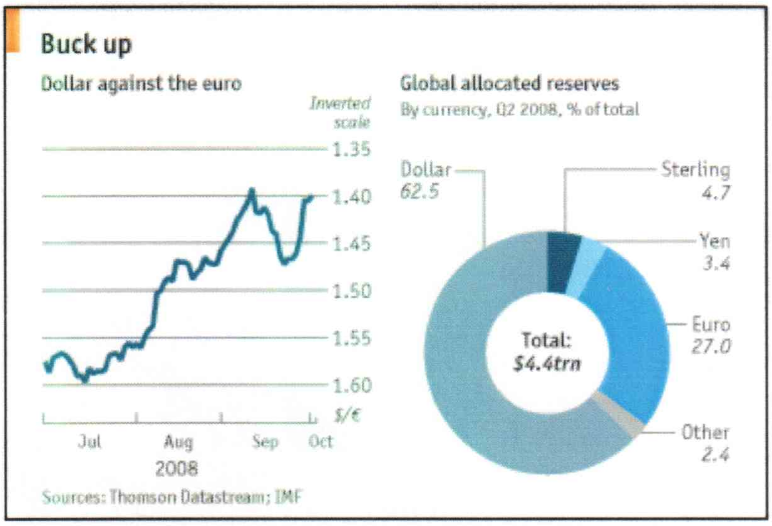
Why the greenback has so far withstood the panic in financial markets

IN BRITAIN, where earnestness is a sin and drollery a virtue, dismay about the global financial crisis is best masked with humour. The British reaction to bank failures is to josh that the best place to store money is under the mattress—or in an Irish bank. When America's $700 billion rescue package stalled in Congress, Willem Buiter, an economics professor, prolific blogger and honorary Brit, joked that his "remaining financial wealth is now kept in a (small) old sock in an undisclosed location."

A worried saver, such as Mr Buiter, shunning banks for the safety of hosiery, still faces a choice about what store of value to use as stocking filler. Gold is for the really scared. Its price has risen by about one-fifth in the space of three weeks. Makers of gold bars are struggling to keep up with demand. Even central banks now seem less keen to swap gold for paper currencies. European ones agreed in 1999 to limit their combined gold sales to 500 tonnes a year. In the 12 months to September, they sold just 343 tonnes, the lowest total since their pact was forged.

Gold tends to do well when the dollar struggles. And there are good reasons to be anxious about the dollar. America depends on foreign savings to finance its large current-account deficit, which was close to 5% of GDP in the second quarter. But the allure of America's financial assets has been tarnished by the shakiness of its banking system. Bail-outs and state guarantees to shore up the system may help, but they also strain public finances and raise concerns that the government may be tempted to inflate away its debts by printing money.

Yet for all these worries, the dollar has come through the recent turmoil surprisingly well. It initially gave up some of the ground it made over the summer but swiftly recovered (see left-hand chart). The persistent foreign demand for American assets is remarkable given all those scares. Last year just over $2 trillion of capital—direct investments in firms or purchases of bonds, equities and other loans—came from investors outside America, mostly private ones. This was more than enough to cover the $730 billion current-account deficit and leave enough over to finance $1.3 trillion of investments by Americans overseas.



In a recent study* Kristin Forbes, of the Massachusetts Institute of Technology, set out to discover what lies behind this hearty appetite for dollar assets. She looked at several factors that might affect the cost and benefits of buying American assets, including each country's capital controls, its financial development, its investment returns at home, and how useful dollar assets were in diversifying risk. Two striking results emerged. First, there was little evidence that foreigners buy American as a hedge against risks at home. If a country's investment returns moved in tandem with America's, this did not reduce their thirst for dollar assets. This is the opposite of what financial theory predicts—that investors would be keener on foreign assets the less they were correlated with their domestic ones.

The second big result has implications for the dollar and how economists think about global "imbalances", the recent phenomenon of big current-account deficits in rich countries financed by poor-country surpluses. Ms Forbes found that a lack of financial development at home makes foreigners keener to invest in America. What attracts them is the size, liquidity, efficiency and transparency of its financial markets compared with what is on offer in their domestic markets. This finding adds weight to theories which explain global imbalances as a consequence of slow financial progress. In this view, poor countries save hard and buy foreign securities because of a dearth of good options at home.

Once lost, never recovered?

A chunk of these savings are in the form of official currency reserves, and the dollar's status as the global currency may have helped it recently. The greenback accounts for almost two-thirds of official foreign-exchange reserves identified by the IMF (see right-hand chart). In scary times, private investors may well see logic in buying the same currency that central banks hold for a rainy day. But does America's economic travails bring forward the day when the dollar loses its reserve-currency status?

Barry Eichengreen of the University of California, Berkeley, takes a middle view. He argues that the dollar is both safe as a reserve currency and vulnerable to a challenge by the euro. In a recent paper** written with Marc Flandreau, of the Graduate Institute in Geneva, Mr Eichengreen takes issue with the common idea that there is room for only one main reserve currency. The authors compile new estimates for currency-reserve holdings between the two world wars that show that sterling and the dollar vied for supremacy. Indeed the dollar first surpassed the pound as the leading currency in the mid-1920s, far earlier than previously thought. But sterling regained supremacy in the 1930s. So history has mixed lessons for the dollar. The good news is that shifts between reserve currencies take place gradually. Sterling was not, as previously thought, abruptly dethroned by the dollar; the dollar in turn is unlikely to fall from grace suddenly. But history also teaches that reserve-currency status is not a natural monopoly, protected by incumbency and inertia. The euro, says Mr Eichengreen, is a plausible alternative to the dollar.

The euro's capital markets are of comparable depth and liquidity as the dollar's, and the euro-area economy is roughly the same size as America's. Faith in the efficiency of America's financial markets must surely have been shaken by recent events. Yet the banking crisis and its economic fallout is a transatlantic affair. This week's banking bail-outs in Europe are a sign that the old continent is not much safer for foreign investors than America. Worried savers may still find that they still sleep a little easier with dollars under the mattress, rather than euros.

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* "Why Do Foreigners Invest in the United States?" National Bureau of Economic Research (NBER) Working Paper No. 13908 (April 2008).

** "The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading International Currency?" NBER Working Paper No. 14154 (July 2008).