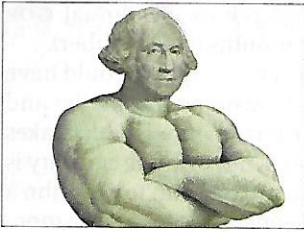


# The mighty dollar

Why a strengthening greenback is bad for the world economy



**T**HE world's most important currency is flexing its muscles. In the three weeks following Donald Trump's victory in America's presidential elections, the dollar had one of its sharpest rises ever against a basket of rich-country peers. It is

now 40% above its lows in 2011. It has strengthened relative to emerging-market currencies, too. The yuan has fallen to its lowest level against the dollar since 2008; anxious Chinese officials are said to be pondering tighter restrictions on foreign takeovers by domestic firms to stem the downward pressure. India, which has troubles of its own making (see separate leader), has seen its currency reach an all-time low against the greenback. Other Asian currencies have plunged to depths not seen since the financial crisis of 1997-98.

The dollar has been gradually gaining strength for years. But the prompt for this latest surge is the prospect of a shift in the economic-policy mix in America. The weight of investors' money has bet that Mr Trump will cut taxes and spend more public funds on fixing America's crumbling infrastructure. A big fiscal boost would lead the Federal Reserve to raise interest rates at a faster rate to check inflation. America's ten-year bond yield has risen to 2.3%, from almost 1.7% on election night. Higher yields are a magnet for capital flows (see page 59).

Zippier growth in the world's largest economy sounds like something to welcome. A widely cited precedent is Ronald Reagan's first term as president, a time of widening budget deficits and high interest rates, during which the dollar surged. That episode caused trouble abroad and this time could be more complicated still. Although America's economy makes up a smaller share of the world economy, global financial and credit markets have exploded in size. The greenback has become more pivotal. That makes a stronger dollar more dangerous for the world and for America.

## Novus ordo seclorum

America's relative clout as a trading power has been in steady decline: the number of countries for which it is the biggest export market dropped from 44 in 1994 to 32 two decades later. But the dollar's supremacy as a means of exchange and a store of value remains unchallenged. Some aspects of the greenback's power are clear to see. By one estimate in 2014 a de facto dollar zone, comprising America and countries whose currencies move in line with the greenback, encompassed perhaps 60% of the world's population and 60% of its GDP.

Other elements are less visible. The amount of dollar financing that takes place beyond America's shores has surged in recent years. As emerging markets grow richer and hungrier for finance, so does their demand for dollars. Since the financial crisis, low interest rates in America have led pension funds to look for decent yields elsewhere. They have rushed to buy dollar-denominated bonds issued in unlikely places, such as Mozambique and Zambia, as well as those issued by bigish emerging-market firms. These issuers were all too happy to

borrow in dollars at lower rates than prevailed at home. By last year this kind of dollar debt amounted to almost \$10trn, a third of it in emerging markets, according to the Bank for International Settlements, a forum for central bankers.

When the dollar rises, so does the cost of servicing those debts. But the pain caused by a stronger greenback stretches well beyond its direct effect on dollar borrowers. That is because cheap offshore borrowing has in many cases caused an increased supply of local credit. Capital inflows push up local asset prices, encouraging further borrowing. Not every dollar borrowed by emerging-market firms has been used to invest; some of the money ended up in bank accounts (where it can be lent out again) or financed other firms.

A strengthening dollar sends this cycle into reverse. As the greenback rises, borrowers husband cash to service the increasing cost of their own debts. As capital flows out, asset prices fall. The upshot is that credit conditions in lots of places outside America are bound ever more tightly to the fortunes of the dollar. It is no coincidence that some of the biggest losers against the dollar recently have been currencies in countries, such as Brazil, Chile and Turkey, with lots of dollar debts.

## The eye of providence

There are lurking dangers in a stronger dollar for America, too. The trade deficit will widen as a strong currency squeezes exports and sucks in imports. In the Reagan era a soaring deficit stoked protectionism. This time America starts with a big deficit and one that has already been politicised, not least by Mr Trump, who sees it as evidence that the rules of international commerce are rigged in other countries' favour. A bigger deficit raises the chances that he act on his threats to impose steep tariffs on imports from China and Mexico in an attempt to bring trade into balance. If Mr Trump succumbs to his protectionist instincts, the consequences would be disastrous for all.

Much naturally depends on where the dollar goes from here. Many investors are sanguine. The greenback is starting to look dear against its peers. The Fed has a record of backing away from rate rises if there is trouble in emerging markets. Yet currencies often move far away from fundamental values for long periods. Nor is it obvious where investors fleeing America's currency might run to. The euro and the yuan, the two pretenders to the dollar's crown, have deep-seated problems of their own. The Fed, whose next rate-setting meeting comes this month, may find it harder than before to avoid tightening in an economy that is heating up.

If the dollar stays strong, might protectionist pressure be defused by co-ordinated international action? Nascent talk of a new pact to rival the Plaza Accord, an agreement in 1985 between America, Japan, Britain, France and West Germany to push the dollar down again, looks misplaced. Japan and Europe are battling low inflation and are none too keen on stronger currencies, let alone on the tighter monetary policies that would be needed to secure them (see Buttonwood).

Stockmarkets in America have rallied on the prospect of stronger growth. They are being too cavalier. The global economy is weak and the dollar's muscle will enfeeble it further. ■