The dollar and the world economy

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Why the dollar should stabilise next year

The global economy, already beset by financial market turmoil and slowing US growth, is now confronted by the risk that the gradual decline of the US dollar could run out of control. In addition to the weakening outlook for the US, there are fears that central banks could suddenly move to dump their huge dollar reserves or that Middle Eastern countries could abandon their pegs to the dollar. Our baseline scenario is for the dollar to stabilise in 2008 before beginning to appreciate. But a US recession or other factors that could lead to a loss of confidence in the dollar pose major risks to this scenario. A dollar crisis would be very damaging for the global economy, making the expected slowdown much deeper and more protracted.

Dollar decline

The financial market turmoil that begun in August has put serious pressure on the US dollar: by end-November the dollar had fallen by some 6% since August against a trade-weighted currency basket tracked by the US Federal Reserve. Dollar weakness is not a new issue: the currency has lost a quarter of its value against a broader range of currencies over the past five years. However, there are fears that, in the current environment, the dollar's decline could turn into a rout.

Much of the reason for the dollar's decline lies in economic fundamentals: notably the large US current-account deficit, which reached 6.2% of GDP in 2006. Dollar weakening has been accelerated partly by the cyclical divergence between the US (where growth is weakening owing to the fallout from the subprime mortgage mess) and the rest of the world (where growth remains robust), and by the associated widening of interest rate differentials following cuts by the US Federal Reserve. The subprime debacle and ensuing turmoil on credit markets have also hit the dollar because uncertainty centres on dollar-denominated assets and confidence in the resilience of the US financial system has been shaken. Net private capital inflows into the US have weakened sharply since August.

Finally, current difficulties have reinforced some investors' worries about the longer-term role of the dollar as a reserve currency in the global economy. Immediate concerns are that central banks and sovereign wealth funds (SWFs) sitting on huge piles of dollars, such as China and several oil producers, could dump their dollar assets out of fear of capital losses from dollar depreciation. Similarly, there are concerns that the dollar could be hit if those central banks that currently peg their currencies to the dollar shift to different exchange-rate regimes. One reason for this, particularly for countries in the Middle East and for China, would be to ease inflationary pressures that are building as the US currency weakens.

Road to recovery

In our baseline scenario for the global economy, the dollar is likely to stabilise in 2008 before beginning to recover later in the year--we forecast an average rate against the euro falling from US$1.371 in 2007 to US$1.46:1 in 2008, before recovering to US$1.33:1 in 2009. The US currency is likely to continue to weaken against the yen into the medium term, but this is mainly because the yen will appreciate strongly as Japanese interest rates rise and the carry trade unwinds.

The main reason to expect the dollar's fortunes to improve is that by late 2008 the current hysteria on global
markets should have abated, and US growth should be beginning to emerge from a period of weakness, allowing for calmer consideration of the relative strengths of the US economy. Robust productivity growth in a global context (even allowing for concerns over weaker US productivity growth in the coming years) and comfortable demographics support the case for a relatively bright long-term outlook and hence provide good grounds for the dollar to strengthen. Once the US’s economy's downturn and weaker dollar have reduced the US external imbalance, we expect the currency to appreciate into the longer term.

It is likely to be supported in 2008 by interest rate dynamics. We believe that markets exaggerate the case for monetary policy easing in the US next year and the Fed funds rate will still stand at 3.75% at the end of 2008. This would lead to some strengthening pressure for the dollar, as investors readjust their interest rate expectations. The US currency may also be supported against the euro by an interest rate cut by the European Central Bank, although the uncertainty about this is high.

Finally, we believe that a large-scale shifting of public foreign reserves out of the dollar is highly unlikely. The investment horizon of these entities tends to be long-term, and, as we have argued, over the longer-term the dollar should appreciate. Even in so far as central banks and SWFs with large US dollar assets are concerned about short-term losses, they will be held back by concerns that any disposal of the currency would trigger even bigger capital losses on their remaining stock of US dollar assets. Moves away from a dollar peg should also have only a limited impact on demand for the dollar—we currently do not expect the Gulf states to re-peg—and even if they did, they would probably move to a basket of currencies dominated by the dollar, mitigating the impact on dollar reserve holdings.

**Considerable risks**

Nevertheless, the risks of the dollar's decline into 2008 turning into a rout are high. Most importantly, there are downside risks to our US growth forecasts, notably from a continuation of the recent financial market turmoil beyond what we currently expect, or from a greater-than-expected impact on consumer demand from the correction in the US housing market. The dollar will also remain exposed for much of 2008 to nervousness among investors about the US current-account deficit and about shifts in central bank and SWF holdings and in exchange rate regimes.

These factors could easily lead to a further sharp fall that could see the dollar clear the US$1.60:1 threshold. Co-ordinated countermeasures by the G7 would probably put a floor under the dollar. Nevertheless, a full-blown dollar crisis, coming on top of the credit crunch and a weakening US economy, would be disastrous for the global economy.

A dollar slump would hit financial markets hard, and could force the Fed to raise US interest rates just as the economy was slowing, pushing the US into a protracted recession. At the same time, the euro would bear the brunt of the dollar's weakening: further euro appreciation would substantially reduce growth in Europe (we estimate that a 10% rise of the euro in nominal effective terms would cut growth in th euro zone by a third of a percentage point). The downturn for the global economy already expected as a result of recent financial market turmoil would therefore be much deeper and more protracted.

**De-dollarfication**

Even under our baseline scenario, in which the dollar avoids a sharp slump in the short term, there are substantial risks to the currency in the medium to long term. A period of below-potential domestic demand growth in the US will contribute to a moderate shrinking of the external deficit to around 4% in 2010 followed by a stabilisation in subsequent years, but this will still leave the deficit at a high level. Foreign investors will not accept low returns on their US holdings for ever, particularly as the US becomes a smaller part of the global economy and the supply of financial assets from emerging markets continues to develop, raising investment opportunities outside of the US. The dollar will therefore remain exposed to shifts in sentiment into the medium term.

Moreover, given structural shifts in the global economy, an end to the dollar's hegemonic status (as an international means of exchange and reserve currency of choice) may be inevitable in the longer term. This shift could be stable or disorderly—but it could yet occur gradually, and certainly need not imply a slump in the dollar in
the short-term.