UNITED STATES

The falling dollar

Losing faith in the greenback

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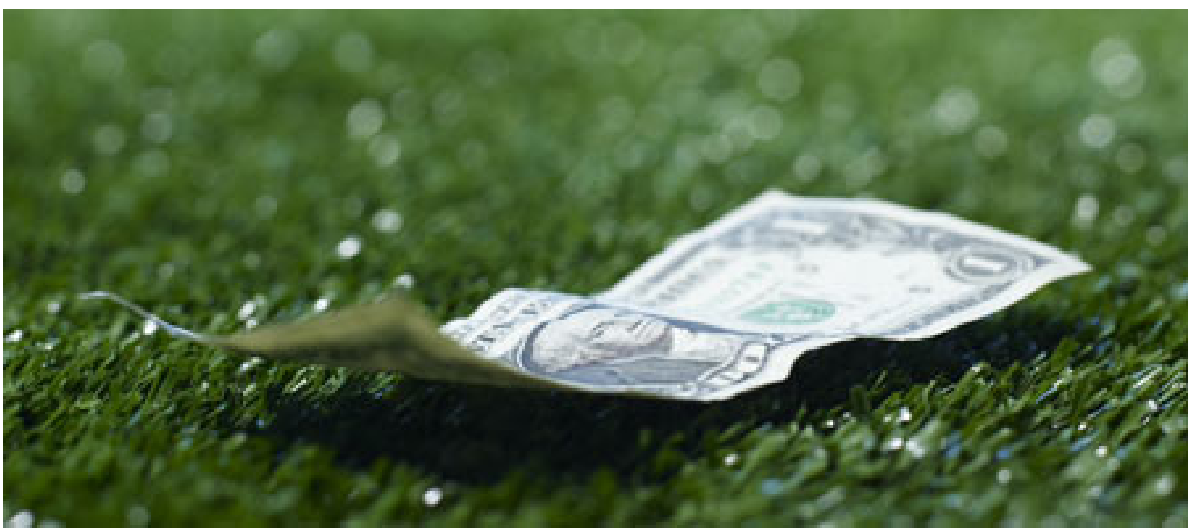
Riser



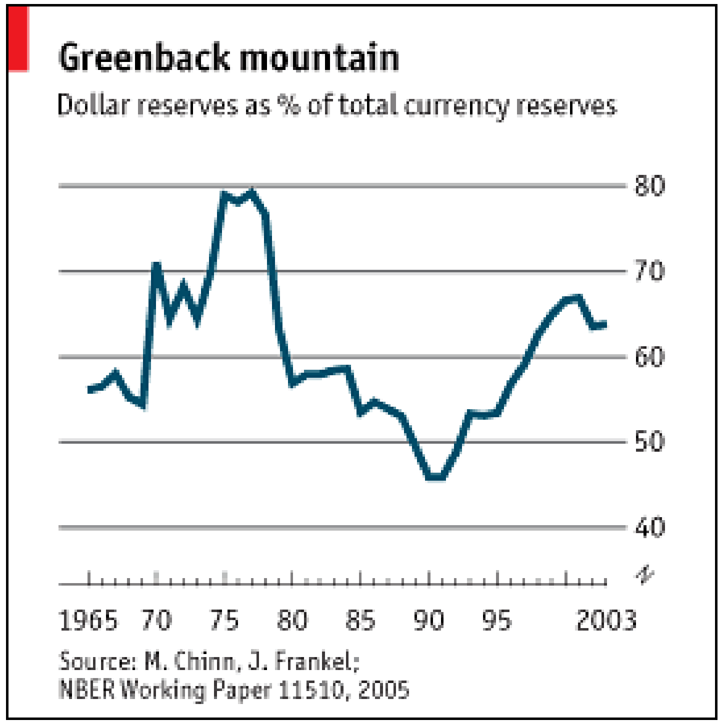
How long will the dollar remain the world's premier currency?

THE long-run value of all paper currencies is zero. That is a fond saying of Bill Bonner, goldbug and publisher of the *Daily Reckoning*, a contrarian financial newsletter. So why should the dollar be any different? Mahmoud Ahmadinejad, Iran's president, seems to think the long run is now: two weeks ago he decried the dollar as a “worthless piece of paper”. And Jim Rogers, a famously shrewd investor, asks why anyone would buy dollars.

America's currency has been infected by the sense of crisis that bedevils its economy and financial markets. Speculative selling of the dollar is close to an all-time high, reckons Stephen Jen at Morgan Stanley. Many believe—and some evidently hope—that the greenback might be on its way out as an international currency. Worrying parallels are seen between the dollar's recent fall and the decline of sterling as a reserve currency half a century ago.

The dollar's value against the basket of leading currencies tracked by America's Federal Reserve has recently been at an all-time low. Against a broader range of currencies, the dollar has lost a quarter of its value in the past five years. Its decline has been especially marked against the euro. At one point in 2002 the euro was worth 86 cents; today it buys $1.48.

That currencies rise and fall and test records is hardly unusual. What lends the dollar's decline an air of crisis is that the world's bloated currency reserves are crammed with depreciating dollar assets. Foreign-exchange stockpiles have almost tripled to $5.7 trillion since the beginning of the decade. China alone has $1.4 trillion of reserves. Japan's $1 trillion or so make it the second-largest holder.



In this period of swelling reserves, the dollar has retained its pre-eminence. It still accounts for nearly 65% of identifiable currency-stockpiles, according to the latest IMF data. This is broadly in line with its historical share (see chart). Factor in the dollars hoarded by China and Middle Eastern oil exporters (not included in the IMF breakdown) and the dollar's share may be higher still.

Subprime currency

The dollar's place as a reserve currency always seems to be questioned when it falls. Weakness in 1977-79, 1985-88 and 1993-95 was each time met with predictions that governments were about to switch their reserves into another currency. A burst of high inflation, which undermined the dollar in the late 1970s, made that slide as serious as today's scare is. Between 1978 and 1980 the Treasury sold $6.4 billion of “Carter bonds”, mostly denominated in Deutschmarks, to raise funds to defend the dollar. In January 1980 the gold price reached a record $835 (around $2,250 in today's prices) as investors sought an alternative store of value. And when the dollar fell to ¥81 in 1995, many—including this newspaper—saw it as the beginning of the end of its reserve-currency status.

The dollar has weathered these storms. But now it faces a nasty squall that combines both cyclical and structural blasts. Its decline in the past five years has imposed a huge capital loss on foreign-exchange reserves. If this becomes too painful, central banks may be tempted to cut their losses and dump their dollars, causing a slump in the currency's value. The lure of selling is made all the greater by the knowledge that other central banks are overloaded with dollars too. Those that get out first have more chance of saving their capital.

America's thirst for overseas funding is another reason to fret. For years it has spent more than it earns, running up large, persistent current-account deficits. Last year the shortfall in America was a whopping 6% of GDP. Bridging that gap requires foreigners to buy dollar assets—bonds, stocks or property. But the more overseas debt that America runs up, the greater the risk that it will partly default on its obligations, either through currency weakness or inflation.

These vulnerabilities are not new but they are made worse by an economy that is turning sour. Losses on subprime mortgages have intensified the housing downturn in America and poisoned its credit markets. The threat of recession has prompted two interest-rate cuts, and more reductions are likely. Faltering growth and falling interest rates make for a weak currency, particularly when growth prospects elsewhere seem rosier. And the downgrades to credit-related securities once deemed top-notch have hurt the reputation of America's capital markets.

America's downturn poses other problems too. The oil-rich Gulf states are thinking of ditching their currency pegs with the greenback. These links have obliged them to buy dollars, so as to prevent their own currencies from rising. The dollar peg has made it hard to curb inflation, especially in fast-growing oil economies, whereas a less rigid exchange-rate regime—say, a peg with a basket of currencies—may allow a more flexible interest-rate policy. Such a regime would also crimp the demand for dollars at a time when confidence in the currency is fragile. All this may not bode well for the dollar's status as the world's reserve currency.

However, even if this is an awkward time for the currency, it need not be a catastrophic one. The fear that the dollar could be swiftly supplanted as top dog is based on the idea that one currency will always have a near-monopoly: if everyone holds dollars chiefly because everyone else does, you could imagine how a falling share of global reserves might reach a point when central banks all suddenly switch to a new currency standard.

The dollar's favoured position in international trade owes something to this kind of network effect. Global markets in commodities are priced and transacted almost exclusively in dollars, because it is convenient for buyers and sellers. But whatever Mr Ahmadinejad thinks, oil exporters would not get more income if commodities were priced in euros or pounds. The competing pressures of supply and demand set the oil price: the dollar is just an easy way of keeping score. The convention of quoting in dollars is often employed when the currency of one or more trading partners is not used. Once such a standard is set, there are costs to shifting to a new one. But the benefits to America of issuing the world's favoured transaction currency are easily exaggerated. Advances in financial technology mean that a given volume of trade requires a much smaller dollar-float than in the past.

The confidence factor

The role for the dollar as an international means of exchange is entirely different from its role as a reserve currency. Reserves are held to buttress confidence in a country's own currency, not as a float for global trading. As a backstop, reserves need to be easily convertible (so they can be used as an emergency source of liquidity) and a good store of value. The dollar, with its large and liquid capital markets, meets the first criterion even if it has failed the second—at least, recently.

Barry Eichengreen, a professor of economics at the University of California, Berkeley, argues that there is no reason why a single currency should dominate reserves as the dollar has. Before the era of the dollar standard, he points out, reserves were in a handful of currencies. On the eve of the first world war, when Britain was the greatest trading power, the pound's share in official currency reserves was all but matched by the combined share of the French franc and German mark. After the war a three-way split was maintained, with the dollar replacing the mark.

If the dollar's dominance is to end, two or more currencies are likely to share the crown. Those who take a grand sweep of history are backing China's yuan as a big reserve currency of the future. The dollar's immediate rival, however, is the euro. In several important respects—the euro area's size, the depth of its capital markets and its share of world trade—it has the attributes of an ideal reserve currency (see table below). Unlike America, the euro area has the added attraction of a broadly balanced current account.

The euro has already made inroads into the dollar's territory. At its launch in 1999, its constituent currencies—the mark, franc, lira, etc—accounted for less than a fifth of the world's official reserves. Its share has since increased to around a quarter, even as total currency reserves have swollen. The euro area is less dependent on oil imports than America is and it sells more to oil exporters as well as to fast-growing economies such as China and Brazil.

The euro's attractions may be somewhat superficially enhanced at the moment. It has risen sharply in value, flattered by cyclical forces that have favoured it over the dollar. But only a year ago Italy's sluggish economy and fiscal problems inspired talk about a break up of the euro. Just five years ago the euro was considered irredeemably weak.

Reserve rivals

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	United States	Euro area
GDP, $trn	11.6	9.5
Foreign-exchange market turnover, % of total	43.0 *(in $)*	18.5 *(in €)*
Stockmarket value, $trn	15.6	13.7
Currency in circulation, $bn	821	895

Sources: BIS, ECB, IMF DoTS, Thomson Datastream

But although the near-term outlook may be favourable to the euro, its prospects in the medium-term may not be so bright. The euro's appreciation is already causing strains within the currency zone. In the coming decades the euro zone's workforce is set to age faster than America's, which will hamper its economy and add to its fiscal pressures. There is also the question of how much trust investors will put in a currency with no central fiscal authority to stand behind it.

Since the title of reserve currency can be split, the dollar's share in global currency reserves is probably too big—whatever happens to foreign-exchange rates. Many of the countries that have built large stocks of dollar assets by pegging their currencies to the greenback are now battling with inflation. Sticking with the peg would mean importing the policies of recession-threatened America and feeding inflation still more. Yet abandoning the peg only adds to the pressure on the dollar.

A compromise is to be weaned off the dollar, with a peg made up of a basket of rich-world currencies, including the greenback. This would give dollar-peggers more freedom over their monetary policy—they would no longer have to mimic the Fed slavishly—while allowing them gradually to slow their purchases of dollars.

Is a dollar rout avoidable? An optimist would say that central banks, having spurned the chance to diversify out of dollars when a euro could be bought for 86 cents, are unlikely to want to switch now when the price is close to $1.50. Against conventional benchmarks like purchasing-power parity, the euro looks dear against the dollar. So it could be a bad time to swap from one horse to another. To the extent that dollar-holders act like an informal cartel, then the biggest dollar-holders will set an example. Japan seems unlikely to start selling its huge dollar reserves—if anything it might intervene to prevent the dollar falling further against the yen. A crash might be averted if China holds fast too, because it recognises how self-defeating dumping dollars would be to such a large owner of American assets.

Yet a pessimist would counter that a revaluation of emerging-market currencies against the dollar could easily turn disorderly. Although economic logic may argue against selling dollars at a cyclical low point, central banks have sometimes been hopeless portfolio managers: witness their shift out of gold just as its price hit a low. Yes, the dollar looks cheap, but currencies often overshoot. So it would be foolish to say where its decline should stop.

Averting a crash

Despite the anxiety and gloom, some straws in the wind suggest that the dollar's decline may soon slow. In the past few weeks it has regained ground against a handful of important currencies, including the pound and the Australian dollar. America's trade balance is narrowing, despite the effects of expensive oil imports, suggesting that a weaker currency is already working to correct imbalances.

As a rule, central banks cannot intervene to determine exchange rates, but as Morgan Stanley's Mr Jen suggests, some sort of official action has often preceded turning points in the world's foreign-exchange markets. If he is right, then a change in rhetoric or even co-ordinated intervention may be the signal the markets need before they stop believing that the dollar is destined to fall further.
