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Last updated: May 30, 2014 6:57 pm

Death of US dollar is greatly exaggerated



By John Authers Author alerts

There is simply nothing that is better and safer



What does not kill the dollar makes it stronger. There have been plenty of obituary notices for the US dollar's reserve currency status in recent years, and with good reason. Other countries are growing far faster; the 2008 financial crisis destroyed confidence in its banking system; and measures taken since to recover from the crisis, keeping rates low and flooding the markets with money, should adulterate the currency.

And yet, whenever crisis hits, the dollar rises – even when the epicentre of the crisis is itself in the US. On a trade-weighted basis, the dollar gained almost 27 per cent during 2008 and early 2009, as the collapse of Lehman Brothers rocked the world. Then it rallied almost 20 per cent in the months after the outbreak of the eurozone crisis in late 2010; and in 2011 the decision by Standard & Poor's to downgrade US sovereign debt sparked a rally of more than 15 per cent for the dollar.

The long-term trend for the dollar does appear to be gently downwards; but it is still the place to which money comes home when there is trouble.

To illustrate these trends in microcosm, look at the past few weeks. During the past year, a relatively benign period for perceived risks, in which the crisis in the eurozone had died down, while the Federal Reserve bumpily but successfully started tapering off its "QE" bond purchases, the dollar has steadily weakened. But this month, it started to strengthen.

This week brought the news that annual gross domestic product growth in the US was -1 per cent for the first quarter. This was far worse than expected, and the first time in three years that growth had turned negative.

The response on the currency markets? Negligible. The euro barely gained on the dollar in the aftermath, and has dropped some 3 per cent against the US currency in a matter of weeks. Chart patterns matter a lot for currency traders, and the euro remains just below its 200-day moving average (an average of the past 200 days' closing prices), which implies that the euro may have moved into a decisive downward trend.

Similar factors were at work when looking at a broader trade-weighted index of the dollar against major US trading partners.

Other round numbers have had their effect recently. The rise of the euro stalled just below \$1.40 – a level that has aroused complaints from European politicians in the past – while the pound sterling has also been falling, having almost but not quite hit \$1.70.

What is going on? Janet Yellen, the head of the Federal Reserve, has convinced markets that the imminent end of bond purchases does not mean that rates will rise soon. That weakens the dollar. But there are limits to how far this can go, and it appears that the market has reached those limits.

In the broader picture, this is part of what Eswar Prasad, who teaches economics at Cornell University, calls the "dollar trap". In a new book he argues that the dollar will not lose its status as the world's reserve currency. Instead, a growing demand for "safety" combined with a shortage of "safe" assets anywhere else, will ensure that it continues to anchor the world financial system.

Emerging central banks, led by China, have piled into US assets. A far higher proportion of US government debt is held by foreigners than is true of eurozone or Japanese government debt. So international trust in the US continues to be deep.

Other options of safety are dwindling. Since the crisis, both eurozone bonds and mortgage-backed paper look far less safe. China's renminbi remains tightly controlled. And no other market has the depth of the US. If foreigners are nervous about the US (as they well might be) and want to put their money somewhere else, they will find few other places that can take it.

So the logic of supply and demand means, according to Mr Prasad, that we take shelter from problems in the dollar.

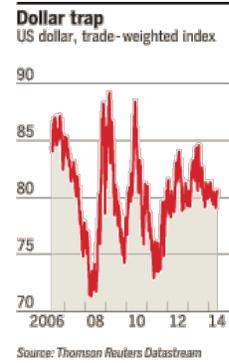
Thus the US, having taken measures that would have risked collapse for any currency that did not benefit from the “dollar trap”, can now raise rates over the next few years, strengthening the dollar. In the immediate future, the feeling is that the European Central Bank must take measures next week to combat the risk of deflation, and that this will involve weakening the euro against the dollar.

Mr Prasad admits that the trap “seems to run counter to logic”, and that the world economy is in a “fragile equilibrium” so that we may be on “a sandpile that is just a few grains away from collapse”. The dollar trap may yet turn into a crash. But it has avoided many opportunities for such a denouement so far.

For the longer run, it appears that the dollar has us all entrapped. There is simply nothing that is better, and nothing that is safer. To quote Mr Prasad, it has become “a protective but prickly cocoon for a troubled world, which could do a lot worse than putting its money and trust in the US”.

The Dollar Trap, by Eswar S. Prasad, Princeton University Press

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