Currencies

Buck to the future

Is the dollar starting another long-term rally?

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SUDDENLY the dollar is the currency of the moment. The greenback has risen 6.3% on a trade-weighted basis over the past three months. It recently hit a six-year high against the yen and a two-year high against the euro.

The trend reflects confidence in the prospects for the American economy, combined with worries about the health of the rest of the world. On October 7th the IMF lowered its forecast for global growth in 2014 to 3.3% from the 3.7% it foresaw in April. Some of the biggest reductions were in Europe: it now expects France to grow just 0.4% this year, half a percentage point less than in July. To confirm the fund’s pessimism, German industrial production fell 4% in August while factory orders dropped by almost 6%; both were the biggest declines in more than five years. In contrast, the latest American data showed a 248,000 jump in jobs in September and a fall in the unemployment rate to 5.9%.

This relatively strong economic performance has reinforced expectations that the Federal Reserve will start to push up interest rates next year while the European Central Bank and the Bank of Japan will keep them low. Higher rates will attract investors to the dollar, particularly those who follow a strategy dubbed the “carry trade”, in which they borrow money in a country with low rates and invest it in a country with higher ones.

The carry trade has been difficult in recent years because nearly all countries in the rich world have held rates close to zero. But there is now a significant carry in the bond markets, where ten-year Treasury bonds yield one-and-a-half percentage points more than German bonds of the same maturity—a very wide gap by historical standards.

A stronger economy also makes American companies more appealing to international investors. America’s stockmarkets have outperformed their rivals in Europe and Japan this year, even before the strength of the dollar is taken into account. Foreign firms have bid a combined $325 billion for American firms this year. That increases the demand for dollars.
The big question, however, is how long this trend will last. As the chart shows, the latest rebound is small by the standards of the huge rallies in the early 1980s and the late 1990s. A strengthening dollar has its advantages for Americans. Foreign investors will be keener to hold Treasury bonds, making it easier for the government to fund its deficit. American tourists will find their money goes further on foreign trips. Imports will fall in price, keeping inflation down despite the healthy economy.

But there are downsides too. American companies will find that their overseas profits are worth less in dollar terms; around a third of the revenues of S&P 500 companies come from abroad, according to Factset, a data firm. America’s exports will be less competitive, at a time when the country still has a current-account deficit of 2.3% of GDP, despite the boom in shale oil. As a result, a big appreciation of the dollar cuts GDP growth by around half a point over the following year, according to the Fed’s models. (This may mean the Fed is slower to tighten policy than the markets expect, a factor that may eventually limit the dollar’s rise.)

A stronger dollar will have the opposite effect on the European and Japanese economies, making their exports cheaper and pushing up import prices. Policymakers in both areas may welcome that, since they are struggling to generate growth and avoid deflation. As David Bloom, head of foreign-
exchange strategy at HSBC, a bank, says, “The dollar on its own may not be able to save the world but it will certainly buy these economies time.”

For emerging markets, the effect is probably less positive. Back in 2010 Guido Mantega, Brazil’s finance minister, warned that loose monetary policy in America and elsewhere was leading to “currency wars” in which rich countries were trying to improve the competitiveness of their exports by devaluing their currencies. Investors were also pouring money into emerging markets, enticed by their better growth prospects, leading some countries (including Brazil) to impose capital controls. A stronger dollar may now prompt capital to flow out of such countries just as fast. That will be a particular problem in places where governments or firms have borrowed significantly in dollars, since their revenues are denominated in local currency but their liabilities in dollars.

A prolonged dollar rally may also have political ramifications. A paper by Douglas Campbell of the University of California, Davis, found that the previous two big dollar surges led to a decline in manufacturing jobs. That provoked complaints from American politicians that first Japan and then China were unfairly suppressing their currencies to take American jobs. It is easy to imagine the same arguments resurfacing this time, with the obvious target being Germany. It already has a current-account surplus of 7.2% of GDP; the euro’s recent weakness is likely to boost it further. Governments resisted calls for protectionism in the past, but their economies were stronger then. It may be harder to ward off in future, given that voters have already been angered by years of austerity and declines in inflation-adjusted wages.

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