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Why the dollar stays steady as America declines

By Gillian Tett

When stormy skies descend on other countries, investors flee – but when the US suffers, they buy

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Last week Nigeria's central bank announced something that might make American politicians blink. Kingsley Moghalu, the deputy governor, pledged to convert almost a 10th of Nigeria's $43bn reserves from dollars to the Chinese currency. "Ultimately the renminbi is likely to become a global convertible currency," he explained, noting that "the future of international economics and trade will shift in large part to business with and by China".

Only 0.01 per cent of central bank foreign exchange reserves are held in renminbi, compared with 60 per cent in dollars and 25 per cent in euros. But Patrick Zweifel, chief economist at Pictet Asset Management, believes renminbi reserves could reach 30 per cent of the total by 2025, posing a challenge to the dollar's pre-eminence.

He is not alone. Such forecasts have much to do with China's rising economic might and the gradual liberalisation of its currency. But they reflect alarm and irritation about America, too. The US current account deficit, rising government debt, the hangover from a financial crisis and political gridlock have prompted economists and investors to warn of a looming dollar decline. Hence the keenness of Nigeria and others to reduce their exposure to the US currency, and escape from being tethered to swings in American policy.

But as Eswar Prasad, a former International Monetary Fund economist, points out in his new book *The Dollar Trap* , there is a paradox. While common sense would say that these developments should have sparked a dollar crisis, precisely the opposite has occurred.

Against a trade-weighted basket of currencies, the value of the dollar is little changed from 2008. And while the dollar's role as a reference currency has diminished in recent years (for example, because more oil is being priced in euros), it remains pre-eminent as a store of value. True, the proportion of central bank reserves held in dollars is lower than in 2001. But it has not declined since 2008. Instead, it is the euro whose stature as a reserve currency was diminished by the crisis. Foreigners continue to flood into American assets, buying 60 per cent of all US debt issues since 2008. When stormy skies descend on other countries, investors flee. But when America hits the rocks, they buy. The result, Prof Prasad argues, is "a topsy-turvy Bizarro World where everything seems inverted or backward".

This is unlikely to change soon. In part that is because America is recovering and the Federal Reserve is tapering its asset purchases, developments that support the dollar's value. But there is another reason that goes beyond economics: fear. In the past decade emerging market countries have amassed highly rated government bonds as a defence against market turmoil. Regulators have pressurised western banks into doing the same. But there are now few genuinely safe assets. In a world where even US government debt no longer seems risk-free, asset managers have rushed towards the second-best option: a flight to liquidity, not safety.

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Dallying with the dollar

December 2013: There is a widespread belief that the dollar is set to soar as the economy recovers from its torpor and the Fed prepares to taper. James Mackintosh,

In that respect, America reigns supreme. Its capital markets are deep and the pool of dollars seems bottomless. Or to put it another way (though Prof Prasad, now an economics professor, does not quite say this) what is happening with the dollar turns the normal rules of economics on their head: it has become ultra-attractive because of bountiful supply, not because supply has been constrained.

Eventually the normal economic rules may prevail again and loose policy that results in an excess supply of dollars may erode the attraction of American money. But once again, political incentives may trump economics. Many of the US government's creditors are American voters. They will fight devaluation. Prof Prasad predicts that, knowing this, foreign investors will keep gobbling up American assets.

Of course, this is not how countries such as Nigeria like to talk. Diversification chatter is all the rage, and central banks are buying not just renminbi but other currencies such as the Canadian dollar. Yet the sheer range of alternatives makes it difficult for any single currency to rival the greenback, a fact that the dollar's discontents do not like to acknowledge. Least of all amid emerging markets turmoil, which is likely to investment editor, analyses why there is no sign of a climb so far

intensify the dollar rush – and the paradox.

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Letter in response to this column:

Dollar strength reflects fundamentals

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