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Buttonwood

Good losers

The "strong dollar" policy means little in practice

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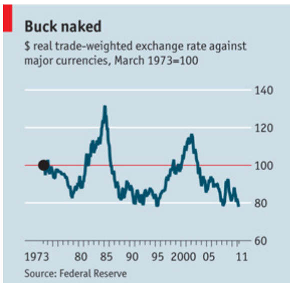
"THE BIGGEST LOSER" is a reality-TV format, broadcast round the world, that encourages gravitationally challenged contestants to reduce their weight. Perhaps the title should go to any viewer sad enough to sit through a series.



The leading currencies of the developed world—the dollar, euro, yen and pound—seem to be undertaking their own version of the show. There are good reasons for despising each of them.

In recent months, however, it is the dollar that has suffered the most. As the chart shows, on a real trade-weighted basis it is now close to its lowest level in the post-Bretton Woods era of floating exchange rates. And this weakness has occurred even though the dollar's greatest rival, the euro, is ensnared in a sovereign-debt crisis.

By and large, foreign-exchange movements seem to be driven by four key factors: yield differentials, relative inflation rates, trade flows and growth prospects. Yield has probably been the dominant influence of the past decade, particularly in the form of the "carry trade", which involves investors borrowing money in the currency with the lowest interest rate and depositing it at a higher rate elsewhere. In the early 1980s the dollar was buoyed by relatively high interest rates in America as Paul Volcker attempted to squeeze inflation out of the system.

Yields on all four leading currencies are low: so low, indeed, that carry traders normally back other currencies such as the Australian dollar. But at 1.25%, rates in the euro zone are already the highest of the four. And the European Central Bank has started its tightening cycle whereas the Federal Reserve is promising "exceptionally low" rates for an "extended period". The futures market expects that by June 2012 short-term rates in the euro area will be around 2.5%, compared with just over 1% in America.

As for inflation, a country with a relatively high rate ought to see its currency depreciate, so that its real exchange rate is roughly stable over time. This does tend to happen when inflation rates are very high, as they were in Latin America in the 1980s or Zimbabwe more recently. But the differences between developed-world inflation rates are so small (the same is true of expected rates, measured via the bond market) that this doesn't seem to be a big influence at the moment.

A country with a persistent current-account deficit might be expected to see its currency fall over the long term. That has indeed been America's experience. But it is hard to explain the recent weakness of the dollar in this way, since the deficit is lower than it was three years ago.

Markets are apt to overlook a trade deficit when they are excited by an economy's growth prospects. The dollar's strength in the late 1990s owed much to a belief that a productivity miracle, driven by the internet, had increased America's growth rate: as investors clamoured to get hold of dotcom stocks, portfolio flows drove the greenback higher.

There is nothing like the same excitement today. America's economic growth is still expected to outpace that of Britain, Japan and the euro zone both this year and next, but if its prospects were truly rosy the dollar would be heading higher, not lower.

All of these factors seem to be trumped by the dollar's unique role as the world's reserve currency and provider of the most liquid markets. The former has given America the "exorbitant privilege" of issuing debt at low rates in its own currency to investors like the Chinese central bank who need to hold dollars for reasons of economic policy (see article). The latter means that the dollar is seen as a "safe haven" currency at times of stress even when, as in 2008, the stress was the result of events within America itself. The perverse corollary is that, as sentiment has improved over the past year or so (in part owing to an American rebound), the dollar has retreated.

At what point does the dollar's decline become a crisis? There was co-ordinated intervention to weaken the yen after March's earthquake but that was spurred more by Japanese than American concern. The next alarm might sound if the euro touches its record high of $1.60.

For all the talk of a "strong dollar" policy in Washington, it is hard to imagine the authorities taking any action, such as raising interest rates, with the specific aim of driving the greenback higher on a trade-weighted basis. After all, the boost to exports is rather handy. The Americans are like failed dieters who talk earnestly about their weight-loss programme while holding a chocolate doughnut.

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