The Economist

Buttonwood

The coin has two faces

Other currencies' losses may be the dollar's gain

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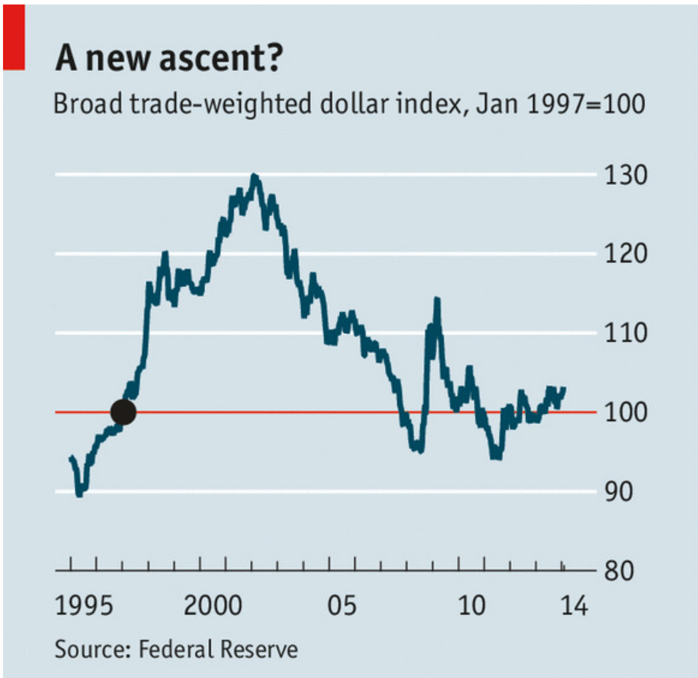
SINCE the debt crisis of 2008, the foreign-exchange market has been the dog that didn't bark. The euro has not broken up; the dollar has not imploded in the face of quantitative easing; the yuan has not become the world's reserve currency of choice. Although the dollar received a lift when markets were collapsing in late 2008 and early 2009, its trade-weighted index is within 2% of where it was when Lehman Brothers crumbled (see chart).



Currency traders have had little to get their teeth into. Often they focus on yield differentials, buying the currency with the highest interest rates, but yields have been low and barely differentiated between countries. Sometimes they look at economic-growth forecasts, but growth has been uniformly sluggish. And sometimes they look at current-account deficits, but the American deficit has shrunk, the Japanese surplus has disappeared completely and the euro area's biggest imbalances are internal, not external.

Policy has also dampened fluctuations. The euro bears were frustrated because the European Central Bank (ECB), under Mario Draghi, proved to be more flexible than its critics suggested while the German government proved willing to do just enough to keep the euro zone intact. Those who predicted the imminent demise of the dollar thanks to the Federal Reserve's experimentation forgot that other central banks were also cutting rates to zero and expanding their balance-sheets. Those who bought yen or Swiss francs in search of a safe haven were frustrated by central-bank intervention to limit their rise.

If there was a long-term trend, it was that the currencies of developed economies were falling and those of emerging markets were rising. Economists viewed this as the "right" thing to happen, even though it caused grumbles from some politicians about "currency wars".

But that trend reversed itself last year, and at the start of 2014 currency markets are on the move again. Attention has focused on the sudden drops in the currencies of various emerging markets, thanks both to slowing growth and poor economic management in the countries concerned, and to the Fed's decision to begin reducing ("tapering") its bond purchases. The corollary of cheaper liras, pesos, rand and *reais*, of course, is a more expensive dollar. There is a sense that American investors are bringing their money home, after a long period when they sought higher returns abroad. Figures from EPFR Global, a data provider, show that investors started switching from emerging-market equity funds into rich-world ones in 2013.

As yet, the dollar is still well below the highs it reached earlier this century against the euro (in 2001) or the yen (in 2002). But Citibank, which monitors foreign-exchange flows, says long-term investors have shifted from being dollar-sellers into dollar-buyers, so its rise may yet continue. The Japanese authorities seem happy to let the yen weaken, and the euro zone is sliding dangerously close to deflation, which may yet prompt further monetary easing by the ECB later this year.

Meanwhile, some of the market's favoured currencies have lost their appeal. Both the Australian and Canadian dollar had moments in the past five years when they traded above parity against the greenback, but each has dropped significantly in recent months. Weak commodity prices may be largely to blame, but it could be another case of American investors rediscovering the joys of home.

The dollar's last extended period of strength was in the late 1990s, when optimism about the growth-enhancing potential of the internet was at its height. A similarly optimistic mood exists today, linked to the potential for shale oil and gas to reduce America's energy costs and thus boost its manufacturing sector.

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A strong dollar can have negative consequences. In the late 1990s several emerging economies struggled to maintain their pegs to the greenback, leading to financial crises in both 1997 and 1998. It will also, other things being equal, make life more difficult for big American companies, making their exports less competitive and reducing the value of overseas earnings when translated back into dollars for quarterly results. Countries that import a lot of commodities will, for their part, pay more for them, since they are all priced in dollars.

But it is not all bad news. If the dollar is starting a bull run, the American government should have no problem finding buyers for its bonds. When the Fed mused about tapering last May, yields rose sharply; so far in 2014, ten-year yields have fallen by a third of a percentage point.

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