The U.S. dollar: changing status?

One of the old, and often reliable, market adages is that when reaction to an event is different from what is normally expected, this is often an indicator of a major trend movement in the opposite direction. As a student of the foreign exchange market, I have been wondering whether the recent movements of the dollar amongst the G3 currencies, is such an event.

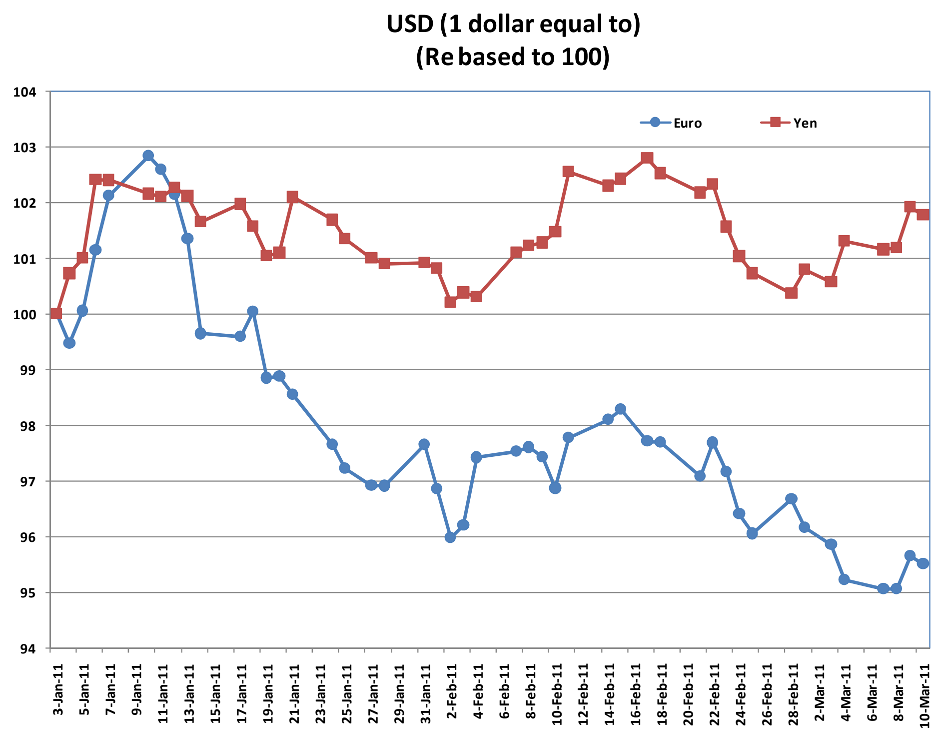
For a long time now, the dollar has been regarded as a “safe haven” currency to which speculators/investors migrate at times of uncertainty. The last time this phenomenon was witnessed was in late 2008 when, after the collapse of Lehman Brothers and the crisis in financial markets, the dollar strengthened sharply in the global markets. But recent experience is quite different (see graph). Recall that this period included the over throw of two long established rulers in the middle-east (Tunisia and Egypt), and the rebellion in Libya which is still continuing at the time of writing. There have been strong protests in Algeria and Yemen and, to a smaller extent, in Iran. OPEC has promised to increase output to compensate for Libya, but any extension of the troubles to Saudi Arabia would really put the oil markets on fire. And, as The Economist reminded in its issue of February 26, much of Saudi Arabia’s oil reserves are in its eastern, Shia dominated provinces in a Sunni-ruled country – which, incidentally, is also one issue underlying the unrest in Bahrain.

Indeed, the entire situation in that part of the world which produces something like 40% of global oil supplies is in ferment. The result is that crude oil has jumped from a few dollars below $ 100 per barrel to $ 120 at the time of writing. Developments in our immediate neighbour, nuclear armed Pakistan, are equally worrying: the murder of a relatively liberal Chief Minister of Punjab for his call for blasphemy law review, has been followed by the murder of a Cabinet Minister, for similar reasons. The murderers are heroes even to the middle class and, indeed, to the lawyers whose protests led to the ouster of President Musharaff. Clearly, the “democratic” government of Pakistan is unable to halt the spread of Islamic fundamentalism, which is gaining ever more support. At the moment there is no indication of what kind of governments come into power in Tunisia and Egypt, but there are reports of sectarian clashes in Cairo.

In the ordinary course, with such tensions in one of the most volatile regions of the world, one would have expected money to fly to the U.S. dollar. What has actually happened is quite different: relative stability against the yen, despite political uncertainties and an extremely unusual deficit on current account; and a sharp fall against the euro, notwithstanding the still major problems in the euro zone (last week Greece, where the euro zone crisis began, was downgraded 3 notches).

To say the least, these developments are a surprise; only a few months back, analysts were questioning the very future of the currency, given the fundamental differences on issues such as inflation, external balance, growth etc. between the southern cone countries and the other group led by Germany. In the New Year, yesterday’s discredited currency suddenly seems to have acquired the status of a new safe haven. On some fundamentals, of course, the euro zone is stronger. The external account is in far better balance than the U.S.’s, and there is a political will to cut the fiscal deficit – in the U.S., the Republican Democrat divide is going to make it far more difficult to restore public finances. Also, latest central bank statements suggest that the ECB is likely to hike interest rates sooner than the Fed.

Surely the country most worried by the fall of the dollar must be China whose exposure to dollar denominated assets is huge. But this apart, one also wonders whether the recent change in the status of the euro, if it lasts, would gradually reduce the predominance of the dollar as the world’s reserve currency, and the “exorbitant privilege” this confers on the U.S. Barry Eichengreen, an economist at Berkeley University, has recently come out with a book of that title, which discusses the rise and fall of the dollar and the future of the international monetary system. In a separate article in The Wall Street Journal (March 2) Prof. Eichengreen discusses "Why the dollar's reign is near an end". This should not really be much of a surprise. Sterling's reign lasted a little over the 19th century, and the dollar's unrivaled status goes back to 1945. And, economic cycles seem to be running ever faster.



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