Lincoln Private
Investment Office

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When will the US stop letting the dollar be the global currency of strength?

“We are in the midst of an international currency war”, proclaimed Guido Mantega, Brazil’s Finance Minister, in September 2010. At this point, the US dollar had fallen by around 25% in value against the Brazilian real since the beginning of 2009, when the Federal Reserve (Fed) began its programme of large scale monetary easing. Other central banks, including Japan and South Korea, soon began to intervene in an effort to depreciate the value of their currencies and improve their exporting power, while China continued to suppress the value of the renminbi, ignoring pressure from the US. Mantega’s war was one of banks, not tanks, where greying central bankers set the rules of engagement. And it was wreaking havoc on his country’s ability to remain competitive against its trading partners.

Mantega’s incendiary language was justified. Large-scale intervention in currency markets ultimately benefits no one, as it is impossible for all countries to devalue their exchange rates against each other: one currency always becomes the scapegoat. But, more importantly, faith in the value of these currencies is eroded. Because at its most basic level currency is a physical manifestation of a mutual agreement of trust: an IOU, traded in exchange for goods and services. In the past, currency was backed by some kind of physical collateral. In the age of the Gold Standard, gold was the commodity which set the standard of value. Having come into fruition in 1900, the Gold Standard was replaced by The Bretton Woods System in 1946. Under this system, countries fixed their exchange rates relative to the US dollar, at a fixed rate of $35 per ounce of gold. The intention had been for the system to mimic the working of the Gold Standard: all currencies pegged to the dollar had a fixed value in terms of gold.

For the first few years following World War II, the system worked well. Countries were rebuilding their shattered economies and were spending US dollars on American goods like steel and machinery. But as Europe and Japan began to recover, the US share of global economic output fell dramatically, from 35% to 27%. This led to a negative balance of payments[1] in the US, which, coupled with monetary easing from the Fed and growing public debt incurred by the Vietnam War and domestic programmes, caused the dollar to become increasingly overvalued during the 1960s. Unemployment and inflation were rising, while output fell. Confidence in the system was beginning to fade. On August 15, 1971, President Richard Nixon announced to the world that the US was leaving the Bretton Woods System. At the time, unemployment in the US stood at 6.1%, while inflation was 5.8% year-on-year. The dollar, in Nixon’s words, was a “hostage in the hands of international speculators”: only a new international monetary system could protect the American economy, and American jobs. At that point, for the first time in history, formal links between the major world currencies and real commodities were severed. Within a few years, currencies around the world were freely floating, controlled by market participants. Commodity money had been replaced by ‘fiat’ money, a term used to describe a currency which derives its value not from the asset by which it is backed, but from government regulation or law.

In a fiat currency system, perception is everything; paper money has no intrinsic value. So the people saving and accepting it are not expressing faith in the money itself but in the competence, honesty, and power of the institutions managing it. And when these institutions manipulate or even lose control of monetary policy, faith is eroded. Take the actions of the Fed in the 1980s as an example. Under Chairman Paul Volcker, the price of the dollar surged as interest rates were hiked aggressively to bring inflation under control. While inflation fell by more than 10% over two years, the precipitous fall in prices offered investors some of the highest real interest rates in the world. This meant that international capital flowed with gusto into the US, driving up the value of the dollar to extremely high levels. The Fed was forced to reverse course and cut interest rates. But this didn’t stop the flow of capital into the US: after a near 50% rise in the value of the dollar against other major currencies (as represented by the Dollar Index), US exporters were under considerable pressure. Soon, the current account[2] had plunged to a deficit of 3.5% of GDP and the economy had fallen into a serious recession. Industry leaders dissented, and the US was forced to take definitive action to end the period of dollar strength. By signing the Plaza Accord in 1985, they agreed with the governments of France, West Germany, Japan and the United Kingdom to depreciate the value of the dollar by intervening in currency markets.

Fast forward thirty years and dollar strength is the name of the game once more. 2014 saw the end of quantitative easing and a tightening of the Fed’s monetary policy in response to improving economic data. This stands in stark contrast to the rest of the world: to date in 2015 over 20 central banks have used monetary policy to manipulate the value of their currencies, with the Fed noticeably absent from this group. Policy tightening in the US in the face of a global shift by other central banks into easing mode has led to a US dollar rally since the middle of 2014.

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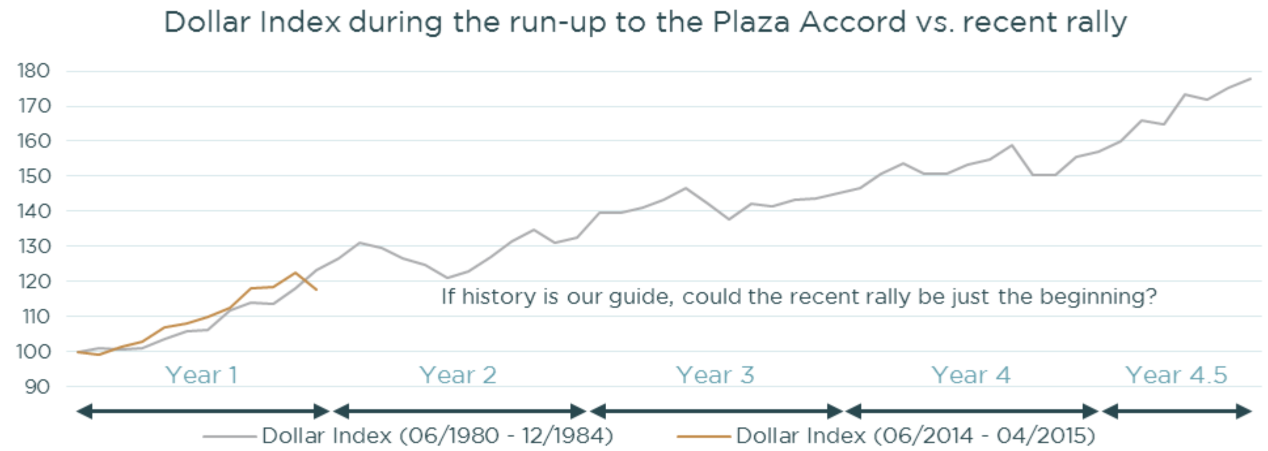
The effects are already becoming clear. GDP figures indicated that the world's largest economy grew by just 0.2% in the first quarter of 2015. Even the most optimistic economist could not put this mediocre performance down to bad weather: dollar strength has become a drag on economic progress in the US. Looking at currency markets the movements have been extreme. The euro has weakened 13% against the dollar in the last six months, while the yen has weakened 14% – in fact, it is now weaker than the time of the Plaza Accord. Aggressive yen depreciation poses another big problem. Japan is China's biggest economic competitor. With the yuan pegged to the US dollar, maintaining a dollar peg at a time when the dollar is surging has led to double-digit appreciation. Some estimate that the yuan is around 20% overvalued[3], making it one of the most expensive currencies globally. The great exporting power will have an extremely difficult time competing if its currency remains so much stronger than Japan's. China may have no choice but to devalue. And the PBOC has never been one for toeing the line; faced with sluggish global demand, there is not much to stop it intervening to take the US dollar/yuan exchange rate back up to 8 or 9 from its current level of 6, in support of its country's export-driven economy.

At this point, all eyes are on the Fed. We have in the last couple of weeks seen a pull back as deteriorating data from the US put a stop to the dollar's sustained rally. But this renewed weakness is not necessarily set to last. The last surge was caused by intimations of a rate rise from the Fed; while weakening economic numbers alter the timeline, they do not put a stop to the Fed's planned course of action. And as other central banks continue to ease, the dollar's upward march appears inevitable. Moves like these in the past have seen the dollar strengthen far more than we have seen to date: when this happens, the change becomes a long-term story. Ultimately, US politicians will not want the dollar to be the buffer for every other currency in the world. At some point, senators will start to stand up in the upper and lower houses of congress, and ask why jobs are being lost to international markets. We might not be far from that point: as global exporters continue to undercut their US competitors, industry leaders will lose faith in the system.

And the Brazilian story? Be careful what you wish for, Guido: dollar strength now threatens to undermine the progress of emerging market economies. Over the past ten years, debt in emerging market nations has been falling. Emerging markets were able to borrow in dollars, which had depreciated considerably versus most major emerging market currencies, and earn in their own stronger ones. This meant that Debt to GDP ratio fell significantly. Now the opposite is the case, and investors are beginning to realise that the last ten years of progress were largely based on currency gains. Emerging market nations are the real canary in the coalmine. Already the Bank of International Settlements has raised major concerns about the effects of dollar strength on these countries' economies, with backing from emerging market leaders. Right when developed market demand is falling, the emerging market growth engine is shuddering to a halt.

Currency is an IOU, and Central banks around the globe are writing them at an unprecedented pace. In doing so they are heightening political tensions and fanning the flames of foreign exchange volatility. When will global markets realise that the world's fiat currencies are backed by fragile promises?



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[1]The balance of payments is a statement that summarises a country's economic transactions with the rest of the world over a specific time period.
[2]The current account is one of the components of the balance of payments. It is the difference between an economy's savings and its investment. A negative current account indicates that the country is a net borrower from the rest of the world. For the US, one of the world's great exporting powers at the time, a current account deficit was shocking.
[3]Source: Barclays Capital