Foreign exchange rates headed in the wrong direction

It is amazing that a country, which consumes much more than it produces, imports a lot more than it exports, saves so little and spends so much, and is mired in deep imbalances of sorts, can have a currency so strong. That country is none other than the United States, and that currency, of course, is the greenback.

If one were to go strictly by economic logic, the greenback should be weak, especially now, as the United States is in the midst of a severe recession. The fact, however, remains that the US dollar is still a high flyer, defying gravity, flying in the face of economic theory. Although the strength of the dollar is apparently an affront to economic reasoning, this is not all that implausible as it may sound after all, as there are weirdly valid explanations for why the greenback is as strong as it currently is.

By most measures, the dollar is hugely overvalued and there are compelling reasons for the dollar to depreciate considerably. The US balance of payments (BOP) has been in the red for a long time, hovering around 6 per cent of gross domestic product (GDP).

In addition, the US budget deficit has been ballooning under the Bush Administration, partly due to the so-called war on terror in Iraq and Afghanistan. The bailouts of failed financial institutions and corporate bodies have imposed an additional strain on the US budget. The planned fiscal stimulus of about $800 billion by the Obama Administration would push the US fiscal deficit to a record level, close to $1.5 trillion.

The dollar should be weakening, not strengthening, under the weight of the twin deficits. In other words, the dollar is strong, in spite of the fact it is tainted by unhealthy fundamentals. But, then, there is much more to the greenback saga than meets the eye.

What the US is currently experiencing is a perfect storm, with all conventional macroeconomic tools breaking down simultaneously. The US monetary policy has become impotent, now that interest rates have been driven down to zero with hardly any room for further adjustments.

Fiscal fatigue, arising from years of continuous budget deficits, threatens to blunt the impact of the planned US fiscal stimulus package. Given the badly damaged monetary and fiscal instruments, it appears that the US could only use the exchange rate instrument to fight off the recession.

This, however, is no more than a wishful thinking, not because a weaker dollar cannot do much for the US economic recovery, but because the system in place does not allow the dollar to weaken sufficiently in the first place.

A weaker dollar is indeed what the US economy badly needs right now. A depreciation of the dollar would enable the US to produce more for the export market by making exports cheaper, and bolster domestic demand for American products by making imports dearer, thereby stimulating output growth. It is in this sense that the current strength of the US currency is greatly detrimental to the US economy.

The dollar, as an international currency, is not entirely under US controls. It is bought and kept by the rest of the world, as it is still considered a relatively a safe reserve currency for central banks the world over. There is no other currency that can rival the US dollar in this regard.

While the unique status of the greenback has enabled the US to run huge fiscal and BOP deficits for years, it has deprived the US of an important countercyclical instrument. The value of the dollar is largely determined not by the US but by the rest of the world.

Countries that hold US dollar reserves and dollar-denominated financial assets are not willing to let the dollar depreciate, as dollar depreciation would mean huge capital losses for them. Not surprisingly, the dollar is propped up by vested interests everywhere, whenever the currency comes under selling pressure. It is simply not in their interest to let the dollar slide substantially.

Countries that export to the US would also like to see a strong dollar so that they can export more to the US, as a stronger dollar means cheaper imports and greater demand in the US market. There is thus a strong motive for the rest of the world to ensure that the dollar does not grow unduly weak. No wonder, central banks are not averse to intervening in the foreign exchange market to stop or limit the slide in the value of the greenback.

What is more, now that the US has stepped up external borrowing to finance its stimulus packages, the demand for the dollar has grown enormously. Massive capital inflows into the US have thus contributed considerably to the growing strength of the greenback.

The US dollar is headed dangerously in the wrong direction. There is no doubt that the strength of the dollar will keep the US economy in a protracted recession. There can be no recovery for the US economy and, by extension, for the rest of the world, so long as the greenback remains overvalued.

To pull the world economy out of the doldrums, there will have to be both expenditure and price adjustments. Expenditure adjustment in the form of fiscal stimulus packages alone will not suffice. The space for price adjustment through changes in interest rates has become increasingly scarce. The only way out of the maze is price adjustment through exchange rates, which unfortunately is headed in the wrong direction, causing havoc to other currencies.

As the US continues to soak up foreign funds to meet its pressing BOP and budgetary needs, smaller economies around the world find it increasingly difficult to source funds at reasonable costs. With capital inflows rapidly drying up, the currencies of smaller economies have come under downward pressure, with weak currencies not translating into increased exports, as export markets remain sedated.

The near-term prognosis looks bleak. The chances are that the strong dollar will keep the US economy locked in a prolonged recession for two to three years. Needless to say this cannot go on forever, as there is the proverbial last straw that can break the camel's back. The dollar will have to take a haircut sooner or later. A time may come for the rest of the world to say enough is enough and let the dollar dive at whatever cost.

To be sure, there can be no end to the ongoing global economic crisis in the absence of a major shift in the exchange rate matrix. The dollar as it stands is clearly a bane, not a boon, to the US or to the world at large.

The end of the current crisis may also signal the beginning of the end of the US dollar as the premium reserve currency. The demise of the "greenback hegemony" in five to ten years is not a remote possibility. Already there are forecasts that the US dollar will fall from 90 yen now to 70 yen (22 per cent) by the end of the year, although one may have to wait for a year or two before one can see long-run shifts in the exchange rate alignments and the establishment of a new equilibrium.

Emeritus Professor Datuk Dr Mohamed Ariff is the executive director of the Malaysian Institute of Economic Research