

THE DOLLAR – UNSAFE HAVEN

Just like any market price, the exchange rate for the dollar fluctuates based on supply and demand. By observing the constituent elements of the supply and demand for dollar assets, we can thus explain the significant appreciation of the dollar during the second half of 2008. Over this period, during which the crisis spread to the whole of the global economy, US Treasury bonds acted as a safe haven, but in net terms foreign investors ceased buying US private securities. Americans, on the other hand, repatriated capital on a massive scale, driving up the net demand for dollars. Supply of dollar assets fell more rapidly than the global supply of assets and thus shored up the US currency. The dollar's future movements remain one of the greatest uncertainties following the crisis, even though the forecast made before the beginning of the crisis remains valid: if the ongoing US deficit is to be resorbed, a weak dollar will continue to be required.

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■ Surprising dollar

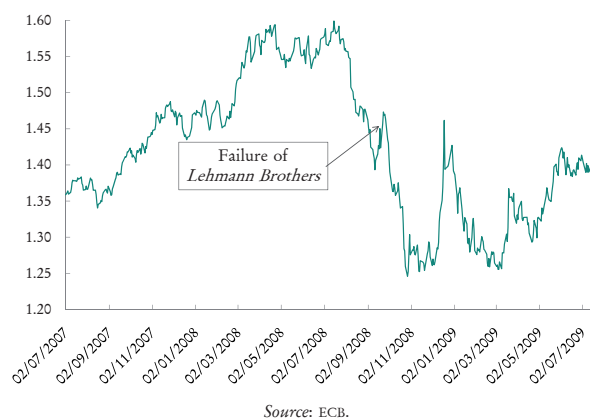
The continuing existence of balance-of-payment imbalances throughout the world, particularly in the USA, is often reckoned to be a significant cause of the current global crisis. Regardless of the reasons for these imbalances – poor microeconomic incentives, failures to supervise, loose monetary policy in the USA, excessive saving in China, *etc.* – the fact remains that no country can accumulate net assets or net debts for an indefinite period without undergoing a correction at some point in time. This simple idea gave rise to a heated debate prior to the crisis. Most economists at the time thought that major adjustments in exchange rates and, more specifically, a strong depreciation in the dollar would be required in order to bring balances of payments back onto sustainable paths, even though this adjustment of net positions could be partially achieved via revaluations of assets and debts.

Since the beginning of the crisis, the dollar's movements have been erratic. During the second half of 2007 and the beginning of 2008, it depreciated strongly against the euro. Then, during the second half of 2008, its value rose again sharply. The movements observed since the beginning of 2009 have been very jerky (Figure 1). Compared with the debate prior to the crisis, these movements of the dollar were surprising: were not the subprime

crisis and its ramifications triggering the long-awaited adjustment of the US economy? Was that country's financial system not turning out to be less secure than international investors had been counting on over the past decade?

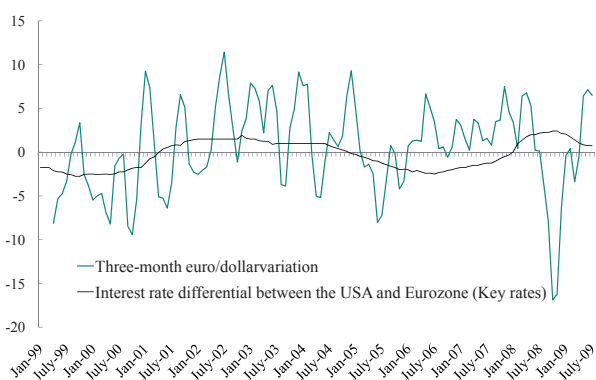
The movements of the dollar appear even more mysterious if we consider the movements in interest-rate differentials. Since its creation, the euro has typically depreciated against the dollar when the interest rate of the Eurozone was lower than that

Figure 1 – Nominal euro/dollar exchange rate
ECB reference rate



of the USA (1999-2000, then in 2005), and it has appreciated when the situation was reversed (2001-2004). This regularity can be explained by the fact that a high interest rate attracts foreign investors in spite of the exchange risk, which then drives up the currency in question. The expectation might thus have been that the rapid drop in the rates of the Federal Reserve between September and December 2008, echoed a short time later by the ECB, would lead to a depreciation of the dollar. This did not happen; on the contrary, the dollar actually appreciated dramatically during autumn 2008 (whereas the euro depreciated) (Figure 2). In order to understand this counter-intuitive movement, we must look closely at supply and demand for dollar assets.

Figure 2 – Interest rate and exchange rate differential

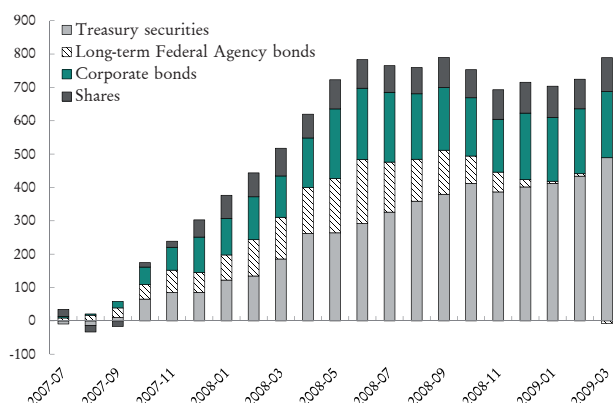


Source: ECB and Federal Reserve. The interest rates used are the minimum or fixed rate used by the ECB for calls for tender and the rate of the US Fed Funds.

The dollar as a safe haven

Why didn't the crisis trigger massive sales of US assets by both American residents and the rest of the world? One explanation lies in the fact that the dollar has enjoyed a status of a safe haven since the end of World War II. It may seem surprising that the dollar should have retained this status, despite the fact that the crisis itself originated in the USA. This paradox becomes clear when the net purchases of US assets by foreign investors are examined in detail. Figure 3 shows cumulated net purchases of US assets by non-residents, starting from July 2007 and broken down by asset categories.¹ It shows that net purchases of US Treasuries continued throughout the crisis, whereas international investors stopped being net buyers of US private securities (shares and bonds) and from summer 2008 onwards reduced their exposure to Federal agency securities. Thus, it was only Treasuries, which were perceived as liquid and riskless, acted as a safe haven, rather than assets on the rest of the US economy.

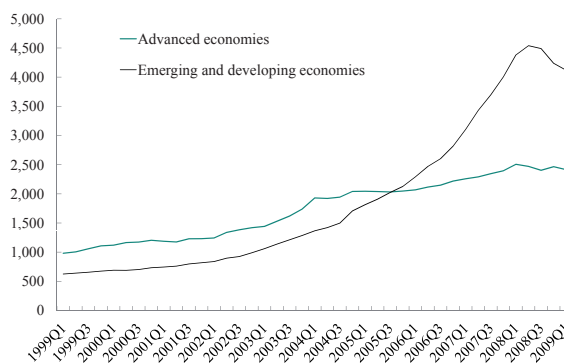
Figure 3 – Cumulated net purchases of US assets by non-residents, by type of assets (in billion dollars) from July 2007



Source: US Treasury.

Another explanation frequently put forward for the dollar's strength over this period concerns the behaviour of central banks, and specifically the sudden discontinuation in July 2008 of the policy begun in July 2005 of gradually appreciating the yuan against the dollar: in order to prevent the yuan appreciating despite large current-account surpluses, combined with net inflows of private capital, the People's Bank of China accumulated foreign-exchange reserves, most of which were denominated in dollars. As a result, the share of US external liabilities held by public institutions, and primarily by central banks, rose from 35% at the start of the crisis to 43% by March 2009.² Upon closer examination, however, the rise in the share of official holdings did not occur as a result of the accumulation of exchange reserves. Although China continued to accumulate reserves after the beginning of the crisis, it did so at a slower pace. More to the point, other central banks (particularly those of Russia, Korea, Brazil and India) reduced their foreign exchange reserves, sometimes drastically, in order to defend their currencies. Figure 4 shows that official reserves remained stable

Figure 4 – Official reserves (in billion dollars)



Source: IMF, COFER database.

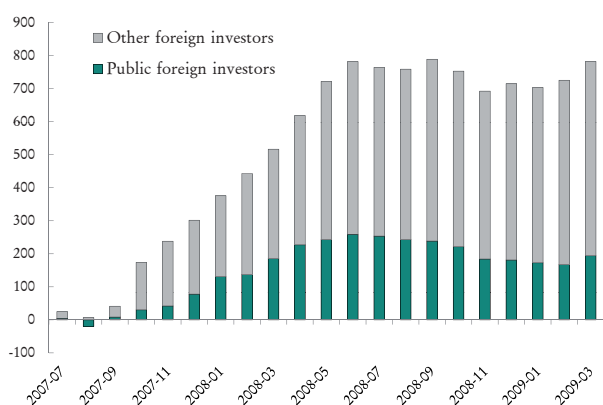
1. Unlike stocks, cumulated flows are not affected by revaluation effects, and thus provide a more accurate reflection of the intentions of international investors. Aggregate flows are also easier to read, as they are less volatile than non-cumulated flows.

2. Source: US Treasury Bulletin, June 2009.

overall in advanced economies and that they declined in emerging and developing countries.³ Since around 65% of global reserves are held in dollars, any fall in these reserves automatically results in a drop in the demand for dollars from central banks.⁴

How then can the rising share of central banks as creditors of the USA be explained? To answer this question, it must be remembered that central banks' holdings consist essentially of Treasury bonds, whereas private investors hold diversified portfolios including not only Treasuries but also corporate bonds, structured assets, shares and more. Unlike other categories of asset, Treasuries did not lose value during the crisis. The rise in the share held by public authorities is thus primarily a result of the devaluation of the portfolios of other international investors. If we examine the cumulated net purchases of US assets during the crisis, it emerges that public investors – central banks, sovereign wealth funds, governments, *etc.* – sold US assets in net terms (Figure 5).

Figure 5 – Cumulated net purchases of US assets by non-residents, by type of investors (in billion dollars) from July 2007



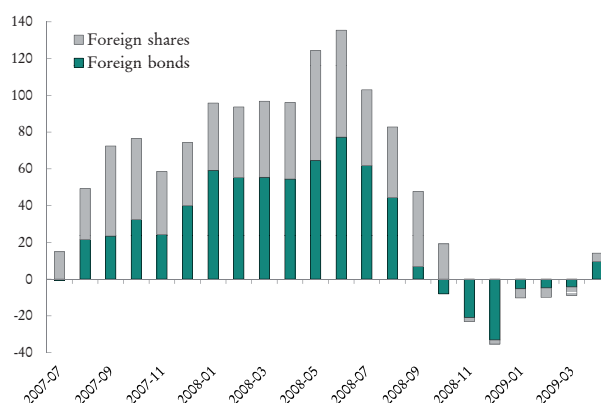
Source: US Treasury, June 2009.

Overall, the behaviour of central banks cannot thus be behind the dollar's strength since the beginning of the crisis. Other investors on compensated for the net sales by public investors but this effect did not extend any further: the strength of the dollar cannot be explained by any rise in the net demand amongst non-residents for US assets, even if Treasuries effectively acted as a safe haven.

The dollar market

Just like any market price, the exchange rate for the dollar fluctuates based on supply and demand. We have just seen that foreign demand for US assets was sluggish from summer 2008 onwards. However, demand from American residents was strong, owing to a massive repatriation of capital from abroad. Figure 6, which shows cumulated net purchases of foreign, long-term assets by US residents, illustrates this phenomenon: from summer 2008 onwards, US residents were net sellers of foreign assets. Although some of these sales were of foreign assets in dollars, it can be deduced from this fact that net demand for dollars from American residents rose.

Figure 6 – Cumulated purchases of foreign, long-term securities by US residents (in billion dollars) from July 2007



Source: US Treasury, June 2009.

This leaves the issue of supply, which can also come from either US residents or non-residents. In spite of the large increase in public debt issues (x 2.5), total net American issues of domestic bonds fell by 27% between 2007 and 2008.⁵ Most importantly, issues of international bonds in dollars for all countries put together fell by 40%. These figures can be compared with the drop in global issues of domestic bonds (-6%) and international bonds (-15%). Supply of dollar securities thus fell more rapidly than global supply of securities. The result was a sharp drop in the share of the dollar in total issues,⁶ which in turn bolstered the exchange rate of the US currency.⁷

3. Taking the appreciation of the dollar into account does not change this observation fundamentally, although it mitigates the drop in the reserves of emerging countries (if the dollar had not appreciated, reserves in currencies other than the dollar would not have been devalued when converted to dollars).

4. The share of the dollar in reserves rose slightly during the crisis, in current dollars, but fell at constant exchange rates. Source: IMF-COFER and author's calculations.

5. Source: Bank for International Settlements.

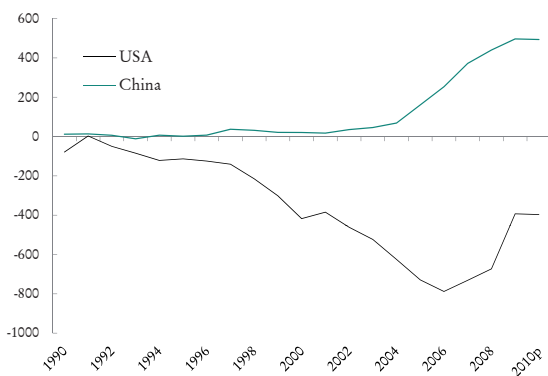
6. The share of the dollar in net international bond issues fell from 41.7% in 2007 to 10.1% in the fourth quarter of 2008. The decreased level of international bond issues, on the other hand, is linked to the financial de-globalisation observed since the beginning of the crisis. In particular, several emerging countries unable to refinance external debts in dollars were forced to turn to their internal markets, in their national currency. See Ch. Broda, P. Ghezzi and E. Levy-Yeyati, "The new global balance: financial de-globalisation, savings drain, and the US dollar", Voxeu.org, 22 May 2009.

7. Other elements contributed to the strength of the dollar, including a fall in the prices of oil and raw materials. Between 1980 and 1990, expensive oil was associated with a strong dollar. This relationship has subsequently reversed, particularly because Middle Eastern countries are spending an increasing share of their oil revenue outside the dollar zone, and because a weak dollar is buoying demand for oil in countries whose currencies are linked to the dollar, especially China. See *La Lettre du CEPII* no. 250. The drop in the prices of oil and raw material also triggered purchases of dollars on the futures market (when the prices were rising, holders of inventories of raw materials had purchased derivative products to hedge against the exchange risk associated with these inventories. See Goldman Sachs, Global Viewpoint 09/08, 10 June 2009).

■ Prospects

The prospects for the dollar are currently very uncertain, especially because the issue of global imbalances remains (almost) completely unresolved: even though the US external deficit has fallen since the beginning of the crisis and the Chinese surplus has stabilised (Figure 7), the drop in stock market prices throughout the world and the appreciation of the dollar have heavily reduced the value of the US net foreign asset position compared with the pre-crisis period.⁸ The forecast made prior to the crisis, according to which a weak dollar was required if these global imbalances were to be resorbed,⁹ remains valid.

Figure 7 – Current account balance in the United States and in China (in billion dollars)



Source: WEO, April 2009.

This is especially true in light of the fact that the deterioration of the fiscal balance partially compensates for the increase in private savings in the USA, limiting the prospects for improvement for the current account balance. Additionally, this deterioration in public finances, combined with a central bank that is less independent than the ECB, has fuelled fears of a potential resurgence in inflation in the US, especially since, given that public debt is largely held by non-residents, devaluing it via inflation would pose fewer internal political problems than it

might in other countries. Such anticipations of inflation could become self-fulfilling prophecies if they gave rise to an increase in public debt yields, which could in turn threaten US public finances, already deemed unsustainable prior to the crisis.¹⁰ Such a prospect is hardly likely to strengthen the markets' demand for US assets, even if American authorities (particularly Fed Chairman Ben Bernanke) have repeatedly sought to reassure the markets in this regard.

Confronted with this prospect of an ongoing supply of dollars from American residents, market normalisation would encourage investors to diversify their holdings once more and to seek out better yields than those offered by US Treasury bonds.¹¹ China's asset strategy in particular is causing concern. The suggestion made by the Chairman of the People's Bank of China, Zhou Xiaochuan, on 23 March 2009 that an extended SDR should replace the dollar as the international currency betrays the nervousness felt by Chinese authorities faced with the difficulty of breaking free from their policy of pegging their currency to the dollar, at a time when any massive reallocation by them would lead to a sharp devaluation of their exchange reserves owing to the effect it would have on the dollar. The best exit strategy thus lies in re-balancing Chinese growth in favour of domestic demand, which would involve reducing current-account surpluses and gradually appreciating the renminbi at the same time. Gradually eliminating the Sino-American imbalance in this way would reduce the risk of a fall in the dollar against other currencies, including the euro. However, rebalancing Chinese growth will take time, and the monetary part of this strategy has still to be launched. In any event, China, closely followed by Russia and Brazil, has made it clearly understood that an abrupt depreciation of the dollar was not in its best interests. This monetary issue remains one of the major uncertainties of the post-crisis period.

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8. See A. Bénassy-Quéré, S. Béreau & V. Mignon (2009), "The dollar in the turmoil", *CEPII working paper*, no. 2009-08.

9. See e.g. O. Blanchard, F. Giavazzi & F. Sa (2005), "International Investors, the U.S. Current Account, and the Dollar", *Brookings Papers on Economic Activity*, vol. 36, no. 1, pp. 1-66.

10. OECD, *Economic study of the United States 2008*.

11. See Broda *et al.*, *op. cit.*

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