The dollar's drift down the Swanee set to halt

Despite America's economic and political might the dollar has been in decline for a long time and is widely regarded as a soft currency, which will go on falling. Why is it about to change?

It may seem strange to think of the dollar in such terms, as it is still the world's main trading currency. Increasing world trade boosts demand for dollars. Also, it has a safe-haven status, best seen in the way it benefits in times of global political uncertainty or war. US assets are very liquid and can be bought and sold easily. In times of trouble, people wish to hold their own currency but the next choice is usually dollars.

The main currency central banks hold in their reserves is the dollar. Yet the dollar's importance is declining. In the last 15 years the dollar has slipped from four-fifths to three-fifths of world currency reserves. Increasing intra-European trade has boosted the attraction of the mark. Rising intra-Asian trade has helped the yen, even though a number of Asian countries have links with the dollar.

Another negative for the dollar has been America's continued large trade deficits, leading the US to run down its overseas assets and accumulate external debts. America is now the world's largest debtor and is thus dependent on foreign capital inflows. But this is not proving a problem, as the US is an attractive place to invest.

America's low costs, big domestic market and improving productivity has attracted direct investment, particularly from Japanese and German firms who have opened factories there. Portfolio flows are also important. A key reason why international investors buy a currency is for capital gain. This has helped the yen and mark in the past. But it also means that interest rate cuts can help a currency, particularly when cuts are seen as economically justified.

This is contrary to popular perception, which wrongly believes that higher rates mean a strong currency. Sometimes the prospect of a rise in rates can give a currency a temporary boost by attracting short-term speculators.

More important is what longer-term funds do. During the last year the dollar has benefited, as US rate cuts have boosted the attraction of US bonds and equities, thus attracting significant inward capital flows.

So what is going to happen to the dollar now? Strong economies tend to have strong currencies. Not the other way round. Sometimes politicians don't understand this, as we saw when sterling entered the Exchange Rate Mechanism. Now, policy makers are content with a stable dollar.

But it not necessary for the US economy to boom for the dollar to rally. In fact, the US economy is not as strong as many believe and will slow from its recent pace to steady growth with low inflation. The outlook for the dollar depends not only on events in the USA, but on developments in other major economies such as Germany and Japan.

In the early Nineties, currency movements were stabilising, helping to correct underlying trade imbalances. Thus the appreciation of the yen and of the DM were justified.

By last year, currency moves had become destabilising. The strong yen had pushed Japan to the brink of recession and financial meltdown. Thus the softer yen since last year is justified. But Germany is still suffering from the consequences of an overvalued mark.

During the last year, two key factors have pushed the yen weaker: government policy has aimed to keep the yen in a ¥:$105-110 range; Japan's trade surplus has fallen substantially. Now, the key to the yen is what the Japanese will do with their money. Where will Japanese savers and portfolio investors put their money? In the past, they have kept it at home. But now, with Japan locked into a weak recovery yields at home will remain low. Thus there will be an increasing incentive for the Japanese to invest overseas, in search of higher yields. This will favour the dollar over the yen, although any movement will be gradual, not dramatic.

For Germany and the deutschemark the problems are greater. The German economy cannot afford a strong currency any longer. Germany's costs are exceptionally high. In the past, this did not matter, as German productivity was also high. But now, other countries have seen big increases in productivity. This has exposed Germany's high wage and non-wage costs.

The result has been large-scale labour shedding in Germany, contributing to a weak recovery. This labour shedding will continue. Moreover, as in Japan, German firms are having to shift production to lower-cost countries.

Such economic factors will push the mark down. But, just as the Japanese hold the key to the yen, the Germans will have a big influence on the fortunes of the mark. Ahead of Monetary Union, there is likely to be more shifts of money out of Germany. Germans are worried about higher future inflation within Monetary Union and are thus concerned about seeing their savings dwindle. The closer Monetary Union becomes, the greater the incentive for Germans to move their money elsewhere. This is already happening. The Swiss franc has been a big beneficiary but so too could be the dollar.

In the last five years, Germany has run continuous current account deficits and thus seen its overseas assets half. This trend will continue. There are large portfolio outflows out of Germany. And with German assets so high, there are large direct investment outflows. The combination of economic necessity and Monetary Union worries mean a weaker mark.

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ECONOMICS WEEK

Long regarded as a soft currency, weak recoveries in Germany and Japan can give a boost to the dollar, says **Gerard Lyons**