THE US DOLLAR: KING OF PAIN

Allow me to present you with a hypothetical scenario. A large country's regulators, financial institutions and households embrace a culture of risk taking that proves so destabilizing it brings the global financial system to its knees. This country's solution to the problem involves a significant expansion of its money supply and selling massive amounts of debt to foreign investors that are already significantly overweight that same debt. What do you suppose might happen to that country's currency?

If you said "depreciate," you probably aren't alone, which makes the strength of the US dollar (USD) one of the bigger curiosities of the credit crisis. From its record low in March to the time of writing in mid October, the Fed's USD index against a basket of major currencies leapt by 15%—the largest gain over a 7-month period since 1989.

Why has the USD been so strong? One explanation involves relative economic fundamentals. The demolition of the decoupling hypothesis has been a USD positive because it has shifted interest rate spreads in the currency's favour. The Fed cut rates aggressively soon after the credit crisis began in earnest, while the ECB tightened into the teeth of a deepening economic slowdown in a poorly-timed skirmish with labour unions. Now that the Eurozone is on the verge of recession, it is the ECB that looks flat-footed. There is considerably more room to cut rates in the Eurozone than in the United States.

A related explanation involves valuation—the USD had weakened to levels that destabilized the global economy, fostering the highest inflation in a decade. Investors piled into commodities as a play on the currency's weakness, compelling policymakers to set interest rates that were too restrictive in light of the intensifying downside risks to growth.

The globalization of the credit crisis has also benefitted the USD. While Wall Street has been shaken to its foundation, European financial institutions have recorded comparable credit-related write-downs, and their relatively high leverage has intensified solvency concerns. European leaders have agreed on a systematic stabilization framework, but the initial bickering between national governments exposed a potential vulnerability of the monetary union.

However, it isn't just European bank rescues that have boosted the USD by undermining the euro, but the very structure of their balance sheets. European banks face large short-term USD funding requirements because of their heavy reliance on interbank funding for their sizeable USD asset holdings. One need look no farther than European banks' insatiable appetite for the ECB's USD liquidity operations for evidence that there is a global scramble for dollars underway.

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What about the sustainability of the USD rally? Here it is important to underline that several of the aforementioned factors are corollaries of the credit crisis. Should policymakers normalize conditions in the credit market, it could spell trouble for the USD. A rising US household savings rate will depress economic activity, threatening the currency from a cyclical standpoint. Ongoing fiscal deterioration, the Fed's liquidity initiatives and funding for the TARP are increasing the supply of US Treasurys. I worry that these initiatives will foster concerns among foreign investors that the United States is content to inflate itself out of its growing debt obligations.

While the risks are sizeable and the coming year could bring periods of weakness for the USD, I do believe the currency has bottomed. The USD became too undervalued, prompting the market to search out a new, less destabilizing equilibrium. Policymakers have rushed to implement a systematic solution to the credit crisis, but it will be some time before conditions normalize, suggesting the USD could feast on others' misery for a while longer. Finally, a rise in the US savings rate and lower oil prices will contribute to a further narrowing of the US current account deficit, lightening the structural anchor that has laid the USD low these past six years.

The road ahead is littered with stumbling blocks for the USD. However, the severity of the losses it has already suffered, the collateral damage that this caused elsewhere and the improvement this will ultimately nurture in the United States' structural imbalances provide reasons to believe that the 6-year USD bear market is over.