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Ever lucky dollar

Short of a strong Biden effect, here we are, stuck with a weak dollar just when we do not want it in Europe. It means a weak return to growth along with continually low inflation. A column by Charles Wyplosz.

CHARLES WYPLOSZ

«For all its brave talk, the ECB has about reached the end of what it can do, and so has the US Federal Reserve.»

For all the discussions about monetary policy strategies, the importance of the exchange rate as a key channel is often overlooked. Yet, a depreciation is a useful channel to boost exports and reduce imports. Since early July, relative to the euro, the dollar has depreciated by some 10%. This is not innocuous and it is a useful reminder that, in difficult times, the dollar is often better serving the US than the euro is serving Europe.

About the author

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It is not clear why this happened nor how long it will last. To clarify the issue, is it the dollar that is weak or the euro that is strong? In fact, the dollar has depreciated vis a vis most main currencies, a bit less vis a vis the Japanese yen, while the euro has remained stable, except again vis a vis the Japanese yen. So, it is clearly a dollar weakness. Many explanations float around. One explanation is that the dollar has been weakened by the expansion of the Covid epidemics in the US, which makes sense, except it did not happen in April-May when the epidemic was receding in Europe and not in the US. Another explanation is that this is the consequence of the strong monetary policy actions taken by the Fed, but the ECB has not stood idle and, anyway, there has not been much difference between them since early July.

Other stories point to the strong performance of Wall Street, driven by the Apple, Amazon and Microsoft. Maybe. Alternatively, markets may have come to believe that the return to growth will be stronger in the US, but the conventional wisdom links growth and exchange rate appreciation, not depreciation. And, of course, many commentators rely on public opinion polls ahead of next November elections, although my experience is that political events are always used to explain whatever happens on financial markets.

Current rebound likely to peter out

My own, equally unsubstantiated, interpretation is that the global resurgence of the pandemic is a powerful reminder of what epidemiologists keep repeating, namely that there will be no durable respite from the coronavirus until an effective vaccine is widely administered. Those who thought that the risks were receding have now realized that things will remain bad for at least a few more quarters. Given the worse impact of the epidemic in the US than in most developed country, including poor social protection and widespread opposition to social distancing, a longer-lasting impact could hurt the US more.

If you are willing to go along with this interpretation, then it follows that the dollar is likely remain weak over the next few quarters. What could happen during this period? We are now seeing an economic rebound, which is the mechanical consequence of the lifting of lockdowns. People can go to work and they can shop around to spend the money that they were forced to save. But the on-going threat from the coronavirus suggests that the rebound is going to be weak. In addition, the huge budget deficits, that allowed most developed countries to ride the last months without an explosion of unemployment and bankruptcies, cannot be maintained at current levels for much longer. This all means that we are likely to see the current rebound peter out.

What can prevent growth to weaken? Beyond fiscal policies, the best hope is a weak exchange rate. International trade has strongly decreased, in part thanks to President Trump's attacks against friends and foes, but a competitive exchange rate still stands to help, and any bit of help can only be warmly welcomed. If the dollar remains weak, this is good news for the US and bad news for Europe, at a crucial time.

What happens to the euro will happen to the franc

I would not bet on my own interpretation, but history provides some backing. For some strange reason, the dollar is usually weak, and European currencies are correspondingly strong, in times of global slowdowns. Close to us, this was the case after the Nasdaq crisis in the early 2000s, and this happened again at the time of the global financial crisis of 2008. This may be pure luck, or the result of specific events each time, or the consequence of something more systematic that we do not understand, but it does matter.

If it repeats itself again, this situation is bad news for Europe. Can anything be done about it? Probably not much. A more expansionary stance from the ECB is about the only hope, but there is not much room for action. Its policy rate is already deeply into negative territory. Cutting the interest rate further by, say, 25 basis points would be a bold action, but so small that the exchange markets are unlikely to react much. Expanding QE is possible, and indeed the ECB keeps mentioning that it is ready to do so, but again by how much? As we know, this is a politically controversial move as it unnerves the German Constitutional Court in Karlsruhe.

For all its brave talk, the ECB has about reached the end of what it can do, and so has the US Federal Reserve. If anything, the Fed's recent announcement of a change in its strategy, makes it look more willing to act in support of the economy. To be sure, the ECB too is preparing its own strategic review, to be divulged sometime next year. The most extravagant expectation is that it will imitate the Fed, but politico-ideological differences among Euro Area member states make that unlikely. And, of course, the SNB is unofficially keeping the franc in line with the euro, so what happens to the euro will happen to the franc.

Trump in favor of a weak dollar

Could the upcoming US elections change the situation? Under my interpretation, the dollar could fall further in the event that President Trump is reelected. He could shed his reluctance to support social distancing and thus provoke another wave of the pandemic, which would achieve the opposite of what the economic recovery that he wants. He would have no incentive to expand social protection, quite the contrary. Given his constant complaints about foreign currency manipulators, he would surely welcome further dollar weakness.

Would the dollar recover if Joe Biden wins the election (and his victory does not open a constitutional crisis)? He is promising to fight the coronavirus, which would indeed help. He is also likely to expand the budget deficit to protect the weaker citizens, which would further help, but he would need to control Congress to get a big package through. On the other hand, his promise to repeal Trump's tax advantages to firms and high-value individuals stands to reduce the attractiveness of the dollar, and so would firm action on the environment.

So, short of a strong Biden effect, here we are, stuck with a weak dollar just when we do not want it in Europe. It means a weak return to growth along with continually low inflation. It is reminding us of Japan, with no growth and zero inflation for more than two decades. I dearly hope that I am wrong.