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EXECUTIVE BRIEFINGS
POLITICS & ECONOMY: THE US DOLLAR

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Oh, the mighty dollar

At a G-10 meeting in Rome in late 1971, John Connally, the Secretary of Treasury in the Nixon administration proclaimed to his astonished peers, "the dollar is our currency but it's your problem". The meeting was another nail in the coffin of the Bretton Woods system. Global financial markets have exploded manifold since Mr Connally's comment and the dollar has been pivotal to their rise. More recently, since the lows of 2011, the greenback has risen 40% against a basket of currencies. After the Trump victory, contrary to previous expectations, it jumped even more.

Going forward, we expect the dollar to strengthen further. In doing so, it will create disruptions across the world's financial markets. Remarkably, bond yields in America spiked from 1.7% to 2.3% in a matter of weeks setting the tone for a rise in short term interest rates. They say the bond markets are good at predicting the future – they must be, because they frequently cause it!

Coinciding with the excitement in the financial markets was the nomination of Steve Mnuchin as Secretary of the Treasury. If approved by Congress, Mr Mnuchin, a former Goldman Sachs investment banker, will be given the responsibility of sorting out America's fiscal policy and administering the promised tax cuts both for companies and individuals. These are expected to be in the region of 12-20% for those in the highest income bracket. Corporation tax is expected to fall to 18%. Secondly, the treasury will be mandated to raise large sums for infrastructure spending, as promised and frequently reinforced during the election campaign. President-elect Donald Trump seeks to create 25 million jobs over the coming decade and the administration will target economic growth at 3.5-4%.

These developments will entice capital back to America with investors eyeing opportunities for higher returns. The fact that bond yields have fortified is the first indicator that future returns in the US may be more promising. Over the past decade capital found its way across emerging and frontier markets in search of better prospects. As of December 2015, USD 10 trillion was raised by companies outside of America, with about a third within emerging markets. In 2012 for instance, the Zambian Government issued USD 12 billion worth of bonds at 5.4%, which were over-subscribed. This was made possible by low interest rates in the US with punters looking for higher yields elsewhere. Businesses across the world, including those in Africa, Latin America and Asia assumed large dollar exposures, which pushed up asset prices and boosted the supply of local liquidity. Now that the cycle has begun to reverse, asset prices will fall and liquidity begin to evaporate. Companies in Brazil, Chile, Turkey and Malaysia will be the worst off because of over-stretched dollar-exposed balance sheets. Moreover, as business scramble to redeem pricey foreign debt, they will have no money left for new investments, undermining growth and economic prospects.

A rising dollar is a threat for global trade and investment. Countries reliant on imports – such as India – will have to pay more for commodities and manufactured goods. This may create inflationary pressures and force their central banks to tighten monetary conditions, effectively triggering a vicious cycle of falling consumption, low investment and poor liquidity. Another consequence of a strong dollar is that it makes countries exporting to America more competitive, enlarging the current account imbalance between the US and its trade partners. This will reinforce temptations for the Trump administration to levy tariffs. The election campaign promised such impositions by defining China as a currency

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manipulator and was followed by the more recent announcement to impose a 35% tariff on products exported to the US by American companies that have relocated jobs to other countries. Readers will recall that a previous article referred to the Mexican peso falling by 12% within days of Mr Trump's victory and the futile reassurances of its President Enrique Pena Nieto.

Over the course of the past decade, the quantum of untaxed profits by American companies hoarded outside US boundaries has soared to USD 2.5 trillion. The Trump administration's policy to lower corporation tax may invite the repatriation of these funds back to America. Commercially too it may seem logical to deploy them in an economy which is expected to indulge on an infrastructure spending binge, with a view to seeking higher returns. This will push up the dollar even further and affect liquidity in source countries. Hedging costs have already begun to rise.

It is reasonable to say that Indian industry is not overtly exposed to un-hedged dollar positions. Therefore, the impact will be limited and on certain sectors such as real estate where a few large companies have issued dollar bonds. However, that is not to say that all is secure in the context of the larger economy. An examination of the external account suggests the following. India's short-term external debt – the sum that comes up for renewal in the coming 12 months – amounts to USD 83 billion. However, if one were to add all liabilities, that include longer-term debt with a remaining maturity of less than a year, the figure jumps to USD 207 billion. This is 42% of total external debt and 57% of reserves. In 2007-08, when the global financial crisis occurred, these ratios stood at 38% and 27% respectively. It follows therefore, that a weakening Rupee will make this debt even harder to service.

Adding to investor worries is the effect of the demonetisation initiative. Markets do not like uncertainty and the demonetisation move, despite its many eventual benefits, may dampen economic activity in the short term. If a global event were to trigger a currency crisis, the ensuing panic may be harder for markets to absorb. In the past, the Reserve Bank has sought to tide over such crises by negotiating short term arrangements including dollar swaps with external agencies. In the current environment, these could prove harder to acquire.

During his term as the United States Secretary of the Treasury, Mr Connally took several punts and made many predictions. None could be more accurate than his comment about the dollar being the world's problem. Going forward, it is likely to give everyone nightmares.

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