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A BACKGROUND BRIEFING ON THE STORIES BEHIND
THE WORLD'S ECONOMIC AND FINANCIAL NEWS

Dollar über alles?

Egypt crisis highlights US currency role as safe haven

By Darrell Delamaide

With the fate of Hosni Mubarak hanging in the balance, investors took a new look at the attractiveness of US assets, giving a firmer touch to the dollar despite general worries about financing America's budget and current account deficits.

Renewed evidence of the dollar's appeal as a 'haven currency' formed a backdrop to the continuing discussion about the dollar's future as a reserve currency. For instance, Israeli central bank governor Stanley Fischer, who held a US passport much of his life, said on a panel at Davos last week that his country is diversifying its reserve currencies and others are likely to be doing the same. "I'm more optimistic about the euro gaining strength as a potential reserve currency," he said.

MIT professor Simon Johnson, a former chief economist at the IMF, told those attending a meeting in Denver earlier this month that the Chinese renminbi would be the world's main reserve currency within 20 years. But another former IMF chief economist at that same meeting, Raghuram Rajan, demurred; saying that Asian economies will not enjoy a straight upward trajectory and the US will remain "the biggest mover" for a long time yet.

The Federal Reserve's policy of quantitative easing has fuelled the new round of debate. Not surprisingly, current and former Fed officials tend to pooh-pooh the notion that this policy is affecting the dollar's role. A group of ex-officials interviewed by the Wall Street Journal, including former Fed vice chairman Donald Kohn, saw the dollar maintaining its role for lack of alternatives. "The dollar will continue to be a reserve currency for decades to come," Kohn was quoted as saying.

Those who forecast that the US will run into trouble financing its deficit, for instance, because it will no longer be the world's reserve currency have got it backwards. Rather, the dollar is the de facto reserve currency because investors worldwide, including central banks,

consider US government debt the safest investment – by far. It also offers the widest and most liquid market in the world.

This was the point driven home by Richmond Fed president Jeffrey Lacker recently when the question came up at a meeting of risk managers even in the sleepy state capital of Virginia. No one needs to tell managers of foreign official institutions how to manage their assets, he said in response to a question from the audience. They will do whatever is best for their accounts.

“The dollar has met a market test as an international reserve currency,” Lacker said. “We didn’t force it on anyone.” He said he was optimistic that the dollar would retain “a fairly strong position” as a reserve currency. In any case, he concluded: “If that were to erode – if our share of the international reserve currency market were to erode – I don't think it would cause any material problem for us.”

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