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What Happens If the Dollar Crashes

Trade wars could break out. Overexposed banks might collapse. And that's just for starters

By Peter Coy

The financial crisis taught us that markets can drop further and faster than anyone expects. Housing prices, for example, fell for three straight years starting in 2006, even though the conventional wisdom right up until the bust began was that prices would not fall even a little bit.

Let's apply some of our hard-won knowledge to the dollar, which is also supposed to be resistant to a bust. After weakening gradually since 2002, the greenback rose during the financial crisis last year. It has fallen roughly 15% since March as investors moved to higher-yielding currencies. The conventional wisdom is that at these levels the dollar is cheap and, if anything, due for a rebound. "Currencies don't go much more than 20% from their long-term averages in real [inflation-adjusted] terms. We're there already," says Michael Dooley, an economist who is co-founder and research chief of Cabezon Capital Management, a San Francisco investment firm.

But it's worth at least thinking about the possibility of a dollar bust. The reason the housing bust had such devastating consequences was a failure of imagination: Lenders, regulators, credit raters, and others simply couldn't believe that house prices would ever fall the way they did, so they were blindsided.

BANK BLOWUPS POSSIBLE

Let's imagine the dollar quickly dropped by a further 25% against each major world currency, roughly parallel to housing's unprecedented 30% decline. That would mean it would take $2 to buy a single euro. On the good side, U.S. manufacturers would find it easier to compete globally, and foreign tourism would boom in the U.S. On the bad side, inflation in the U.S. would zoom because of the rising cost of imported products. Americans would have even more trouble getting a loan as foreign buyers pull out of the debt market.

Abroad, the cheap dollar would make it harder for other nations to export to the U.S., hurting their growth. China could face social unrest. Trade wars could break out. And there could be blowups at overexposed banks whose risk managers were sure no such dollar bust could happen. As investor Warren Buffett once said: "You only find out who is swimming naked when the tide goes out."

Federal regulators are monitoring banks for a wide variety of risks, including the threat of a dollar bust: "We're not looking quarter to quarter, we're looking hour to hour and minute to minute at what those risks are," says one regulator who requested anonymity.

From its spring peak, the dollar is down 11% against the Japanese yen, 16% against the euro, 21% against the Canadian dollar, and about 30% against the Brazilian and Australian currencies, which are benefiting from a commodity price spike. Against a broad market basket of all U.S. trading partners, and adjusted for inflation, the dollar has fallen 15% from its spring high.

DEFICITS DEPRESS DOLLAR

Behind the dollar's weakness are near-zero short-term U.S. interest rates. As they once did with yen, investors are borrowing dollars cheaply, then selling them to buy currencies of countries whose stocks and bonds promise better returns. The Federal Reserve is keeping the federal funds rate at a rock-bottom zero to 0.25% to stimulate the U.S. economy and heal the banks, but a side result is the dollar has turned into the preferred fuel for an international

speculative play that is weighing down the greenback.

Another force driving down the dollar: continued U.S. trade deficits, which the U.S. is paying for by borrowing from the rest of the world. Some economists and traders believe that eventually the U.S. will be forced to devalue its own currency to make its global debt more affordable. While the trade gap has narrowed to less than 3% of gross domestic product in the second quarter from 6% at its peak in 2006, it is still high by historical standards.

Now, some of the foreign central banks that have propped up the dollar seem to be getting cold feet. Instead of buying just dollars for their foreign-exchange reserves, they're diversifying into other currencies. The countries that reveal the composition of their reserve holdings put 63% of their new reserves into euros and yen in the second quarter, according to an analysis by Barclays Capital (BCS). Says Steven Englander, Barclays' chief U.S. currency strategist: "Their incentive is to try to do stealth diversification, not 'get me out of here at any price.' " (China, with more than $2 trillion worth of reserves, doesn't reveal what currencies in which it holds the funds.)

THE BEARISH CASE

Obama Administration officials don't seem perturbed by the dollar's slide so far. A weaker dollar helps shrink the trade deficit by making American-made goods more competitive in world markets. Drew Greenblatt, owner of Marlin Steel Wire Products in Baltimore, which makes high-tech baskets for assembly lines, says he's winning orders from countries that are better known as exporters. Exults Greenblatt: "We are shipping ice to Eskimos."

This state of calm would vanish overnight, though, if the financial markets got a sense that the dollar's decline was starting to snowball out of control. At that point, the invisible "force field" protecting the dollar would fade away, says Martin D. Weiss, chairman of Weiss Group, a financial data and analysis firm in Jupiter, Fla. Says Weiss: "We would become more like ordinary mortals and more vulnerable to attacks on our currency."

The bearish case for the dollar is that the decline takes on a life of its own. Selling begets more selling. The world's central bankers and finance ministers intervene to prop up the currency, but speculators, having tasted victory, aren't scared off. Princeton University economist Paul R. Krugman once called this the Wile E. Coyote scenario, after the character in the Road Runner cartoons who runs off a cliff but doesn't start to fall until he looks down and sees there's nothing beneath his feet.

Speculation that the dollar is headed for a tumble can become self-fulfilling if traders rush for the exit. Ashraf Laidi, chief foreign exchange strategist at CMC Markets, a London currency and commodity brokerage, says "right now there is around a 30% to 40% chance we are going to see the dollar falling toward a crisis point."

Dollar bulls like to point out that the currency rallied strongly last year during the worst of the financial crisis. But Laidi says that was no show of support for the dollar or the U.S. economy. Rather, he says, investors retreated from all types of risk and put their money into the most liquid, short-term instruments they could find—which just happened to be U.S. Treasury bills, which are held in accounts all over the world. Agrees Barclays' Englander: "It wasn't a long-term bet that the U.S. economy would be the most dynamic in the world."

INFLATION COULD EMERGE QUICKLY

Currency traders don't put much stock in the statements of support for a strong dollar by Treasury Secretary Timothy F. Geithner and other Administration officials. They note that Treasury chiefs dating back to the Clinton Administration have said they support a strong dollar, yet the U.S. has not supported its currency through purchases since 1995.

If the dollar did tumble, import prices might rise faster than most economists now expect. New research by Columbia University economists Emi Nakamura and Jon Steinsson shows that the "pass-through" from a cheap currency to high import prices was underestimated because of poor data. In other words, inflation could emerge more quickly than is commonly believed. It would be disastrous for the economy if the Federal Reserve had to jack up interest rates to cool inflation or defend the currency while growth remained weak. A lower dollar makes Americans poorer by cutting the

purchasing power of their currency. And there's no guarantee it would bolster U.S. industry, says David Malpass, president of New York research firm Encima Global. Malpass says the fall of the dollar in the late 1980s hurt rather than helped Detroit by giving Japan the buying power to strengthen its automakers. Says Mallpass: "We can make ourselves poor enough that we can't import very much and we'll have balanced trade. But how would that be good for the U.S.?"

In the short run, the biggest risk would be the failure of some firm that made a highly leveraged bet that was vulnerable to a falling dollar. A dollar plunge would affect not only currency trades but also interest-rate derivatives and credit default swaps. Five big banks accounted for 88% of the credit-risk exposure from derivatives in the entire U.S. banking system in the second quarter.

No one knows whether the dollar is headed for disaster. But assuming the best is perilous.

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What Good Are Reserves?

After the Asian financial crisis of the late 1990s, emerging-market nations built up huge foreign-currency reserves. But new research by the International Monetary Fund shows that those reserves didn't help the countries weather this decade's crisis. A possible explanation: Countries feared that using any of their hard-earned reserves might be taken as a sign of weakness.

To read the IMF's analysis, go to http://bx.businessweek.com/emerging-markets/reference/

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