



The surge in the US dollar comes amid an already worsening global macroeconomic environment, but is not without precedent.  
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# Rise of the US dollar: Deja vu all over again?

The ongoing USD strengthening cycle will eventually pass once geopolitical fears subside and advanced economies catch up. BY RAMKISHEN S RAJAN AND BHAVYA GUPTA

JUXTAPOSED against the recent sharp sell-offs in the much-hyped cryptocurrency markets has been the turbo-charged US dollar (USD). While the surge in the USD comes amid an already worsening global macroeconomic environment, it is not without precedent. Previous periods of sustained appreciation of the USD have occurred from mid-1980 to mid-1985; mid-1995 to early 2002; a short-lived period during the global financial crisis (mid-2008 to early 2009); and mid-2014 to late 2016.

What has led to this persistent strength in the USD? Recent announcements and actions by the US Federal Reserve to raise interest rates in response to growing inflationary pressures has no doubt been a major contributing factor. Fed hawkishness has driven up the USD vis-a-vis its advanced economy counterparts like the eurozone and Japan which have chosen to delay interest rate hikes. Indeed, on a bilateral basis, the USD is at a 2-decade high against the Japanese yen and a 5-year high against the euro.

## Strong USD spells trouble for emerging economies

The flip side of USD hegemony and the monetary superpower status of the Fed implies that monetary developments in the US create global spillovers, with emerging economies usually being disproportionately impacted.

In particular, many emerging economies continue to be plagued by the so-called 'original sin' problem, which broadly refers to their inability or unwillingness to borrow in international markets in their domestic currency.

Most often, these countries (governments or corporates) end up accumulating USD-denominated debt which leaves them exposed to currency risks. An appreciating USD and rising US interest rates will in turn raise debt servicing costs which could lead to outright debt defaults.

Having learnt painful lessons from previous crises, several emerging economies in Asia have better managed their foreign currency exposures.

Nonetheless, these foreign currency risks have not disappeared. Instead they have just been transferred to the external creditors and investors, who tend to en-

gage in massive sell-offs of emerging economy assets when confronted with capital losses due to a strengthening USD.

This in turn leads to sharp capital outflows and severe tightening of domestic liquidity conditions — which subsequently dampens international trade, as much of bank trade credit in Asia and elsewhere is denominated in USD.

It is for these reasons that prolonged USD strength is viewed as a huge risk to emerging economies specifically and global growth in general.

Interestingly, despite widespread expectations and financial media reportage that the current USD surge would hurt emerging economies, the damage to date has in fact been rather limited. Why? In past cycles of US dollar appreciation, emerging economies have lagged the US in raising interest rates.

However, this time, many of these economies have actually moved faster than the US in reversing years of loose monetary policy. Of course, there are exceptions.

A notable one is China where monetary policy has remained loose due to the weakened growth outlook (caused in part by the unwavering pursuit of a zero-Covid strategy), triggering portfolio outflows and consequent selling pressures on the yuan.

To be sure, apart from China, the USD has also risen against other emerging market currencies given 'flight to safety' effects due to the worsening global geopolitical tensions. US Treasuries are, after all, viewed as the premier safe asset to which global investors flock during episodes of global volatility and uncertainty. However, the impact thus far has been manageable on the whole.

Nonetheless, countries with weak macroeconomic fundamentals such as a persistent current account deficit (suggesting increased reliance on the USD to pay import bills), a heavy dependence on essential food and energy imports (most of which is denominated in USD), mega projects fuelled via US dollar debt, and insufficient foreign exchange reserves, are the most susceptible to a rising USD. Apart from the well-publicised case of Sri Lanka, Pakistan and Turkey are potentially vulnerable emerging economies in this scenario.

The combined impact of a sustained as-

pendancy of the USD, acute supply chain disruptions, and soaring commodity prices has no doubt created a great deal of pain, leading to concerns about global stagflation (that is, accelerating inflation and slowing growth).

## Back to the future

While it is admittedly hard to look beyond the current fog, the ongoing USD strengthening cycle will eventually pass once geopolitical fears subside and the rest of the advanced economies catch up with the Fed's rate hike cycle. When (not if) there is an inevitable USD pullback, commentators will invariably return to the perennial question of the sustainability of the dollar-centric global financial system.

Some observers have argued that the US' decision to weaponise its currency and penalise Russia for its Ukraine misadventures will hasten its demise as a dominant currency.

While this is debatable, it is a fact that since 2000 the share of USD in global reserves has fallen from 70 per cent to just under 60 per cent in 2021. It is important, though, to note that this is not because of rising dominance of the Chinese yuan or euro, but rather due to an increase in currency holdings of other advanced economies such as Canada, Australia, Sweden, South Korea, and Singapore.

Similarly, the share of the USD in global interbank fund transfers (SWIFT payments) has declined, and there is some evidence to suggest a gradual movement towards invoicing in local and regional currencies.

However, this gradual erosion notwithstanding, most of the USD's potential rivals have their own underlying structural problems (capital controls in China; fragmented financial markets in the eurozone; lack of private-sector access to special drawing rights, etc).

As Eswar Prasad of Cornell presciently noted in his Princeton book of 2014, the world is destined to remain stuck in a *Dollar Trap* for quite some time to come.

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