US dollar surge causing financial and economic instability

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The surge in the value of the US dollar against other major currencies under the impact of the Federal Reserve's interest rate hike is raising concerns about its effect both on the financial system and the global economy.

According to an index compiled by the *Wall Street Journal* (WSJ), the dollar has risen 13 percent this year against a basket of currencies. But the movement is even more marked in relation to other major currencies.

So far this year the dollar has risen 17 percent against the pound, sending the British currency to its lowest point since 1985.

The Japanese yen has fallen to its lowest against the dollar in 24 years, amid expectations that its precipitous slide will go further, prompting hints from the government that official intervention may be necessary. The euro is now trading at below parity against the US currency for the first time since its launch in 1999.

Warnings about the continued dollar surge are being sounded in the financial press. Over the weekend the *Financial Times* (FT) published an editorial comment under the headline "Currency shifts add to global woes."

It said that in the midst of an energy crisis and the highest inflation in four decades the "global economy is also being rattled by big realignments in exchange rates." Under conditions of war in the Ukraine, the European energy crisis and concerns over how some emerging markets will manage high oil and food prices, there was a move to seek security in US assets, which are regarded as "the least unsafe option."

The surging US dollar, which is fueling price hikes in the rest of the world via imported goods, is one of the factors driving interest rate hikes by central banks, particularly in Europe.

For so-called emerging market economies in addition to rising food and energy prices, the rise in the dollar increases the burden of dollar-denominated debt and threatens to spark capital outflows. According to the International Monetary Fund, around 20 emerging markets have debt now trading at "distressed" levels. This proportion can be expected to rise.

The WSJ noted that because the dollar is at the centre of world financial markets its rise can have unforeseen consequences. Investors and policy makers, it said, were being forced to "consider history's unkind lessons."

"Currency shifts were behind the 1997 Asian financial crisis and played a role in the Russian financial crisis of 1998, which took down giant US hedge fund Long-Term Capital Management."

The strong dollar was hitting major US corporations because it made their goods more expensive on world markets, with the foreign earnings of Microsoft, John Deere taking a hit to their international earnings along with Apple, the Google parent, Alphabet, and the chip maker Nvidia.

Financial analyst and Bloomberg columnist Mohamed el-Erian wrote in a recent piece that while the US may be comforted by the anti-inflationary impact of the surging dollar, it needed to be concerned about the prospects for the rest of the world.

"The longer and higher the dollar soars above the rest, the greater the risk of a more prolonged stagflation, debt problems, more restrictions on the free flow of goods across borders, greater political turmoil in fragile economies and greater geopolitical conflicts."

This would affect the US "sooner rather than later through some combination of lower demand for its exports, more uncertain supply chains, financial losses and greater national security concerns."

He called for the US to lead the way in coordinating with allies to contain the scale and scope of the damage to the global economy.

But, as the FT editorial reminded its readers in 1971, when Nixon removed the gold backing from the US dollar, US Treasury Secretary John Connally told his international counterparts that the dollar was "our currency, but your problem." More than 50 years on, his words "remain true."

The interest rate hikes, which are a major force in the dollar surge, are having a significant effect on global bond markets. The price of bonds has fallen by more than 20 percent since the start of January 2021. Interest rates and bond prices have an inverse relationship.

The yield on US 10-year Treasury debt—a benchmark for the US and global financial system—has risen to around 3.35 percent, compared to 1.5 percent at the start of the year,

This means that investors holding bonds in the expectation that their price would rise—expectations that prevailed in the 40-year bond bull market enabling vast fortunes to be made—have been hit with significant losses.

At the same time, contrary to the "normal" situation, the yield on two-year treasuries has risen above the 10-year. Such an inversion of the yield curve is regarded as a reliable indicator of recession.

The market movement is not confined to government debt. The yield, or interest rate, on "junk bonds"—those rated at less than investment grade status—has risen from an average of 4.3 percent at the start of the year to more than 8.5 percent, going from three percentage points above the 10-year Treasury bond to more than five percentage points.

And besides the interest rate increases there is another factor which could lead to considerable financial turbulence. This is the decision by the Fed to start reducing its holdings of financial assets, currently above $9 trillion, at the rate of $95 billion a month.

This means that instead of being a buyer in the bond markets as it was as under the policy of quantitative easing, providing a backstop for Wall Street, the Fed has moved to quantitative tightening and is a seller.

At this point the issue is something of a "sleeper" but its effects, at present unknown, could have far-reaching consequences of which there are warnings.

An article in the *New York Times*, published at the weekend, noted that the Fed's exit out the US bond market—the world's biggest—put in on "shakier ground."

It said the importance of the Treasury market was hard to overstate as it was the main source of funding for the US government and underpinned borrowing costs around the world for a "huge variety of assets."

This is why "even small wobbles in this market can generate huge worries," such as in March 2020 when markets went into free fall at the start of the pandemic. The $25 trillion Treasury market froze, leading to a massive intervention by the Fed in which it doubled its asset holdings in just a matter of weeks.

A repeat would bring about a collapse of the global financial system.

According to Ralph Axel, an interest analyst at Bank of America, whose comments in a recent research paper were cited in the article: "While this sounds like a science-fiction movie, it is unfortunately a real threat."

Axel said emerging strains in the Treasury market—liquidity has been widely reported as drying up—were "the single greatest systemic financial risk" with a capacity to more damage than the crisis of 2008.

Sydney Morning Herald business columnist Stephen Bartholomeusz noted that the speed with which interest rates were rising and the steady withdrawal of liquidity by the Fed, as it reduces its balance sheet, had taken equity and bond investors by surprise.

"How that will play out in a world that, post-pandemic, it awash with debt is the multi-trillion-dollar question."