# Why a stronger dollar is dangerous

**Min Kim**

June 6, 2024

글로벌경제세미나

한동대학교

*Disclaimer: The views expressed herein do not necessarily reflect the official views of the Bank of Korea*

# Outline

1. Summary of "Why a stronger dollar is dangerous" (*Economist*, April 2024)
2. From *Economist* to Economics
    i. US Manufacturing sector
    ii. Dollar and NX
    iii. Global effects of Dollar
    iv. Capital flows and ESG

# Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Article**

  The dollar is looking formidable. As American growth has stayed strong and investors have scaled back bets that the Federal Reserve will cut interest rates, money has flooded into the country's markets—and the greenback has shot up.

  It has risen by 4% this year, measured against a trade-weighted basket of currencies; the fundamentals point to further appreciation.

  With a presidential election looming, and both Democrats and Republicans determined to promote American manufacturing, the world is on the verge of a new period of strong-dollar geopolitics.

## Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Summary**
  1. The value of US dollar has gone up and that is because of capital inflows caused by strong economy and high interest rates
  2. This will bring a new geopolitical dynamics since politicians are trying to revive manufacturing industry

## Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Article**

  This situation is made still more difficult by the fact that the currency's strength reflects weakness elsewhere. By the end of 2023, America's economy was 8% larger than at the end of 2019. Those of Britain, France, Germany and Japan each grew by less than 2% during the same period.

  The yen is at a 34-year low against the dollar. The euro has dropped to $1.07 from $1.10 at the start of the year. Some traders are now betting that the pair will reach parity by the beginning of next year.

- **Summary**:
  - When dollar is strong, other currencies (somewhat obviously) become weak

## Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Article**
  Should Donald Trump win in November, the scene is therefore set for a fight.

  A strong dollar tends to raise the price of American exports and lower the price of imports, widening the country's persistent trade deficit—a bugbear of Mr Trump's for many decades. Robert Lighthizer, the architect of tariffs against China during Mr Trump's time in the White House, wants to weaken the dollar, according to Politico, a news website.

  President Joe Biden has made no public pronouncements on the currency, but a strong dollar complicates his manufacturing agenda, too.

# Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Summary**
    i. US has been experiencing trade deficit and strong dollar tends to exacerbate it
        - exports become expensive while imports become cheaper

    ii. Bad news to US manufacturing because foreign goods become relatively cheaper

# Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Article**

  Elsewhere, a mighty greenback is good for exporters that have costs denominated in other currencies. But high American interest rates and a strong dollar generate imported inflation, which is now exacerbated by relatively high oil prices.

  In addition, companies that have borrowed in dollars face steeper repayments. On April 18th Kristalina Georgieva, head of the imf, warned about the impact of these developments on global financial stability.

- **Summary**: Strong dollar is typically a bad news to other countries as well
  - hard to borrow and repay in dollars
  - high imported inflation (esp. commodity prices)

## Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Article**
  Many countries have ample foreign-exchange reserves that they could sell to bolster their currencies: Japan has $1.3trn, India $643bn and South Korea $419bn.
  Yet any relief would be temporary. Although sales slowed the strengthening of the dollar in 2022, when the Fed began raising interest rates, they did not stop it. Central banks and finance ministries are loth to waste their holdings on fruitless fights.

  Another option is international co-ordination to halt the greenback's climb. The beginnings of this were on display on April 16th, when the finance ministers of America, Japan and South Korea issued a joint statement expressing concern about the slump of the yen and won. This may be the precursor to more intervention, in the form of joint sales of foreign-exchange reserves, to prevent the two Asian currencies from weakening further.

# Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Article**

  But as much as these countries may want to be on the same page, economics is unavoidably pulling them apart. After all, yen and won weakness is driven by the gap in interest rates between America and other countries.

  South Korea's two-year government bonds offer a return of around 3.5%, and Japan's just 0.3%, while American Treasuries maturing at the same time offer 5% (see chart 2). If interest rates stay markedly higher in America, investors seeking returns face a straightforward choice—and their decisions will buttress the dollar.

# Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Summary**
  - FX intervention (including joint and verbal ones) would defend currencies
    - but wouldn't have much impact on the depreciation trends
  - As long as rates are higher in US, dollar would continue to be strong

## Why a stronger dollar is dangerous (*Economist*, April 2024)

- **Article**
  Then there are countries with which America is less likely to co-operate. According to Goldman Sachs, a bank, China saw $39bn or so in foreign-exchange outflows in March—the fourth most of any month since 2016—as investors fled the country's languishing economy.
  The yuan has weakened steadily against the dollar since the beginning of the year, and more rapidly from mid-March, since when the dollar has risen from 7.18 yuan to 7.25. Bank of America expects it to reach 7.45 by September, when America's election campaign will be in full flow. That would place the yuan at its weakest since 2007, providing a boost to China's latest export drive. Cheap Chinese electric vehicles may be about to become cheaper still.

## Why a stronger dollar is dangerous (*Economist*, April 2024)

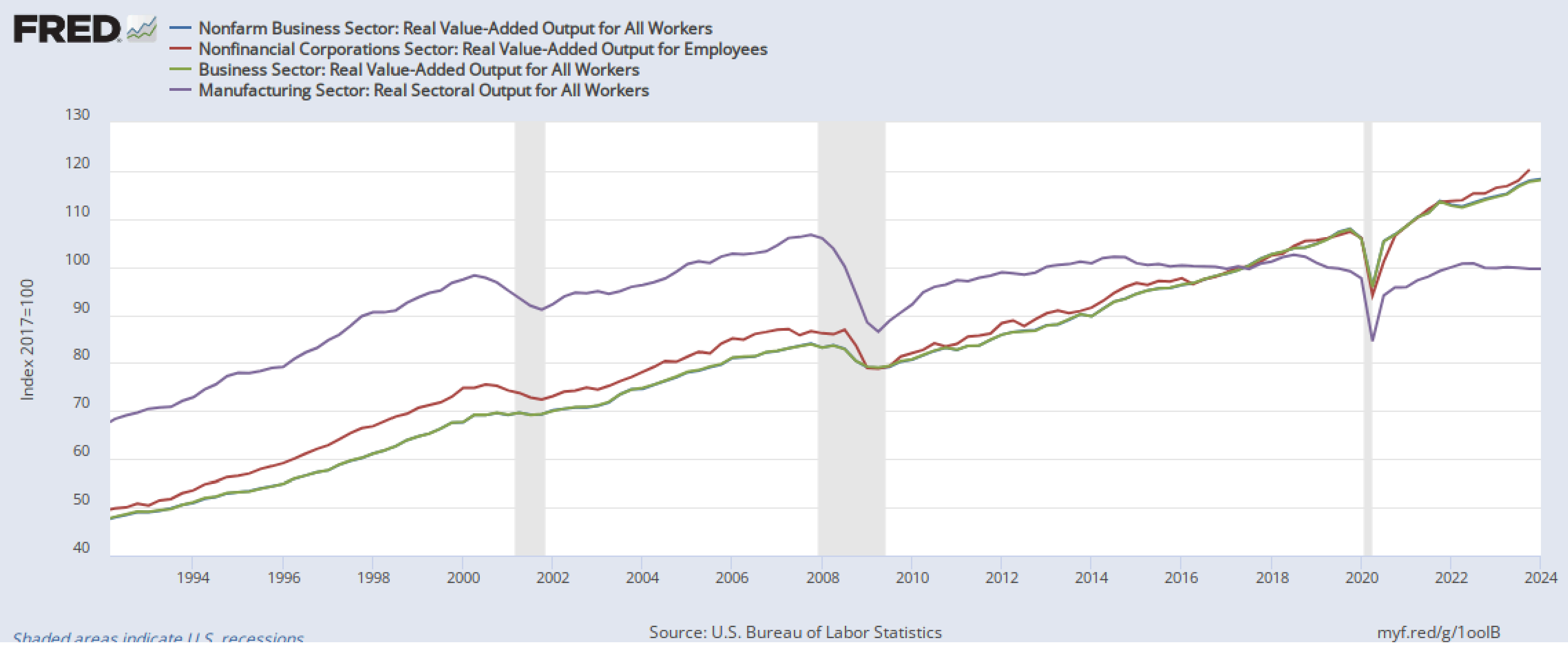
- **Article**
  Even protectionists in America may be willing to overlook allies' weak currencies, at least for a time. They are less likely to do so for China. This raises the risk of further tariffs and sanctions, and maybe even the return of China to America's list of currency manipulators. As long as America's economy outperforms, the dollar is likely to remain strong. And as long as American politicians see that as a cause for concern, trade tensions are sure to rise.
- **Summary**
  - China benefits when yuan is weak as it boosts exports
    - which may cause possible trade tension between US and China

# From *Economist* to Economics

- The main argument in the article is
  1. *US dollar has been strong recently*
  2. *Strong dollar tends to exacerbate further US trade deficits*
  3. *Geopolitical tensions (a.k.a. trade war) esp. between US and China may arise*
- The questions we want to address today
  1. How is US manufacturing? Did tariffs and sanctions in the past help the industry?
  2. Does strong dollar worsen trade deficit? Is trade deficit necessarily bad?
  3. What does strong dollar mean to other countries (esp. small-open economies)?
  4. What drives global capital flows? Would ESG be related?

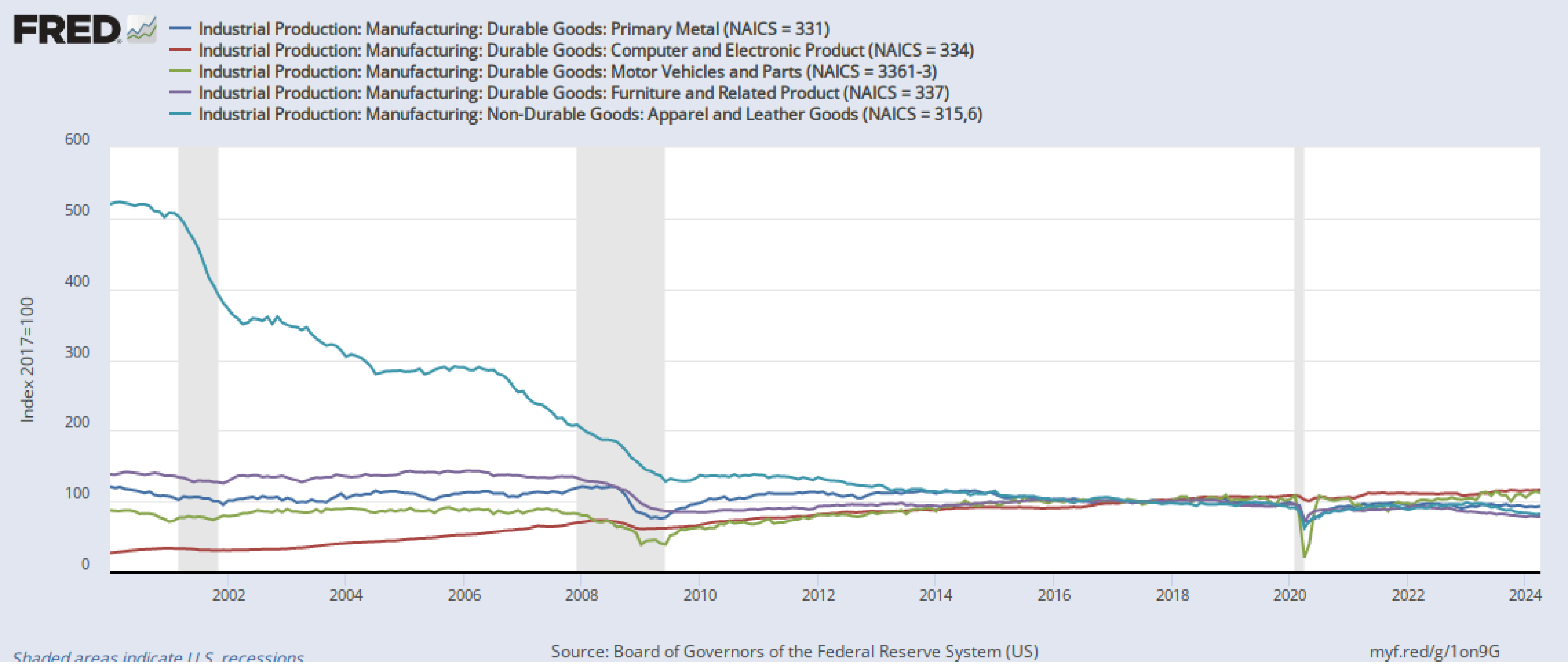
# From *Economist* to Economics: US Manufacturing sector

- Starting with the first question, typical argument by politicians are as follow
  - *"US manufacturing is declining and that's because of China"*
  - *"Tariffs and sanctions are needed to revive the industry (eps. in terms of jobs)"*
- Let's see how US manufacturing is doing [link to data]



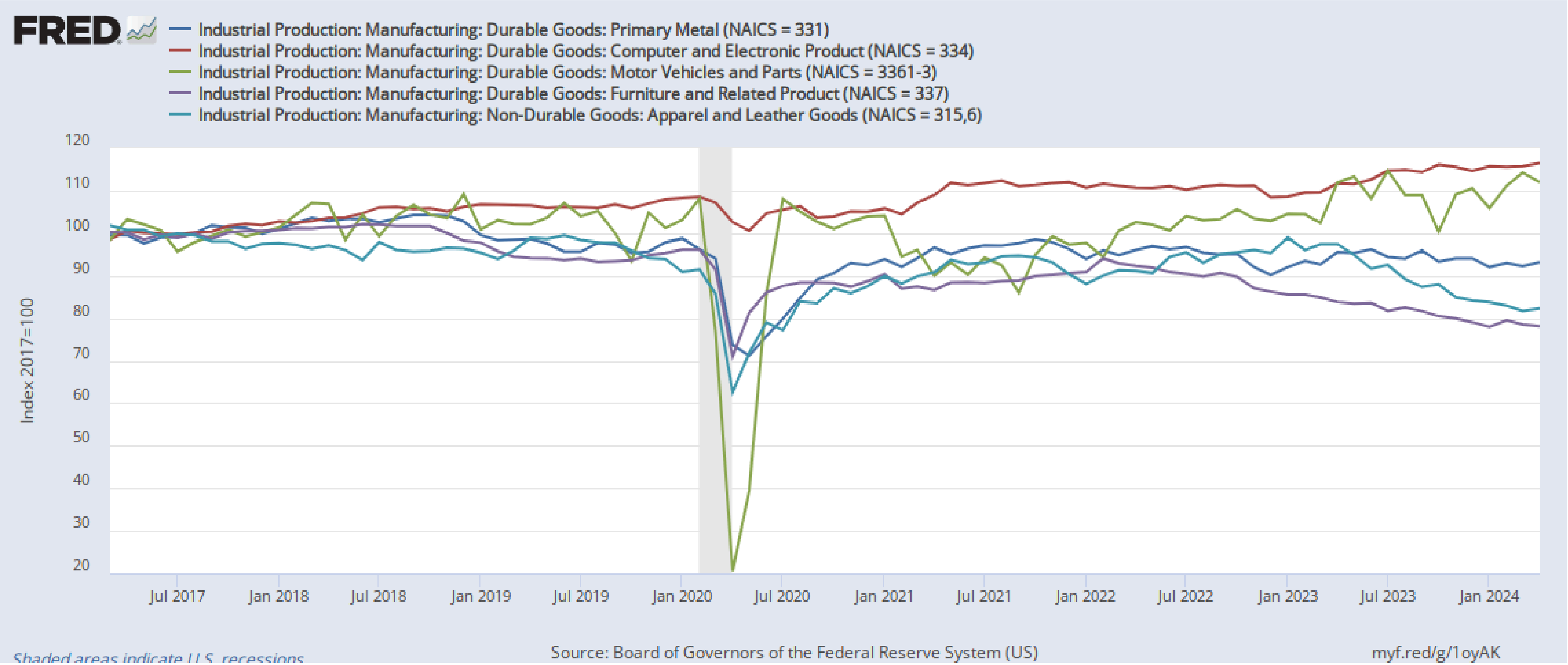
# From *Economist* to Economics: US Manufacturing sector

- In terms of sub-industry, [link to data]



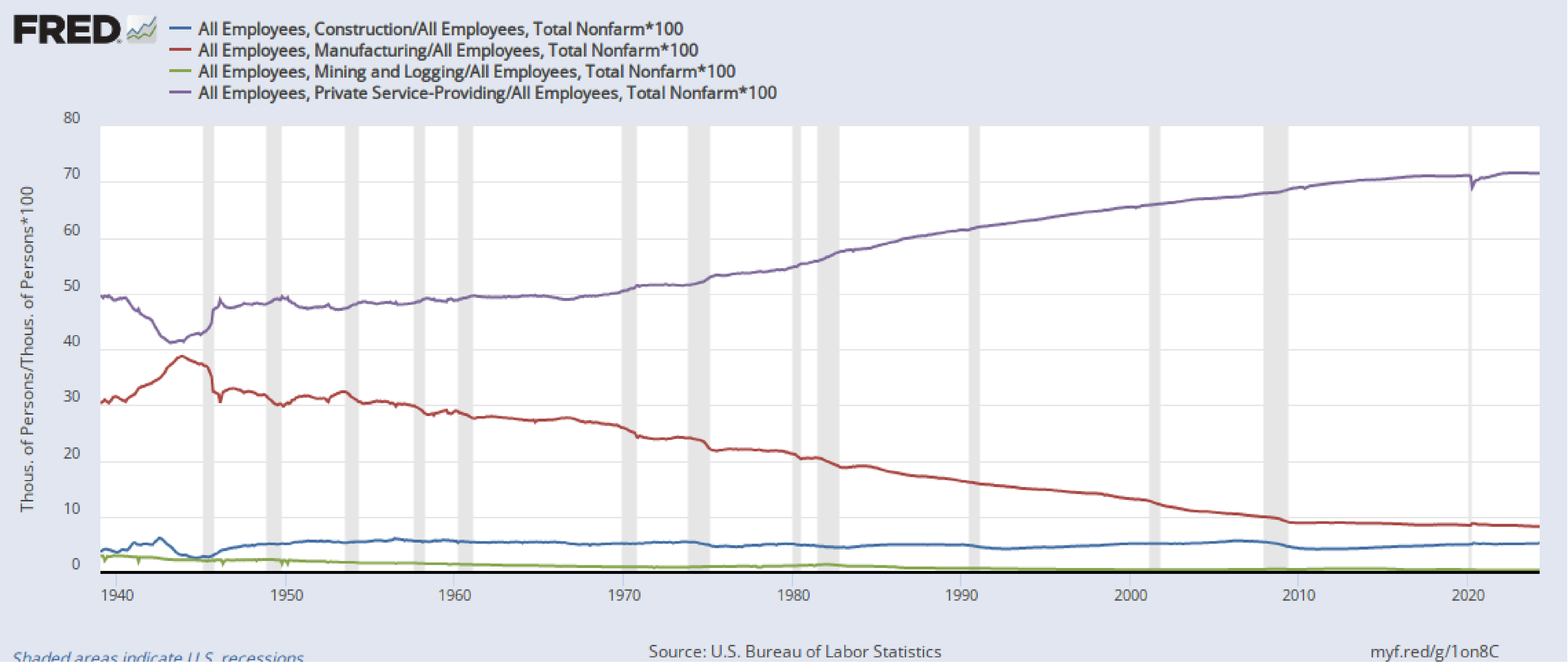
# From *Economist* to Economics: US Manufacturing sector

- More recently, [link to data]



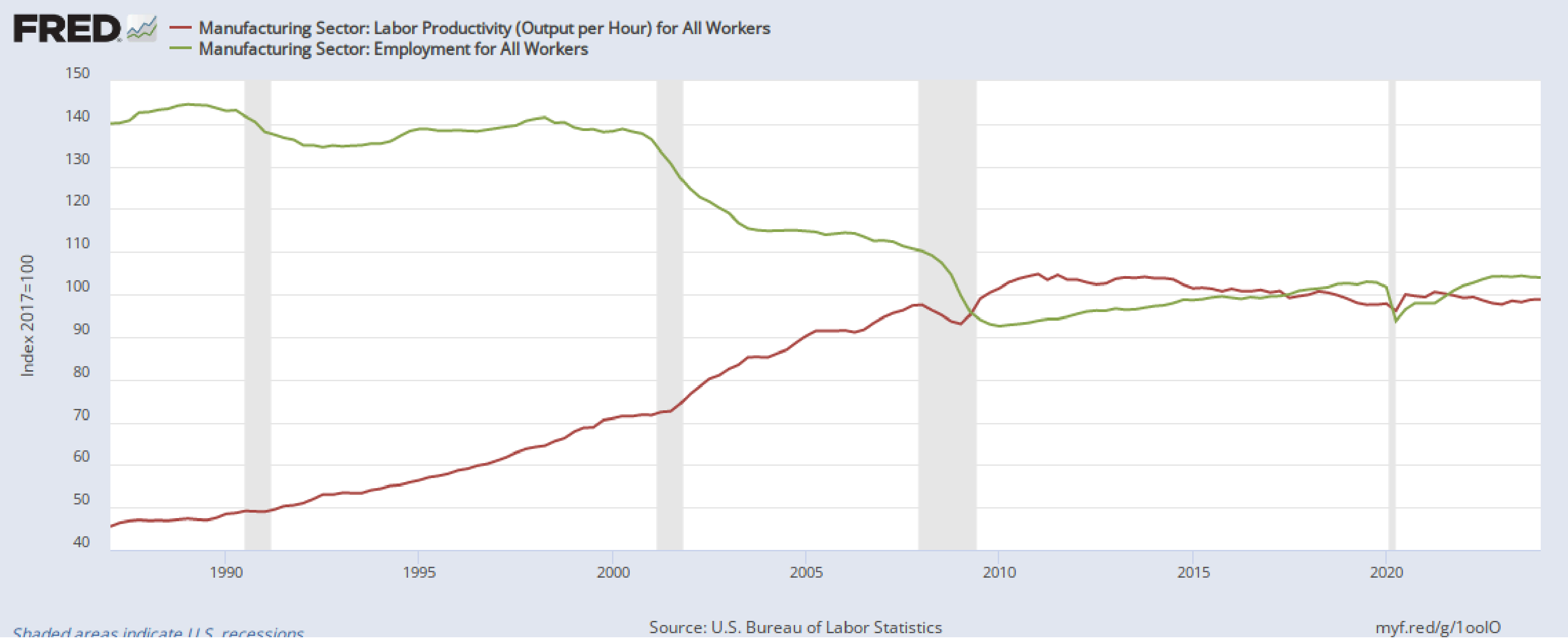
# From *Economist* to Economics: US Manufacturing sector

- In terms of employment, [link to data]



# From *Economist* to Economics: US Manufacturing sector

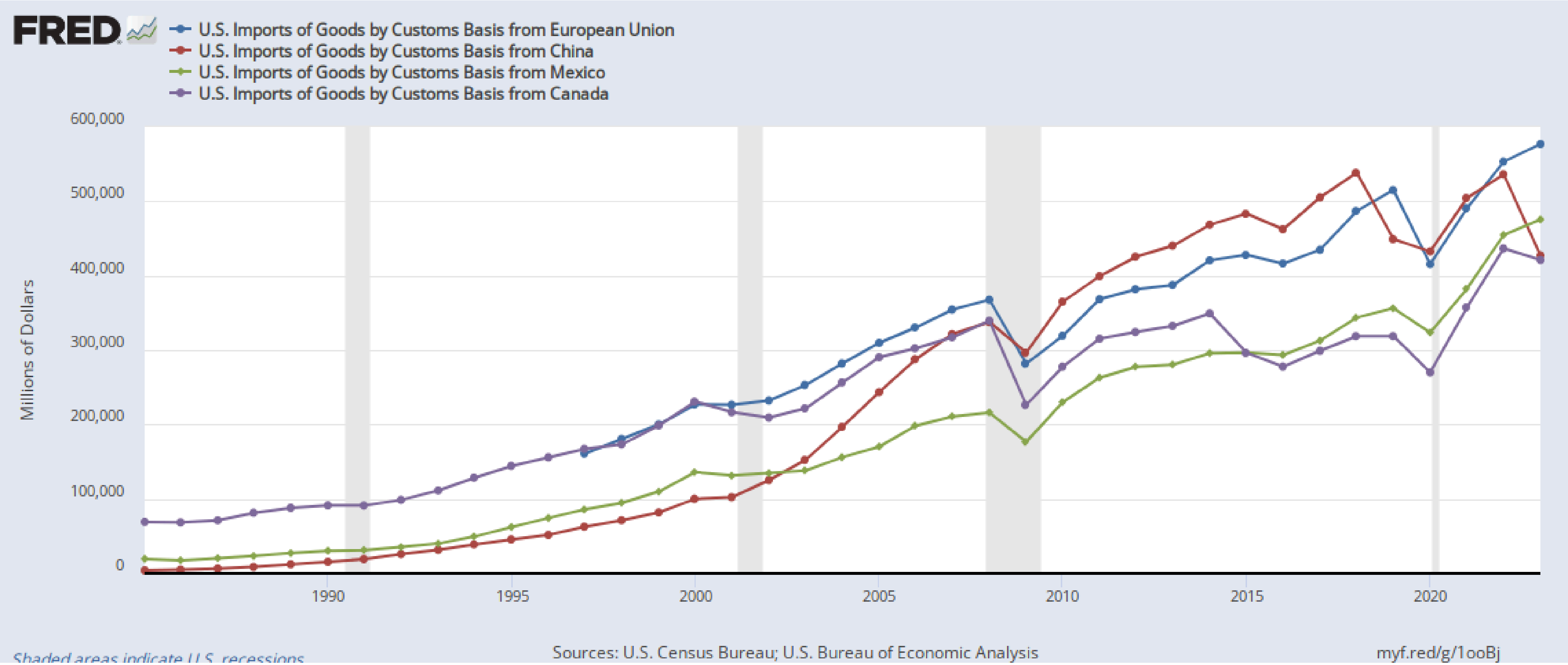
- In terms of labor productivity, [link to data]




- One can think of a different story:
  - Manufacturing requires less labor inputs due to high productivity
  - Workers have been (presumably voluntarily) reallocated to other sectors

# From *Economist* to Economics: US Manufacturing sector

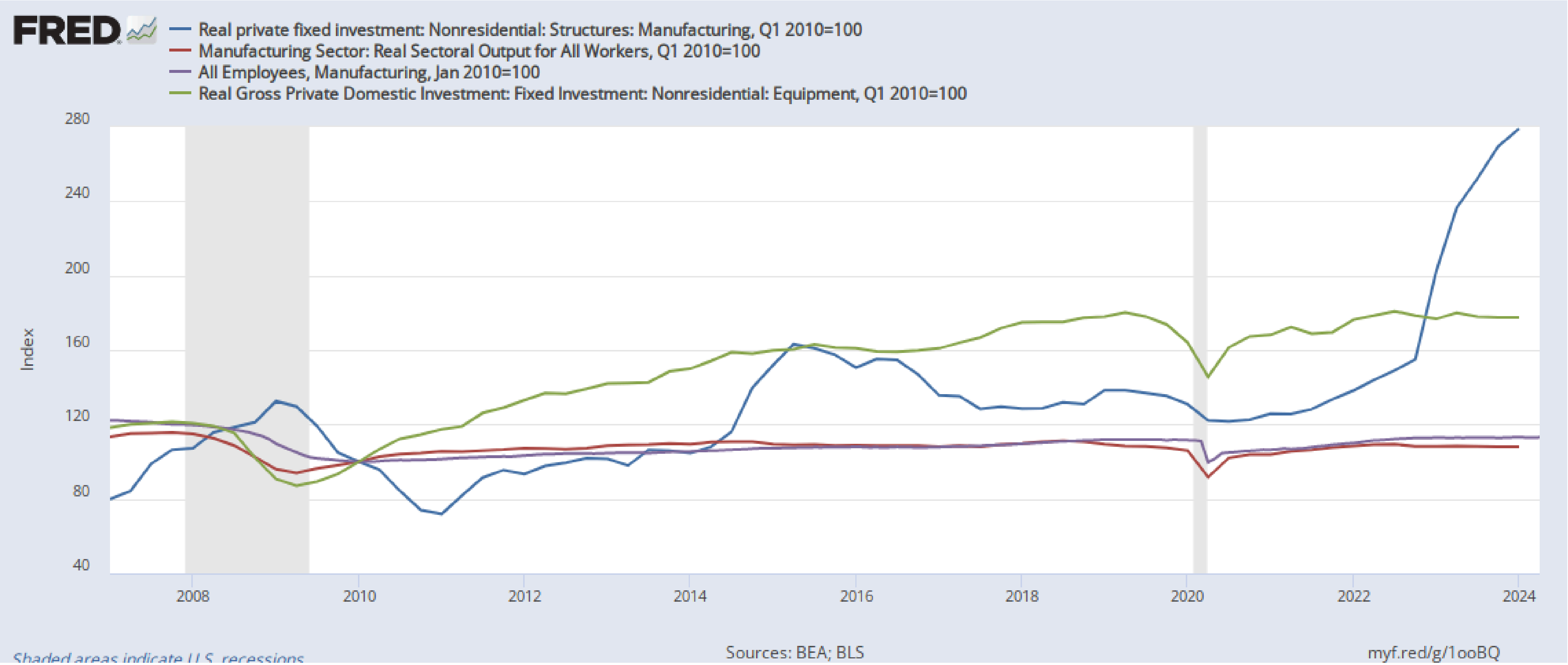
- Anyways sanctions imposed during Trump admin and recent years as CHIPS Act




  - resulting in lower imports from China [link to data]

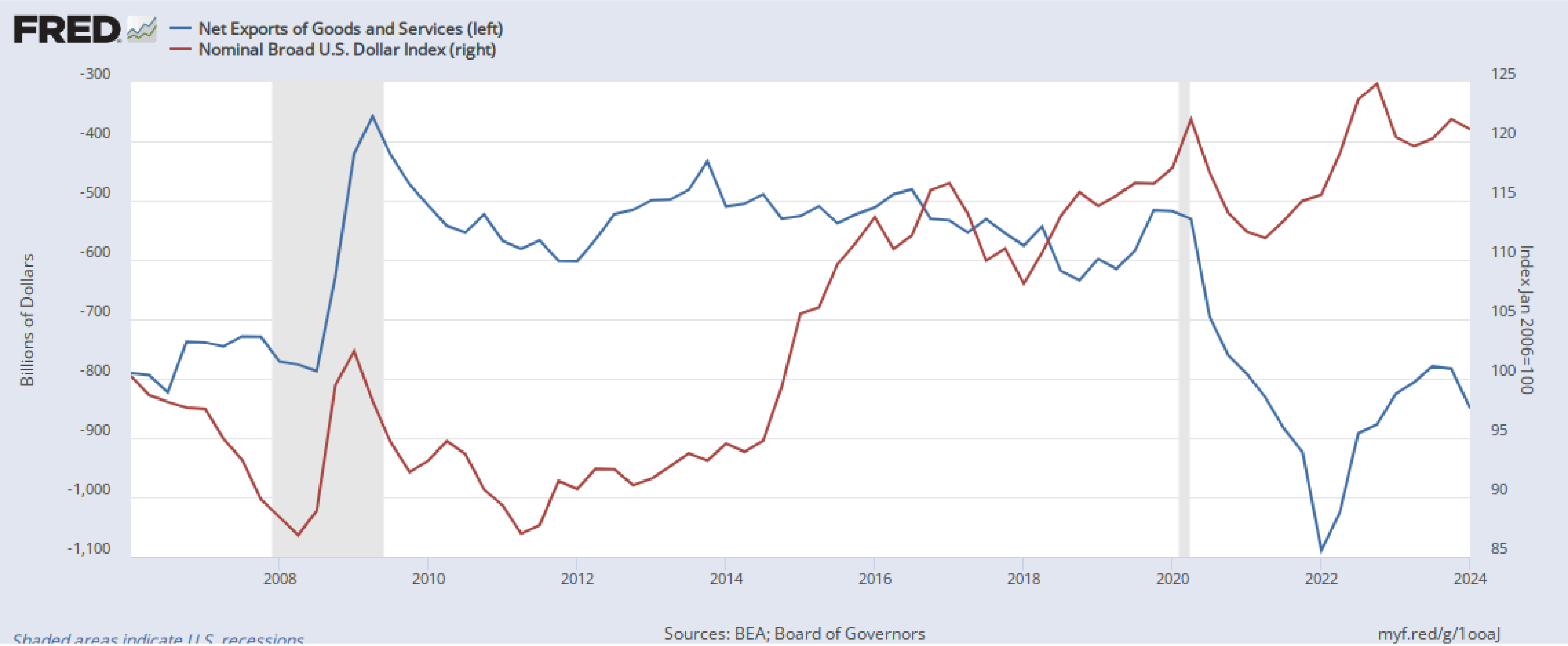
# From *Economist* to Economics: US Manufacturing sector

- But will have to wait and see the effects of higher investment [link to data]



# From *Economist* to Economics: Dollar and NX

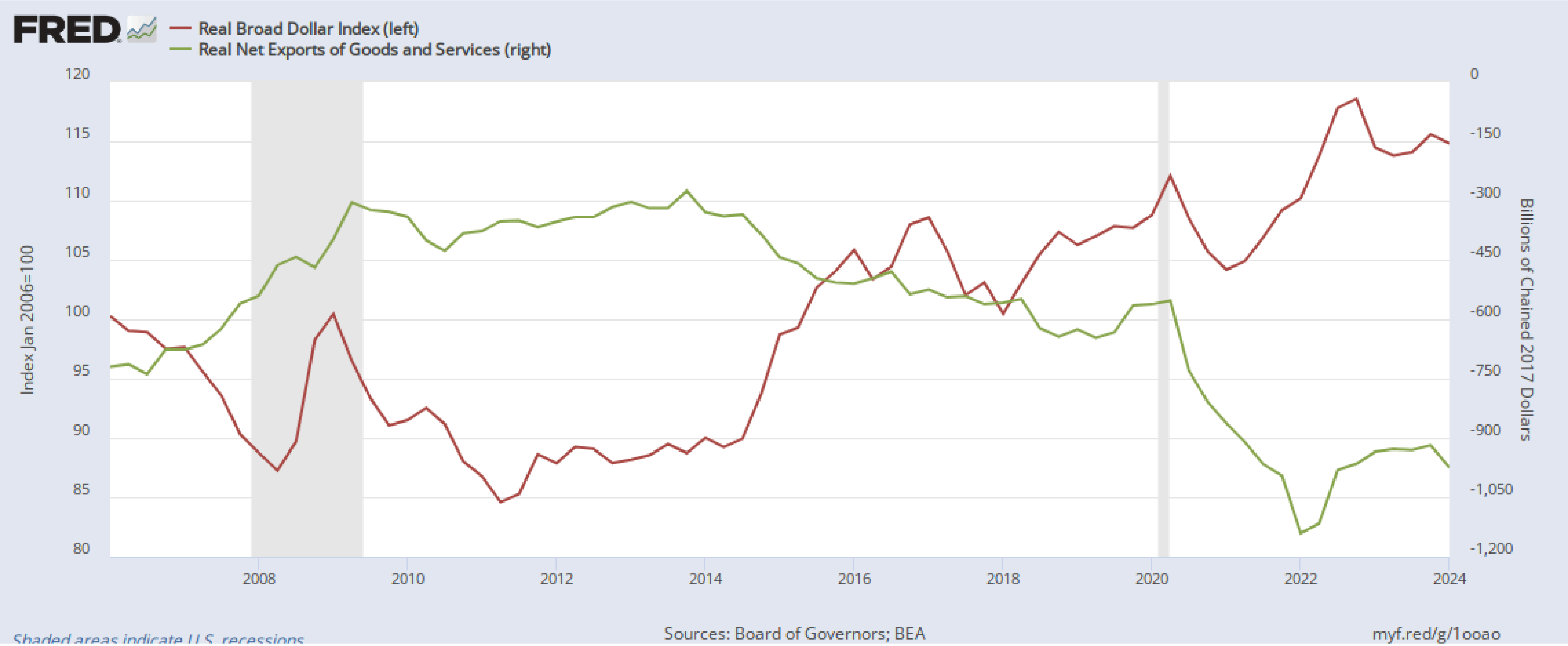
- Moving on to the second question, let's look at dollar and NX [link to data]




  - Do you see negative relationship ($\rho = -0.38$)?
    - Stronger dollar does seem associated with larger trade deficit

# From *Economist* to Economics: Dollar and NX

- After inflation adjustment, you get smoother movements [link to data]




  - and a stronger negative relationship ($\rho = -0.8$)

# From *Economist* to Economics: Dollar and NX

- What makes strong dollar and NX deficit move together is *capital flow*
- Recall from intermediate macro,

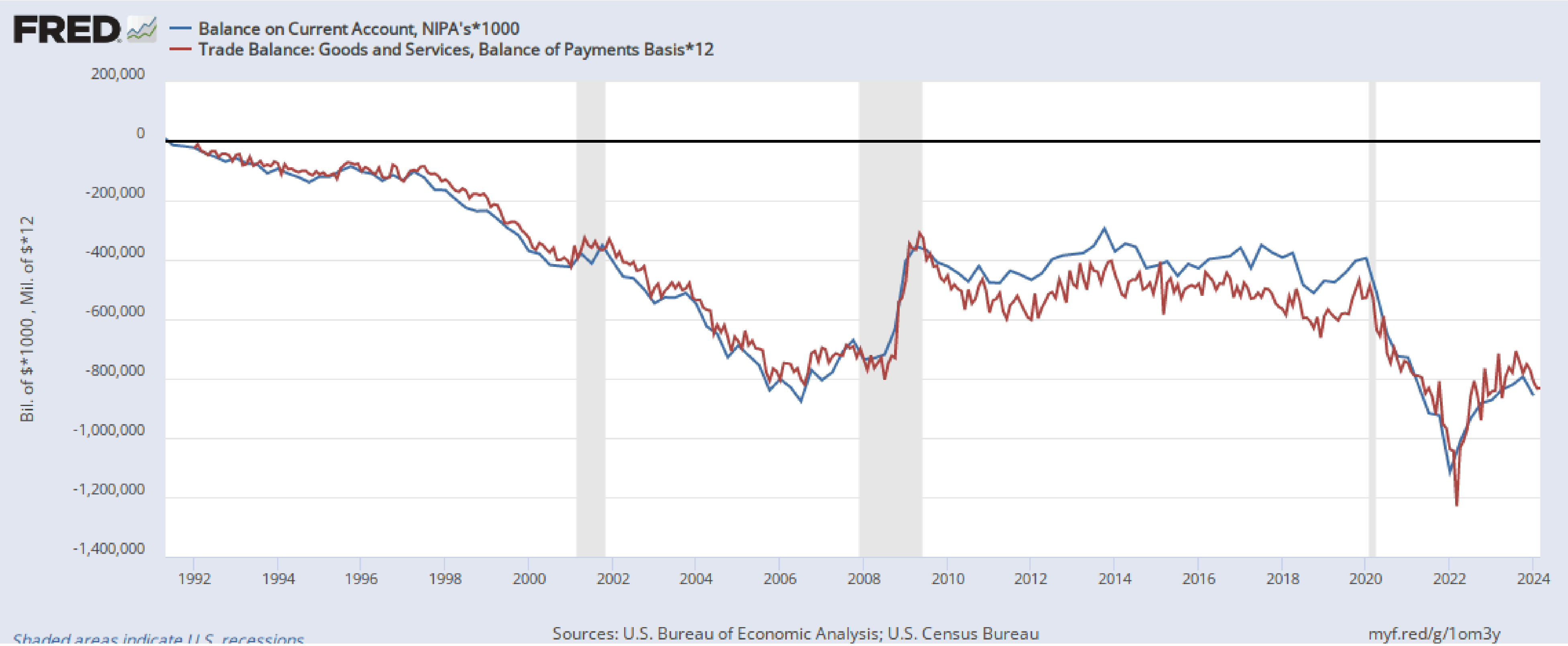
$$S - I = NX$$

  where $S_G = T - G$ and $S_P = Y - T - C$

- It says trade deficit must be financed by capital inflow
  - Foreigners are willing to lend you money by investing in your assets
    - for you to purchase foreign-produced goods
  - Why would not be for a strong economy with high interest rates?
    - Strong dollar is a result of this capital movement

# From *Economist* to Economics: Dollar and NX

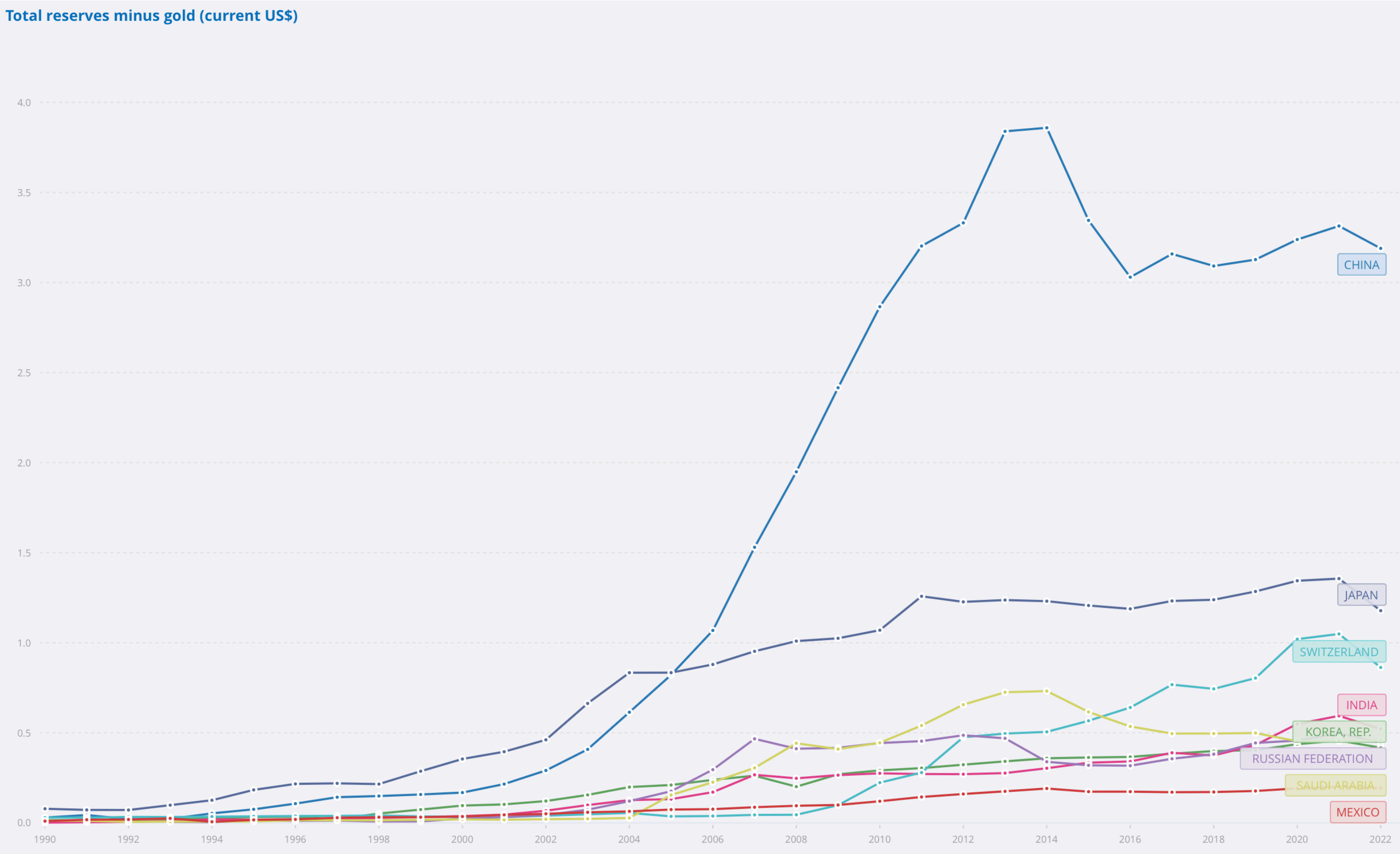
- Checking with US data, [link to data]




- (perhaps more important) Q: Why do rest-of-world would like to hold US assets?

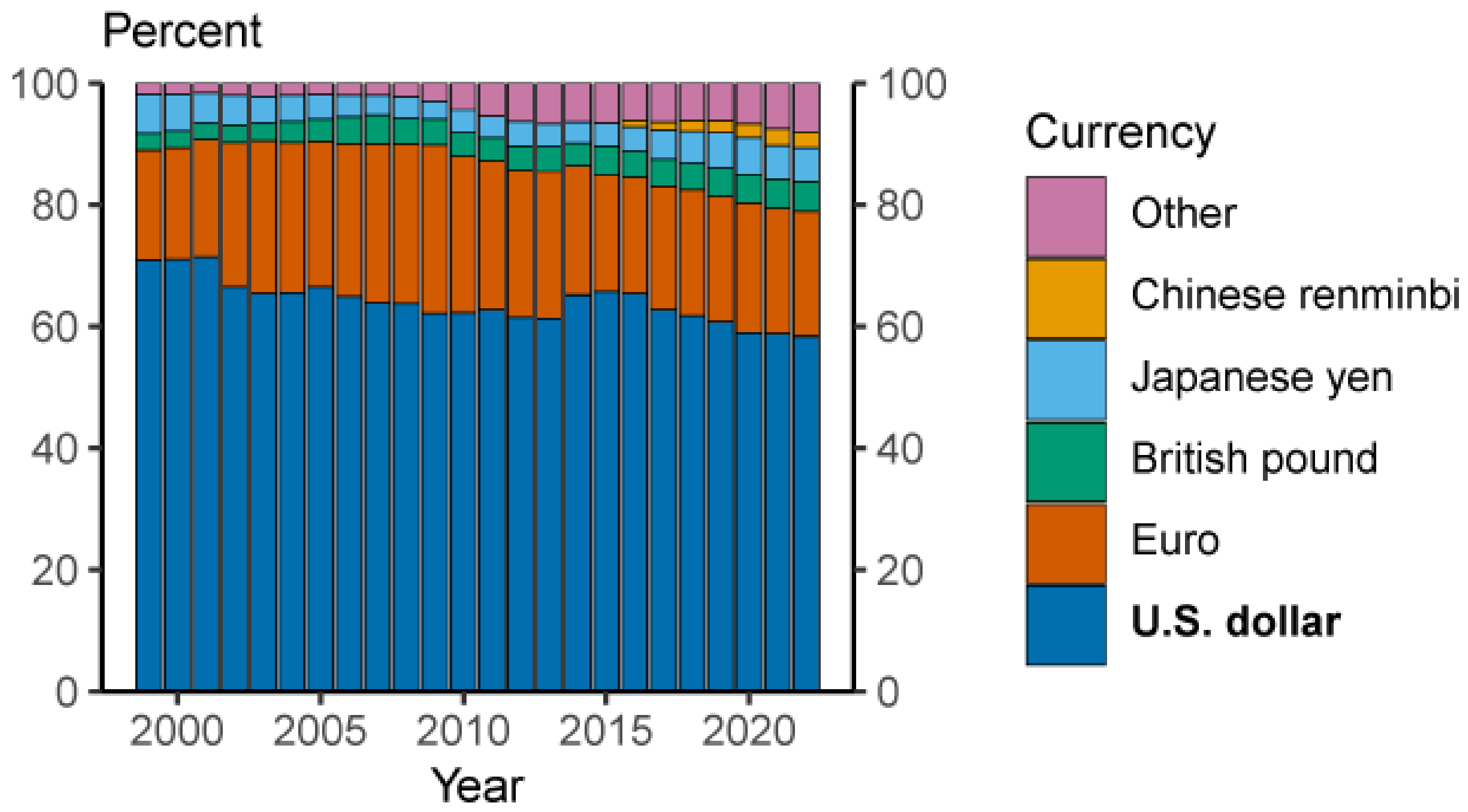
# From *Economist* to Economics: Dollar and NX

- One way to see this is to look at FX reserve holdings [link to data]



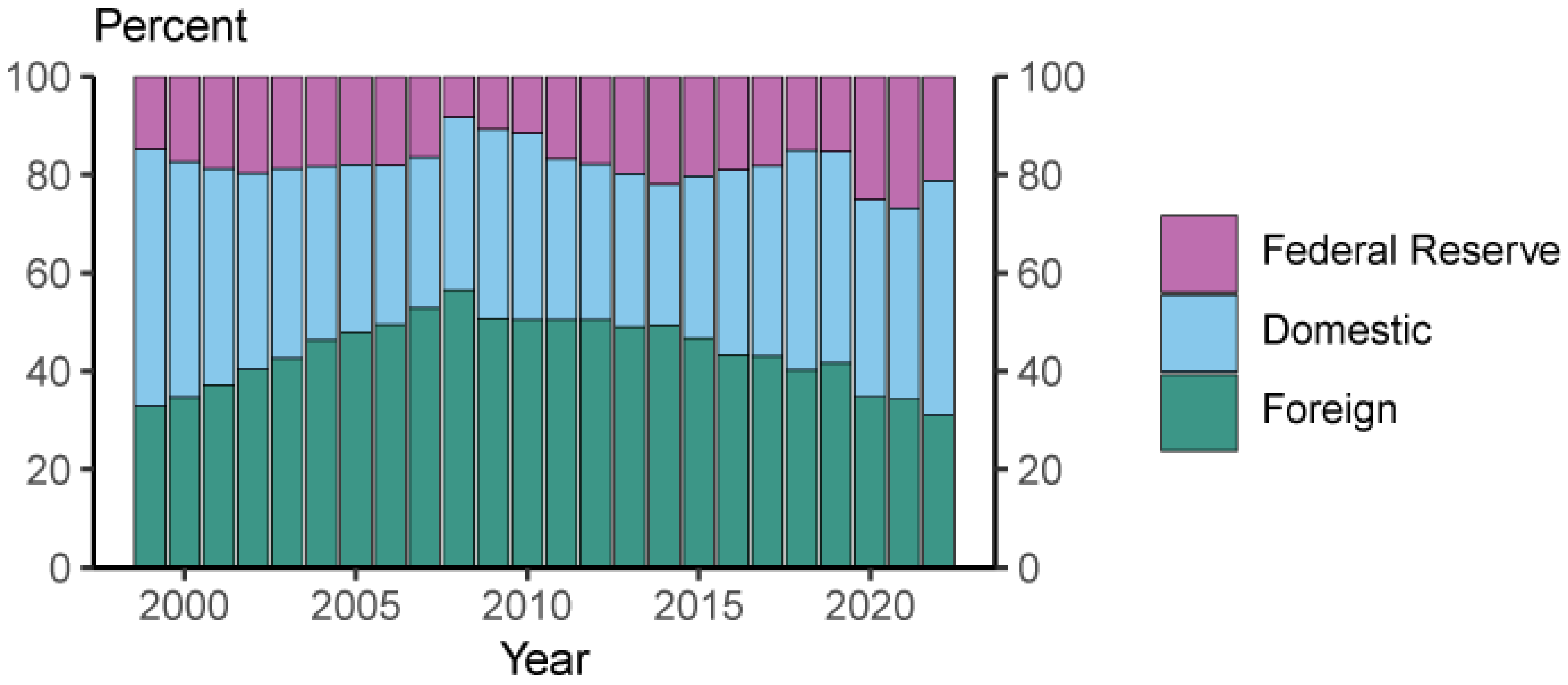
# From *Economist* to Economics: Dollar and NX

- Most of the reserves are held in US dollar [link to data]



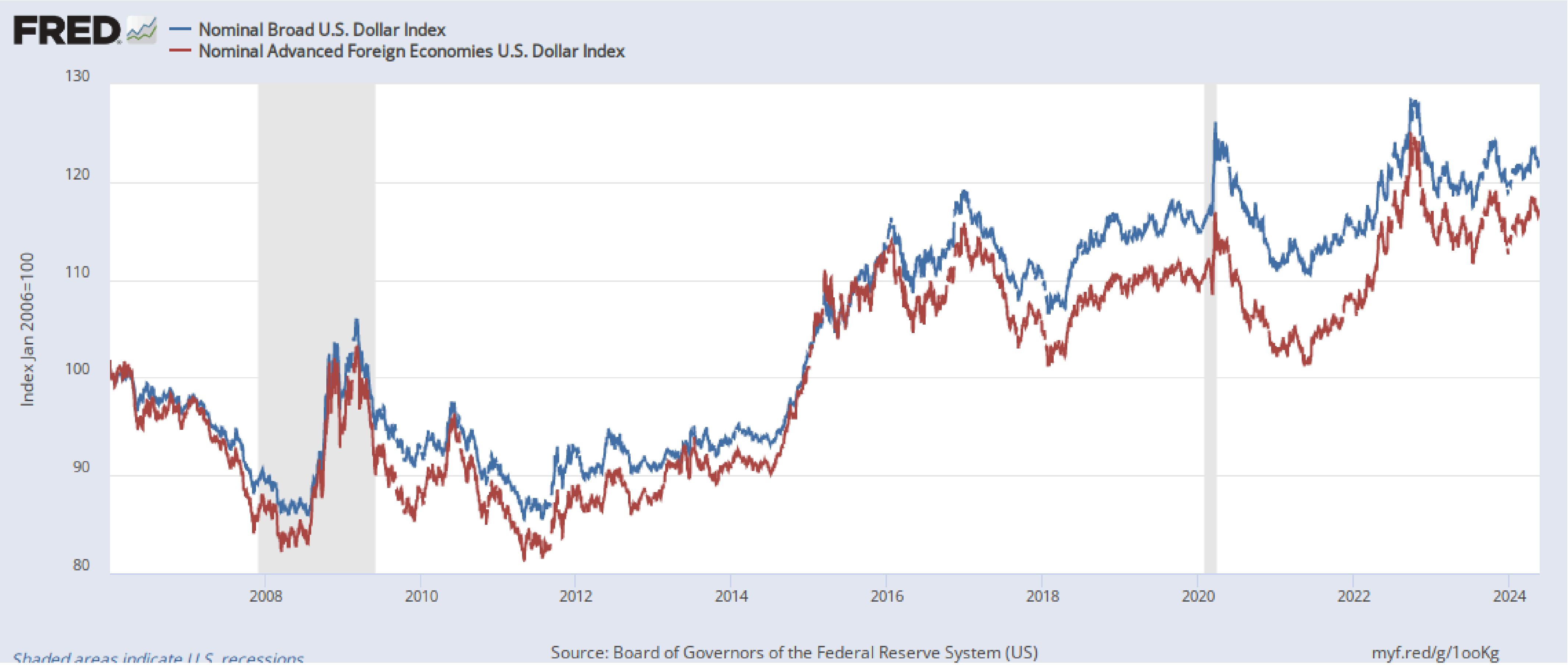
# From *Economist* to Economics: Dollar and NX

- In the form of Treasury securities, [link to data]
  - Safe and liquid: a nice store of value



# From *Economist* to Economics: Global effects of Dollar

- Getting into the last question, for a small-open emerging economy, [link to data]

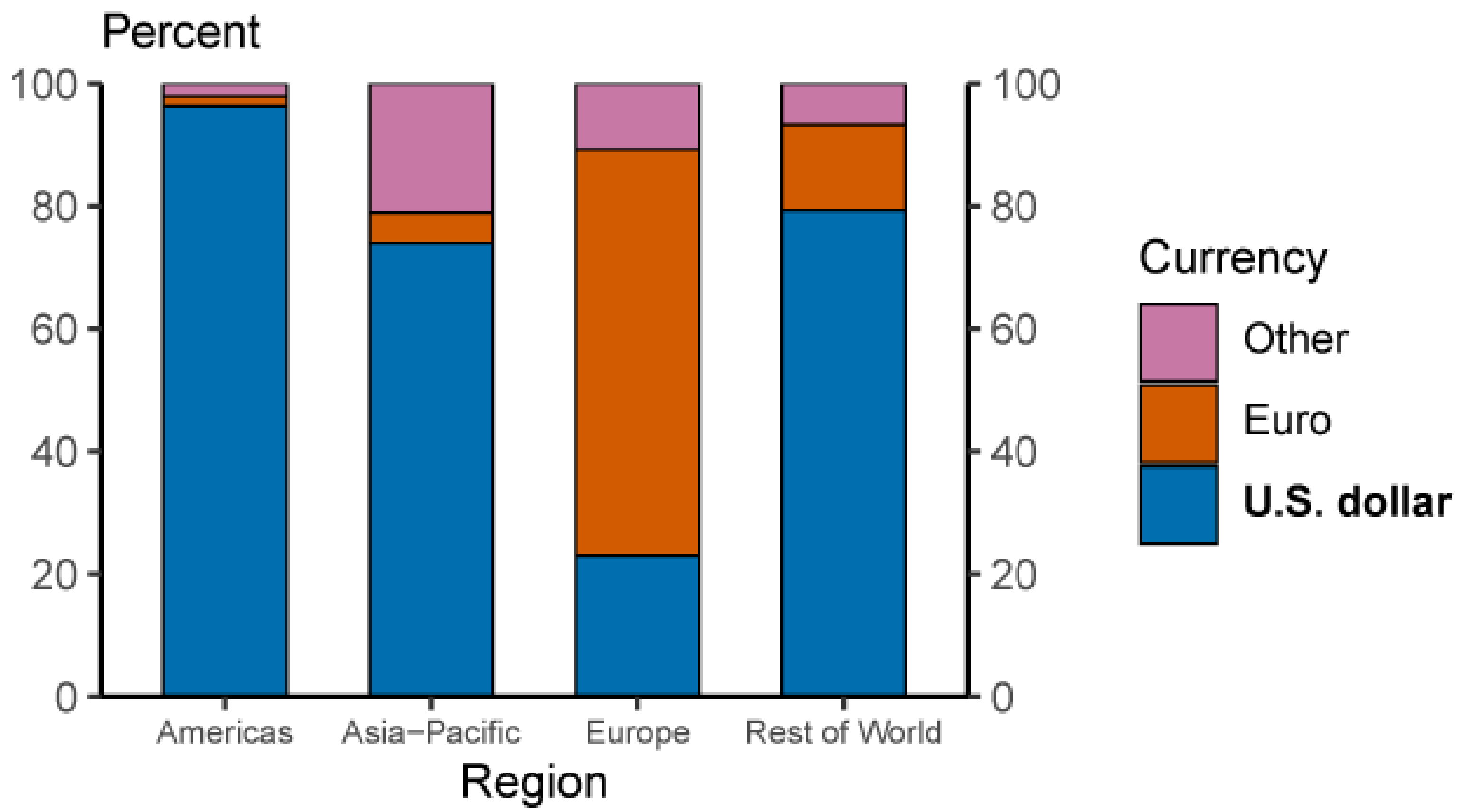


## From *Economist* to Economics: Global effects of Dollar

- Strong dollar impacts other countries through the following channels
  - Invoicing: Depending on invoicing currencies
    - export demand may be affected
    - higher import prices would induce inflation
  - Financial: greater burden to repay dollar debts and to get dollar credits

# From *Economist* to Economics: Global effects of Dollar

- Dollar is dominant invoicing currency, [link to data]



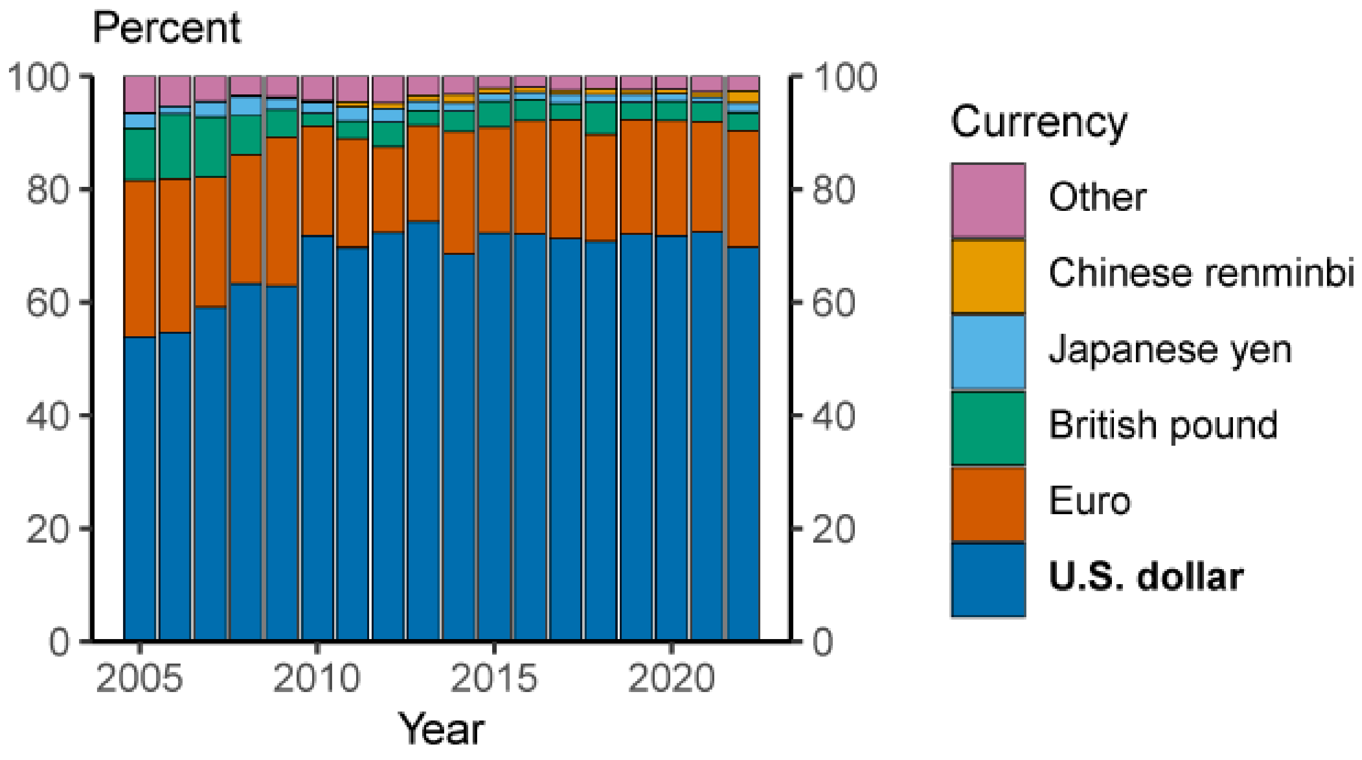

  - Strong dollar dampens foreign demand for exports for bilateral trade w/o US

# From *Economist* to Economics: Global effects of Dollar

- How would you evaluate the following argument in the article?
  - *"A strong dollar tends to raise the price of American exports and lower the price of imports, widening the country's persistent trade deficit"*
- This argument makes sense as long as Chinese exports are invoiced in yuan
  - which is called *"producer currency pricing(PCP)"*
  - Are they though? One should check with data (I doubt it is the case...)
- Bruno-Shin (2023) demonstrate financial channel
  - Even exports to US decrease (while invoicing channel is muted) with strong dollar
  - Reason: exporting firms are having trouble to get dollar credits from banks

# From *Economist* to Economics: Global effects of Dollar

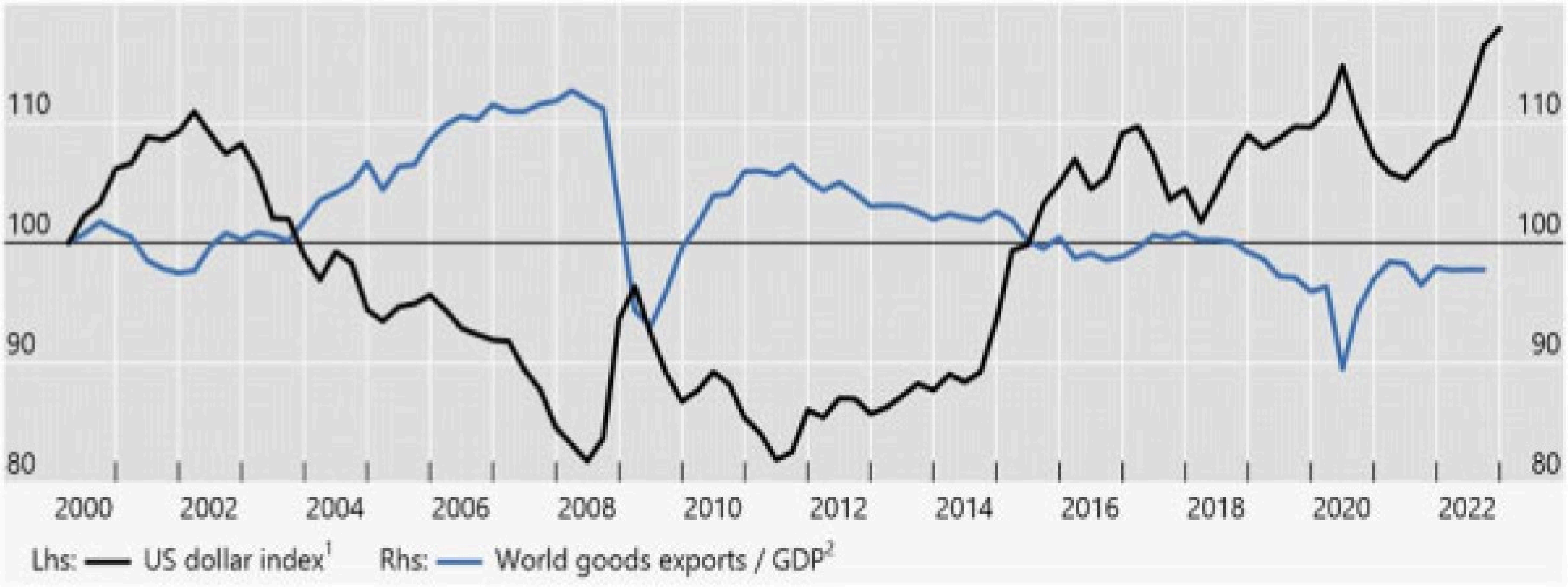
- Firms are issuing foreign currency debts mostly in dollar [link to data]




  - With assets held in local currency, strong dollar may create *balance sheet effects*

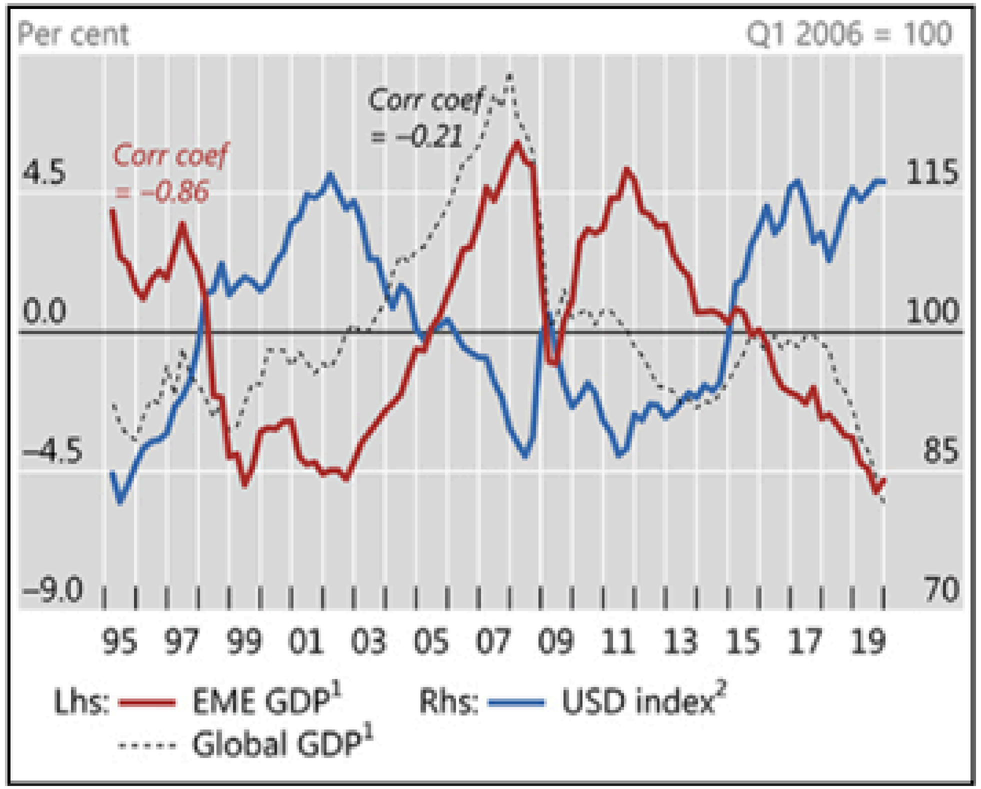
# From *Economist* to Economics: Global effects of Dollar

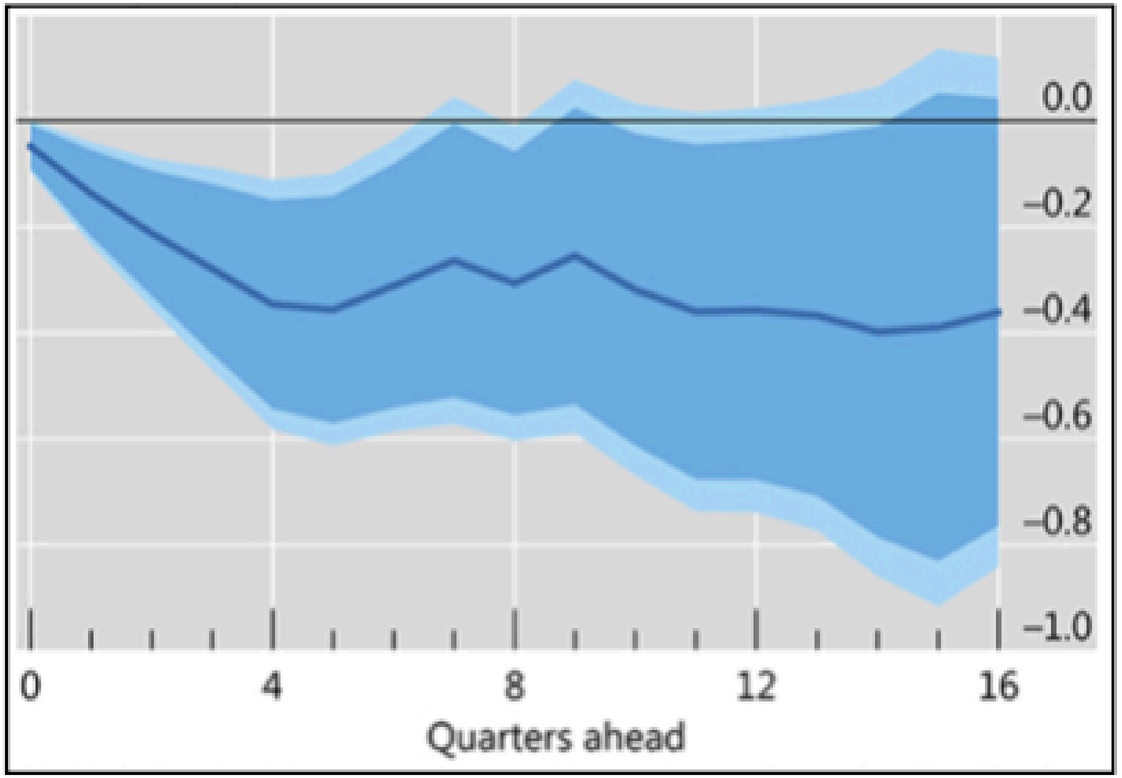
- Thus, there is a strong negative relationships between dollar and world trade,



# From *Economist* to Economics: Global effects of Dollar

- Through these channels, strong dollar dampens GDP esp. for emerging economies,



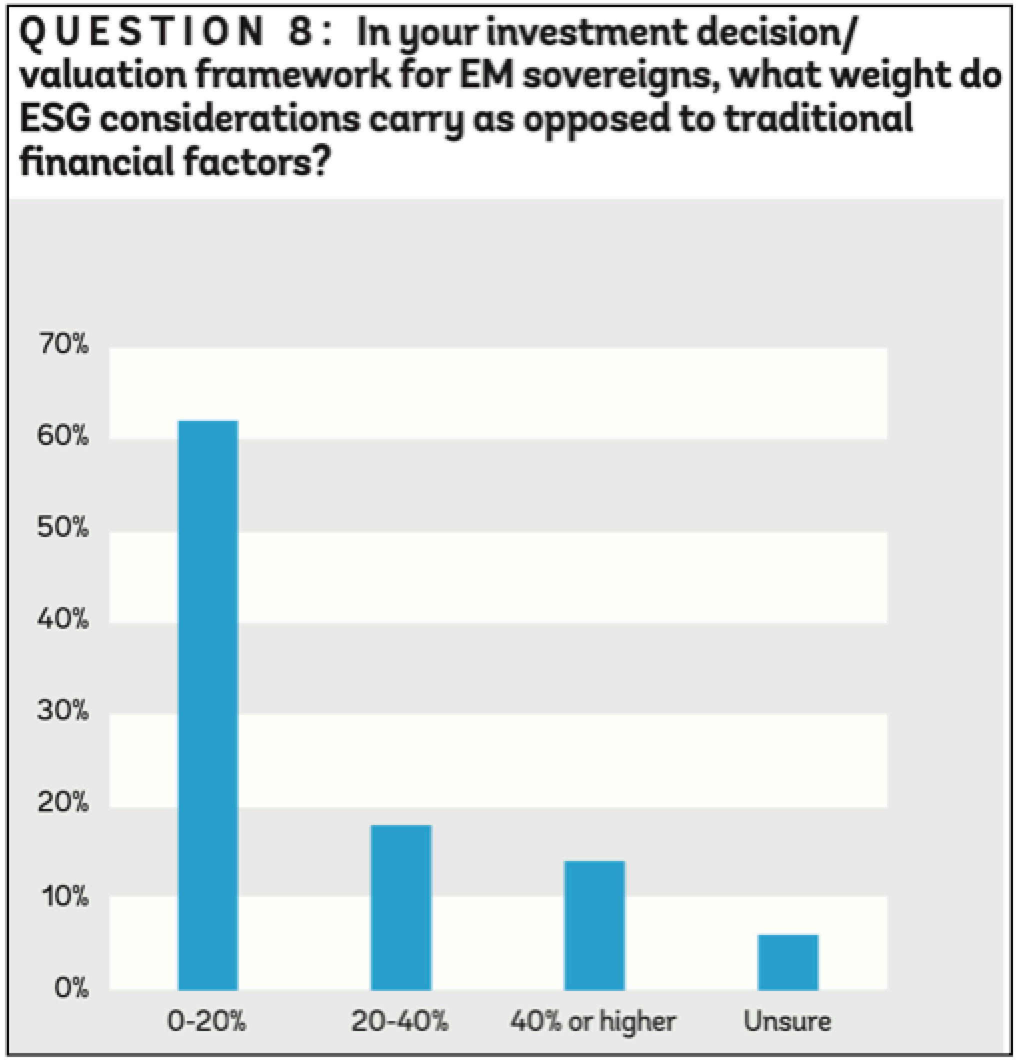



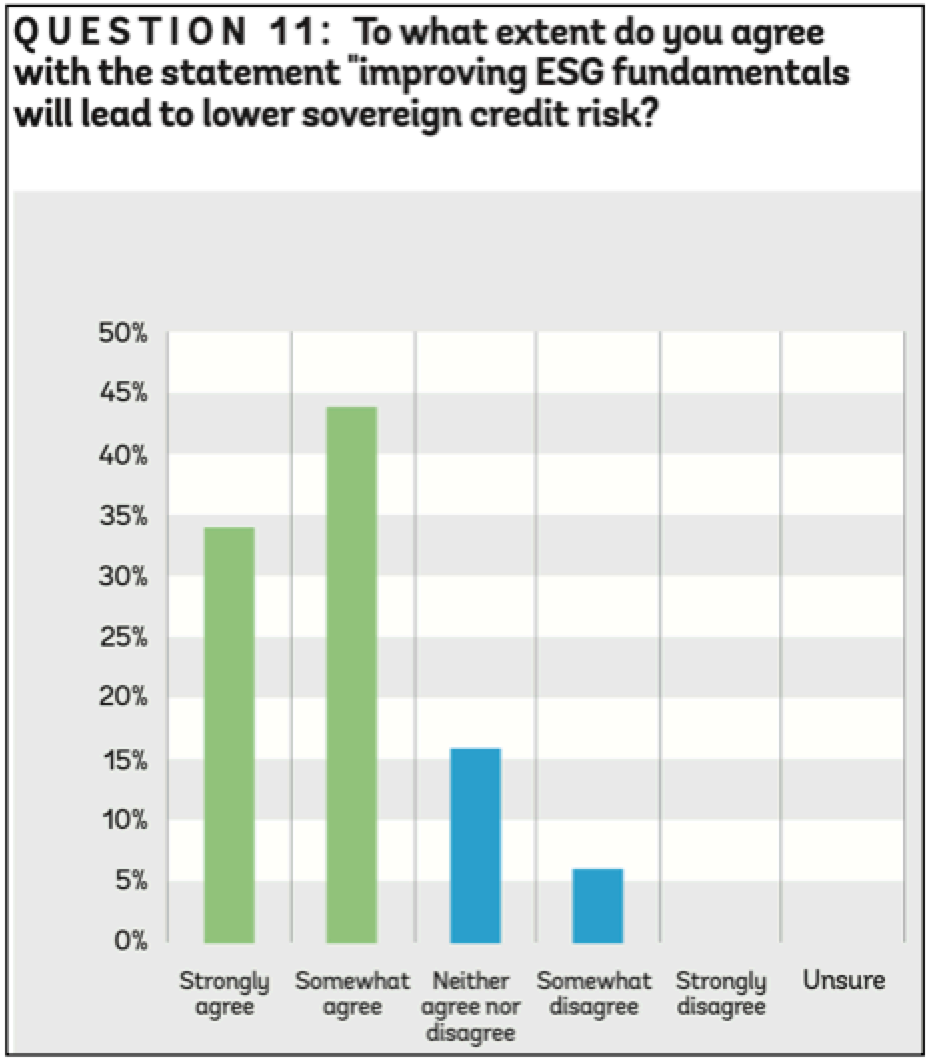
## From *Economist* to Economics: Capital flows and ESG

- Now that you know global capital flows are important
  - Q: What are the factors that move the funds?
- Recent emphasis on ESG (Environment, Social, Governance) as a investing strategy
  - They want to invest in corporates and countries that are sustainable
- J.P. Morgan introduced ESG suite of indices (JESG)
  - using scores based on a combination of qualitative and quantitative approaches
- World Bank launched Sovereign ESG Data Portal to provide further information
  - covering 71 ESG indicators with 40 additional indicators over 61 years and across 217 economies.

# From *Economist* to Economics: Capital flows and ESG

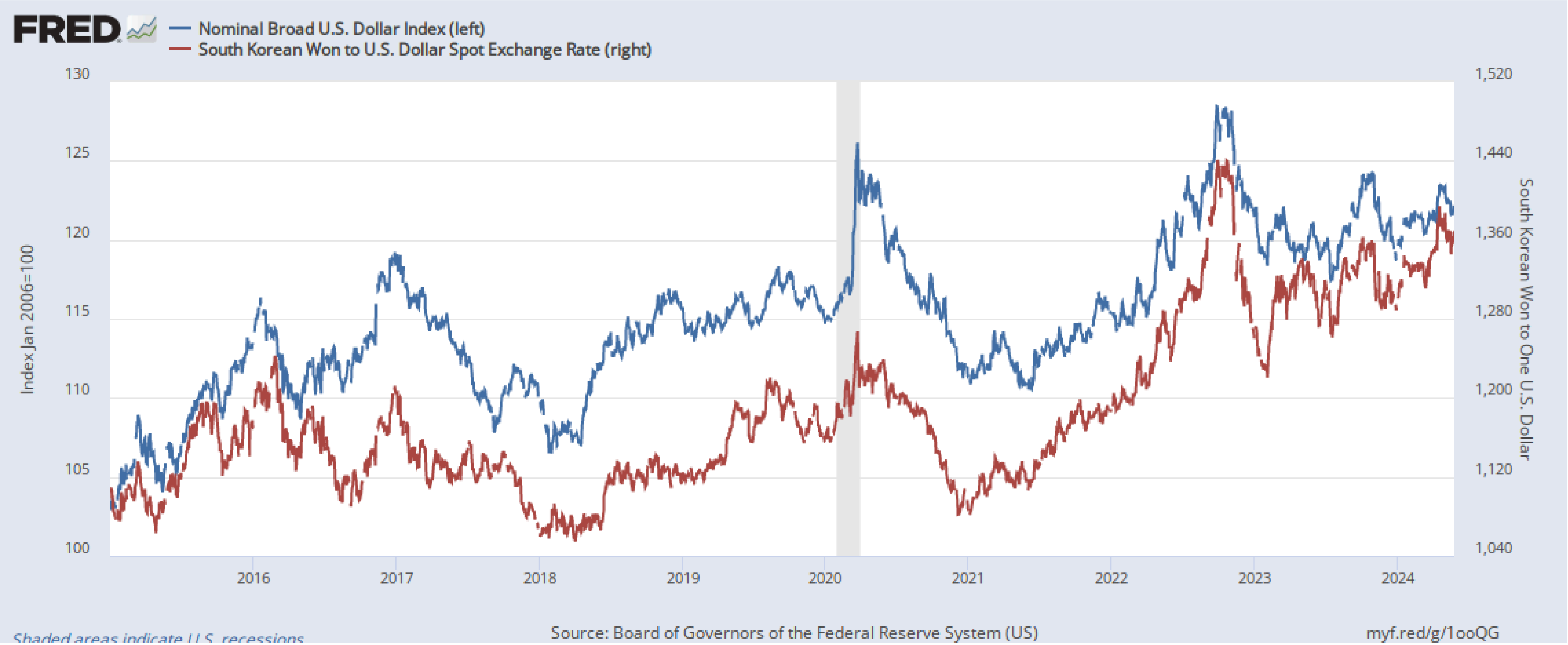
- A survey by WB and JPM among emerging market sovereign debt investors shows



# From *Economist* to Economics

- Last but not least, Korean won seems to move closely with dollar [link to data]




  - Strongly positively associated ($\rho = 0.86$) even in daily frequency since 2015

# References

Bruno and Shin (2023) "Dollar and Exports", *The Review of Financial Studies*

FEDS Notes (June 23, 2023) "The International Role of the U.S. Dollar"

FRED Blog (December 30, 2019) "Is the decline in manufacturing economically “normal”?"

FRED Blog (February 1, 2018) "How's manufacturing?"

FRED Blog (March 18, 2024) "Has US-China decoupling energized American manufacturing?"

Gopinath et al. (2020) "Dominant Currency Paradigm", *The American Economic Review*

Hofmann and Park (2020) "The broad dollar exchange rate as an EME risk factor" BIS Quarterly Review

The Economist (April 23, 2024) "Why a stronger dollar is dangerous"

World Bank (2021) A New Dawn: Rethinking Sovereign ESG