# Benign neglect may turn the dollar from a safe haven to a dangerous place to be

## The US government is shouldering a vast $12 trillion debt pile – that's 12, followed by 12 zeros.

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The trade deficit of the world's biggest economy also remains huge. How much longer can the dollar defy gravity?

Last week, America's currency fell to a 15-month low against the euro, cutting through $1.5050. Against a trade-weighted currency basket, the dollar was also at its weakest since July 2008. The greenback plunged to parity with the rock-solid Swiss franc, then hit a 14-year low against the yen.

The dollar's weakness is based on fundamentals – not least America's jaw-dropping debt. It's a long-term trend. From the start of 2002 until the middle of last year, the dollar lost 30pc on a trade-weighted basis.

It was during the summer and autumn of 2008, though, that the sub-prime debacle entered its most vicious phase (so far). The rescue of Fannie Mae and Freddie Mac, America's quasi-state mortgage-lenders, followed by the Lehman collapse, sent shock waves around the world. For six months or so, Western investors piled into what they knew, liquidating complex positions and buying plain dollars. The greenback became stronger, spiralling upward during the so-called "safe haven rally".

All that has now changed. The trade-weighted dollar has lost 22pc since March. One reason is that, since the spring, the Federal Reserve has been printing money like crazy – both to bail out Wall Street and service America's rapidly growing debt.

Sophisticated investors have also been exploiting America's ultra-low 0.25pc interest rate to borrow cheaply in dollars, switch these borrowings in currencies where returns are higher, then pocket the difference. This so-called "carry trade" has flooded foreign exchange markets with US currency.

The dollar fell particularly sharply last week, though, as traders were reminded of the patently obvious – that the White House actually wants the dollar to fall. US Treasury officials have lately taken to staring into the TV cameras, puffing out their chests, then stating: "We are committed to a strong dollar." That's nonsense, of course, because a weaker currency boosts US exports and lowers the value of America's external debt.

When the minutes of the Fed's latest policy meeting were published on Tuesday, describing the dollar's decline as "orderly", the markets rightly took that as confirmation of America's "benign neglect" approach – with intervention to support the dollar unlikely. The minutes also showed the Fed's key committee members voted "unanimously" to keep interest rates at rock-bottom for "an extended period" – another reason to sell.

In addition, the Federal Deposit Insurance Corporation, the fund that safeguards US bank deposits, warned that the number of "problem" banks grew in the third quarter, leading to speculation it could seek a credit line from the US Treasury. That would mean more borrowing and money-printing, concerns which sent the dollar even lower.

Yet "benign neglect" is fraught with danger. A weak US currency makes commodities more expensive (seeing as they're priced in dollars). It was when the dollar hit an all-time low of $1.60 against the euro during the summer of 2008 that oil soared to $147 a barrel. Expensive crude damages the economy of the world's biggest oil user. And as the dollar falls, America's huge commodity imports cost more, making the trade deficit even worse.

On top of all that, a falling dollar makes it even more difficult for the US government to meet its massive borrowing needs. Just to service existing debt, America must sell $205bn of Treasuries this year, a total set to hit more than $700bn a year by 2019 – even if annual budget deficits shrink. Selling long-term sovereign debt, in a currency expected to fall, is not easy.

Almost every American economist I know dismisses these concerns. Several have contacted me over the last 48 hours, gloating that the dollar has just put on a renewed "safe haven" spurt in the midst of fears about Dubai.

Yet the state of the dollar poses enormous dangers. For one thing, America's currency depreciation trick could backfire if "the rope slips" and a steadily dollar decline turns into free fall. The cost of US imports would soar, with the Fed being forced to sharply push up rates. The world's largest economy would then be caught in a stagflation trap – a slump, but with high inflation.

A more immediate concern is that a blind rush into the US currency could cause the carry-trade to go badly wrong – with those who've borrowed in dollars suddenly owing more, while their dollar-funded investments elsewhere are worth less.

A rapid "unwinding" could cause major losses at financial institutions, posing renewed systemic dangers. Far from being a safe haven, the dollar is the likely source of the next financial crisis.

http://www.telegraph.co.uk/finance/economics/6678334/Benign-neglect-may-turn-the-dollar-from-a-safe-haven-to-a-dangerous-place-to-be.html