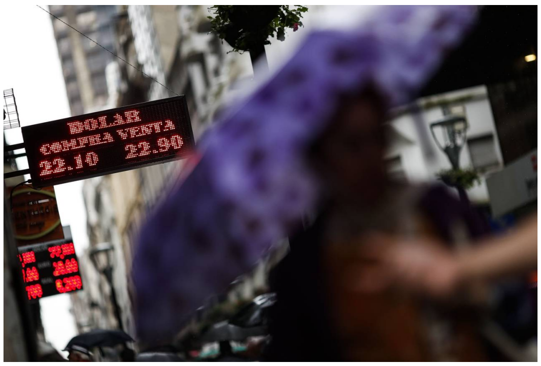
CAPITAL ACCOUNT

In a Dollarized World, a Rising Dollar Spells Pain

Even as U.S. economic influence shrinks, the dollar's clout in global trade and borrowing is growing, magnifying impact of its rise in value



Argentina's recent economic woes, including a plunging peso and rising interest rates, have been compounded by rising U.S. interest rates and a stronger dollar. Here, a money exchange story in Buenos Aires **PHOTO:** DAVID FERNÁNDEZ/EPA/SHUTTERSTOCK

By Greg Ip
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Economic ties between the U.S. and Argentina are modest, yet Federal Reserve policy is wreaking havoc on Argentina. It also threatens Turkey, Indonesia and others, for the same reason: their imports, exports and a lot of their debt is denominated in dollars.

The latest emerging market tumult exposes a critical though dimly understood fault line in the global economy. Though the U.S. share of global output and trade has declined over the decades, the dollar has become even more dominant in global trade and finance.

Dollarization, new research shows, means an appreciating dollar may hurt rather than help other economies by raising their import and debt costs. In fact, a rallying dollar may help explain why global growth has already faltered this year. The dollar's dominance is also why the U.S. can isolate Iran simply by cutting off its access to the U.S. banking system.

Argentina's problems are mostly homegrown: Inflation exceeds 20% and its current-account deficit, which includes trade and investment income, has widened. But those problems have been compounded by rising U.S. interest rates and expectations that fiscal stimulus will lead to even higher rates. This has drawn capital from Argentina, causing the peso to plummet 17% against the dollar this year.

And that's a problem, because even though just 15% of Argentina's imports come from the U.S., 88% of its total imports are invoiced in dollars, according to Harvard University economist Gita Gopinath. Thus, a rising dollar quickly jacks up prices in pesos.

Furthermore, Argentina's various levels of government owe $98 billion in dollar-denominated debt and its private sector another $68 billion, equal to about a third of gross domestic product. As the peso falls, that debt becomes harder to pay off. The run on the peso has prompted the central bank to boost interest rates to 40% and Tuesday, the country asked the International Monetary Fund for a credit line.

Argentina's vulnerability is extreme but not unique. Ms. Gopinath has found that around 40% of world trade is invoiced in dollars, roughly four times the U.S. share of world trade. Moreover, developing countries collectively owe $2 trillion in dollar-denominated debt, according to the Bank for International Settlements.

With the dollar rising, emerging-market currencies, stock markets and bonds are all selling off. "This is a currency that has spillovers that are far more than what was recognized in the past," Ms. Gopinath said in an interview.

In some ways, dollarization is a puzzle. Though U.S. interest rates are often lower than foreign interest rates, economic theory says borrowing in dollars should not be cheaper because currency changes eventually eliminate any such advantage. (Economists call this "uncovered interest parity.")

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After financial crises in Latin America the 1980s and Asia in the 1990s, emerging market governments drastically reduced their foreign currency borrowing.

Their companies, though, still borrow heavily in dollars, even when they don't export much in dollars and thus lack a natural "hedge." And this may actually make economic sense because the dollar isn't like other currencies. It has become the default currency of choice for trade; much as Turkish businesses communicate with Brazilians in English rather than their own languages, they invoice each other in dollars rather than their own currencies.

Ms. Gopinath and fellow Harvard economist Jeremy Stein argue in a recent paper this means foreigners hold a lot of dollars to settle transactions even if they earn no interest. This is the source of the U.S.'s "exorbitant privilege," the ability to borrow cheaply in dollars without currency swings eliminating the benefit. Foreign companies share this privilege when they borrow in dollars. Once a company borrows in dollars, it naturally wants to invoice its exports in dollars, and vice versa, so dollarization becomes self-perpetuating.

In a new University of Chicago Becker Friedman Institute working paper, Matteo Maggiori, Brent Neiman and Jesse Schreger examined $27 trillion of global portfolios and found investors overwhelmingly prefer bonds denominated either in their own currency, or dollars. Moreover, the dollar's share of cross-border borrowing has climbed to 62% in 2016 from 45% in 2008 at the expense of the euro, whose future came into question during the region's sovereign debt crisis.

Yet just because borrowing in dollars makes economic sense, that doesn't make it riskless. Robin Brooks, chief economist at the Institute of International Finance, says countries such as Turkey have been hooked on growth and thus allowed their companies and banks to borrow heavily in foreign currency without costly hedging. "Assuming the Turkish lira doesn't fall much, you're fine." The lira, however, has tumbled 12% this year.

The saving grace is that the dollar so far hasn't risen much relative to last year's drop. How much further it goes depends a lot on the Fed. In a speech Tuesday, Chairman Jerome Powell said rising U.S. interest rates should "prove manageable" for emerging markets given they haven't been surprised and have much better fiscal and monetary policies than in the 1980s and 1990s.

Yet, the Fed cannot ignore the risk of igniting a crisis abroad that ricochets back to the U.S. The dollar's "exorbitant privilege" imposes an "exorbitant responsibility" on the central bank says Mr. Stein, a former Fed governor.

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