Ready for a rout?

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The dollar's decline accelerates

YOU know that nerves are taut when a couple of stray comments set off a flurry of selling. The dollar fell sharply on Wednesday November 7th after mid-ranking Chinese officials, not actually responsible for foreign-exchange policy, made remarks that were seized upon by already jittery markets. A Chinese parliamentarian called for his country to diversify its reserves out of "weak" currencies like the dollar and another official suggested that the dollar's status as a reserve currency was "shaky". The greenback reached $2.10 against the pound and a new record of $1.47 against the euro, before recovering slightly. A widely traded index, which tracks the dollar's value against six major currencies, also fell to a new low.

The sliding dollar, along with record losses from General Motors, the threat of $100-a-barrel oil and more bad news from the mortgage industry, spooked Wall Street. On November 7th the Dow Jones Industrial Average fell by 2.6% and the S&P 500 index by almost 3%. To add to the worries, Nicolas Sarkozy, France's president, ramped up the political rhetoric on a visit to Washington.

Alarmed that the weak dollar boosts America's competitiveness relative to Europe's, he told Congress that George Bush's administration needed to do something about the dollar or risk an "economic war". Wall Street seers wondered whether official intervention to prop up the dollar was on the cards.

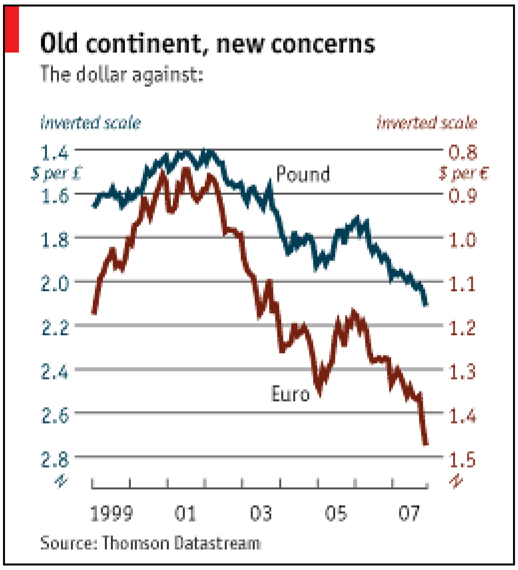
A true dollar crisis has long been one of the more frightening possibilities for the world economy. If foreign investors suddenly abandon America's currency and the dollar collapses, financial markets could crash while the plunging currency constrains the Federal Reserve's ability to cut interest rates. That fear is exacerbated by rising concerns about higher crude oil and food prices.

For now, the dollar nightmare is still unlikely. The currency's decline is neither surprising nor, at least until this week, alarmingly rapid. The gaping current-account deficit and interest-rate differentials between America and other big economies point to a weaker currency. The Fed has cut short-term interest rates by 0.75 percentage points in the past two months. Given the scale of the credit mess and rising fears of recession, expectations are growing that the central bank will cut rates once again when its rate-setting committee next meets on December 11th.

Elsewhere, central bankers have stood pat or tightened. The Reserve Bank of Australia raised short-term rates to 6.75% on November 6th, citing inflationary pressure. The European Central Bank and the Bank of England, meeting on November 8th, both kept short-term rates on hold, at 4% and 5.75% respectively.

If cyclical considerations point to a weaker dollar, the most recent nervousness seems to be driven more by structural worries. Judging by the dollar's slump in the wake of the Chinese officials' comments, investors are fretting that central banks in emerging economies will abandon the ailing greenback. In the short term at least, that fear is easily exaggerated. The share of global foreign-exchange reserves held in dollars has fallen in recent years, but only gradually.

Central banks are unlikely to accelerate a dollar rout by making dramatic changes in their reserve portfolios. That said, many long-standing dollar bulwarks are looking weaker. Many countries that link their currencies to the dollar, from Arab oil exporters to China, face inflationary pressure. As the greenback slumps, these countries have ever-stronger domestic reasons to allow their currencies to rise.



So far, the dollar's decline has caused little alarm among American policymakers. There is scant sign that the depreciation has aggravated price pressures. And inflation expectations, though up slightly, have not soared. Instead, the weaker currency, along with strong growth abroad, has boosted exports, helping to support output growth and unwind external imbalances faster than many thought possible.

America's current-account deficit fell to 5.5% of GDP in the second quarter, from a peak of 7% at the end of 2005. For all the official talk of a "strong dollar", most American policymakers have lost little sleep over the sliding greenback. A dramatic fall in the dollar, however, would be a different story. If this week's ructions are a sign of things to come, the weak dollar could become a big headache.