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A strong US dollar – a blessing or a curse?

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The US dollar is gaining strength wherever one looks. As of the end of January this year, it had gained almost 30 % in value against other major currencies, relative to the previous cyclical low in the summer of 2011 (see Figure 1). Such major fluctuations in the world's leading currency cannot help but influence global economic events. A glance back at previous occasions when the dollar was this strong is hardly reassuring. Examples include the start of the debt crises in Latin America (1982) and Asia (1997). However, we do not currently expect developments to unfold in such a tumultuous fashion. On the contrary, we expect the global economy to benefit overall from the strength of the greenback – although the possibility of undesirable side effects can never be ruled out.

Strong dollar – a reflection of a strong US economy

While the Eurozone, Japan and numerous emerging economies are struggling with weak growth and structural problems, the US economy appears to be in good health. The dollar's appreciation is, therefore, consistent with what is happening in the real economy, acting as an important adjustment mechanism able to prevent national economies from drifting too far apart.

Dollar debt is a risk

Although increased competitiveness might well be expected to blow some urgently required wind into the sails of the Eurozone and Japanese economies, the consequences of a strong US dollar for emerging markets (EMs) are rather more uncertain. EM nations with large volumes of dollar-denominated indebtedness could find themselves threatened by serious problems which may include higher levels of payment default and balance-sheet recession.

Excluding the banking sector, total EM dollar debt as in the middle of 2014 amounted to some USD 3.3 trillion (see Figure 2), growing especially rapidly from late 2008 onwards. Since then, we have seen a virtual doubling of the volume of outstanding local loans, international loans and international bonds denominated in US dollars. Dollar debt has grown at a considerably faster rate in EMs than in the global economy as a whole (+60 %). As a result, levels of EM dollar-denominated debt accumulated since 2008 have grown in significance.

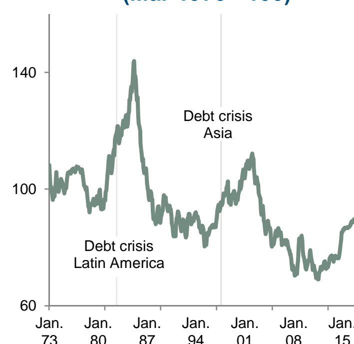
Recent data suggests that such debt now accounts for some 10.6 % of GDP – a situation caused by plentiful supplies of dollar liquidity in the wake of the financial crisis, which made USD carry trades attractive. It was not so much the EM governments that capitalised on low US dollar interest rates and significant overtures from international investors, but rather EM corporations. Bond markets played a key funding role. Net new issues of EM bonds reached a record high in 2012/2013 (see Figure 3).

Caution is called for

Notwithstanding recent increases in dollar-denominated debt levels, EMs are generally in a much better position now than they were in the 1990s. But there are some exceptions where a degree of caution may be necessary. A country’s vulnerability is influenced on the one hand by the relative devaluation of its currency and on the other hand by its levels of dollar-denominated debt.

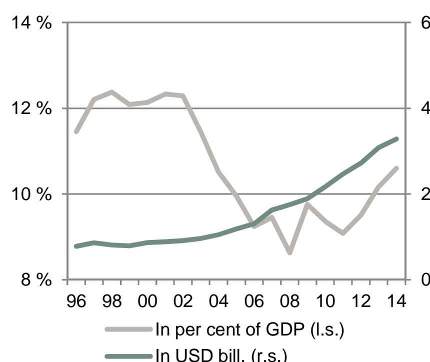
The amount by which individual currencies have lost value relative to the US dollar since the start of 2013 varies greatly. The worst affected include crisis-stricken countries such as Ukraine (-70 %), Russia (-50 %) and Argentina (-43 %), followed by the countries such as South Africa, Turkey and Brazil (-27 %) that are particularly susceptible to capital outflows. It is rarely possible to obtain data on dollar-denominated debt in individual countries. We have to, therefore, make do with estimates. These reveal strikingly high debt levels (in excess of 25 % of GDP) in Ukraine, Turkey, Chile and Peru. ■

Figure 1: Dollar, nominal eff. exchange rate (Mar 1973 = 100)



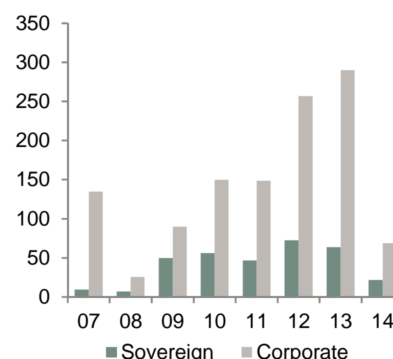
Source: Federal Reserve, own calculations

Figure 2: Dollar indebtedness in EMs



Source: BIS, own calculations

Figure 3: Net new emissions of EM bonds



Source: IWF, GFSR April 2014

Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.