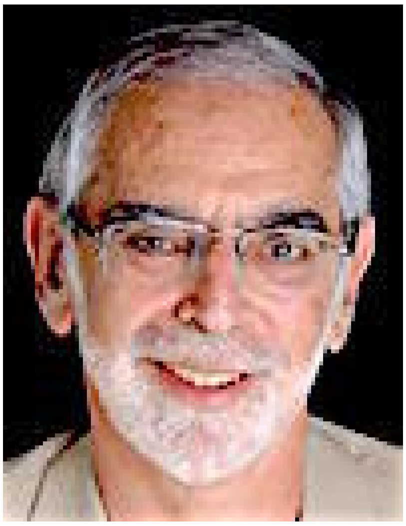
Is Trump Killing the Dollar?

By Benjamin J Cohen *Thu, Aug 17, 2017*

'In the administration's first 200 days, the dollar has lost almost 10% of its value,' writes our guest columnist. 'Investors have been looking for alternative safe havens in other markets, from Switzerland to Japan.'



For nearly a century, the US dollar has been viewed as the financial world's ultimate safe haven. No other currency has promised the same degree of security and liquidity for accumulated wealth. In past times of trouble, skittish investors and prudent central banks have all piled into dollar-denominated assets, not least US Treasury bonds. This may no longer be the case.

US President Donald Trump's chaotic administration has severely undermined confidence in the greenback. Since being inaugurated before a phantom crowd of millions, Trump has picked fights with one government after another, including allies like Australia and Germany. More recently, he has taken the world to the brink of nuclear war by locking horns with North Korean dictator Kim Jong-un.

The dollar is about to face a serious test. Will global investors continue to put their money in a country whose leader loudly provokes the Hermit Kingdom with threats of "fire and fury," or will they find financial refuge elsewhere?

Not since World War II has the safety of the dollar been in such doubt. In the post-war period, America's extraordinarily large and well-developed financial markets promised unparalleled liquidity. And because the US was the dominant military power, it could ensure geopolitical security, too. No country was in a better position to supply safe and flexible investment-grade assets on the scale the global financial system required. As New York investment strategist Kathy A. Jones told the *New York Times* in May 2012, "When people are worried, all roads lead to Treasuries."

The bursting of the US real-estate bubble in 2007 is a case in point. Everyone knew that the financial crisis and ensuing recession had started in the US, and that the country was to blame for a near-collapse of the global economy. And yet, even at the height of the crisis, a tidal wave of capital flowed into US markets, enabling the US Federal Reserve and Department of the Treasury to implement their response.

In the last three months of 2008 alone, net US-asset purchases topped $500 billion dollars—three times more than what was purchased in the preceding nine months. Far from depreciating, the dollar strengthened. The Treasury-bond market stood out as one of the few financial sectors that was still operating smoothly. Even after the credit-rating agency Standard & Poor's downgraded Treasury securities in response to a brief US government shutdown in mid-2011, outside investors continued to acquire dollars.

Much of the spike in demand for dollars ten years ago could be attributed to sheer fear: no one knew how bad things might get. The same could be said of the US and North Korea's escalating confrontatin today. But will history repeat itself, and send investors flocking toward the dollar?

The short answer is: don't count on it. Markets have been signaling their distrust of Trump for months now. At this point, fear of a new crisis could precipitate capital flight away from the dollar, at which point the US would have to deal with a dollar crisis in addition to a potential military conflict.

Risk of a dollar crisis seemed minimal in the weeks immediately following Trump's surprising electoral victory last November. In fact, by the end of last year, capital inflows had pushed the dollar up to levels not seen in more than a decade, owing to expectations of large-scale deregulation, tax cuts, and fiscal stimulus in the form of infrastructure spending and increased outlays for America's supposedly "depleted" military. Economic growth, investors believed, was bound to improve.

But with the Trump administration now engulfed by scandals, the post-election "Trump bump" has faded, along with faith in the dollar. In the administration's first 200 days, the dollar has lost almost 10% of its value. While Trump has been tweeting nonsense, investors have been looking for alternative safe havens in other markets, from Switzerland to Japan. This trend began before the US's latest contretemps with North Korea, but it was only a trickle then. Now, that trickle is threatening to turn into a flood that will leave the dollar permanently damaged.

Of course, the Trump administration might actually want a weaker dollar, and to let others assume the role of global safe haven. But such an abdication would be historically—and dangerously—shortsighted.

The dollar's popularity as a store of value confers an "exorbitant privilege" to the US. When investors and central banks place their wealth in Treasury bonds and other US assets, the US government can go on spending whatever it needs to sustain its many security commitments around the world, and to finance its trade and budget deficits.

With his transactional approach to politics, Trump seems to focus more on the costs of having a global reserve currency than on the advantages. But he cannot hope to "Make America Great Again" if he has to worry about capital flight, and he will not be able to enact his domestic agenda if he has to accommodate negative market sentiments abroad.

There will be nothing "great" about an America that has sacrificed its dominant position in the global financial system. If Trump tests the dollar too much, he will probably come to regret it.

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