As Dollar Falls, World Perks Up



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Recent signs of stability in China's economy, spurred by a reversal of the dollar's long rise, has offered hope that the worst of the global slowdown is in the past. Here,Qingdao port in Shandong provice on a recent day. *Photo: STR/AFP/Getty Images*

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There's nothing traders love more than a juicy conspiracy theory. So when the dollar abruptly reversed a yearlong climb and began sinking this year, rumors swept the markets that the world's 20 leading economies secretly agreed in Shanghai in February to drive it down.

The "Shanghai accord" is a myth. Never mind the odds against keeping a global currency

accord secret. At the summit, <u>officials actually dialed up their condemnation of exchange-rate manipulation</u>.

Nonetheless, the dollar's slide, which began before Shanghai but accelerated thereafter, does signal something important: The worst threats that hung over the global economy at the start of the year—higher U.S. interest rates, an oil-price collapse and a Chinese economic slump—have receded. The global economy isn't about to take off, but its miserable first quarter may mark the bottom.

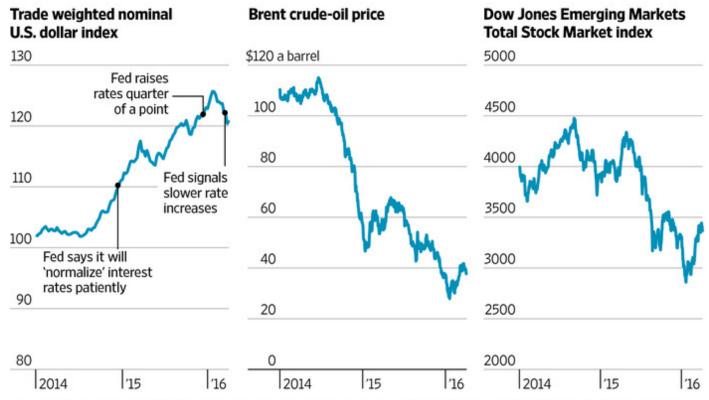
Ironically, this improvement has come about precisely via the channel that policy makers sought to de-emphasize in Shanghai, namely monetary policy. U.S. officials persuaded their counterparts to emphasize fiscal policy and structural reforms as the way to lift economic growth. Yet little on that front has happened; China and Canada have blessed bigger budget deficits, but Britain has doubled down on austerity. As a result, central banks have dialed up their activism.

Most important, the Federal Reserve has decided that a fragile global economy requires more caution about raising rates. This benefits the U.S. but even more so China and emerging markets whose economies remain deeply linked to the fortunes of the dollar, still the world's dominant reserve currency. On the other hand, it makes it even harder for the eurozone and Japan to get their inflation rates up and puts pressure on them to dial up their monetary medicine.

The panic that seized markets earlier this year actually traces its roots to 2014, when Saudi Arabia ramped up crude production and let oil prices crater and the Fed signaled that interest rates, which had been near zero since late 2008, would start to rise in the coming year. With its European and Japanese counterparts easing further, that sent the dollar up.

The Return of Risk

Currency, commodity and stock markets have signaled lower odds of a financial meltdown or a global recession.



Sources: Federal Reserve Bank of St. Louis (dollar Index); WSJ Market Data Group (Brent); Thomson Reuters (DJ Emerging Markets index)

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The combination of a rising dollar and weaker commodity prices undermined both U.S. investment and junk-bond markets, which shale-oil companies had dominated, and squeezed commodity-dependent emerging markets whose companies carried significant dollar-denominated debt. Because the Chinese yuan is linked to the dollar, the rising greenback squeezed Chinese exporters. When the People's Bank of China responded by devaluing the yuan, it triggered expectations of even bigger devaluations and a flood of capital outflows.

The dollar peaked in January, while stocks and junk bonds bottomed out in mid-February. Several factors played a part: Oil prices stabilized on expected supply cuts and investors began exiting a crowded bet on a rising dollar.

But the most important factor was the Fed's decision to dial back on its plan to raise interest rates a full percentage point this year. On March 16 it signaled it would raise rates

only by half that much, if that. This was driven not by any change in the U.S. economic data but by a desire to pre-empt some of the Fed's newfound fears.

In a speech last week, <u>Janet Yellen</u> emphasized her concerns about <u>global growth and</u> markets' expectations of too-low inflation. "If I am seeing a downgrading of the outlook for global growth...we'd want to get ahead of that development," she said.

It would be too strong to call this a new "Fed put," a commitment akin to a financial derivative that protects investors against losses. Nonetheless, the Fed's new posture suggests a greater willingness to risk inflation breaching its 2% target in order to prevent worse scenarios for the global economy. That's a new—and invaluable—safety net.



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The dollar's rally has stemmed investors' emergingmarkets exodus in recent weeks. Here, a currency exchange store in Hong Kong earlier this year. *Photo: Xaume Olleros/Bloomberg News* The Fed's shift has halted the capital outflows that had pushed emerging-market currencies down. In February, foreign purchases of emerging-market stocks and bonds turned positive for the first time in eight months and in March hit a 21-month high, according to the Institute of International Finance. Indeed, the PBOC has guided the yuan higher since mid-February.

Stable commodity prices could signal a nearterm recovery for exports and manufacturing production world-wide. Purchasing-manager surveys show that industrial activity around

the world accelerated modestly in March, according to J.P. Morgan Chase. In the U.S., it is growing again after five months of contraction. That suggests the first quarter—when the U.S. economy probably grew less than 1% annualized, and the world just 2%—might be the bottom.

This will likely be nothing more than a return to the sluggish postcrisis rates of growth: 2% in the U.S., 3% globally. U.S. officials had no doubt hoped for more out of their Shanghai summit, but it's a lot better than the recession or crisis that seemed all too possible in January.

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