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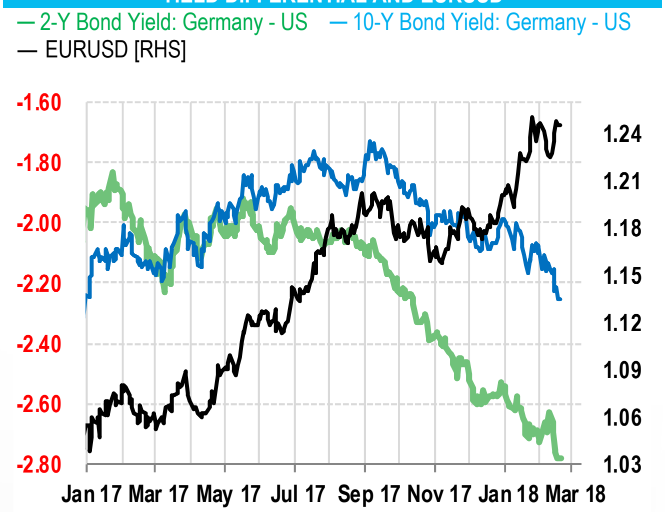
US: playing with privilege

■ Fiscal reflation in a full employment economy makes it very likely that the US current account deficit will increase alongside the budget deficit ■ Despite rising bond yields, fuelled by the prospect of increasing budget deficits and monetary tightening, the dollar has weakened ■ A possible interpretation is that the privilege of the dollar as a reserve currency is under pressure

Is the "exorbitant privilege" of the US of having the dollar as the global reserve currency on the wane? Only time will tell: after all, changes in the international role of a currency materialise very slowly. Yet, there is some reason for concern. The US policy mix for this year and next consists of an expansionary fiscal policy and gradual tightening of monetary policy marked by a higher policy rate and a reduction in the balance sheet of the Federal Reserve. This has already and should continue to put upward pressure on US bond yields. The interest rate differential with German bond yields has widened, but since September last year this has been accompanied by a strengthening of the euro versus the dollar. Eurozone specific factors play a role (speculation of the ECB adopting a more hawkish tone sooner rather than later, the euro is still considered to be below fair value) but perhaps it also reflects concern about the short and long term consequences of current US policy. In the short run, fiscal reflation in a full employment economy makes it very likely that in conjunction with the budget deficit the current account deficit will also increase: corporate tax cuts should boost investment, at least to some degree, and households will not be inclined to increase their savings rate, given their near term confidence about the future. Rising "twin deficits" need to be funded. So, to attract capital higher rates are needed. A weaker currency can also help to the extent that investors think that the dollar, having become undervalued (which is not yet the case today), will strenghten subsequently. For the longer run, there could be concern that the US, is spending its fiscal policy leeway today by running large budget deficits at the peak of the cycle. This would mean it will be forced to run even bigger deficits and accept a significant increase in the debt/GDP ratio when the next downturn hits. In addition, in such a scenario it might force the Fed to adopt an even more aggressive monetary policy, with ensuing risks for the inflation objective part of its mandate (risk of an inflation overshooting). Under this interpretation, as a long term consequence of the current policy mix, the privilege of issuing the reserve currency would become more constrained than has been the case hitherto with an ensuing impact on the level of bond yields and the dollar.

YIELD DIFFERENTIAL AND EURUSD



Source: Thomson Reuters, BNP Paribas

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