IT BEATS the Oscars any day. For months, markets have been giving odds on who would replace Alan Greenspan when he retires at the end of January after 18 years as the world’s super-banker. The name that George Bush came up with on Monday October 24th was hardly a surprise: Ben Bernanke, once Princeton professor, recently Federal Reserve governor and currently chairman of the Council of Economic Advisers, was the odds-on favourite. But it did much to cheer dollar bulls. Waiting for the news to be made official, the greenback skidded as investors were forced to face Mr Greenspan’s official mortality. Hearing his successor, it rallied. Is Mr Bernanke good for the dollar?

Something certainly is. The currency has gained more than 10% this year, hitting a two-year high against the yen last week and a three-month peak against the euro. This is despite an American current-account deficit even wider than last year’s and apparently reduced enthusiasm among Asian central banks for dollar-denominated assets. Buttonwood was among those early in the year who expected the dollar to go every which way but up. How wrong can a columnista be? Why didn’t the currency behave as she told it to? Don’t deficits matter?

The answer seems to be that they do, but only when relative returns are not compelling and other news looks likely to be gloomy too. Coming into 2005, the dollar had been sliding, broadly since 2002 but specifically since the summer of 2004. Investors were worried that global economic growth, the highest in 20 years, was set to slow along with America’s. Asian central banks were propping up the US Treasury market, in an attempt to keep their own currencies from appreciating, and the word was that they wanted to diversify away from dollars. Though the Fed had started raising short-term rates in June 2004, the difference between the yield on three-month dollars and that on three-month euros was still only 17 basis points (hundredths of one percent) in December. The dollar kept slipping and, with their eyes on America’s mountainous trade and fiscal deficits, a lot of people bet against it, including Warren Buffett.

How different things have been in 2005, thanks mainly to the widening gap between American interest rates and those of most other big developed countries. Despite hurricanes, higher oil prices and indeed higher interest rates, America’s economy has grown more strongly than most people expected. And Mr Greenspan’s
Fed has shown an increasing amount of anti-inflationary zeal: it has raised the federal-funds rate 11 times, to 3.75%, and is likely to do so again on November 1st. In the slow-growing euro area, by contrast, the European Central Bank (ECB) has left its rate untouched at 2% for more than two years, while the Bank of Japan is still looking at virtually free short-term money. So investors have stopped worrying about America’s deficits and started salivating over the returns it offers.

Then there is the vanishing central-bank scare. Those who feared that Asian central banks would get tired of buying depreciating dollars, causing the currency to collapse and long bond yields to shoot up, have also had to think again. Though official statistics capture only a fraction of what the banks do with their fast-growing foreign-exchange reserves ($2 trillion higher since 2000), central banks are certainly a shadow of their former selves at Treasury auctions these days. The dollar has strengthened nonetheless, and ten-year bond yields are only a little higher than a year ago. Now that dollar bonds look a plausible investment, the central banks that used to buy them to foster their own export-led development have been able to retire, while private investors have stepped up to the plate.

So too, intriguingly, have the oil-exporting countries, whose current-account surpluses—far larger than China’s—cast a long shadow over financial markets these days. The impact of petrodollars on the ordinary sort is hard to pin down. Economists at Credit Suisse First Boston, for example, have calculated that for every increase of $10 a barrel in oil prices, the daily demand for dollars just to carry out transactions increases by $300m (though other transactions may be crowded out because energy-consumers don’t have money for both).

More important is where the petrodollars end up invested. Though credible figures are elusive, a fair whack has certainly found a home in dollar-denominated assets, some in corporate bonds and some in short-term paper. In the longer term, much of it will flow to Europe and Asia—to Germany, for example, which exports the kind of capital equipment the Gulf states need to develop their infrastructure. For the moment, however, the sharp rise in oil prices this year may well have helped the dollar.

Other circumstances, too, are boosting the greenback. The Homeland Investment Act offers American firms a tax break if they repatriate foreign earnings held abroad by the end of this fiscal year and use them for vaguely-defined useful things. After a slow start, more companies are showing interest. The total brought back is likely to be some $200 billion-300 billion, reckons Thomas Stolper, global market economist at Goldman Sachs, and about a third of it will have to be converted to dollars. There is probably another $30 billion still to come through the foreign-exchange markets. And another point: China’s mini-revaluation in July made it clear that the dollar had nothing to fear for the moment from a significant Asian realignment.

**Handle with care**

Yet if all this sounds too Goldilocks to be true, it probably is, for a couple of reasons. Any big upward movement in the dollar’s exchange rate is probably limited by the perception that there are sellers of dollars out there waiting for right price (central banks, especially). “Non-commercial traders” have longer net positions in dollar futures than almost ever before, on figures from the Commodity Futures Trading Commission—always a bad sign. As the dollar strengthens, American investors themselves are pouring money into foreign markets, which in time could blunt the greenback’s rise. Some of Japan’s normally risk-averse investors are stripping off their currency hedges to capture higher yields in America; they could flee at the slightest sign that the dollar is in trouble or Japan’s economic recovery is finally starting to lift the yen. And the euro has lost 12% in value since the beginning of the year. If the ECB starts raising interest rates in the first half of next year just as the Fed stops, it might gain it back.

So though many on Wall Street have raised their forecasts of where the dollar will be trading three to six months from now, fewer are as sanguine about the outlook in a year’s time. Much will depend on how Mr Bernanke handles his inheritance and how he is perceived to handle it. He has received a rare unanimous welcome from economists and politicians and, tellingly, from former students. But only time will tell whether he is as tough on inflation as his predecessor (who perhaps talked a better game than he played). He may well find the federal-funds rate at 4.25% when he takes office: high enough to do damage if the next move is the wrong one. For now, he has won the prize, and the plaudits. But he has miles to go before he sleeps.

**Send comments on this article to Buttonwood (Please state whether you are happy for your comments to be published)**
Read more Buttonwood columns at www.economist.com/buttonwood

Copyright © 2005 The Economist Newspaper and The Economist Group. All rights reserved.