If the dollar dives, what will happen to America's interest rates?

WHEN policymakers and pundits debate America's current-account deficit, the phrase "hard landing" is never far from their minds. It sums up what might happen if foreigners tired of financing the gap, now over 6% of GDP: a sinking dollar, soaring interest rates, tumbling asset prices—all dragging America's economy into recession.

Optimists, including Alan Greenspan, chairman of the Federal Reserve, think that all this is pretty unlikely. It is far more probable, they say, that America's imbalances will come right gradually, via a (gently) weakening dollar and slower demand growth at home. More pessimistic observers fear that the risk of a hard landing is rising. Some of these point to the financial crises that hit several emerging markets in the 1990s, in which currencies collapsed and interest rates climbed as foreign investors fled. The same could happen in America, they worry, once foreigners sour on Uncle Sam.

So far, the optimists have had the better of it. Foreigners have carried on lending to America, and at low rates of interest. Although the dollar has weakened, it has not crashed. But what if it did sink suddenly? Then, surely, the hard-landing logic would come into play: bond yields would rise sharply as investors demanded compensation for the risk of higher American inflation and further falls in the dollar.

Or maybe not. In a new paper*, Joseph Gagnon, an economist at the Federal Reserve, takes issue with this argument. It is true, he says, that currency crashes in emerging economies have sent interest rates soaring. And it used to be true of rich countries, too; but in the past 20 years their experience has been rather different. Since 1985, every industrial country whose currency has crashed—defined by Mr Gagnon as a depreciation of at least 8% in the first year and over 20% in two years—saw its bond yields fall, by 1.5 percentage points on average, the following year. Nor did bond yields rise much in anticipation of a currency's troubles: Mr Gagnon finds an average rise of only one-fifth of a percentage point in the year before a currency crash.

Mr Gagnon ascribes this change in rich countries' experience to the taming of inflation. A weaker currency might boost bond yields if investors fear higher inflation, or if they think monetary policy might be tightened to combat it. Yields might also be pushed up because investors fear further depreciation, or suspect that borrowers—in particular, the government—might default on their bonds. In rich countries, however, the default risk is remote, since rich countries issue debt mainly in their own currencies, so that the real burden of repaying debt does not rise after a depreciation. What really matters is the inflation risk, and this has become much less of a worry in the past 20 years. If inflationary expectations are falling, the link between tumbling currencies and rising bond yields may be weakened.

And another thing

Mr Gagnon's paper is one of several recent studies by Fed economists that dispute much conventional,
pessimistic analysis of America's current-account deficit. Another†, by Hilary Croke, Steven Kamin and Sylvain Leduc, finds "little evidence" that shrinking current-account deficits in rich countries were accompanied by both sharply weaker currencies and recessions. Sometimes, the shrinking of a deficit went with a downturn—but with neither a plunging exchange rate nor rising interest rates. Sometimes, the currency dropped as the deficit narrowed—but then economic growth was strong. History suggests that not everything goes wrong at once.

Such studies might suggest that it is time for the pessimists to quell their fears. Or they might be a sign that the Fed's researchers are as sanguine as its officials, perhaps unwisely. Which?

Both studies may overstate the relevance to America of the other rich countries' experience. The sheer scale of America's economy and its borrowing may make it a case apart. In addition, American interest rates are already unusually low and although expectations of inflation are low and stable, they are not falling. A sharp fall in the dollar could therefore push inflationary expectations up. Perhaps most important is the role of foreign central banks, especially in Asia, in financing America's current-account deficit. Their willingness to devour American bonds has helped hold down American interest rates—maybe, reckon some, by two percentage points. If the central banks lost their appetite, the dollar could tumble while interest rates rose.

But Mr Gagnon has a counter-example. In 1997-98, Australia's dollar tumbled. Net foreign purchases of the country's bonds, worth 5% of GDP in 1996, turned into an outflow of 1% in 1998. Yet bond yields fell by more than two percentage points, partly because of the inflation-fighting reputation of Australia's central bank, but also because investors were worried about the country's growth in the wake of the Asian financial crisis.

The point is that there is no mechanical connection between currency crashes, long-term interest rates and the hardness of a landing. A fall in the dollar when America's economy was at full tilt ought to boost exports and might cause the economy to overheat; interest rates might rise, but no recession would ensue. Or a fall in the dollar might be the product of a slowdown—if, say, America's consumers stopped spending. Then lower, not higher, interest rates could ensue. Mr Gagnon has not refuted the idea that America could have a hard landing; but he has exposed some loose thinking on the subject.
