Questioning the Dollar

In the near-term, the stars are aligned against the US dollar. Sentiment is decidedly negative. If the news stream is good, we are told investors are less risk averse and do not need the dollar's security. If the news stream is poor, we are told the US is in horrific shape and the budget deficit and Fed's balance sheet will swell even more.

It is difficult to see what will break this psychology in the coming weeks. The euro could rise toward $1.4600-$1.4800, with sterling headed toward the mid-$1.60s. The dollar also looks poised to fall into the low JPY90 or high JPY80s.

Yet despite the likelihood of these near-term dollar losses, we are reluctant to substantially alter our more constructive medium term outlook. It may be helpful to put our views in the context of questions often asked.

Question 1: How can you offer a constructive view of the dollar when the US government is acting like it has an unlimited checking account and the Federal Reserve is abetting them by rapidly expanding its balance sheet?

The aggressiveness of the US policy response needs to be understood within the current financial and economic crisis, which is of historic proportions. A strong policy response is important and it can make a difference in the magnitude and duration of a crisis. The strong policy response from government officials and the dramatic liquidation of inventories should help the US economy find steadier footing in the coming quarters. The sooner the US economy begins to expand; the sooner the government and Federal Reserve can withdraw or otherwise unwind some of their emergency measures.

Question 2: But the cost of that policy course will be inflation and won't that debase the dollar?

Inflation could be a problem in the future, but the immediate risk is just the opposite. Policy makers and many economists believe that undesirably low inflation or outright deflation pose a greater risk as the de-leveraging process continues.

Question 3: The Fed is creating reserves (money) and the government is spending hundreds of billions of dollars. Why won't that fuel inflation?

The answer lies in how you understand inflation and in some way pits the monetarists against the Keynesians. To the extent that quantitative easing expands the Fed's balance sheet and high power money, some monetarists will worry about inflation. The Keynesians, on the other hand, are not as worried about inflation because of the low levels of capacity utilization and rising levels of unemployment.

Question 4: Then isn't stagflation possible as in the economy remains in the doldrums and we have a dramatic increase in inflation?

US core inflation has been remarkably steady. Over the past 120 months, the prices of core personal consumption expenditures have increased at a year-over-year average rate of 1.8% and over the past 24 months, it has averaged 1.81%. This measure of inflation, often cited as the Fed's preferred, though not sole, gauge, has averaged 1.9% over the past year, and 1.78% over the past six months. The most recent data in March stood at 1.8%. If anything there has been some easing of core inflation pressures. The average monthly increase in the first quarter of this year was the lowest since the third quarter of 2007.

This is not simply backward looking. The point here is that there is no compelling sign that price pressures ought to be the main concern of policy makers. One can also look at inflation expectations, for which there are many different measures. The Fed and the ECB both cite the 5-year/5-year forward, which looks at market based instruments to uncover expectations for inflation not in the next five years, but for the five years after that, to offer a cleaner view of inflation expectations. The US measure stands around 2.45%. However, in Europe this measure picks up greater inflation expectations, with France, the proxy for the euro zone, standing at almost 3.10%, and the UK just below 4%.

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Question 5: What then do you make of Bill Gross's point that the dollar and US assets suffer amid concerns that the US sovereign debt rating could be downgraded in the future?

With all due respect to the famed investor, this assertion seems an unlikely narrative to explain the recent price action. Consider that recently a former Comptroller of the Currency wrote an op-ed piece which threatened that the US could eventually lose its triple-A rating if it did not quickly get its fiscal house in order. Since that op-ed appeared, Japan's foreign currency debt rating was cut and the outlook for Great Britain's debt was cut to negative from stable. According to IMF figures, the US government's debt-to-GDP was just above 60% going into this year. When S&P expressed its concern over the UK's debt outlook, it indicated that one of its considerations was that the UK's debt was approaching 100% of GDP. Roughly speaking, the US budget deficit for both this year and next will be little more than 20% of GDP, bringing the debt-to-GDP ratio to around 80%.

The point is not that this is good, but rather that many other countries are in worse situations. According to IMF data, last year Japan's debt-to-GDP was almost 200%, while Italy's was 104%. Germany entered this year with a debt-to-GDP ratio of 76.4% and France was at 65%. Moreover, Gross's claim seems incongruous with the fact that in the face of an actual change in the outlook for UK debt, sterling fully recovered from the initial sell-off and managed to make new highs against the dollar; and we are to believe this was on the distant prospect of a US downgrade.

One would not know by the rhetoric, but the risk of default by the United States, judged by the cost of a 5-year credit default swap, has fallen by nearly 40-50% this year. Even as the budget, bailout, and Fed's bond purchases expanded, default risk remains lower than for almost every other country. However, there have been some unusual anomalies, like the time recently when the cost of insurance for one or a few individual companies was lower than for the US government.

Question 6: Surely you have to agree that with numerous central banks diversifying their reserves, the official supply of dollars will undermine it?

The demise of the dollar as the numeraire for the world economy is greatly exaggerated. The most authoritative data from the IMF suggests that until the last part of 2008, central banks as a whole were accumulating reserves. For two-thirds of the world's reserves for which the composition is reported, central banks held more dollars than ever before. In the last quarter of 2008, the IMF data shows an overall reduction of reserves, which appeared to be a function of valuation and, ironically, intervention to slow the dollar's rise. Federal Reserve custody holdings for foreign central banks rose roughly $94 billion in the final quarter of 2008, almost $80 billion in the first quarter of 2009, and have risen by more than $100 billion thus far in the second quarter.

US Treasury data is unequivocal: China increased its Treasury holdings by more than a third in the second half of 2008, has continued to increase holdings this year, and currently holds more Treasuries than ever before. No country has a monopoly on politicians whose declaratory and operational policies differ. Most recently, both Saudi Arabia and Bahrain reaffirmed a commitment to their dollar-peg currency regimes. South Korean and Russian officials have stated that they have no intentions to sell Treasuries. Ten years into the great experiment of our time, monetary union without political union in Europe, and the single currency is roughly the size of its constituent parts (ECU, the German mark and French franc), as a reserve currency.

By the ECB's own figures a little more than 50% of the euro-zone's exports are invoiced in euros. Likely the smaller half is mostly dollars, with a little sterling and yen thrown in the mix. The yen, backed by the world's second largest economy, has a small and, in recent years, diminishing share of world reserves. Only about a quarter of its imports and a little more than a third of its exports are invoiced in yen. The recent buzz about China and Brazil using their own currencies for bilateral trade was largely a market/media generated story with little official encouragement and of course, no action.

Question 7: Don't US policy makers really want a weaker dollar as a stealth form of default and to boost exports?

In testimony on May 21st, US Treasury Secretary Geithner specifically said he is committed to policies that sustain confidence in a strong dollar and US economy. Compare that with the Swiss National Bank, which has committed itself to preventing the appreciation of the Swiss franc to resist deflationary forces. Yet thus far in the second quarter the Swiss franc has appreciated by more than 4% against the US dollar. Since Geithner's confirmation hearings were he quoted campaign rhetoric about the Chinese currency, there simply is no evidence that the Obama Administration is seeking a weaker US dollar overtly or covertly. Of all the challenges the US economy faces, the dollar's exchange rate is not one of them.

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