

Greenback Omissions and Other Hot Air

In recent days, a number of numerous prominent people have warned of the downside risks facing the U.S. dollar.

Warren Buffet argued while aggressive U.S. monetary and fiscal policy response is necessary, Congress must bring spending back under control in a timely fashion or the ensuing inflation will undermine the value of the dollar.

Joseph Stiglitz, the former White House economic advisor and World Bank economist, warned of the downside risks to the dollar and wants a new international monetary regime because the current reserve system is fraying.

Curtis Mewbourne, portfolio manager at PIMCO, warned the dollar is losing status as the world's reserve currency. In a report on PIMCO's web site, Mewbourne explained, "While we have not yet reached the point where a new global reserve currency will arise, we are clearly seeing a loss of status for the U.S. dollar as a store of value even in the absence of a single viable alternative."

The Truth is Out There

The problem with most of this cant about the dollar is simply and factually wrong. Stiglitz and Mewbourne confuse assertions with arguments. The IMF is the most authoritative source of information about the currency allocation of reserve holdings. The data is unequivocal. The dollar's share of world reserves remains relatively constant at approximately 65%. There was a little bump up as the central banks prepared for European monetary union

The euro's present share of world reserves is roughly the sum of its original parts. In the early 1990s, the Deutsche mark, French franc, and ECU accounted for about 25% of the world's reserves, the same as the euro's share today. This is to say that the U.S. dollar and the European currencies and now the euro account for about 90% of the world's reserve currencies. Where is the evidence that the international reserve system is fraying as Stiglitz claimed?

The dollar remains the numeraire of the world economy. Energy, foodstuff, and fibers are priced and traded in U.S. dollars, even if Russia, Iran and Venezuela accept other currencies for their commodities. The lion's share of world trade is invoiced in U.S. dollars. The greenback is on one side of more than 80% of all foreign exchange transactions. Most countries continue to use the dollar as the key metric for their currency and intervene vis a vis the dollar. Where is the evidence that the dollar is losing its status as Mewbourne asserted?

It is Political Economy

Adam Smith, David Riccardo, Alfred Marshall and other classical and neo-classical thinkers thought what they were studying was political economy. Yet these days, many of critics seem to be engaged in crude economic reductionism. As the psychologist Abraham Maslow observed, "If all you have is a hammer, every problem looks like a nail."

The U.S. provision of the world's chief reserve asset, invoicing currency and unit of account is supported by many factors. One of the factors is the size, depth, and transparency of the U.S. Treasury market. There is no other bond market that comes close to it. The European bond market is too fragmented. The Japanese bond market is too insular and barriers to entry are great.

The Treasury market and dollar are also backed by the world's strongest military might. U.S. defense spending is nearly equal to the rest of the world combined. The U.S. also controls the seas. The U.S. naval tonnage exceeds the next 17 fleets together. As Josef Joffe points out in a recent Foreign Affairs essay, China, India, Russia, Japan, and the EU cannot individually or collectively conduct a major war 8000 miles from their territory. Since 1990, the U.S. has done it three times: twice in Iraq and once in Afghanistan.

The Future

Stiglitz and Mewbourne also are too one-dimensional in their thinking about the complex issue of the U.S. hegemonic status, of which the dollar as numeraire is but an expression.

The U.S. invests more in improving its human capital and research and development. The average education level in the U.S. is 12.3 years, the highest in the world. The U.S. spends around 6% of GDP on higher education, higher than China, India, Japan, Russia and Europe. Joffe cites research that places 17 of the top universities in the world in the

U.S. and 39 of the top 50. In contrast, China's top three are in the 200-300 placed rankings.

The U.S. spent 2.68% of its GDP on research and development in the first half of the decade, according to the most recent UN data. Proportionately China spent a little more than half of that, and Russia even less. The U.S. devotes a greater share than all but a small handful of countries (Israel, Sweden, Finland, Japan, and Iceland).

The idea that the U.S. has lost its innovative edge and no longer produces goods is simply absurd. Last year, one U.S. company alone received more patents than China—IBM. It takes fewer workers to produce more goods. There are fewer Americans employed in manufacturing than at any time in the past 58 years, though output has risen, only reaching a peak when the economy did in the 2007-2008 period. It is called productivity.

University of Michigan Professor Mark Perry, drawing on data from the Federal Reserve and Bureau of Labor Statistics, notes that U.S. productivity reached a record high in July 2009 with each worker producing \$223,000 of output (in constant 2000 dollars). Each worker's output is equivalent to that of three people in the mid-1970s and the output of two in the mid-1980s.

Supply and Inflation

Warren Buffet's concern is different than those of Stiglitz and Mewbourne. He does not make unsubstantiated claims. He simply observes that the deficit spending that he approves of to address the crisis has limits. He fears that the politicians will not have the backbone to cut spending on the other side of the crisis. Getting toothpaste out of the tube is easy. Putting it back in is the difficult part.

Milton Friedman famously noted that inflation was always and everywhere a monetary phenomenon. For Buffet, inflation is a political phenomenon. It can be a politically expedient way to reduce a debt burden in lieu of the less tasteful reduction in spending or raising taxes.

While Buffet may be the most savvy investor of our time, but when it comes to macro-economics, he demonstrates a firm grasp on the obvious. That the U.S. government is borrowing an incredible sum of money and the Federal Reserve is purchasing nearly \$2 trillion of long term securities has been known for months. There was no real new information or insight in his argument.

Knowing full well the facts, here is what the market has done. In the past six months, with a deluge of supply and evidence that the economy has stabilized, the 10-year Treasury yield has risen 45 basis points. New supply has been fairly smoothly absorbed by a wide range of investors.

At around 3.45%, the yield is only about 20 basis points more than the perceived to be more prudent Germany, the benchmark for the euro zone. The U.S. 10-year yield is a few basis points less than what the French government must pay. The spread between the U.S. and Germany is tighter than the spread between Germany and France, who of course share a common currency.

There are many ways to monitor inflation expectations. The five-year/five-year forward (in essence taking a five year forward of the 10 year TIPs last five years), which has been cited as a good indicator by both the Federal Reserve and European Central Bank, is hovering around 2.5% for the U.S. This is around where it traded quietly in 2007 and most of 2008. The French five-year/five-year forward, the proxy for the euro zone since Germany's is less liquid, is about 25 basis points higher.

It seems only prudent to be concerned with the vast amount of debt the U.S. is taking on. Between the fiscal year just ending and the fiscal year about to begin, the Obama Administration has warned of a combined deficit of something near 25% of GDP.

It should be a bit comforting for Buffet and ourselves that the U.S. government debt was a significantly smaller part of our GDP than most of Europe and Japan before the crisis hit. Japan's gross government debt is approaching 200% of GDP, incidentally, and their problem has not been inflation but it's opposite.

As of the end of the first quarter of 2009, as the stock market was forming a bottom and house prices were still falling rapidly, household net worth—that incorporates assets as well as liabilities—stood at more than 3.5 times larger than GDP at \$50.4 trillion. This is a painful economic crisis but it is not existential in nature.

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