The Dollar in the Year since Lehman's Demise

The Stage is Set

The U.S. dollar has been trending lower since late 2000, around the time the U.S. Treasury last authorized intervention and that was in conjunction with other major countries to support the euro. This trend should be understood, at least in parts, as the unwinding of the dollar's gains, which some argue were overshoot, from the second half of the 1990s.

The dollar did enjoy a one year rally in 2005, arguably encouraged by the tightening of monetary policy as the Federal Reserve lifted its target for Fed funds from 1% in mid-2004, where it was for about a year, to 4.25% by the end of 2005, on its way to 5.25% by the middle of 2006.

The dollar's decline resumed in late 2005 and continued for the next two years. By late 2007, the price of the dollar in terms of a number of foreign currencies was further away from levels economists regard as "value" such as purchasing power parity and/or long-run (10-year) moving averages as it ever has been.

Before the end of that year, the dollar bottomed against the British pound and Canadian dollar (ironically half the G7 currencies). The dollar set a record low against the Swiss franc in March 2008, around the time Bear Stearns collapsed. At the time it looked as if the dollar also bottomed against the Japanese yen then, but it was to fall further before years end.

The dollar, however, continued to sell-off against the euro. In early July 2008, the ECB ill-advisedly (at the time and in hindsight) hiked interest rates and the euro rallied, briefly moving above the April high above $1.60 before coming off. In the two months between the euro's peak and the demise of Lehman, the major currencies declined sharply, with the euro and sterling falling about 10.5%, the Australian dollar slumping nearly 16%, the New Zealand dollar 13.5%; while the Norwegian krone fell 11.6%, the Swedish krona 11%. The yen fell by almost 3% and the Canadian dollar fell about 5.5%.

Fall of the House of Lehman

Many observers and investors can't understand why the government let Lehman fail after arranging the forced marriage of the much smaller Bear Stearns. Although public opinion had turned against Wall Street and there was much discussion of moral hazard issues at the time, it seemed to have little bearing on decisions that were made. Leave also aside the obvious fact, rarely discussed in mixed company that many of the institutions represented in those arduous meetings a year ago appeared, at least on paper, placed to benefit from Lehman's demise.

In the first instance the Treasury Department did not have the authority and the Federal Reserve lacked the ability. Recall the press reported that Lehman claimed greater assets than liabilities when filling for bankruptcy. Yet, ironically Lehman did not have sufficient collateral to borrow the sums it needed.

If there was a bigger Bear Stearns imploding, couldn't officials have found the equivalent of another J.P. Morgan? They did. Initially it was Bank of America, but Merrill Lynch managed to steal its affections. That left Barclay's, a willing suitor, but did not want Lehman's real estate portfolio. Some reports suggest that the close examination of Lehman's financials a year ago revealed it was over-valuing this portfolio by as much as $30 billion.

Barclay's sought a temporary guarantee by the British government until shareholders approved the take-over. The UK government refused and modern capitalism was driven to the edge of the proverbial abyss.

The special relationship said to exist between the U.S. and UK seems limited to the military sphere. Recall that in the early 1970s, it was Britain and France, not the Soviet Union, "Red China", or Cuba demanded more gold from the U.S. Treasury than President Nixon wanted to part with, causing a collapse of that modern capitalist system and Bretton Woods.

The Dollar

From peak the trough the euro lost almost a quarter of its value. Sterling lost more than a third. The Australian dollar crashed nearly 40% and the Canadian dollar by almost 45%. While most conventional explanations focus on the safe haven status of the U.S. dollar, we have been more persuaded by the de-leveraging aspect.

In the years that led up to the crisis, a wide array of investors financed their purchases by selling the dollar. To a lesser extent, the yen and Swiss franc were also used as funding currencies. As participants unwound these positions

Marc Chandler	212.493.8800
Win Thin	212.493.8361
Meg Browne	212.493.8744
Audrey Childe-Freeman	44.207.614.8791

and leverage was reduced, willing or under direction of one's creditors, short dollar positions had to be covered. This process was well underway before Lehman's failure.

Standing conventional wisdom, which claimed a surfeit of dollars, on its head, the greenback soared because there was a shortage of dollars. This was especially true in Europe and a handful of other countries, including Mexico, Brazil, South Korea and Russia. Several countries in eastern and central Europe like Hungary and Poland relied more on the Swiss franc for funding and had to buy it.

As the body blow dealt to the financial system and the global economy by the collapse of Lehman was blunted by the dramatic expansion of monetary and fiscal policy, in concert even if not coordinated in any meaningful sense, the dollar has weakened.

After such a strong performance for three essentially three quarters, the dollar is arguably consolidating its gains. The worst performing major currencies have become among the best performing—the dollar-bloc, the Scandi-bloc and sterling.

Hair of the Dog

There are of course other drivers behind the price action than the price action itself. As the financial crisis has ebbed, investors have returned to the scene of the accident and have once again re-established dollar funding positions. The low short-term U.S. interest rates make the dollar an obvious choice as leverage is rebuilt and the appetite for risk returns.

Market participants have a penchant for exaggerating structural influences and under-appreciating the powerful cyclical influences. Many seasoned, astute investors and observers warn that the dollar's role in the world economy is diminishing. Despite the trillions of electrons, gallons of ink and acres of trees that have been employed asserting this as a fact, there is simply no compelling evidence that it is taking place or is responsible for the price action.

Consider central bank reserves, which are the subject of numerous claims by the declinists, but with little real examination. The IMF is the most authoritative source for data on the currency composition of central bank reserves. They report data with a quarter lag, so that it will not be until the end of this month that the IMF publishes Q2 2009 figures.

Here is what we know about what has happened for the last three quarters. Global currency reserves peaked in Q2 2008 just above $7 trillion. Of that amount, member countries have provided the IMF with the currency allocation of $4.43 trillion of reserves. Of this amount, $2.78 trillion were in dollars and $1.19 trillion worth were in euros.

In the following three quarters, two things happened that impacted the reserves. First, adjustments for the dollar's appreciation would lower the value of reserves for those countries that diversified away from the greenback. Second, as the dollar rallied some countries drew down their reserves to smooth the decline of their currencies.

At the end of Q1 2009, global reserves were valued at $6.53 trillion of which $4.06 was allocated. Both the dollar's share and the euro's share fell by $140 billion to $2.64 trillion and $1.05 trillion respectively. In percentage terms then the euro's decline was steeper than the dollars. The value of reserves that were not allocated fell by $110 billion.

Drilling down a little deeper reveals that advanced industrialized countries dollar holdings actually increased to $1.46 trillion at the end of Q1 2009 from $1.42 trillion at the end of Q2 2008. Among developing countries, where the currency allocation is not reported for an increasing share of reserves, dollar holdings fell by about $180 billion or 13.3% and the euro's holdings fell by $72 billion or about 11%.

The dollar's share of allocated reserves rose to 65% at the end of Q1 2009 from 62.8% at the end of Q2 2008. The euro's share slipped from 26.8% to 25.9%. While there has been some fluctuation, the world's central bankers collectively continue to vote with their nation's largess: the dollar's role as a reserve currency, an invoicing currency and a vehicle currency—as the world's numeraire remains unrivaled in the aftermath of the fall of Lehman.

Marc Chandler

Global Head of Currency Strategy