Economics Group

WELLS FARGO SECURITIES

Special Commentary

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What's Wrong with the Dollar?

Executive Summary

The dollar has followed a downward trend over the past six months, weakening against the currencies of other major economies and developing countries alike. Some observers claim that the dollar's depreciation reflects unease among foreigners about the U.S. fiscal outlook. However, there is very little evidence to support this hypothesis. Purchases of long-term U.S. Treasury securities by private foreign investors and foreign central banks have remained strong during the recent period of dollar weakness.

Rather, the depreciation of the greenback reflects, at least in part, an unwinding of the forces that propelled it higher last autumn. As the global financial system stood on the cusp of collapse, foreign purchases of short-term Treasury bills, considered by many to be the safest asset in the world, surged. In addition, foreign banks had to scramble for dollar liquidity as U.S. banks pared back their credit lines. Now that the global financial system has stabilized, net foreign purchases of low-yielding Treasury bills have weakened considerably as investors have gone in search of higher returns. In addition, American banks have started to reopen some credit lines to their foreign counterparts.

What could cause the dollar to turn around? Another increase in risk aversion likely would cause the greenback to strengthen, but even the most fervent dollar bull probably would blanch at the thought of another financial market meltdown. The dollar's best, and less psychologically stressful, hope probably lies in a truly self-sustaining U.S. economic recovery. A run of better-than-expected U.S. economic data would lift rates of return in the United States that would attract long-term capital inflows.

Greenback Resumes Its Slide

Does the dollar's slide reflect concerns among foreigners about the U.S. fiscal outlook?

After rising to a three-year high earlier this year, the trade-weighted value of the dollar has slid over the past few months (Figure 1). Not only has the greenback weakened against most major currencies—it has dropped to a 12-month low vis-à-vis the euro—but the dollar has also depreciated versus the currencies of many developing economies. Predictably, the financial press has been filled with renewed prognostications of the greenback's ultimate demise. A theory that has gained currency among some observers recently is that the weakness of the dollar since the beginning of the year reflects concerns among foreign central banks and foreign investors about the gaping federal deficit and/or fears of runaway inflation. Does this theory have any merit? If not, why is the dollar weakening again?

To make sense of the dollar's depreciation over the past few months we examine the U.S. balance of payments data, which measure transactions of U.S. residents with the rest of the world. We begin with the current account, which records transactions of goods and services.[1] After narrowing sharply late last year and early this year, the U.S. trade deficit has been essentially

[1] **The current account also includes transactions in investment income and worker remittances, but goods and services comprise the vast majority of the current account.**

stable since March (Figure 2). Therefore, it is hard to make a convincing case that the dollar's depreciation over the past few months is linked solely to a renewed deterioration in the U.S. trade position with the rest of the world.

Figure 1

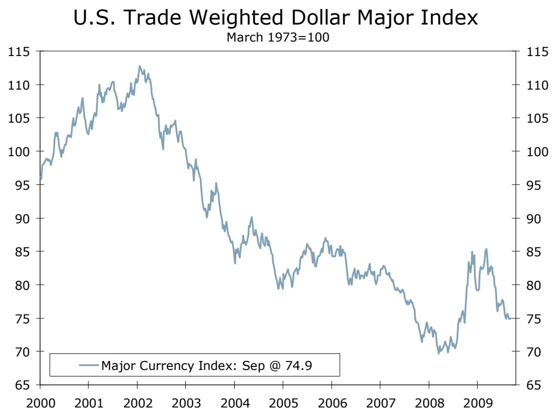
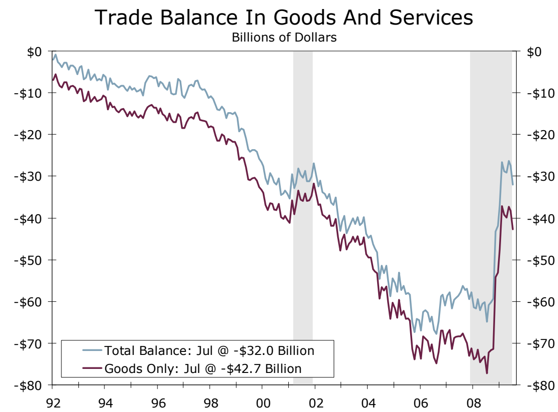


Figure 2



Source: Federal Reserve Board, Department of the Treasury, and Wells Fargo Securities, LLC

Increased Risk Tolerance Leads to an Outflow of Short-term Funds

Turning to the other side of the balance of payments, however, reveals a trend that goes further toward explaining the dollar's recent weakness. Namely, net capital inflows into the United States have been negative most of this year (Figure 3). The combination of a modest trade deficit, albeit one that has not changed much in recent months, and net capital outflows from the country has exerted downward pressure on the dollar.

Safe-haven purchases of short-term Treasury bills are reversing.

So why has capital flowed out of the country over the past few months? Figure 3 shows that there are three asset classes in which net capital inflows have either turned negative or have weakened this year. First, net purchases of short-term securities have weakened significantly. Foreign purchases of U.S. Treasury bills, which are considered the safest and most liquid securities in the world, jumped by $380 billion in the second half of last year when the global financial storm was raging.[2] However, governments took steps to stabilize the global financial system, leading investors to become more tolerant of risk again. Rather than continuing to purchase low-yielding Treasury bills in droves, foreign investors are searching for higher yields elsewhere, which often can be found in their own countries.

Foreign banks had to scramble for dollar liquidity last autumn.

Second, U.S. banks lent hundreds of billions of dollars to foreign banks when the good times were rolling earlier this decade. However, as the credit crunch gathered force in the second half of last year, U.S. banks largely refused to roll over their credit lines (see light blue bars in Figure 3). Foreign banks were forced to scramble for dollar liquidity, which contributed to the dollar's appreciation at that time.[3] Now that financial markets have stabilized, U.S. banks are starting to reopen credit lines to their foreign counterparts and funds are beginning to flow out of the country again.

Therefore, the depreciation of the greenback this year reflects, at least in part, an unwinding of some one-off factors that led to dollar strength between July 2008 and March 2009. The spike in risk aversion led foreign investors to seek the safety of U.S. Treasury bills, and the credit crunch caused foreign banks to scramble for short-term dollar financing. Now that financial markets have stabilized, foreign investors are favoring higher yielding assets at the expense of low-yielding

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[2] **Treasury bills are classified as short term securities because they have a maturity of one year or less.**

[3] **The unprecedented surge in demand for dollar liquidity caused LIBOR rates to spike during the credit crunch. In response, the Federal Reserve significantly raised its swap lines with foreign central banks so that these institutions could extend dollar liquidity to their respective commercial banks.**

U.S. Treasury bills. In addition, the scramble for dollar liquidity has subsided as U.S. banks are reopening some credit lines to foreign banks.

Figure 3

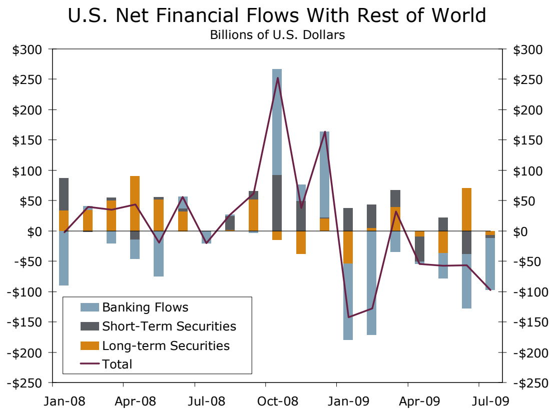
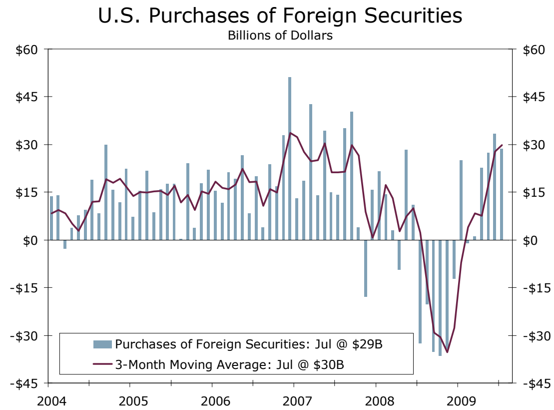


Figure 4



Source: Department of the Treasury and Wells Fargo Securities, LLC

Net Inflows of Long-Term Securities Have Also Weakened

The behavior of net purchases of long-term securities, which is the difference between foreign purchases of U.S. securities and American purchases of foreign securities, has also contributed to the downward pressure on the dollar over the past few months. Indeed, net purchases of long-term securities have been negative for most of 2009 (see dark blue bar in Figure 3). Purchases of foreign securities by U.S. residents turned sharply negative in the second half of last year as the global financial crisis deepened in the wake of Lehman Brothers' bankruptcy (Figure 4). That is, shell-shocked American investors liquidated some of their holdings of foreign securities that were built up before the crisis. However, as American investors have become more tolerant of risk in recent months they have dipped their toes back into foreign financial markets to realize higher rates of return. Indeed, U.S. purchases of foreign securities recently returned to pre-crisis levels.

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On the other side of the ledger, foreign purchases of U.S. long-term securities have weakened this year. In the first seven months of 2009, foreign investors bought $279 billion worth of long-term American securities, down from $462 billion they purchased during the same period last year. This drop in overall foreign purchases of long-term U.S. securities reflects net sales of agency securities and corporate bonds (Figure 5). Agency securities include the obligations of Fannie Mae and Freddie Mac and the well-publicized problems with those two institutions have led foreign investors to refrain from purchasing their bonds. Securitized assets are included in the "corporate bond" category, and the weakness in foreign purchases of U.S. "corporate bonds" over the past two years reflects, at least in part, net sales of securitized fixed-income securities. In contrast, foreign purchases of U.S. stocks have strengthened from $28 billion in the first seven months of 2008 to $78 billion so far this year, and net foreign purchases of long-term Treasury securities have continued to trend higher.

Foreigners have been net sellers of agency securities and securitized assets this year.

Speaking of Treasury securities, some commentators fret that foreign central banks will soon become disillusioned with the fiscal prospects of the U.S. government and will start to sell their holdings of long-term Treasury securities. At the end of June 2008, foreign holdings of U.S. Treasury notes and bonds totaled $2.2 trillion.[4] The amount owned by foreign central banks ($1.7 trillion) accounts for nearly half of the marketable supply of long-term Treasury securities outstanding. Should foreign central banks begin to dump their holdings of U.S. government bonds, Treasury yields would surely spike higher, which would put upward pressure on other

[4] **The Treasury Department conducts a detailed annual survey of the outstanding amount of U.S. securities owned by foreigners. The next survey, which will show holding as of June 2009, will not be released until early next year.**

long-term interest rates. Wholesale liquidation of Treasury holdings by foreign central banks could clearly have some adverse consequences for the U.S. economy.

Purchases of long-term Treasury securities by foreign investors and central banks remain strong.

As measured by custody holdings at the Federal Reserve Bank of New York (FRBNY), however, foreign central banks continue to buy Treasury securities, at least through mid-September (Figure 6). The FRBNY data show that holdings of Treasury securities by foreign central banks have increased by nearly $300 billion since the dollar began to depreciate in early March. Yes, interest among foreign central banks for agency securities has waned since the summer of 2008, but so too has the interest among essentially everyone else. Purchases of long-term Treasury securities by foreign investors have not buckled either. Since March, foreign investors have bought $143 billion of long-term Treasury securities.

Could the interest among foreigners to buy U.S. Treasury securities wane as well? Absolutely. In our view, indications that the United States is not serious about addressing its long-run fiscal challenges could eventually lead foreign investors and central banks to reassess their willingness to continue financing U.S. government obligations. However, there is little evidence to date to suggest that that point has been reached.

Figure 5

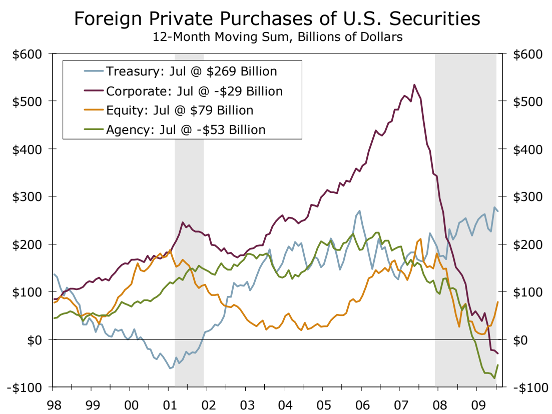
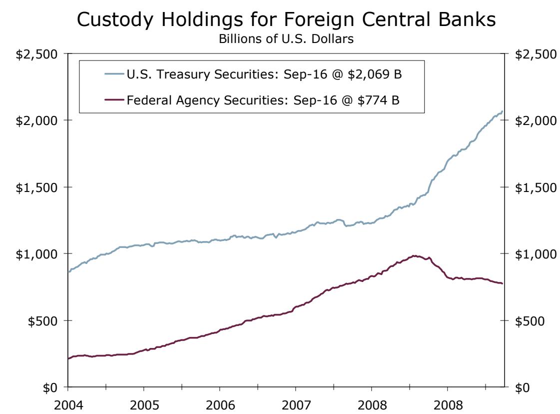


Figure 6



Source: Department of the Treasury and Wells Fargo Securities, LLC

Conclusions

We have shown in this report that the dollar's trend weakness over the past few months has been associated with a modest amount of net capital outflows from the United States. Some of the outflow simply reflects an unwinding of panic-driven inflows that occurred last autumn. Not only did foreign purchases of U.S. Treasury bills surge when the global financial system was on the cusp of collapse, but a scramble for dollar liquidity by foreign banks also caused the greenback to strengthen. Investors are now liquidating their holdings of safe, but low-yielding, Treasury bills in favor of higher rates of return that can be found in foreign countries, and U.S. banks are starting to lend again to their foreign counterparts. In addition, net purchases of long-term U.S. securities have weakened due entirely to fewer foreign purchases of agency securities and securitized assets.

What can reverse the dollar's recent slide? In our view there are two developments that have the potential to lead to a stronger dollar. First, a return of risk aversion among investors would likely lead to a partial replay of autumn 2008 when foreign purchases of U.S. Treasury bills surged and U.S. banks reduced their credit lines to foreign banks. However, even the most fervent dollar bull would probably not welcome another financial market meltdown. A less psychologically stressful road to sustained dollar appreciation would be an increase in rates of return on U.S. assets. A run of stronger-than-expected U.S. economic data would raise hopes that the recent bounce in U.S. economic activity will turn into a truly self-sustaining recovery. Not only would Treasury yields rise as expectations of eventual Fed tightening were ramped up, but returns on other U.S. assets likely would increase as well. Higher rates of return on dollar assets usually attract capital inflows that lead to dollar appreciation.

We are mindful of some downside risks that confront the greenback at present. First, the dollar faces some challenging technical factors including "the trend is your friend," and the current trend is clearly working against the greenback. As noted above, indications that the United States is not serious about addressing its fiscal challenges could be the catalyst that causes foreigners to significantly reduce their purchases of Treasury securities. Despite all the ink that has been spilled recently about the deterioration in the country's fiscal outlook, however, there is very little evidence to support the notion that foreigners, whether private investors or central banks, are refraining from buying U.S. Treasury securities at present.

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