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MONTHLY REVIEW



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Does the Dollar matter? The multi-trillion dollar game of chicken

I have just been reading an article about the decline of the US dollar describing the current period of weakness not as a collapse, but as a bear market. Indeed, the strength and direction of the world's only liquid reserve currency (we can hardly call SDRs liquid) have now become something of a preoccupation with economists, investors and politicians alike. Ironically, this has not been much of an issue for most Americans, who never leave their vast country and who therefore never come up against the reality of a weakened dollar buying less abroad. The rest of us, including the 325 million odd souls who make up the vast heterogeneous area known as the Euro zone, are only too aware of the impact of fluctuating currencies.

Does it really matter? And who loses or benefits from the movements in foreign exchange rates?

Entire forests have been decimated and the cybersphere has been jammed by the huge amounts of newsprint and blog space devoted in recent months to the end of America's economic and political power and its eclipse by a rising China. I think such predictions are a little premature and, more importantly, not relevant to the current conduct of US economic policy.

Anyone can see that the US stands to benefit from a significant decline in the value of the dollar as the cost of imports rises and US exports become more competitive. Not

only does a weaker dollar stimulate the domestic manufacturing sector – whose workers are key Obama voters – it also sends a timely reminder to America's trading partners, who have long benefitted at its expense by maintaining their own currency in an artificially weak position relative to the dollar. These countries now possess enormous dollar reserves, invested mainly in US government bonds yielding next to nothing. And the purchasing power of these reserves is falling, as these same countries are powerless to stop the dollar's weakening. They cannot sell their holdings of dollars without precipitating a massive one off appreciation in their own domestic economy, which would stop any recovery in its tracks, make their export sector uncompetitive and put millions out of work.

I think that, contrary to what we are being told, the balance of power remains firmly in the hands of the US. The Chinese and other significant holders of dollar assets are not going to sell all their Treasuries and US dollar holdings: the market would not be able to absorb the volume of sales without a very significant (read massive) price decline. In fact, these countries will remain **net** buyers of US dollars, as long as they maintain a policy that constrains the appreciation of their own currency.

In this game of chicken, we are still waiting for the US to blink.

The common refrain had historically been that the US should be concerned about the dollar's weakness and the massive

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holdings of Treasury notes and bonds by foreign Central Banks and governments, since these holders would *demand* a premium to hold US assets. This typically meant that US interest rates should be higher than other countries' interest rates in order to compensate investors for the expected currency loss – or risk of loss - that they would incur. A brief look at the 10-year yields for a range of countries suggests that this is simply not the case: US 10 Year Notes yield about 3.4 % versus Germany at 3.3 %, France at 3.6 % and the UK at 3.6 %...not much of a risk premium there!

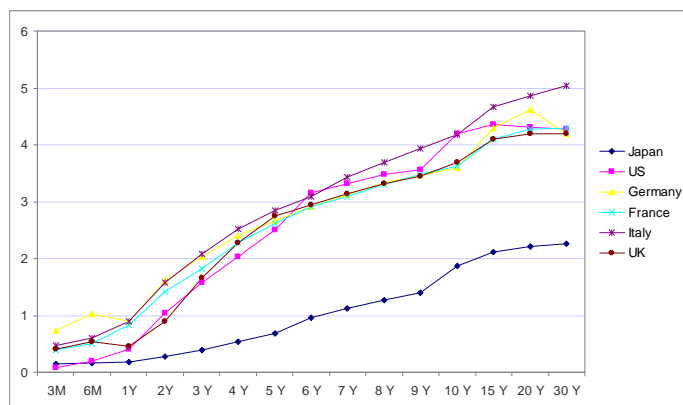


Figure 2. Domestic Yield Curves (2000-2009)
Source: Bloomberg

The US government is unconcerned (“my currency, your problem”) or probably even happy with the dollar’s current weakness. And the captive foreign holders of dollars might be displeased with this situation, but they have little choice but to accept it. After all, they created the sword of Damocles that now obliges them to maintain their currencies artificially weak. An ironic by-product of the credit crisis has been the development of Quantitative Easing (QE), which has led Central Banks to purchase government bonds and, some argue, to keep interest rates low. When your Central Bank is buying Treasuries, who needs the Chinese?

A noticeable by-product of the dollar’s weakness has been the strength of commodity markets and the surge in commodity prices *in US dollar terms*. Most commodity products – be they energy, precious metals or agricultural – tend to be priced in US dollars per predefined quantity.

As the dollar has weakened against a trade-weighted basket of other currencies to its weakest level in over two decades, the sellers of commodities have enjoyed substantial increases in the price of their product. For example, Gold’s recent break above \$1’000 per ounce is the highest ever price in US dollar terms. Yet, in Euro terms, the highest price of gold was back in 2008 and in Yens, Gold reached its peak last February.

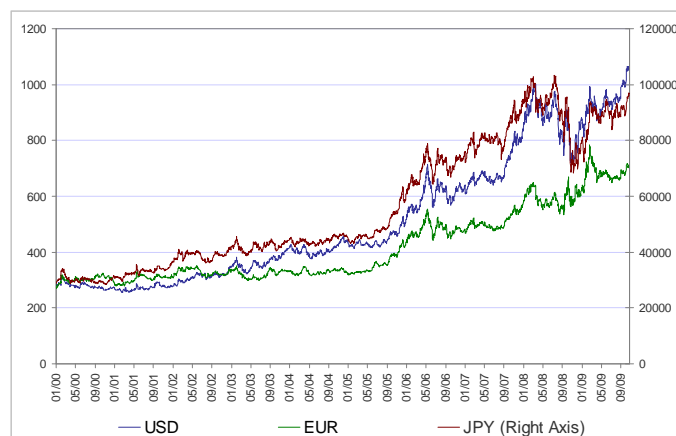


Figure 3. Gold Prices (2000-2009)
Source: Bloomberg

The US dollar does matter, of course. But what is interesting is that the level of the dollar matters to different people for different reasons. In the end, the US is able to influence the



Figure 3. Trade-weighted Dollar Index 1980-2009
Source: CrossBorder Capital, Bank of England

direction of their currency via crude levers of supply and demand. And they happen to be supplying lots of dollars as the balance sheet of the Federal Reserve expands. One day, this expansion will slow down and the price of the dollar may well reverse course. But for the moment, the value of the dollar happens to be a convenient and powerful weapon in the trade war with the largest external holders of US bonds.

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