

**Friday, February 8, 2008**

## **Strong Dollar policy: Is the Fed wearing the emperors new clothes?**

The Dollar is still widely seen as the world's reserve currency, namely the most secure, most liquid currency in the world today. However, anyone living in a country whose currency isn't pegged to the Dollar, ie most countries, will have lost a lot of money over the last few years if they have been holding the Greenback. Since the start of 2002 the US Dollar has lost 43% against the Pound, 40% against the Euro, 31% against the Swiss Franc and 37% against the Canadian Dollar. It's even depreciated against the Yen. For many investors, holding the reserve currency must seem like a license to lose money.

After slashing interest rates to 1% after the dotcom crash, another classic example of financial market mismanagement, the Fed has since raised rates until this year when it started cutting again. Even during this period of monetary tightening, the Dollar struggled to retain its value. The US Federal Reserve has maintained that it has a 'strong Dollar policy', which in terms of credibility ranks alongside those other famous US beliefs such as the existence of weapons of mass destruction in Iraq (remember those?) and that Elvis is alive. At the very least someone should inform the Fed that their policy doesn't seem to be working..... and that it would be difficult for someone as famous as Elvis to hide away for this long without being discovered.

In reality there are plenty of arguments to explain why the Dollar is so weak and why it is no longer needed as the world's reserve currency. Firstly, the US is the world's largest debtor country, having formerly been the world's largest creditor only a few years ago. It can be described as 'living beyond its means' and if it were a company it would probably be declared insolvent. In fact, the plummeting value of the Dollar means that the US is, in practise, holding a liquidation sale of its assets such as US treasuries, property and well known businesses, all of which can be bought at knockdown prices by the overseas investor.

Secondly, the Euro provides a handy alternative and is certainly liquid, tradable and relatively strong. Iran already sells its oil in the Euro denomination and other countries are at least considering making the switch. At the last OPEC meeting one of the microphones was left on after the press conference had finished and several ministers were unwittingly heard discussing the subject. Oil producers have been protected from the weak Dollar by rapidly rising oil prices but they probably can't help thinking how much richer they would be if the US and other countries were forced to pay for its oil in Euros.

Thirdly, if the Federal Reserve continues to print more Dollars each time the economy sags then the Dollar is simply going to be devalued even further. It goes against the laws of nature that something so abundant and easy to create, by simply printing more, should be used as a store of value. In the world of commodities it is the least abundant metals and energy products that are the most highly valued. Gold is doing a great job in its role as the anti-Dollar, with the price having nearly tripled in the last 5 years, because it is a store of value and because supply is limited. If we could master the art of alchemy and simply make gold whenever we wanted then a large part of its value would be lost. This is what has happened to the Dollar. I'm sure that the Federal Reserve Chairman was only trying to be colourful when he said they would drop Dollar bills from helicopters if the economy needed reflation but that comment is on a par with Gerald Ratner saying that his jewellery company's products were cheap because they were crap, a remark that caused sales to dry up and the company to go bust.

With the US possibly heading for a recession, after years of excess leverage that is now unwinding, the attraction of US assets is waning even further. The question now is "why would you want to invest in US Dollars at all?" There is no good reason; there are alternative currencies that are liquid, there are plenty of attractive foreign assets if you are in the mood for buying up a company and the US is no longer particularly welcoming to foreign ownership anyway, especially if you come from the Middle East.

The US is still considered the premier location for entrepreneurial activity and is the spiritual home of capitalism, materialism and the equity culture but in recent years it has become more of a leader in off balance sheet financial engineering, collateralised debt obligations and sub-prime lending. The spirit that once drove

the American Dream is looking a little tarnished and is facing some strong competition from other quarters such as Vietnam (rather ironically), China and India. If the fundamental reasons for investing in the States are becoming less clear then the demand for more Dollars is going to get a little thin. Even the Chinese have realised that it might have been prudent to spread their foreign currency reserves around a bit, having lost billions of Dollars whilst they watched the local currency value of their assets fall. Still, they are probably happy in the knowledge that they could dump their foreign reserves tomorrow and bring the US economy to its knees if they wanted. They probably won't do that, but they could, and it puts the Americans in a position of weakness.

So, at what point will the Federal Reserve admit it has a problem, and seek help? As Alcoholics Anonymous say, admitting you have a problem is the first step. But many alcoholics can't give up because they like drinking. And the Fed likes the fact that US exports are a lot cheaper if the currency is weaker, and therefore people start to buy more from them. But ultimately a weak currency is inflationary, as prices of imports rise and interest rates need to rise to attract capital inflows. America can't afford to raise rates now, at the end of history's largest credit boom, so it remains to be seen what solution they come up with. But if the Arab states or any other countries that are pegged to the Dollar decide to break those pegs, they will have to do something, or the Dollar will spiral out of control. At that point, make sure you are holding gold.