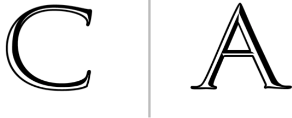

CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT: THE U.S. DOLLAR

August 31, 2001

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The U.S. Dollar

The real trade-weighted U.S. dollar (US$) reached a 16-year high in July of this year, but its more recent decline against other major currencies has led to speculation that this long dollar bull market may be over. (See Table A.)

Danger Signs

The massive size of current account deficit, now a record 4.5% of GDP, weighs heavily on the US$, and history generally has shown that currencies of countries with large current account deficits eventually depreciate. Economies that have an insufficient level of saving to support investment must either attract sufficient capital to run a capital account surplus, or support their deficit through spending down official reserves, or borrowing from agencies, such as the IMF. Ever-widening current account deficits can raise the debt-servicing burden to onerous levels, as economies must export an increasingly larger share of domestically generated income to offshore creditors.

Massive current account imbalances mean that the surplus countries hold an ever-growing share of their wealth in deficit countries. This is what has occurred in the United States, with about two-thirds of the world's net savings going to finance the current account deficit. Another ominous sign is America's increased dependence on portfolio inflows, as opposed to foreign direct investment (FDI). (See Table B.) Approximately two years ago, FDI accounted for $151.9 billion of foreign net inflows, while portfolio flows were $78.5 billion. Today, FDI is at $67.6 billion and portfolio inflows have increased to $124.4 billion.

Economists worry about the reliance on portfolio inflows because investors may lose their appetite for dollar-denominated assets if the severity or length of the U.S. slump exceeds expectations, prompting them to seek higher returns elsewhere. (This concern is usually framed in terms of non-U.S. citizens selling dollar-denominated assets, but U.S. investors, including hedge funds, might also sell these assets and invest abroad.) Significant sales of dollar-based assets could unleash a vicious cycle of dollar weakness, lower prices for equity and fixed-income investments, diminished economic performance, further falls in the dollar, and so on. In addition, should capital inflow begin to reverse, the Federal Reserve may have to raise interest rates to continue to attract investors, which could undo the benefits of its recent reflationary policies.

Overvalued? If So, Does It Matter?

It is difficult to unambiguously claim that the dollar's strength has harmed U.S. economic interests. Although the strong US$ hurts the export industry, especially the manufacturing sector, and reduces the value of U.S. foreign affiliates' profits in US$ terms, it holds down import prices, inflation, and interest rates, while also reducing the cost of FDI. Furthermore, if the dollar continues to weaken amid an overall deterioration in the global economy, U.S. exporters, while benefiting from a weaker dollar, could also get hurt from weak global demand.

A sharp fall in the US$ could be a contractionary force for the global economy because non-US$-based exporters benefit from the high value of the greenback. Many countries deliberately maintain a low value for their currencies in order to boost their exports, and it is highly likely that during a U.S. slowdown they will further depreciate their currencies in order to maintain their competitive advantage.

Why the Current Account Deficit May be Your Friend

In contrast with other deficit countries that must borrow foreign currency, the United States enjoys the unique position of being able to finance its external deficit in its own currency by attracting sufficient foreign investment. In addition, some commentators, like the Bank Credit Analyst (BCA) argue that not all current account deficits are detrimental and draw a distinction between the forces underlying today's deficit and the deficit during the first half of the 1980s. According to BCA, in the first half of the 1980s, the U.S. current account deficit grew because national savings dropped faster than investment as a percent of GDP. The deficit was driven by a rise in consumption, as evidenced by the sharp increase in consumer goods as a percentage of total imports. In addition, at that time non-U.S. citizens were reluctant to invest in long-term US$-denominated assets because they were not confident about the U.S. economic outlook. Therefore, the deficit had to be financed by short-term capital flows and central bank purchases. These sources cannot finance a large current account deficit for very long because they require higher domestic interest rates and ongoing central bank intervention.

According to BCA, today's current account deficit has been driven by very different factors: the increase in investments at a faster rate than the increase in national saving and the stabilization of consumer goods as a percentage of imports ("national saving" includes government saving and private saving). Therefore, today's current account deficit is a product of the investment boom, not of a consumption boom as in the early 1980s. A current account deficit caused by an investment boom is a healthy deficit, BCA argues, because it at least holds out the prospect that the United States will earn a rising return on assets that will help to service the increase in foreign debt. Because the strong US$ has been driven by

relatively attractive returns on capital, the United States does not need to rely on short-term intervention or central bank intervention to finance the deficit, as it did during the first half of the 1980s.

Another factor that sheds doubt on the perception that the US$ is significantly overvalued is the fact that its economic fundamentals remain strong. Despite the ongoing slowdown, the United States has thus far not lost its competitiveness. Its share of exports has held up relatively well, compared with the 1980s. Despite the rising dollar during the 1990s, U.S. manufacturers far outpaced their global competitors, increasing their share of global markets at the expense of competitors. In the beginning of the 1990s, the United States accounted for 12.2% of world manufactured exports, and by 1999, 13.7%. In contrast, Germany's global share of manufactured exports fell from 15.7% in 1990 to 10.8% by 1999, while Japan's global share slid from 11.5% to 9.4% in 1999.

What Can Challenge the US$?

For the US$ to fall on a secular basis, not only must its economic slump be more severe and protracted than expected, but another currency (or gold, possibly) must step forward to replace the greenback. However, the U.S. economy remains the world's preeminent economy and most significant investment arena. The euro is unlikely to supplant the US$, at least over the near-term, because Europe's economic growth and fundamentals are weak relative to those of the United States, while its transition to a unified monetary union has thus far been singularly unimpressive. Furthermore, with regional officials being more concerned with containing inflationary pressures than with stimulating economic growth, it is unlikely that Europe will assume the mantle of the world's locomotive. The Japanese yen is also unlikely to supplant the US$ because the economy's outlook grows ever bleaker, and many economists believe that Japan needs a weaker yen to jump start the economy (see the Developed Markets Comment in this month's *Market Update* for a more in-depth look at the yen). Until overseas economies grow stronger on a relative basis, the US$ is unlikely to decline significantly. That said, however, it is possible that a weaker dollar will allow Europe the flexibility to lower interest rates, which could generate easier monetary conditions worldwide and possibly launch a global reflationary drive.

While the above discussion makes the case that the US$ is unlikely to be supplanted by another currency, it also underscores the risks of a sharp drop in the greenback. The last time the dollar was seriously overvalued, the correction did little harm, primarily because the countries with appreciating currencies easily expanded their domestic demand. The current situation, however, seems more troubling because non-dollar countries have been experiencing difficulties in increasing demand through conventional policies, and they have not yet introduced plans for meaningful structural reform or unconventional policies, such as radical monetary expansion, to increase domestic demand. Economist

Paul Krugman argues that it is precisely the unwillingness of Europe and Japan to consider unconventional policies that constitutes the world economy's real source of vulnerability—not the value of the US$.

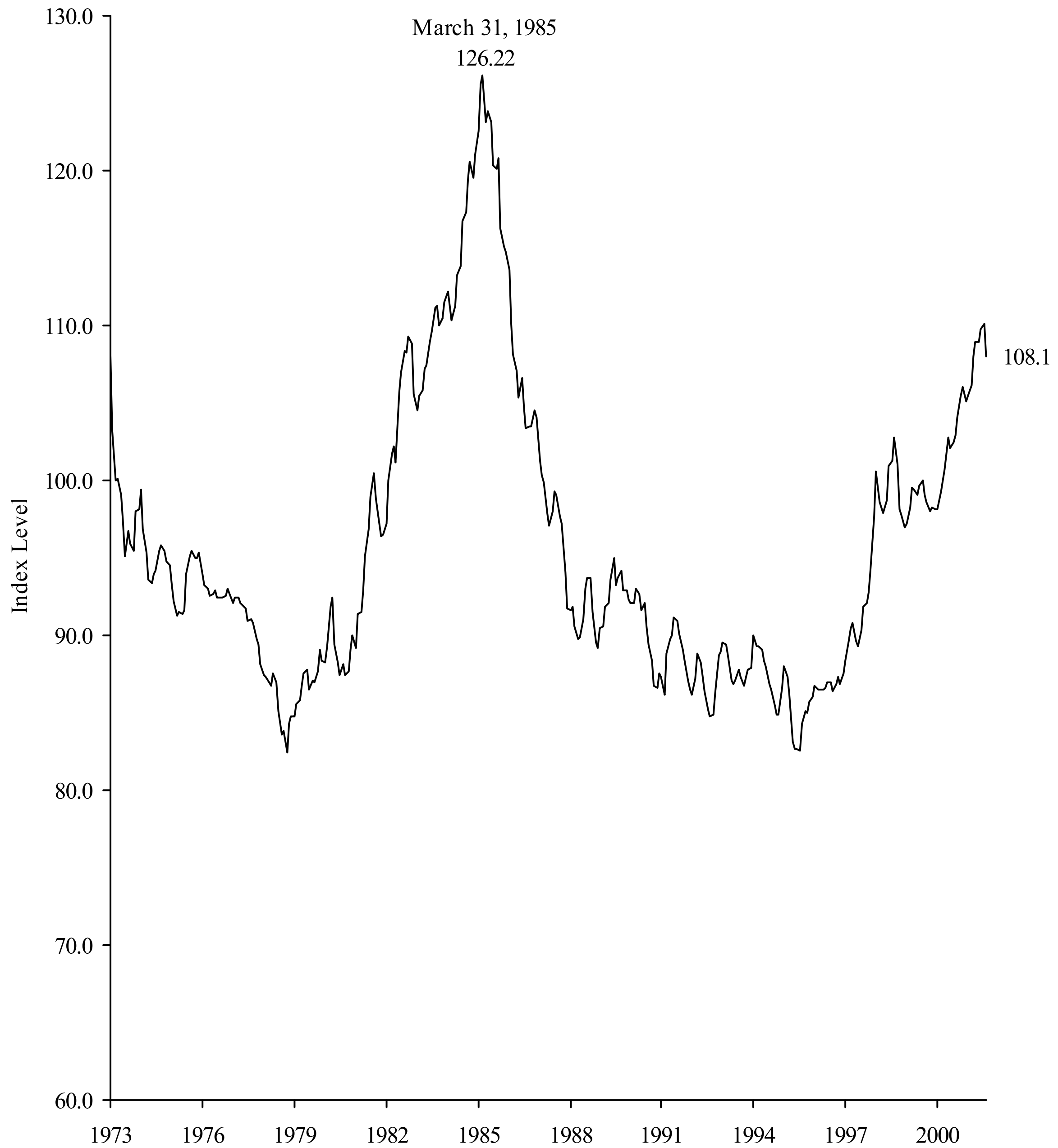
While a secular decline or sharp drop in the US$ is not inevitable, it cannot be ruled out. The circumstances that would precipitate at sharp fall in the US$ are as follows:

- If non-U.S. investors decide that the return on capital in the United States will continue to fall over the long term. This realization could occur if productivity growth reverts to its long-term mean, and would probably be preceded by a significant drop in equity prices.
- If the weakness of the U.S. economy proves more prolonged and painful than expected, then it is possible that U.S. policy makers will intervene in foreign exchange markets to lower the value of the dollar.
- If the dollar reaches new highs, global policy makers may intervene in foreign exchange markets to bring it down. The US$ is currently 16.6% below its previous record reached in 1985, so policy makers would probably not intervene until it reaches that level.
- If Europe or Asia recovers more rapidly than the United States, then it may allow them to replace the U.S. as the global locomotive.

Table A

REAL TRADE-WEIGHTED VALUE OF THE DOLLAR

January 1, 1973 - August 31, 2001



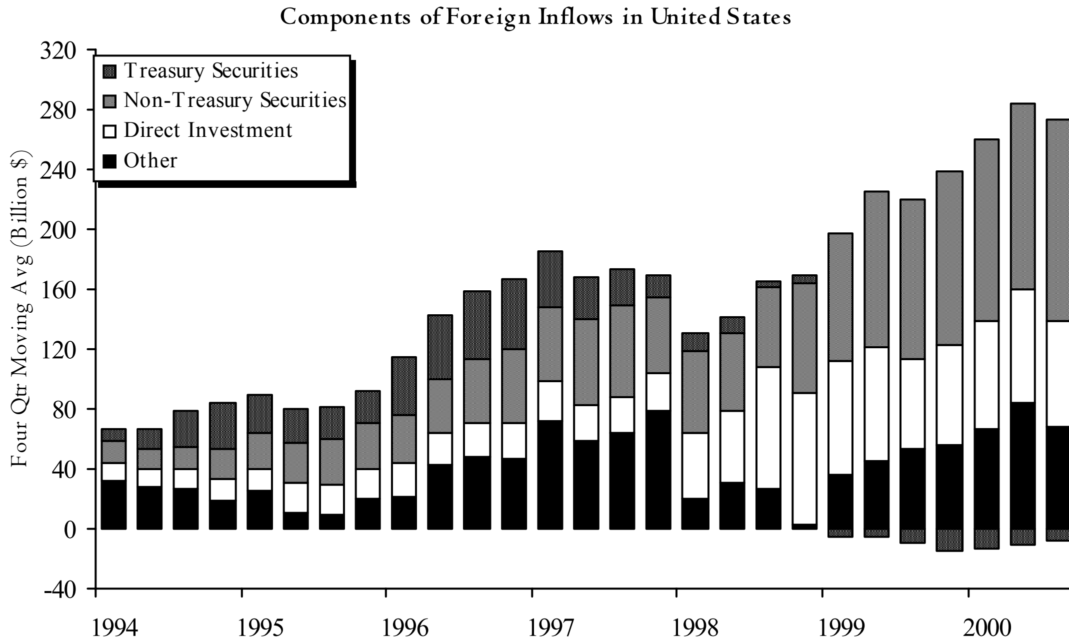
Source: Federal Reserve Board.

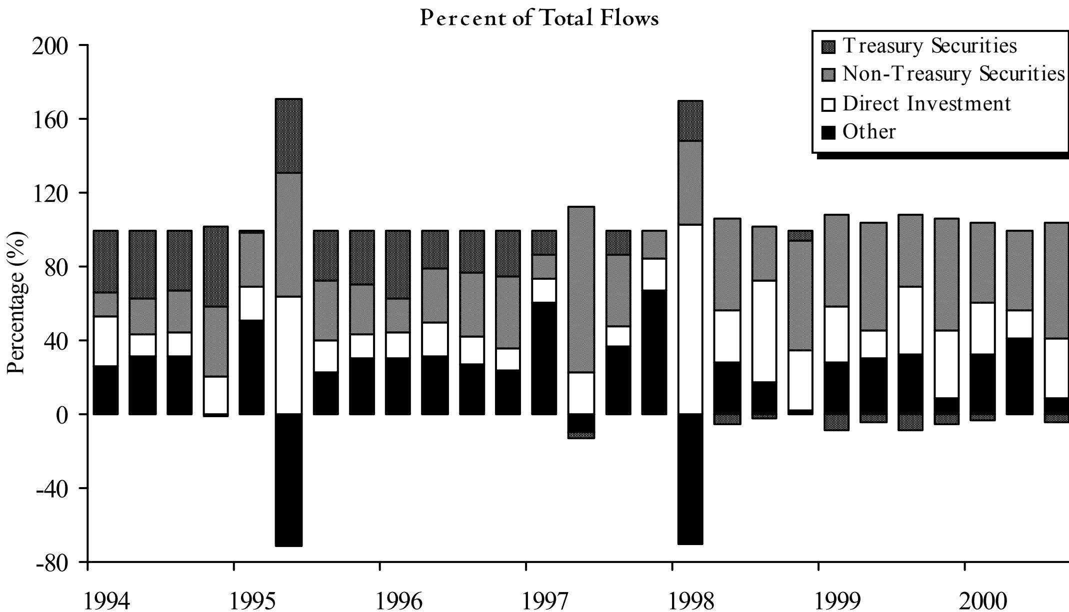
Note: The index is based on a basket of non-U.S. currencies weighted by the dollar amount of trade with the United States.

Table B

FOREIGN CAPITAL INFLOWS

Decenber 31, 1994 - June 30, 2001





Source: Bureau of Economic Analysis.

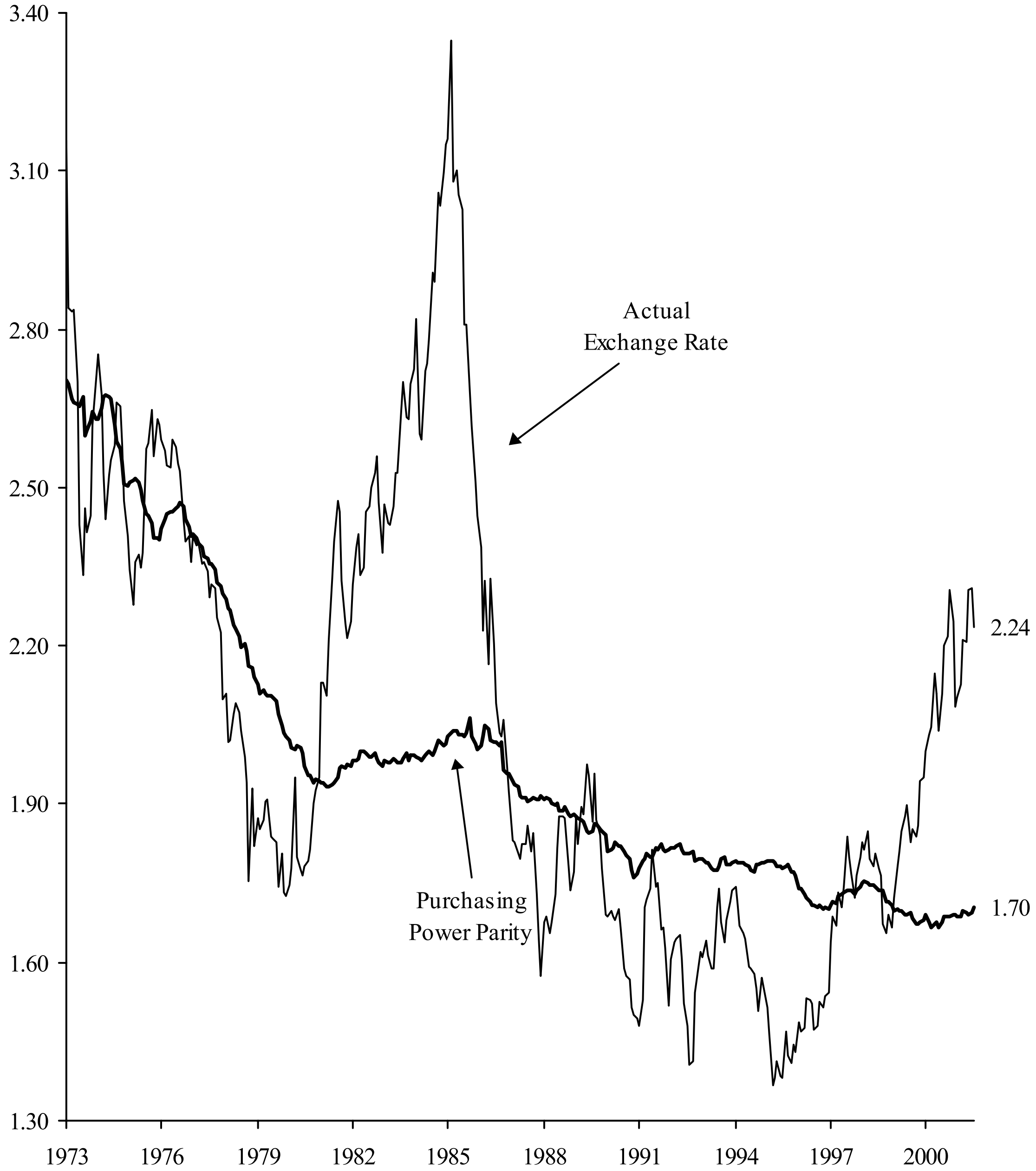
Notes: Top graph represents a four-quarter moving average of quarterly data. Portfolio flows are the sum of Treasury securities and non-Treasury securities.

Table C

FOREIGN EXCHANGE RATES

Deutsche Mark/U.S. Dollar

January 1, 1973 - July 31, 2001



Source: Datastream International.

Notes: Graph represents monthly data. We continue to use Deutsche Marks in this exhibit because of the lack of historical producer price index data available for euros.

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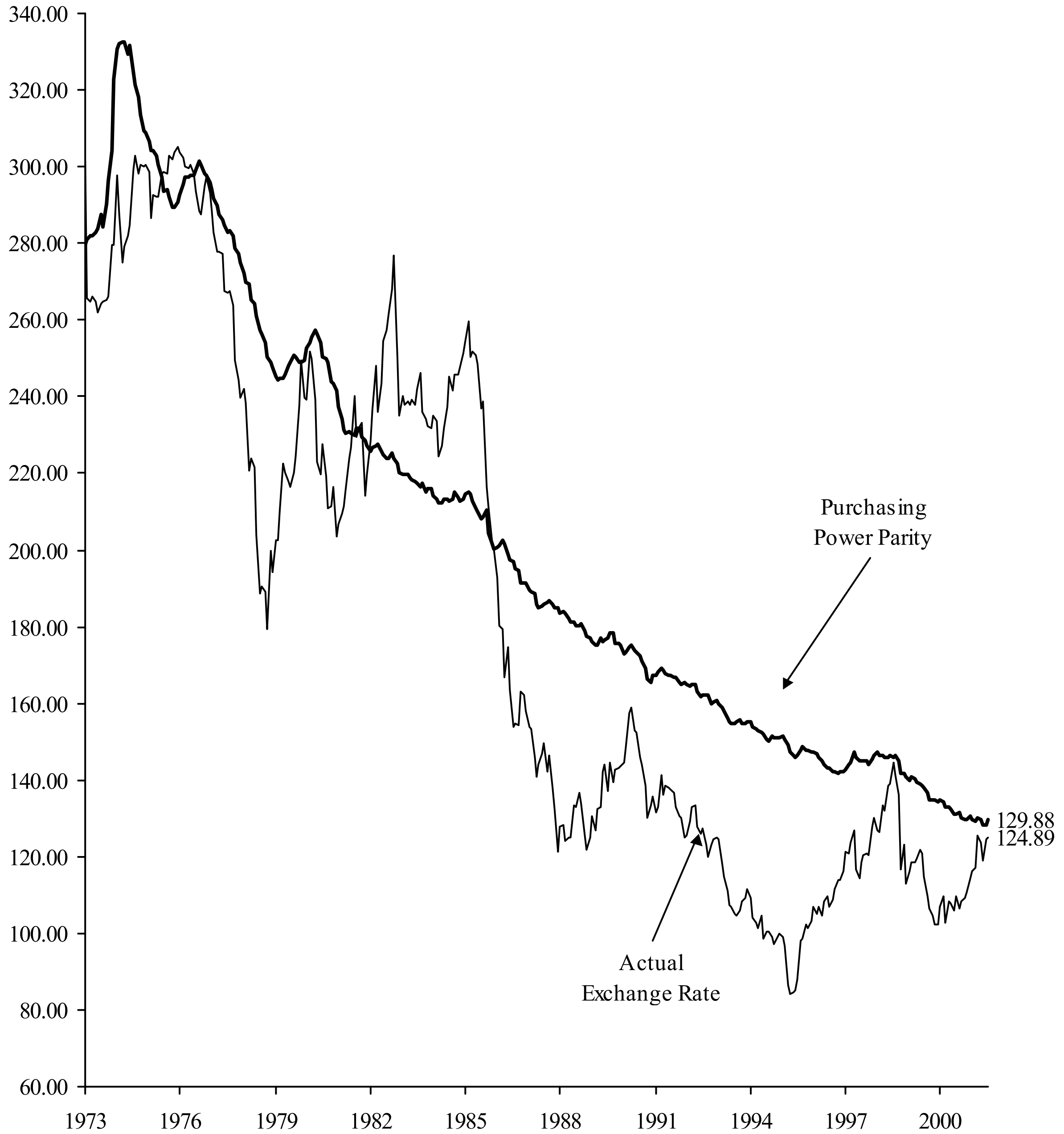
Table D

FOREIGN EXCHANGE RATES

Japanese Yen/U.S. Dollar

January 1, 1973 - July 31, 2001



Source: Datastream International.

Note: Graph represents monthly data.
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