Dollar Risk:
Inflection Point or Continued Trend?

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Introduction

Even before the downgrade of US sovereign debt, there were questions about the extent of dollar risk in the global financial system. A depreciating dollar tends to augment returns to foreign currency investments for the US investor, but yields a currency-valuation loss on US investments for the foreign investor. This could set in motion a negative feedback loop whereby US investors buy more foreign securities and foreign investors unload US securities, both of which would tend to further depreciate the dollar.

On the other hand, the double-digit depreciation of the dollar since February 2002 was narrowing the external deficit (even before the Great Trade Collapse and rebound). Thus, the need to sell dollar assets to finance external borrowing has been, on balance, smaller, putting less depreciation pressure on the dollar. Yet, at the same time as the external deficit has narrowed the fiscal budget deficit is much larger, implying a need to sell more US Treasury securities to some investor, domestic or global.

Thinking about these factors follows generally the relationships and framework (albeit in 'reverse') from the last time the issue of dollar risk arose. That is, in 2000 the dollar was still appreciating, but many thought that the trend was unsustainable because of the magnitude of the US current account deficit and stock of international obligations, and the narrowing budget deficit (into surplus) reducing the availability of US Treasury securities, among other factors.

Applying the framework and analysis from 2000 to current data suggest an inflection point for the dollar. First, based on an asset allocation view, there is plenty of head-room for adding dollar investments into the global investor's portfolio. Second, key global players have not de-coupled, and in fact continue to depend on growth in US and Europe to support economic activity at home. This habit of export-led growth, which has been supported by the policy of under-valued exchange rates, remains entrenched, thus making it difficult for these important players to allow own-currency appreciation even in the

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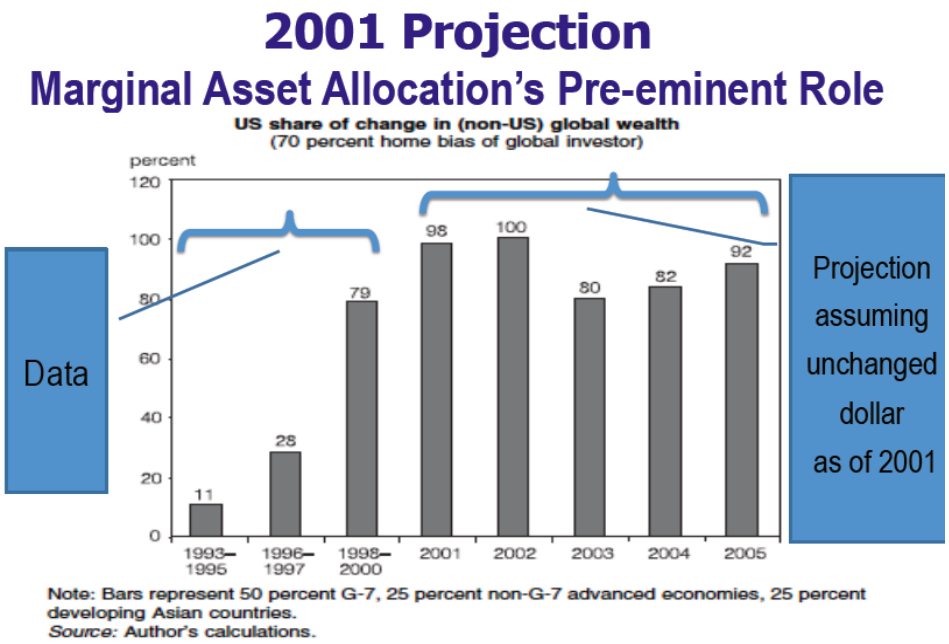
face of potential further capital losses on their increasing holdings of dollar-based international reserves. Even countries that, on balance, do not heavily manage their exchange rates are finding that their currency appreciations to date exact a toll on the global competitiveness of their producers (witness the yen and Swiss franc interventions in August 2011). Finally, with regard to holdings of US Treasury securities in international reserves, despite some rhetoric toward diversification, purchases continue a-pace. The sum of these factors, as well as a long-run chartist view, suggest that the trend dollar depreciation has reached an end.

An Asset Allocation Perspective—from the 1990s to 2011

Over the last decade, I have written a number of papers on the sustainability of the US external balance with implications for the exchange value of the dollar. Figure 1 shows the findings of one of those papers, "How Long the Strong Dollar?" (written in 2000 and published in 2003) in which I calculated the historical share of US investments that the 'global investor'[2] added to their growing portfolio over the 1990s. The share of growth (e.g. the marginal investment) in the global investor's portfolio allocated to US assets increased from 11% to 79% over the 1990s decade, indicating that global investors were increasing their average share of US investments in their portfolio.

By 2000, the sustainability question was ripe. Constructing a projection for the growth in the global investor's financial portfolio and a projection for the US current account deficit with an unchanged dollar, yielded a projection for the 2000s decade of what share the global investor would have to put into US assets to be consistent with an unchanged dollar. That calculation showed a marginal investment in excess of 100%, evidence pointing to the inconsistency between the assumption of unchanged dollar with the growth in global wealth. In fact, the dollar started its trend depreciation in February 2002, of course for a number of reasons, but also no doubt because based on an asset allocation perspective, foreign investors had 'enough' US assets.

[2] Throughout, 'global investor' portfolio is calculated excluding the U.S.



Source: Mann, "How Long the Strong Dollar?

Figure 1

Fast forward to a decade later. What turned out to be the average and marginal US asset allocation in the global investor's portfolio over the 2000s decade, given that the dollar was depreciating? The depreciation of the dollar narrowed the external deficit and growth abroad increased global wealth. Figure 2 shows that these factors, among others, led to a situation whereby the global investor could and did comfortably add US investments to their portfolios. In 2000, I had to construct global wealth. Now, the IMF's Coordinated Portfolio Investment Survey contains the data that we need to calculate the average US share in the global investor's portfolio, and along with the actual US current account, the marginal share. A key point is that the marginal share usually is lower than the average share, indicating that on balance over the 2000s decade the US share in the global investors' portfolio was falling. This leaves us in 2011 with plenty of 'head-room' for the global investor to add US assets. The dollar need not depreciate further.

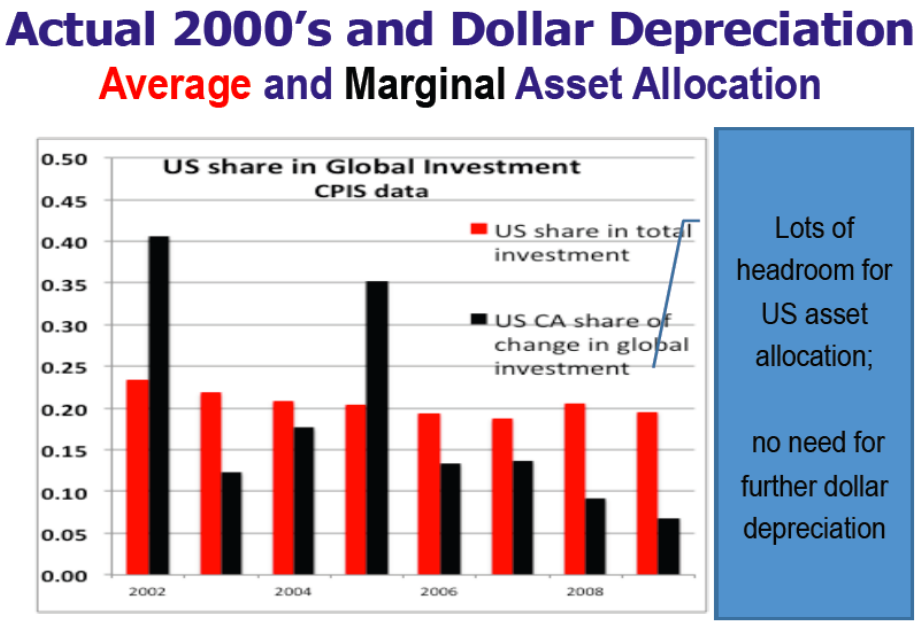


Figure 2

Foreign purchases of US Treasury and other portfolio assets

In 2000, who would buy US Treasury securities was not so major an issue, in part because the fiscal budget had moved into surplus. The situation is different today. Although the dollar direction need not be hostage to the purchases of US Treasuries, it is worthwhile to take a look at the pattern of foreign purchases of US assets and consider implications of the widening fiscal budget deficit.

Over the 2000s, foreign financial inflows were substantial, well in excess of that needed to simply finance the current account deficit (since of course there were US investors buying foreign securities and that had to be financed as well). Figure 3 shows the composition of net foreign purchases of portfolio assets through 2011q1. First, foreign official purchases of US Treasury securities and other obligations of the US government are significant portion of the inflow—before, during, and after the financial crisis—it is only in the most recent quarter that the official flows have moderated (although some of the bank and securities flows are likely official purchases in conduit, and will be reallocated to other categories when the data are revised).

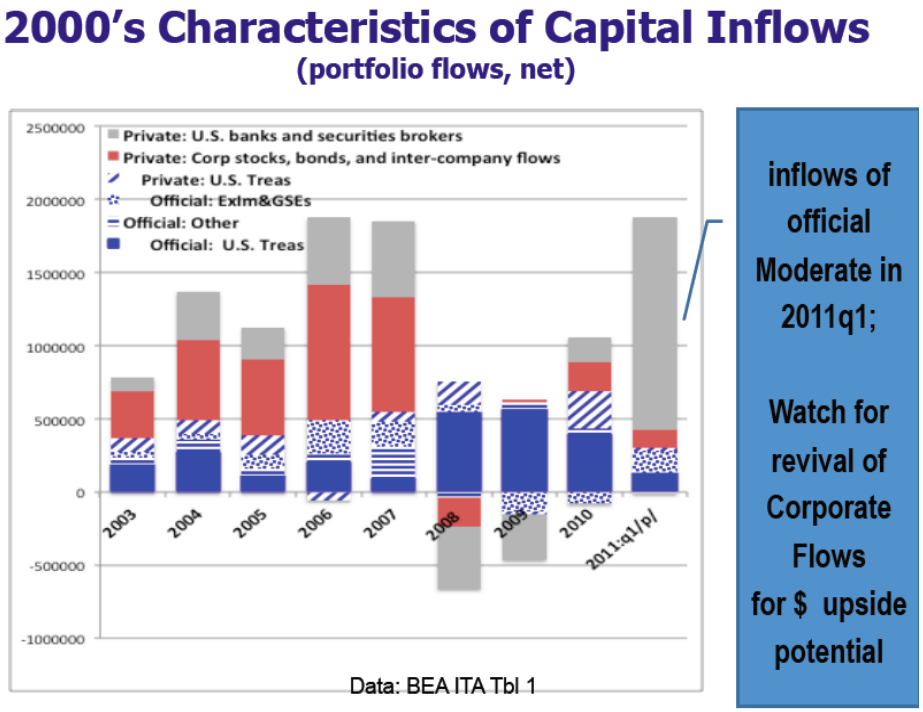


Figure 3

During the recent recession, when the US budget deficit widened dramatically, foreign official and private purchases of US treasury securities continued apace. As has been documented, foreign investors choose the relatively safety and liquidity of the US Treasury market over other sovereign or private instruments. A threat to the inflection point thesis would be a flight from US Treasury assets as the US budget deficit remains in the trillion-dollar range—but the question, for exchange rate movements, is flight to what alternative?

The second largest category of foreign purchases of US assets, before the crisis, was foreign purchases of corporate capital—stocks, bond, and inter-company flows. In the years running up to the financial crises, these flows were dominated by the mortgage-backed securities, primarily purchased by European investors (see BEA International Transactions Table 8a through 2010). Going forward, official purchases, particularly by authorities in the Asian region seem destined to continue, baring a dramatic change in portfolio preferences.(BEA Table 5 through 2010 reveals that despite the rhetoric regarding diversification, the share of Asia in official purchases is as large as ever). And, even if portfolio preferences do shift away from US Treasury securities, their substitution toward AAA rated US corporate bonds and equities would support the dollar inflection point.

De-coupling or co-dependency?

In 2004 I wrote an article about the trajectory of the US current account, trade with China, and exchange rates. At the time, the widening US fiscal and external deficits were financed by increased foreign purchases of US treasury securities (among other assets). The foreign official purchases were in part designed to limit what might otherwise have been pressure for own-currency appreciation against the dollar. At the time, I argued that the behavior on the US side of spending by households and government and on the foreign side of persistent official purchases of US Treasury securities represented a co-dependent relationship. That is, although both trajectories were ultimately unsustainable, they were jointly complementary, and therefore they could continue on, as indeed they did until 2008.

Is there evidence for the de-coupling hypothesis, whereby the US net export deficit narrows and domestic demand-led growth abroad picks up? The US net export deficit has narrowed (although it may be on the down-swing again). What about domestic demand-led growth abroad? This is a global topic, but the issue of domestic demand within Asian economies is of greatest interest because of its nexus to the Asian purchases of US Treasury securities and associated issue of exchange value of the dollar. Slide 7 shows the net export surplus for China and for All developing countries in Asia with the US and EU.

Under the de-coupling hypothesis, Asian demand would be the growth engine for the region and so the region's net exports with the world should be about in balance, or at least headed that way. But the evidence shows that net exports surplus of the region with the US and EU rose dramatically following the 2001 pause (it is about half and half US and EU in 2010). During the Great Trade Collapse of 2009, the net export surplus of all Asian developing economies and of China both contracted (Figure 4). But this is not evidence of de-coupling, rather the opposite. Moreover in 2010, both net export surpluses rebounded, with China's net export surplus to the US and EU rebounding completely—with exports in 2010 greater than ever. In contrast, for non-China Asian developing countries, net exports fell more and has not completely recovered—in particular, their exports have not returned to the previous peak because their ultimate markets (US and EU) have not returned to their previous growth paths and they are competing with China's exporters.

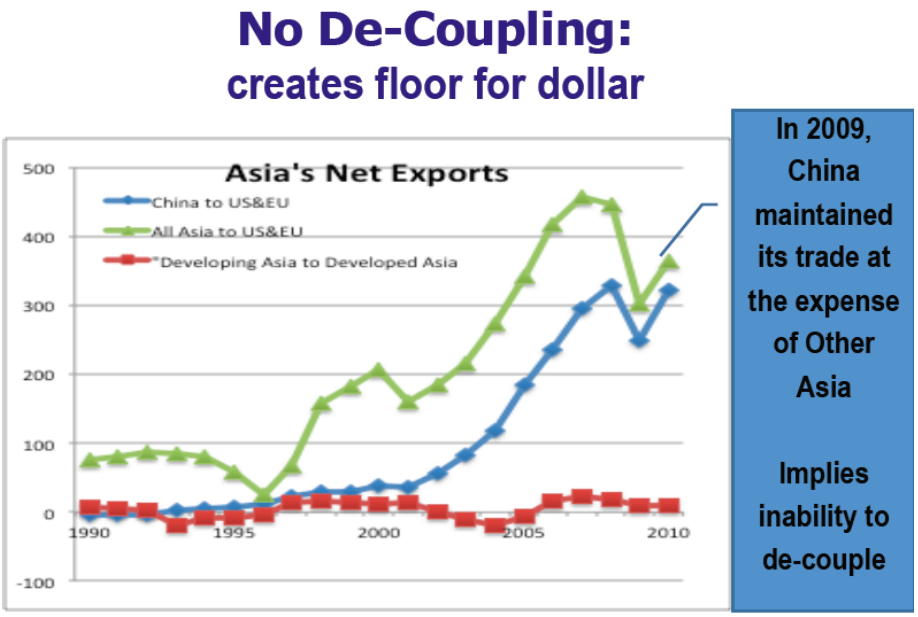


Figure 4

The internal perspective on the de-coupling hypothesis examines consumption and investment as a share of real GDP. Data for 2010 are not yet available. Yet, from 2000 to 2009, China's consumption ratio fell steadily from 44 to 35% of GDP, even as the investment ratio rose from 37 to 42% (2000 to 2008) and surged to 46% of GDP in 2009. As implied from the net export data, the domestic demand share of GDP for China will fall in 2010, perhaps lower than in 2008. For all developing Asia, the domestic demand share of GDP is somewhat higher than for China, but the trends are the same.

Therefore, whether considered through the lens of net exports or of domestic demand as a share of GDP, there is little evidence that the dependence on industrial country markets for growth has changed. Neither the region nor China have de-coupled. Going forward, this dependence on net exports to support GDP growth implies continued purchases of US assets into international reserves for the objective of exchange rate management—which supports a dollar inflection point.

A Chartist View of Dollar Risk

A final view on dollar risk in 2011 takes the chartist perspective. Considering the whole floating rate period, since 1973, the real trade-weighted exchange value of the dollar has moved through two significant cycles of appreciation and depreciation, with a period of moderate fluctuation in between during the early 1990s. (Figure 5) Taking the chartist view, there appears to be a resistance point for the dollar around an index value of 80. Further extended period of dollar depreciation would put the real dollar index into uncharted territory.

During the early 1990s, Europe was expanding robustly with the impetus of the unification of Europe, among other positive global macroeconomic forces. At that time, the appreciation of the various European currencies was both valid from the standpoint of economic returns, as well as helpful from the standpoint of curbing inflationary pressures. Neither of these factors is true today. Therefore, the resistance point in the chart is validated by economic fundamentals.

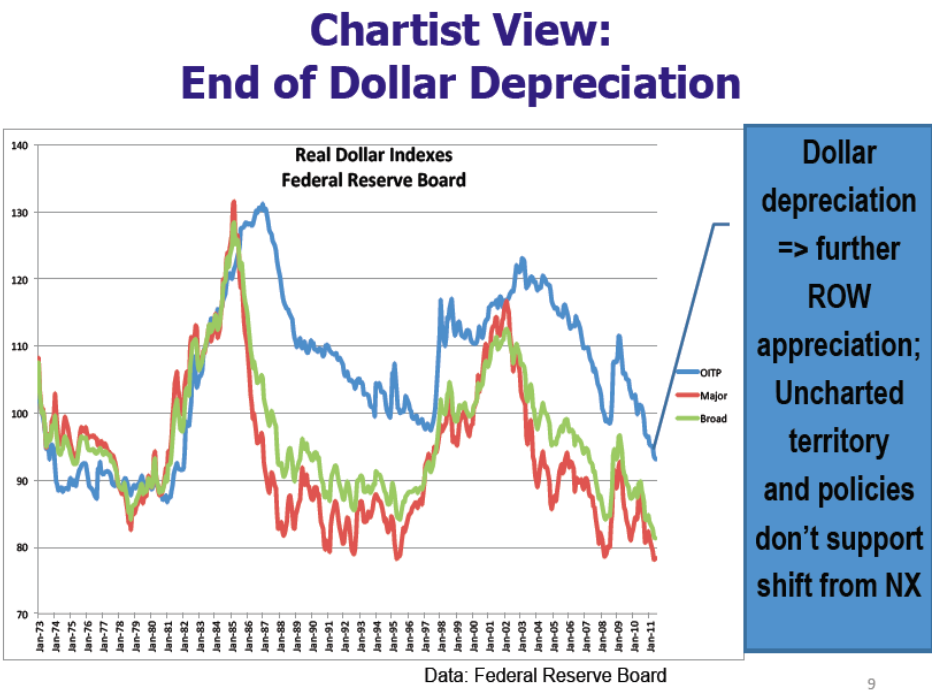


Figure 5

Moreover, whereas further dollar depreciation may make sense against the 'other important trading partners' in that they have been growing more robustly than the industrial country markets, because their growth has been relatively less internal than externally generated (as discussed above), these countries cannot 'play the part' of Europe this time around. Hence the chartist view points to an inflection point for the dollar.

<u>Conclusion—the dollar is at an inflection point</u>

The asset allocation perspective has been shown to be a useful way of gauging demand for assets and for the direction for the valuation of the currency of a country. From an asset allocation perspective, there is plenty of head-room in the global investors wealth portfolio to add US assets.

Official purchase of US securities is likely to continue, not necessarily because of any investment rationale based on fundamentals, but because policy authorities wish to limit own-currency appreciation. Domestic demand is not yet a sufficient source of GDP and

job growth in Asia--de-coupling has a ways to go. In the industrial country markets, the appetite for continued appreciation already has reached limits.

In sum, private asset allocation, official intervention into exchange markets, and a chartist view all point to the end of the trend depreciation of the dollar. An inflection point and likely a period of trendless volatility, similar to that of the 1990s is most likely in the offing.

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