



DAVID HALE GLOBAL ECONOMICS

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There is Only One Alternative to the Dollar

By David Hale

The great challenge confronting the foreign exchange market at the start of 2009 is finding a good alternative to the US dollar. One of the ironies of market events during 2008 was that the US financial crisis produced a flight to safety in the dollar. The dollar emerged triumphant from a financial debacle that centered on \$1,300bn (€960bn, £890bn) of subprime US mortgage loans. The fallout has triggered a \$32,000bn decline in global stock market capitalization and driven all the Group of Seven leading industrialized countries into recession.

The dollar slumped against the euro during the final weeks of 2008 but fears about the financial system still drove US Treasury yields down to zero on three-month paper and less than 2.1 per cent on 10-year notes. This fear factor is likely to sustain demand for the dollar during the early months of 2009.

There is not now a clear alternative to the dollar because all big economies have slid into recession. Real gross domestic product could contract by 1.5 per cent in both the US and Europe during 2009 and by as much as 2.5 per cent in Japan. The decline in world trade and commodity prices will also reduce significantly the growth rates of the emerging market economies. South Korea and Taiwan are already in severe slumps. The growth rate of China could halve.

The US economy could be the first to emerge from recession this year because it appears to be headed for a far more aggressive macroeconomic stimulus program than any other country. Barack Obama's administration will announce a \$700bn-\$800bn multi-year fiscal package focusing on cuts in payroll taxes, aid to state and local governments and infrastructure investment. The Federal Reserve

is also engaging in a program of unprecedented monetary stimulus. It has slashed its core lending rate to zero and tripled the size of its balance sheet since August. Ben Bernanke, the Fed chairman, has also stated his willingness to engage in further large liquidity injections to buy mortgages, consumer loans and government securities.

The European response to the recession has been far less aggressive. The European Central Bank is still under the influence of the Bundesbank and will ease monetary policy far more gradually than the Fed. Japan's government has been announcing modest fiscal policy changes but it cannot act decisively since it no longer controls the upper house of the Diet. And an election, before September, could produce a change of government.

If the US stimulus policy revives the economy by spring or summer, the dollar could rally further. The risk posed by US policy comes from potential market concerns about monetary policy becoming inflationary. The current growth rate of the Fed's balance sheet is totally unprecedented. As a result of the Obama fiscal policy and the troubled asset relief program, the Federal government's borrowing requirement could rise to \$1,500bn-\$1,700bn this year. Government bond yields have collapsed because of investor fears about the safety of the financial system but they could rebound when conditions normalize. The current level of yields is the lowest since the period of official interest rate controls during the Second World War. Mr. Bernanke has indicated that he would be prepared to return to the wartime policy of restraining yields. What remains unclear is whether such a policy of accommodation would provoke fears about inflation and encourage dollar selling, which could in turn drive up bond yields.

Foreign central banks could play an important role in the US government bond market because they already own about half of the existing debt stock. China recently displaced Japan to become the largest holder of US government securities because of its long-standing policy of intervening to manage its exchange rate against the US dollar policy. As a result of the downturn in its

economy, China has recently begun to lose foreign exchange reserves and may not need to intervene in the market again to restrain the renminbi. Japan, by contrast, has been experiencing significant upward pressure against the yen despite the severe downturn in its exports and output growth. Japan has not intervened since 2003 but, if the yen rallies another 5 per cent, the country could be forced to spend large sums restraining its currency. If it does, Japan could provide \$200bn-\$300bn of funding for the US deficit during 2009 while Chinese demand for US securities fades.

As a result of the global scope of the recession, there is no country that wants its exchange rate to appreciate. The clear alternative to the dollar in 2009 is not other currencies but that ancient form of money: gold. Precious metals could emerge as a hedge for investors suspicious of central banks and fearful that inflation will be the simplest solution to the challenge of global deleveraging.

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