

A Comeback for the Greenback

BY JONATHAN R. LAING

The news has been nothing but grim for the U.S. dollar as of late. For the year, the buck is down against all 16 major trading currencies save the Mexican peso. But perhaps most disconcerting, last Friday the greenback fell to an all-time low against the 13-nation euro, which has been in existence only since 1999. The European currency now fetches nearly \$1.50, compared with less than 83 cents as recently as 2000.

And to hear dollar bears talk, the buck will soon lose its privileged status as the preeminent global reserve currency and major medium of exchange to the euro and, perhaps even later in the century, to the Chinese renminbi. Indeed, last week, several Persian Gulf oil powers threatened to unpeg their currencies from the dollar because the expense of buying goods and services from Europe was so boosting price inflation in their domestic economies.

Of course, the case against the greenback is invariably couched in apocalyptic terms. America's continuing budget deficit, for example, is said to betoken U.S. decadence, fueled by fiscal irresponsibility and imperial over-reach. The trade and current-account deficits? They are symptoms of a society that consumes more than it produces, spends more than it saves and relies on poorer nations to finance its profligacy.

Nor, at this point, can a strong case be made for foreign investment in U.S. assets in order to sop up the dollar surpluses in foreign coffers. U.S. gross domestic product growth is slowing. Treasury rates seem headed lower. Interest differentials favor higher-yielding government paper like the German bund. U.S. residential and commercial real-estate prices seem headed further south.

Then too, the U.S. financial system is currently a mess with the subprime, structured products crisis having seemingly spread to the entire credit market. U.S. capital gains and dividend taxes are likely to jump once the Democrats allow the

Bush tax cuts to expire in 2010. And finally, sovereign funds and other foreign investors worry that nativist uproars could obtrude again, in the way that kept China from acquiring Unocal and Dubai from completing its U.S. sea ports deal.

Thus, it comes as something of a surprise that GaveKal, an international investment research boutique with offices in the U.S., Hong Kong, Paris and Abu Dhabi, recently penned a report lauding the dollar's prospects against the euro. In fact, in a telephone interview from Paris, firm founder Charles Gave terms the euro "grotesquely overvalued" at its current level. In the next couple of years, he maintains, the euro should fall to its "parity" value of \$1.05 to \$1.10.

Gave, whose firm's good track record has won it a large institutional following in the U.S. and Europe, points to several secular factors that bode well for the greenback versus the euro. For example, rapidly aging populations in euroland figure to decimate working populations there and increase the governmental financial burden at a pace far faster than in the U.S. European countries such as France have far higher debt to GDP burdens than the U.S., especially when estimates of their unfunded pension liabilities for government employees are figured in.

Adding to this European fiscal burden is a trend that Gave, out of political correctness, hesitates to even verbalize -- Islamization. Higher birth rates of Muslim populations that have been only imperfectly integrated into European economic and cultural life could pose big problems in the Old World over the next several decades. For one thing, the trend could boost unemployment.

Likewise, he sees the U.S. maintaining its lead over the euro zone in such prerequisites of wealth generation as productivity growth, research, product innovation and strong institutions of higher education. "Ultimately, currency values are determined by relative rates of return on capital, and here the U.S. has a decided

advantage," he contends.

Finally, according to Gave, the euro is of such recent vintage that it is untested during a serious global recession. In tough times, the nations comprising the union have such different social and economic traditions that some might opt out the euro in favor of traditional currencies to stimulate their economies rather than accept a zone-wide tough-love solution.

According to research by GaveKal, the dollar's current woes against the euro owe to temporary factors that are likely to ameliorate. If one accepts the premise, which GaveKal doesn't fully, that chronic trade deficits weaken a nation's currency, good news seems to lie ahead for the buck. The GaveKal report points out that the weaker dollar has caused U.S. exports to rise three times as fast as imports. In fact, Gave thinks that Uncle Sam will achieve a trade balance, excluding the impact of energy, within three years or so.

A major problem for the U.S. on the trade front has been that China and some of our other major Asian trading partners have loosely pegged their currencies to the buck, to generate trade surpluses from systematically undervaluing their currencies. This policy of competitive devaluation, when followed in the 1930s economic contraction, was known as Beggar Thy Neighbor.

Yet, according to GaveKal, Asian central bankers are starting to realize the downside to such currency manipulation, beyond the complaints of trading partners. Pegged currencies also can create unhealthy booms in local stock and real-estate prices and push inflation above desired levels.

Signs of policy changes are afoot. Recently, South Korea has been allowing the won to creep higher. This spring, India allowed the rupee to rise from 44 to 39 against the dollar. The Monetary Authority of Singapore announced last month that in order to regain control of its monetary aggregates, the Singapore dollar would likely be permitted to rise over the

next year.

In addition, Chinese authorities probably will increase the pace at which the renminbi is allowed to appreciate versus the greenback. If not, GaveKal argues, China is likely to face increase in gasoline and food prices that could tear at the very fabric of its society since so much of the huge nation's needs are filled from abroad.

Obviously, rising oil prices also help push up the euro-dollar exchange rate as much as U.S. trade deficits with Asia. Both phenomena create surplus dollars that, at least in part, are invested in the unified European currency for the sake of diversification. In fact, GaveKal and others have noted the tight correlation that has developed in recent years between moves in oil prices and shifts in the euro-dollar exchange rate.

There's little mystery why the dollar weakens as petro prices go higher. Many of the nations on the other side of this oil revenue transfer, like Iran, Venezuela and Russia, share an intense dislike for the U.S. and probably dump the dollars they receive as soon as they get them. But, Charles Gave, at least, thinks that the oil price hikes since summer have been irrational and soon will reverse. This certainly would help the dollar.

Finally, the GaveKal report rejects the notion that the euro has been strong because the Federal Reserve Bank has been engaging in loose monetary policies intended to debase America's currency.

In fact, the research house points out, since 1995 the growth rate in euroland of narrow monetary aggregates has been consistently stronger than that of the U.S. That's also true when one looks at broader monetary aggregates. The U.S. is, if anything, less promiscuous and more virtuous with its monetary policy than Europe.

Of course, little is more daunting than calling turns in currency markets. Even the great Warren Buffett badly mistimed his 2005 bet against the dollar. That said, so much negativity is swirling around the greenback that bucking the trend might not be a bad businessman's bet here .
