Currencies: A Way Out Of The Mess

Why economics is called "the dismal science" is a mystery; just as Voltaire dismissed the Holy Roman Empire as neither holy, Roman, nor an empire, economics is neither dismal nor a science. The scientific method allows for controlled experiments and laws with predictable outcomes. We can't set up a global economy in a parallel universe to run controlled experiments. Nor can we predict the outcomes of, say, Federal Reserve actions.

The present strength of the U.S. dollar demonstrates the lack of predictability. Standard economic theory would have predicted a weaker greenback by now. After all, the Fed drives down short term interest rates by buying Treasury securities, thus increasing the level of free reserves in the banking system. The slowing U.S. economy should slow the growth of credit demand. These supply/demand factors have led to a drop in short-term interest rates, and this in turn should lower the attractiveness of dollars to foreign investors. These very same investors now have to borrow at their domestic rates to lend at lower U.S. rates. The 4.44% yield on three-month EURIBOR (Euro Interbank Offer Rate) is 60 basis points over the comparable LIBOR (London Interbank Offer Rate) yield on dollars, yet the woebegone euro is hovering just over its all-time low of .8218 set in October 2000.

Go With The Flow

The most powerful signal in any market is when the reaction is not as expected. For example, Merrill Lynch's earnings warning of this past week failed to spill over into other financial services stocks, and that constituted evidence of a market ready to move higher. In our present topic, the willingness of investors to pay a 60 basis point penalty for the privilege of holding dollars over euros provides evidence that something more powerful is lurking beneath the surface, and that is the expectation of higher returns on U.S. assets.

Of course, a firm currency in the face of an interest rate penalty doesn't necessarily signal a higher expected return on assets, just take a look at the Japanese yen. The world hasn't been expecting higher rates of return on Japanese assets over the past decade, so we can throw that argument out the window. Interest rates on three-month TIBOR (Tokyo Interbank Offer) yen are 0.07%, scarcely worth the paperwork, which means an American buyer of yen will borrow dollars at 3.84% to lend in yen at 0.07%, a 377 basis point penalty. What genius will do this, you ask? Anyone who needs to buy yen to pay their bills to Japanese exporters, that's who. The permanent Japanese trade surplus, therefore, is responsible for a strong yen, which in turn is reducing Japanese competitiveness with respect to China and other Asian exporters. Until the basis for the Japanese economy changes from export dependency, its competitive advantages will continue to erode. See how much fun economics is when you give it a chance?

The U.S. trade position is quite the opposite of Japan's. We haven't run a single monthly current account surplus since April 1976, back when people like Donald Rumsfeld and Dick Cheney were White House powers. Oh. As a result, the U.S. runs a permanent capital account surplus. Every month, thick and thin, with the dollar rising or falling, with interest rates rising or falling, with stocks rising or falling, the rest of the world sends money into the U.S. to finance our trade deficit. So long as we keep the expected rates of return on our assets high, the rest of the world will want to invest here, and happily will send us the goods they now can't consume themselves, and lend us the money to boot. While trade deficits make scary headlines, capital surpluses don't get any attention at all, and that's a shame. They make economists smile, and isn't that what it's all about?

Keep On Keeping On

The key to keeping this game going – and yes, it does bear some resemblance to a perpetual motion machine – is keeping the expected rates of return high on U.S. assets. Without this, we won't have a strong dollar to keep inflationary pressures in check and interest rates lower than they would be otherwise, and we will raise the risk of holding U.S. assets for foreign investors. This last point is critical for us as investors: The U.S. joined an intervention on behalf of the euro last September 22, and the Wilshire 5000 index has never been one tick higher. Would you as a foreign investor want to hold assets that could be depreciated instantly in such a manner?

How do we keep the expected returns on U.S. assets high? Keep on doing what we do best, and that's allowing innovation to flourish. This means allowing the world's best brains to come here on H1-B visas, lowering taxes on investment, ending political distractions like finding new and better ways to sue people, and encouraging the rest of the world to imitate us. The global burst of democratic capitalism in the early 1990s produced a lot of winners, and it still is the only system ever shown to create wealth for ordinary citizens.

The euro will firm and Japan will right itself only if they adhere to this economic model; it'll be a far better use of their time than telling us what rubes we are. As a side bonus, a firmer euro will reduce the dollar's strength and allow, finally, the Fed's monetary stimulus to take effect.