Doomsday for the Dollar:
WHY THE DOLLAR WILL CRASH AND HOW YOU CAN PROFIT

A Special Report From

The Richebächer Letter

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Why the Dollar Will Crash and How You Can Profit

The dollar's fate is definitely the most important question for the world economy and world investors. For American investors, the result is weakened spending power. But overseas investors find themselves tied to the dollar as well.

That is because foreign investors hold over $10 trillion in U.S. assets. With the dollar down more than 30% against the euro since early 2002, the sale of those assets would reveal gigantic capital losses.

Foreign — especially European — firms are effectively stuck with their malinvestments in the United States. Essentially, they have no choice but to bet on the dollar's comeback, as happened between 1995 and 2002. This is probably the overwhelming hope around the world — the hope, in other words, that the U.S. recovery has not stalled.

We believe it is foolish thinking. The U.S. economy is on the verge of a disaster… one that will certainly bring the dollar down with it.

We will explain reasons behind this impeding crisis in due time. But first, a short history of the U.S. dollar's role in the world economy.

FROM THE GOLD STANDARD TO NO STANDARD

Of course, before the U.S. dollar rose to prominence, there was only one choice when it came to evaluating currencies — by valuing it in gold.

The gold standard was very beneficial to the world economies. It did not allow the emergence of significant trade deficits; there was nobody to do the lending. In the same vein, the gold standard made internal credit excesses impossible. Also important, consumer credit did not exist. Balanced trade implied balanced benefits.

The dollar did not come into power until 1944, when the conference at Bretton Woods made U.S. dollars — along with British pounds — the foundation of a reserve currency, which created a system of fixed exchange rates. The link to gold was maintained by fixing gold's price at $35 an ounce.

But even under the Bretton Woods system, greater trade imbalances were virtually impossible for two reasons: *First*, the currency markets used to react sorely even to very moderate deteriorations in a country's trade balance, forcing the central banks to tighten their reins; and *second*, central banks were entitled to demand gold payments at a fixed price of $35 per ounce from the U.S. Treasury — which the French, in particular, did.

This system changed radically in 1973, when President Nixon cut the dollar's peg to gold. Implicitly, the existing fixed exchange rate system had to be abolished in favor of flexible exchange rates. That was the theory. In practice, many central banks decided to prevent any rise of their currency against the dollar by interventions in the currency market. The cause of dollar's chronic weakness in the 1960s and '70s, by the way, was capital outflows in excess of a trade surplus. Today's chronic U.S. trade deficit emerged a decade later.

THE FIRST MAJOR DOLLAR CRISIS

Beginning in the 1980s, the U.S. dollar's fortunes began to change. As the American stock market turned around, the world rushed to buy American assets. Such confidence could only boost the dollar's value. Between 1980 and 1985, the dollar virtually doubled against the German deutsche mark, from DM 1.70 to DM 3.47 — despite America's burgeoning trade deficit.

There were many scornful comparisons between the ailing economies of Europe and the super-healthy and dynamic U.S. economy. For Europe, the popular, derisive catchword was "euro-sclerosis," while U.S. economic policy basked in the glorification of "supply-side Reaganomics."

But towards the end of 1985, the perceptions of the United States began to change, and the dollar began a

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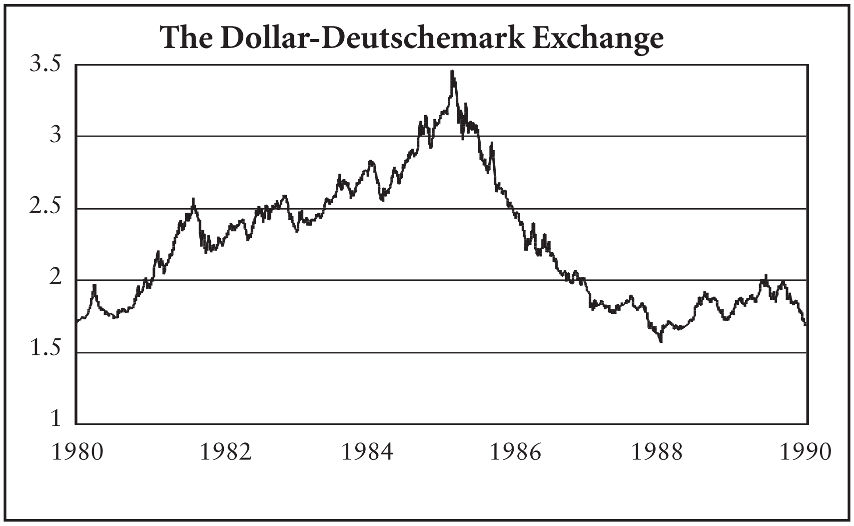
long slide downward.

It was the great fear of central banks that the falling dollar would cause foreign capital to take flight and upset the U.S. financial markets. But even though the dollar went into an almost vertical fall in 1985, U.S. bonds and stocks continued on their bull run for two years. Yields of 10-year Treasurys slumped from 11.5% in early 1985 to a little over 7% in early 1987. Corporate yields took a similar plunge.



But this benign relationship between the skidding dollar and bullish financial markets abruptly changed in the course of 1987. As the year wore on, the markets became increasingly obsessed with an escalating trade deficit and the dollar's endless slump.

Bond prices started to plunge right from the year's start. Yet the dollar rebounded, and stock prices continued their bull run. In August, the Dow made its high of the year, up 21% from its start.

But sentiment in the financial markets deteriorated dramatically in the year's second half. All of a sudden, attention turned to the trade deficit, which was again showing distinctly deteriorating numbers. People began to realize that the dollar's steep fall had completely failed to rectify the trade imbalance. Now stocks, bonds and the dollar slumped in concert.

Apparently triggered by unexpectedly bad August trade figures, which the Commerce Department announced on Wednesday, Oct. 14, 1987, this development climaxed in mid-October. Within two days, the Dow lost over 250 points, or more than 10%, on a historic high volume — to be followed by a virtual meltdown on Monday, Oct. 19. Within a single day, the Dow lost 508 points, or 22.6%

THE UNLIKELY REBOUND

The dollar fluctuated wildly over the next decade, but the overall trend was clearly down. Then, all of a sudden, in the mid-1990s, the dollar suddenly began to take off again. The culprit was a perception of strength in the U.S. economy, which led to booming domestic credit demand, as well as foreign credit and capital.

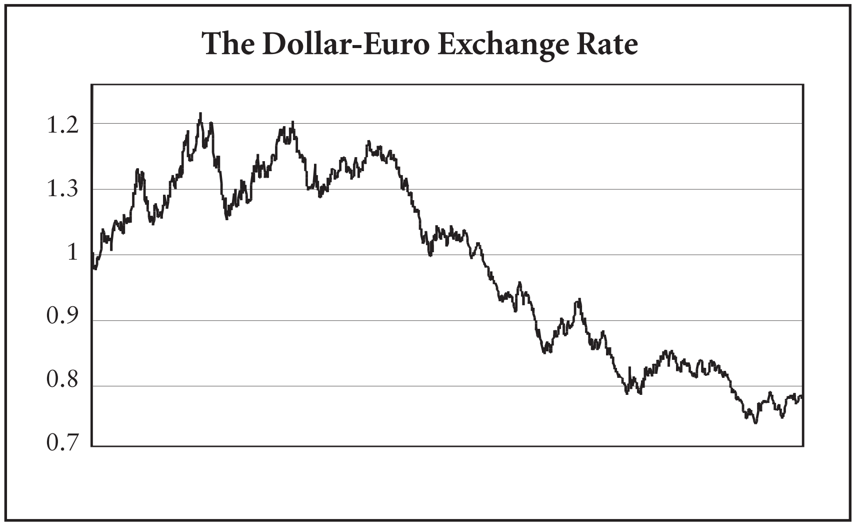
But what made the American economy seem so strong? In a word, nothing. Only the power of the Federal Reserve to delude the people kept the system afloat. American policymakers bragged about a "new paradigm" economy that would spur vast investment flows — in particular from Europe — into the U.S. economy.

This rosy view further held that the gaping U.S. trade deficit was by no means the unhealthy outgrowth of American borrowing and spending. Instead, it was the very healthy mirror image of these capital inflows, attracted by the U.S. economy's superior profitability. Under a system of flexible exchange rates, according to this explanation, the resulting strong currency would implicitly generate the current account deficit that makes the dollars available to the foreign investors.

Regardless of drastically weakening U.S. economic activity, a plunging stock market and the Fed slashing its interest rate below the officially targeted euro-area interest rate, the dollar continued to appreciate during 2001 against the currencies of other major industrial countries, on average by 6%.

This behavior of the currency flagrantly contrasted with normal past experience. The reasonable explanation is that foreign faith in the U.S. economy's superior performance and prospects had until then remained untouched by the dismal facts. Reflecting record-high capital inflows, foreign-owned assets in the United States soared by $895.5 billion in 2001, though lagging the previous year's record inflow of $1,024.2 billion.

Some $285 billion of these capital inflows still went into U.S. stocks in 2001, down from $481 billion in 2000.



Foreigners were definitely the single strongest support for America's stock market during these two critical years. Without this money from abroad, U.S. stocks would clearly have encountered a far steeper slide.

The bulk of the massive foreign buying both of U.S. equities and corporate bonds, by the way, came from Europe.

WEAKNESS CATCHES UP TO THE DOLLAR

Eventually, things caught up with the dollar. In the second quarter of 2002, dollar strength quite abruptly gave way to pronounced dollar weakness.

While it took the U.S. currency more than two years to rise 20% against the euro and yen, it lost this gain within a few months. The slide has continued unabated ever since. And although the consensus readily sees a bottom whenever the freefall slows, the fact is that the dollar will continue to lose value due to America's complete lack of saving and its overwhelming trade deficit, now standing at over $617 billion a year.

Of course, hard falls in saving and soaring trade deficits are nothing new in history. Yet compared to the past, there are two great differences now. One is in the contrasting reaction of policymakers, investors and economists; the other is in the enormous, unprecedented size of today's imbalances.

Until the early 1980s, fairly small trade deficits could cause tremors in the markets, forcing policymakers to take countermeasures. Today, there is generally complete indifference to trade deficits of mammoth size on the part of both policymakers and the markets.

The following article from Ragnar Bentzel, a professor at Uppsala University, in the Scandinavian *Skandinaviska Enskilda Banken Quarterly Review* in early 1980, struck us as an exemplary analysis of the macro problems inherent to falling savings and a rising trade deficit:

The lack of balance may be seen as a result of refusing to cut our coat according to our cloth and of attempting to maintain as long as possible our standard consumption by two tricks: namely, in the first place, by borrowing abroad; and secondly, by cutting back investments. In order to understand today's situation, it is important to realize that, for several years now, we have devoted ourselves to "excess consumption" in the sense that we have allowed the share of consumption in the national product to become far too large to permit balanced economic growth. Let us examine this more closely.

During the 1960s, 25% of the national product was allocated to investment and 25% to consumption (private and public). In the second half of the 1970s, things began to happen. The investment ratio fell at the same time as the current account balance began to exhibit large deficits. [By] 1979, the savings ratio was not larger than 17%, while the current account deficit rose by 1% or 2% of national product. On a net basis, i.e. making deductions for wear and tear, the calculation shows that the net savings ratio has fallen from 15% to 6%.

One can note that today's large lack of balance, current account deficit, budget deficit, inflation and unemployment have a common denominator, and that is the restructuring of the Swedish economy from industry to public service, or, to express it in other words, the deindustrialization of the Swedish economy. This has had a completely devastating effect on the Swedish economy.

If the Swedish economy is to achieve a state of balance again, we shall have to reduce the share of consumption in the national product from 84–85% in 1980 to something like 76–77%.

We must get rid of the romantic dream that the Swedish industries of the future will be based on a foundation of gloriously sophisticated industries. It is all right to invest in them; but as for the expansion that must come

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about, we must devote ourselves also to more trivial occupations such as extracting iron ore from the ground, making steel, pulp, cars and even simpler types of engineering products.

Sounds familiar, does it not? Not the argument, of course, but the underlying facts. In essence, the Swedish professor argued that Sweden is being deindustrialized through "excess consumption," leading to shrinking capital investment and a rising trade deficit.

Measured by the slump in savings and the size of the current trade deficit, the U.S. economy is clearly in far worse shape today than the Swedish economy was at the time of his article.

FINALLY, THE U.S. TRADE DEFICIT FINDS ATTENTION

Lately, the U.S. trade deficit has gained growing attention. Its key role in determining the dollar's exchange rate has finally been recognized. Yet American arguments reveal a lot more complacency and indifference than worry.

This complacency starts with the widespread view that the huge U.S. trade deficit primarily reflects slow economic growth and excessive saving abroad, and it ends with the happy conclusion that the U.S. economy's superior growth and wealth performance assures the large capital inflows it requires to finance the deficit.

Others, rather, rely on the Asian central banks to prevent a steeper and damaging fall of the dollar. Asian central banks, they argue, have deliberately chosen to peg their currencies — either rigidly or more loosely — to the dollar, defending these exchange rates with heavy dollar purchases. While they may suffer heavy losses on their rapidly rising dollar holdings, they readily accept this loss, because keeping their exports cheap in support of their domestic economic growth is the far more important consideration for them. In fact, they are mainly financing their own exports.

Recently, a series of papers from three economists at Deutsche Bank — M. Dooley, D. Folkerts-Landau and P. Garber — found some publicity. In their view, a newly symbiotic world has developed in which Asian central banks readily finance the excessive spending of the American consumer, reflecting a revived Bretton Woods. *"It is in everyone's best interest that this continues"* is their conclusion, finding many ready believers in the world.

We would say it is in everyone's *perceived* interest that this development is beneficial to both sides and that it should therefore, hopefully, continue. For sure, it does look mutually beneficial at first sight, but more careful thinking should make it clear that destructive implications are looming in the longer run.

First of all, it is a badly flawed view that the U.S. trade deficits primarily reflect faster U.S. economic growth rates. Historically, just the opposite is true. It has been typical that fast-growing economies regularly run a trade surplus. In the past, booming Germany and Japan ran a surplus for decades, and presently, so does Asia ex Japan, with economic growth rates of more than twice that of the United States.

In reality, what determines the state of a country's trade balance are two specific conditions: *first*, the level of domestic saving; and *second*, the pattern of growth —consumption led or investment led. The United States has consumption-led growth with record-low national savings. With much higher economic growth, China has a chronic trade surplus due to record-high rates of saving and investment.

Economic growth biased toward high capital investment is implicitly also biased toward strong exports and a trade surplus. In contrast, economic growth biased toward high consumption invariably weakens investment and exports and boosts imports. Capital formation through saving and investment are the decisive basics behind a country's trade performance. In fact, they are the decisive basics for healthy, sustainable economic growth.

WHY A TRADE DEFICIT MATTERS

Discussing the U.S. trade deficit, American policymakers and economists mainly ponder its sustainability. There is very little or no thinking at all about possible deleterious implications for the U.S. economy, at least not in public.

There are, in effect, two different kinds of damages: One is a soaring bill of compound interest on the soaring foreign indebtedness; the other is a shift in the economy's resource allocation from investment and international trade toward consumption.

In a recent report titled *Debt and the Dollar*, the Economic Policy Institute in Washington presented a chart projecting the debt service on foreign debts over 10 years into the future based on two assumptions: *first*, that the U.S. current account deficit neither improves nor worsens; and *second*, that GDP will grow at the rate forecast by the Congressional Budget Office and that the interest rate on the soaring foreign debts will follow the projections of the CBO.

First of all, these assumptions are too good to be true. Even then, the debt service costs just from the additions to the foreign indebtedness over the next 10 years would rise from zero in 2004 to 1.7% of GDP in 2014, the equivalent of $250 billion in 2004 dollars. Net U.S. foreign indebtedness would then hit 64% of GDP, up from 24% at present.

We would say this surge in debt service costs makes the U.S. trade deficit flatly unsustainable at its present size. In reality, it is rapidly increasing in relation to GDP growth due to an ongoing shift in the allocation of available resources away from investment and toward consumption. Its most spectacular and also most frightening part is the progressive hollowing out of the U.S. manufacturing sector.

Consider that U.S. industrial output has increased by a paltry 1.5% since 2000, as against a simultaneous increase in real GDP by more than 10.4%. Manufacturing has decoupled from spending growth, as measured by GDP. More than all of the job losses before 2003 — around 3 million — were in manufacturing. Growth is exclusively in services, health service in particular.

A RUINOUS TRADE DEFICIT

Assessing the various imbalances in the U.S. economy, we regard the huge trade deficit as the most dangerous for two reasons: *First*, through the currency link, it threatens the stability of the whole financial system; and *second*, it wrecks the manufacturing sector. In new American parlance, though, this is creative destruction.

We fully realize that the statement about wrecking U.S. manufacturing will meet protest and ridicule from most American economists. They entertain an almost religious belief that outsourcing, globalization and cheap Chinese products are rendering long-run benefits to the United States as a whole by providing cheap imports, though this may hurt some people in the short run.

The apologists of the U.S. trade deficit like to quote the famous David Ricardo (1772-1823) as their most prominent witness for the mutual advantage of international trade, even if one country is cheaper in all products. One such example he cited was the trade between England and Portugal in wine and cloth. Although Portugal produced both goods cheaper than England, it specialized in wine as the product with the greatest comparative advantage.

He was right. Yet any comparison with today's grossly imbalanced trade between the United States and Asia is misplaced. At Ricardo's time, international trade was governed by the gold standard, under which even small chronic trade deficits were flatly impossible.

At issue are not the advantages of outsourcing and globalization as such; rather, at issue are the immediate and long-term implications of the factual, monstrous U.S. trade deficit for the U.S. economy. This deficit is lately exceeding an annual rate of $700 billion, after $413 billion in 2000.

In essence, this deficit implies that this amount of domestic spending is diverted from American to foreign producers. The most important next point to realize is that this loss of spending and associated income creation does not distribute across the whole U.S. economy. No — it is narrowly concentrated on the relatively small manufacturing sector, accounting today for less than 15% of U.S. GDP.

American economists cheer the U.S. economy's ability to run such a huge trade deficit for an indefinite period of time, thanks to the largess of the Asian central banks in financing this spending excess. What they are cheering is America's deindustrialization. That, namely, is the somber reality behind the easy financing of the monstrous U.S. trade deficit.

The following quote from Joan Robinson, a brilliant economist of the 1930s, has put our elaborate reflections about the extremely harmful economic implications of the huge U.S. trade deficit for the U.S. economy into a few, easily comprehensible sentences:

The deficit country is absorbing more, taking consumption and investment together, than its own production; in this sense, the economy is drawing upon savings made for it abroad. Whether this is a good bargain or not

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depends upon the nature of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin.

A VERY DIFFERENT BUBBLE

What about the benefits that the Asian countries gather from their dollar pegging and the export surplus with the United States? Undisputedly, China is the key variable. Over the three years 1997–2000, its central bank increased its foreign reserves rather modestly, from $142.7 billion to $168.3 billion. Last year alone, they soared by $206.7 billion, to $609.9 billion, with almost half of this increase occurring in the last three months of the year.

These numbers compare with total exports of $593.36 billion and a small export surplus of $31.98 billion in 2004. Most of the Chinese dollar deluge resulted, therefore, from speculative inflows betting on the Chinese currency's revaluation. China's annual trade surplus with the United States is, actually, around $165 billion, but most of it dissipates in deficits with other countries.

All these numbers hardly make exciting reading. What gives them their great global thrust is the fact that the Asian central banks generally monetize their trade surpluses. Purchasing dollars to prevent the appreciation of their currency, they flood their commercial banks with central bank deposits (high-powered reserve money). This has stoked the Chinese economy through runaway credit expansion into its own runaway boom — with pronounced bubble features — which, in turn, has been stoking other booms in Asia.

The typical features of bubble economies are unsustainable gross disproportions in their growth pattern. Ironically, the disproportions in Asia are diametrically opposite to those in the economies of the Anglosphere. Thanks to record-high savings and investment ratios, the production side in these countries is outpacing the demand side. Anglo-Saxon monetary looseness delivers the missing demand to fill the output-spending gap. It seems a perfectly complimentary system. Americans do the consuming, while Asians do the producing.

YET THERE IS A TIPPING POINT

For sure, it has worked satisfactorily over the past few years. But the inherent structural distortions on both sides are not standing still. They keep worsening. The U.S. trade deficit is relentlessly increasing as a share of GDP. In the fourth quarter of 2004, it hit 6.3% of GDP, up from 4.5% a year before.

As we pointed out earlier, the trade deficit is wrecking U.S. manufacturing for a manifest reason: It is the one sector in the economy in which the deficit is concentrated. In the fourth quarter of 2004, fully 98% of the U.S. current account deficit accrued from U.S. foreign trade in goods.

Our stance concerning the U.S. economy has been quite simple since early last year. During 2003–04, it got a tremendous impetus from the most prodigious monetary and fiscal pump priming in history. The result, despite all the hype, has been the weakest and most lopsided economic recovery in the postwar period.

Consumer spending responded promptly and strongly to the extraordinary stimulus. Yet it was clear right from the start that a self-sustaining recovery of sufficient vigor would require strong support from rebounding business capital investment with its implicit dynamics of job creation and income generation. It has not happened. There were improvements during 2004, yet they remain grossly subpar for self-sustaining economic growth.

Under these circumstances, we read with growing amazement reports portraying a U.S. economy bursting with vigor now that *"wages and salaries are growing at a healthy pace and corporations are awash in cash"* (*BusinessWeek*, March 28, 2005). For many commentators, the Goldilocks economy has returned in full force with a combination of strong growth, relatively low inflation and record profitability.

Manifestly, we believe differently.

THE TRUE MEASURE OF ECONOMIC STRENGTH

But how does this conform with the fact that it has for years been the strongest in the world, even pulling the rest of the world with it?

The fact that the U.S. economy has outperformed the rest of the world in the past several years has one reason that is obvious and also easily explained. That is its credit machine, which has no parallel in world. It is geared to accommodate absolutely unlimited credit for two purposes — consumption and financial speculation.

There has developed a tremendous and growing imbalance between the huge amount of credit that goes into these two uses and the minimal amount that goes into productive investment. Instead of moving to rein in these excesses and imbalances, the Greenspan Fed has clearly opted to sustain and foster them.

Today, it is customary to measure economic strength by simply comparing recent real GDP growth rates. It always becomes fashionable when U.S economic growth is higher than in Europe.

From a long-term perspective, however, economic policy and economic growth are about resource allocation, meaning allocation of physical resources, that is, available tangible capital stock and labor. How much of the current production is devoted to consumption and how much to capital investment? Looking for economic health and strength, generations of economists have focused on two economic aggregates: savings and investment, in particular net savings and net investment.

It used to be a truism among economists of all schools of thought that the growth of an economy's tangible capital stock is the key determinant of increased productivity, and subsequently of good, high-paying jobs. And it also used to be a truism for economists that, from a macroeconomic perspective, tangible capital investment into factories, production equipment and commercial and residential building represents the one and only genuine wealth creation.

CORRUPTED THINKING IN A MONEY CULTURE

In America's new money culture, policymakers and economists make no difference anymore between wealth created through saving and investment in the real economy and wealth created in the markets through asset bubbles, created by extremely loose money and credit.

In 1996, an article in *Foreign Policy* entitled "Securities: The New World Wealth Machine," explained how securitization — the issuance of high-quality bonds and stocks — has become the most powerful engine of wealth creation in today's world economy. Whereas societies used to accumulate wealth only slowly, they can now do so quickly and directly, and "the new approach requires that a state find ways to increase the market value of its productive assets." In such a strategy, "An economic policy that aims to achieve growth by wealth creation therefore does not attempt to increase the production of goods and services, except as a secondary objective."

This a perfect description of the corrupted economic thinking that is today ruling in America, not only in corporations and the financial markets, but even among policymakers, elevating wealth creation — that is, bubble creation — to the ultimate wisdom in the policy of economic growth.

There can be no question that the rapid sequence of asset bubbles — stocks, bonds, housing — that the United States has seen in the past few years were crucial in stimulating economic growth. Considering, though, its tremendously lopsided effect on consumer spending and the associated consumer-borrowing orgy, we are unable to regard this as a reasonable and sustainable policy. It works in the short run from the demand side, but it has come at heavy structural costs.

With these remarks, we wanted to make one thing perfectly clear. It is not profits, savings and investment that drive U.S. economic growth. It is America's unparalleled credit machine, and that alone makes all the difference in economic growth and wealth creation between America and the rest of the world.

WHO NEEDS RESTRUCTURING MOST OF ALL?

Looking at the United States and Europe, we keep asking ourselves which economy needs drastic restructuring most of all. Our categorical answer is the U.S. economy, with its egregious, destructive trade deficit.

This protracted, drastic shift in the U.S. economy's demand pattern has essentially invoked a commensurate drastic shift in the use of available resources. Dollar devaluation, clearly, does very little or nothing at all to rectify this detrimental resource shift in the economy away from investment and toward consumption.

The reversal of this destructive trend first requires a consumer who significantly restrains his borrowing and spending excess. Actually, we think that the unfolding sharp slowdown in disposable income and the fading, if

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not bursting, of the housing-refinancing bubble will force him to retrench in due time. This is inescapable and will be the great surprise of 2005. If the Fed continues its rate hikes, this will, of course, also help.

DOLLAR APOCALYPSE

Could the dollar's decline turn into a total collapse, also capsizing the financial markets? Earlier, we described what happened in 1987, when American and foreign investors lost their nerve about the falling dollar. For several months, it also spelled disaster for U.S. stocks and bonds. Yet it proved a brief crash that ended in a soft landing for the dollar and the markets. It now seems a comforting experience.

On closer look, it is not. Today's economic and financial conditions in the United States are incomparably worse than in 1987–89. Economic growth is much slower today, the trade deficit is much higher and interest rates are still much lower.

But there is still another factor that makes a great difference: the unprecedented exposure to the risk of a falling dollar, running into trillions of dollars, both from existing foreign holdings of dollar assets and from euro liabilities incurred by American corporations and institutions. The important point here is that both have principally abstained from covering their exchange risk. Strong expectations to gain from a strong dollar or from a weak euro prohibited any hedging.

But the unexpected reality for them now is a falling dollar and a rising euro. Being sure of a further long and steep fall of the dollar, we have been wondering for some time when foreign investors and American borrowers will finally give up on the strong dollar and stop their bloodletting either by liquidating their positions or by safeguarding themselves at least against currency losses by selling dollars in the forward market. Such hedging has probably started, though at a moderate scale.

This brings us to the destabilizing forces at work in the markets. There is a widespread assumption of a "normal" level of the dollar against other currencies, from which it will not diverge too far or too long. No such level exists. The dollar is effectively out of control. There is no way to say where it may bottom. This is a measure of the macroeconomic costs of allowing an external disequilibrium to become so large and to accumulate for years. The dollar's fate no longer lies in the hands of central banks or banks, but in the hands of many millions of fickle private investors.

Mr. Greenspan's extreme monetary looseness created a whole variety of bubbles. The dollar bubble was one of them. All bubbles infallibly burst. Considering the incredible size of the excesses and imbalances that have accumulated in the U.S. economy and its financial system, there is certainly the potential for an uncontrollable crash of the dollar.

It may be argued that financial markets outside the United States are too small to absorb the large capital outflows from the United States accruing from a flight out of the sinking dollar. The fact is that America's huge deficit in its current account allows only capital inflows, even at a large scale, but it allows no capital outflows. It is the huge outflow of dollars through the trade deficit that makes the dollars for capital inflows available. The foreign investors pick them up to buy dollar assets.

Who, however, makes the necessary euros available to those foreign investors who want to exit the dollar for the European currency? Nobody. Given the chronic national and international U.S. spending excesses, there is effectively no way for foreign investors to decrease their dollar holdings in the aggregate. If they attempt to exit, they have to find owners of euros who are willing to switch them against dollars. They will be a rarity in the markets, meaning that the brunt of foreign selling of dollars assets will fall heavily on the currency and the financial markets.

WHAT CAN STABILIZE THE DOLLAR?

It always amazes us how many questions are asked and pondered about the dollar's prospects. The key cause of its slide, of course, is the fact that capital inflows are more and more lagging the stubborn current account deficit. As long as this lag lasts, the dollar will fall.

In principal, there are two radical solutions to stabilize and strengthen the dollar: *First*, the United States must offer higher rates of return on assets than Europe and Japan to restore high capital inflows; and *second*, it must curb its trade deficit by drastic monetary and fiscal tightening.

It hardly needs any explanation that neither of the two has the slightest chance of materializing. We go a step further in stating that the Greenspan Fed will do nothing to defend the dollar. It cannot, for a compelling reason: Both the economy and financial markets, each being completely based on financial leverage and carry trade, would collapse.

CARRY TRADE SETS THE LIMITS TO RATE HIKES

Although the Fed has moved its federal funds rate from 1% to 2.75%, its speakers, and Alan Greenspan himself, keep emphasizing that "easy money" is still in place. In his congressional testimony on Feb. 16, 2005, Mr. Greenspan said, *"The cumulative removal of policy accommodation to date has significantly raised measures of the real federal funds rate, but by most measures, it remains fairly low."*

The official target is to raise the Fed's federal funds rate to a "neutral" level. Although Mr. Greenspan has admitted not to know where that rate is until he gets there, there seems to be a general assumption that it implies sustainable economic growth with price-level stability. Where could that rate be in the U.S. case?

We have learned that the inflation-adjusted federal funds rate has averaged around 2% over the postwar period. Given a present inflation rate for consumer prices of around 3%, this would put the "neutral" nominal federal funds rate presently at close to 5%, plainly far above its current reading of 2.75%.

To be sure, nobody in the Fed is seriously eying this rate. They are undoubtedly fully aware that a short-term rate at this level would definitely pull the rug out from under the whole U.S. financial system.

The crucial point to keep in mind is that America's present high level of asset prices has its foundation not - as is normal - in available savings, but in highly leveraged "carry trade," the extensive practice of financial institutions to ride the yield curve by borrowing short at low rates to buy higher-yielding assets, mainly longer-term bonds.

By holding U.S. short-term rates at artificially low levels and also making unlimited liquidity available, the Fed has driven the carry trade to unprecedented extremes in history. The desired result was artificially low long-term interest rates to fabricate the housing bubble. But as short-term rates rise, the carry traders get squeezed. Implicitly, there comes a point when they are forced to liquidate their leveraged positions.

However hawkish the Fed's talk about fighting inflation may be, the monstrous carry-trade bubble is setting narrow limits on any further rate hikes, regardless of what may happen to consumer price inflation or the dollar.

To put it briefly and bluntly, the Fed is no longer in control of its interest rate instrument. Considering the threat of collapsing carry trade, it would surprise us if they dared to move the federal funds rate above 3.5%, though this might barely match the current inflation rate.

With 20 times leverage, or just 5% equity, as the virtual norm in bond carry trade, a rise in the yield of 10-year bonds by just one percentage point would more than wipe out the whole underlying equity.

CONCLUSIONS

Despite all the worried talk about the sliding dollar, both the financial markets and economic forecasters are taking it in stride. Conspicuously, nobody speaks of a dollar crisis at present or in the future.

There appears to be widespread hope that the declining dollar will reduce the U.S. trade deficit to levels that can be sustained by reduced capital inflows. Past experience gives no cause for such hope.

To emphasize the main point: The chronic U.S. trade deficit reflects exceptionally high levels of consumption, undersaving and underinvestment. Improving the trade deficit requires a major correction of these imbalances. America’s bond and stock markets are far too fragile to allow serious monetary tightening.

We have not seen the dollar hit bottom yet.