

## The US Dollar

**Since 2002 the trend of this currency has been devaluation!**

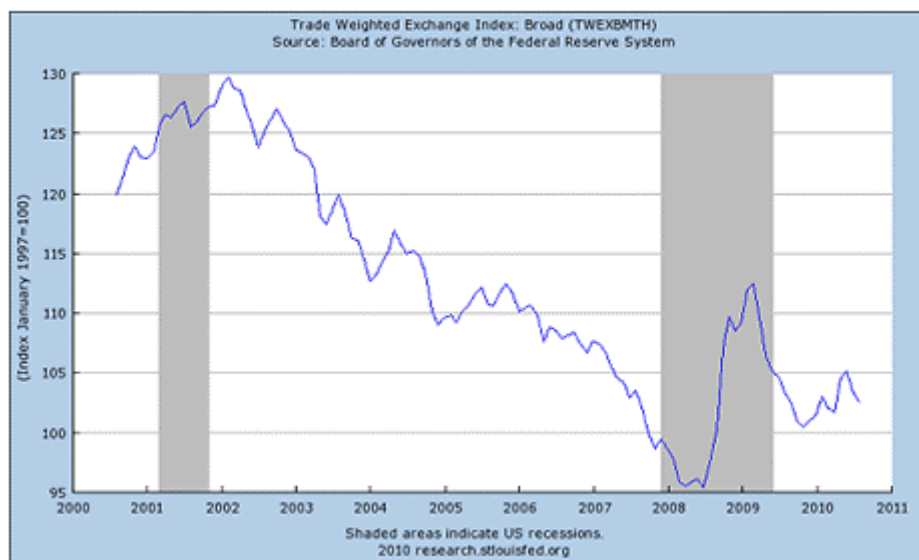
07 October 2010

This week's report on the decline of the dollar has prompted over 25 members to request a more in-depth explanation of the topic. The main question focuses on what may happen if RIO's perception is correct and the USD will continue to decline? The dollar has been in decline since I first predicted its fall in value over eight years ago.

I will both quantify and clarify the question posed by those who have e-mail and to further address the topic on the dollar decline as best I can by first re-addressing the question. How large a decline in the dollar is required to allow for a meaningful adjustment in relative wages is the real issue? I should point out that it is impossible to make precise estimates, but a close look at real effective exchange rates, which allow for cross-border wage comparisons, then something in the order of 30-40% is probably required.

This is in addition to the approximately 20% devaluation of the dollar seen over the past eight years. US dollar depreciation was accurately predicted by me in 2002, as illustrated in the chart. The downward trend in the US dollar's value did indeed begin in 2002, with an exception being a short-lived rally during the middle of 2008 to early 2009 (This rally has since eased, but that's another story).

**In broad trade-weighted terms the dollar has only declined by 20% since 2002**



Once unemployment declines far enough, say to 5% or so, wage pressures are likely to build. Eventually, wages will rise to the point that they enable households to service previously accumulated debt burdens. When that happens, sustainable growth will again be possible, although households will find that their global purchasing power and relative standard of living has declined dramatically. This is another lesson of the stagflationary 1970s, in which the US standard of living was more or less stagnant yet that of the rest of the world, including Japan and Germany, increased markedly.

Those who recall the 1970s must wonder why on earth the Fed would want to enact policies which would in all probability lead to a similar set of stagflationary conditions. The Fed might claim that it does not have much of a choice. Once originated, debt simply needs to be serviced. It can, however, be serviced in a strong or in a weak currency. A country with a solid infrastructure and industrial base and with plentiful natural resources might easily manage to service debt in a strong currency.

Indeed, had the US run up its accumulated debt in order to finance sensible investment projects over the years, it would most probably be able to manage to service this debt without resorting to dollar devaluation. **This has not been the case as pointed out in my investment reports over the years. Much of the debt the US has piled on in recent decades has been used to finance consumption rather than investment.** Furthermore the Fed has done so to the extent that the US has invested in rather than consumed capital, with much of it going into ill placed investments.

Examples of this type of investment were widespread in the dot.com and subsequent massive housing and securitized credit bubble, which grew with the support of all manner of federal subsidies—courtesy of Fannie and Freddie, among other federal agencies and, of course, artificially low Fed interest rates.

The statistics clearly show that the debt-financed consumption and housing boom is now over. **But the debt remains and it cannot be properly serviced with the existing productive resources of the US economy. The debt needs to be either devalued or defaulted on!**

Looking back though reports I note a string of warnings from as far back as 2001. Some US members of our club were offended in some cases by my choice of words on the issue of dollar devaluation!

In September 2003 was written “US dollar volatility to continue” (attached for reference) and again the subject featured in RIO News Past, Present and Future edition printed in 2005. I said then that a lower dollar would help ease the US debt burden, lower their current account deficit and give American manufacturers a boost in global commerce”.

The record shows that my concerns over the devaluation of the dollar were well founded. The USA policymakers clearly want the dollar devaluation to continue and, more to the point have even defined the road ahead. The Fed and US policymakers generally have made it very clear that they much prefer to reduce the debt burden by a policy of devaluation-inflation rather than go through a comprehensive default. A debt restructuring exercise would be another possible approach, but in the current economic climate this would seem to be a hazardous of course of action, which is why policymakers are set against it.

Fed Chairman Bernanke himself has previously weighed in on this matter. In his opinion, it comes down to politics and the ability, or inability, to make tough choices:

The solvency of banks and corporations and the implementation of significant structural change are necessary for long-run economic health. However, in the short run, comprehensive economic reform will likely impose large costs on many, for example, in the form of unemployment or bankruptcy. As a natural result, politicians, economists, businesspeople, and the general public have sharply disagreed about competing proposals for reform. In the resulting political deadlock, strong policy actions are discouraged, and cooperation among policymakers is difficult to achieve.

But when did Bernanke say that he preferred “comprehensive economic reform” rather than zero interest rates and open-ended liquidity creation (e.g. quantitative easing)? In fact he was not talking about the US in this case, but rather about Japan. Mr. Bernanke seems to think that while that is what is required for Japan to achieve “long-run economic health”, it somehow does not apply to the United States! But of course it does! The above quote indicates that he probably knows that it does. However, as he also says above, to take such action “will likely impose large costs on many”.

**To reiterate there would definitely be cost impositions, including of course those financial institutions supposedly regulated by the Fed, many of which have been bailed out by the powers that be. These institutions are still sitting on large holdings of bad loans and toxic securitized debt.**

**It is obvious that it is much easier to understand recent Fed policy actions in light of the above admission that the Fed is focused primarily, perhaps exclusively, on the short-term survival of the financial system rather than the long-term health of the US economy generally?**

But what would happen if the euro-area governments, Japan and other countries resisted such a US Fed policy of foreign asset purchases? How could these countries fight such actions? By countering any such actions with purchases of their own, the net result being that the dollar does not devalue, but rather that the global money supply soars and a currency war could ensue!

I would predict that, in this situation, investors will attempt to escape the risk of general, global fiat currency devaluation by fleeing into real assets, most probably liquid commodities, including of course precious metals. **I have been outspoken on this in meetings with members/investors having been proven right on the mortgage collapse and the rise in the value of gold.**

**Members may consider an inward investment to RIO Professional Investors Fund which is likely to see strong gains should my predictions above come to fruition. The fund is trading in gold regularly and oil occasionally with both commodities traded successfully both have produced gains for the fund.**

As I have said in my reports an all-out currency war could spark an incipient hyperinflation which could occur if policymakers did not take immediate action to restore fiat currency credibility—possibly by implementing Volcker-style rigid money supply targets, or even pegging to gold.

I consider a global hyperinflation scare unlikely, however, but the possibility of a global currency war should give investors food for thought? The RIO Professional Investors Fund would benefit from any decline in the US dollar's value. Should the USA not get what they obviously wish for, the US dollar devaluation due to the onslaught of a currency war, again the Professional Investors Fund would likely see its commodity holdings soar in paper value terms.

This report provides a cautious view for members/investors with a practical suggestion on wealth preservation, combined with the advantage of maintaining liquidity, in a world in which currencies can no longer be considered reliable bastions of safety.

**William Gray**

Executive Chairman

The RIO Club

The largest Private Investment Club in Asia.