

Monthly Economic Review

No. 185, November 2004

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Another interesting debate

Monetary and non-monetary approaches to forecasting

Money growth suggests further interest rate rises needed in 2005

An interesting debate has opened up in the last few weeks between monetary and non-monetary approaches to forecasting the UK economic outlook. The central conclusion of the monetary analysis is that, because money supply growth has been rising and is now almost 10% a year, the prospect is for continued buoyancy in domestic demand in early 2005, further excessive pressure on the nation's resources and the risk of above-target inflation in late 2005. The punch-line for policy-makers and markets is that base rates at 4¾ % will not be sufficient to keep inflation under control. By contrast, most non-monetary analysts take a relaxed view of the situation, believing that the rise in base rates so far announced has imposed enough restraint in the housing market and on consumer spending for inflation to remain on track. The OECD - not well-known for monetary analysis - has weighed into the debate by suggesting (according to a report in the *Financial Times*) that base rates may need to peak at 5¾ % in late 2005. In the words of its latest *Economic Outlook* the economy "is probably operating close to capacity".

Growth in money and nominal GDP are related

Three points will be made here to amplify the monetary analysis. The first is perhaps routine, but has to be stated. Although the growth rates of money and nominal gross domestic product may not be identical, they are related in the long run. If the decade to the second quarter of 2004 is chosen, the annual growth rates of M4 and nominal GDP averaged 7½% and 5½ % respectively. The 2% gap may or may not continue, but - if it did - the annual growth rates of nominal GDP consistent with 9% - 10% M4 growth would be 7% - 8%. Plainly, these could not be reconciled with inflation at the target rate of 2%. At current interest rates banks are finding it easy to add assets and to grow their balance sheets at annual rates of about 10%. Unless this situation changes, interest rates are too low. Secondly, evidence of a slowdown is not enough. As the level of output is probably at trend (or perhaps a smidgeon above it), trend growth is the maximum compatible with stable inflation. If the quarterly growth rate of demand moderates from the 1%-per-quarter seen over the last year to, say, 0.7% - 0.8% a quarter, that is welcome, but growth would still be above the economy's trend rate (usually put at about 0.6% a quarter).

Mistake of equating housing market with whole economy

Finally, recent commentary has fallen into the habit of equating "the state of the housing market" with "the state of the economy". This is a mistake. Housing matters enormously to consumer confidence, but investment in dwellings is only a small part of demand and large parts of the economy are more sensitive to other developments (oil prices, exchange rates, utility prices, etc.). Company investment is more volatile - and so more important to the cycle - than the personal sector's investment in houses. Over the last 40 years companies' investment plans have been much influenced by their balance-sheet strength, including their money holdings. At present corporate liquidity is in great shape.

Professor Tim Congdon

30th November, 2004

Summary of paper on

'Dollar redux'

Purpose of the paper

Financial markets have become concerned that a further large fall in the dollar will be needed to correct the USA's current account deficit. This research paper considers the risks in the USA's perhaps excessive reliance on official foreign buying of US Treasuries to finance its budget and current account deficits.

Main points

- The current account deficit on the USA's balance of payments has exceeded 5% of gross domestic product and may approach 6% of GDP over the next few quarters. The downturn in 2001 narrowed the deficit, but not by much. The smallness of the cyclical benefit argues that the dollar was then heavily over-valued. (See p. 4.)
- When assets are valued at market prices, the USA's net international investment position (its net "debt") is negative by over 20% of GDP. (See p. 5.) But its investors achieve a much better return on their overseas investments than foreign investors achieve in the USA and the USA still has a surplus on international investment income. (See pp. 6 - 7.)
- An area of particular vulnerability is the international demand for US Treasuries. This demand is partly from the private sector, but central banks and governments around the world also have large holdings of US Treasuries in their foreign exchange reserves and social security funds.
- In 1998 - when the USA had a budget surplus - just above a quarter of US Treasuries were held by policy-motivated investors (i.e., official foreign investors and the USA's own Federal Reserve); at mid-2004 - when it had a budget deficit - they held almost 45% of US Treasuries. (See pp. 8 - 9.)
- Foreign official holdings of US Treasuries jumped by \$261.5b. (or 30.1%) in the year to mid-2004. While central bank demand for US Treasuries depends on monetary policy (and particularly on the continuation of exchange rate links with the US dollar), it is difficult to believe that central banks will want to accumulate this low-return asset on the same scale in future. (See p. 10.)
- If Asian central banks stop buying US Treasuries, either the current account deficit will have to narrow or the gap in the capital account will have to be filled. Higher interest rates and/or a fall in the dollar may be needed to make US bonds and deposits more attractive to international investors.

This paper was written by Professor Tim Congdon.

Dollar redux

Challenges to the US dollar's reserve status

Crisis of 1997 and 1998 followed by massive increase in Asian holdings of US Treasuries,

With the collapse of communism, the USA was the world's pre-eminent economic power in the 1990s. The dollar enjoyed a strong bull market against other currencies between 1995 and 2000, despite the USA's large and widening deficit on the current account of the balance of payments. The dollar was given a particular fillip in 1997 and 1998 by "the Asian crisis". Financial turmoil in such nations as Thailand and South Korea was caused by capital flight, much of it into the dollar. Chastened by their experience in these years, Asian central banks have spent much of the subsequent period building up their foreign exchange reserves. Today Japan has more than \$800b. of FX reserves, China over \$500b., Taiwan almost \$250b., South Korea over \$175b., and Singapore and Hong Kong both over \$100b. Most of these reserves are in dollar-denominated assets, particularly US Treasuries. Since 2000 foreign official holdings of US Treasuries have soared from just above \$600b. to over \$1,100b. Such holdings will not continue to increase at the same rate as in the last few years, creating an awkward adjustment problem for the USA.

partly because of Asian nations' reluctance to revalue

(Note that Asian nations' currency management is fundamental here. China and Japan may make a great fuss and say that the USA should keep its finances in order. But, if they want to resist their currencies' appreciation against the dollar on the foreign exchanges, they have to buy dollars; and – if they buy dollars – it is sensible to invest them in US Treasuries. To pay for the dollars they have bought, the governments have to borrow in local currency, probably in part from the central bank and the commercial banking system. The result is faster money supply growth and inflation.)

Dollar assets must become more attractive through either a cheapening of the currency or a rise in US asset yields

In the year to mid-2004 foreign official holdings of US Treasuries climbed by \$261.5b. This was vital to the financing of the current account deficit, which exceeded \$570b. If the Asian central banks now stop buying US Treasuries, either the USA will have to reduce its current account deficit or another type of capital inflow will have to replace the official purchases of Treasuries. One conclusion is that the dollar has to fall heavily in value relative to other currencies, in order to induce new capital inflows of a different kind. However, an alternative view is that the adjustment may take place through a rise in yields on US assets, particularly US bonds. Some of the evidence in this research paper supports the need for a rise in yields. First, compared with experience over the past 20 years, the yield on 10-year US Treasuries is at present very low compared with the increase in factory-gate prices. (See p. 11.) Second, the proportion of US Treasuries held by US non-bank private investors is far less than has been normal historically. (See pp. 8 – 9.)

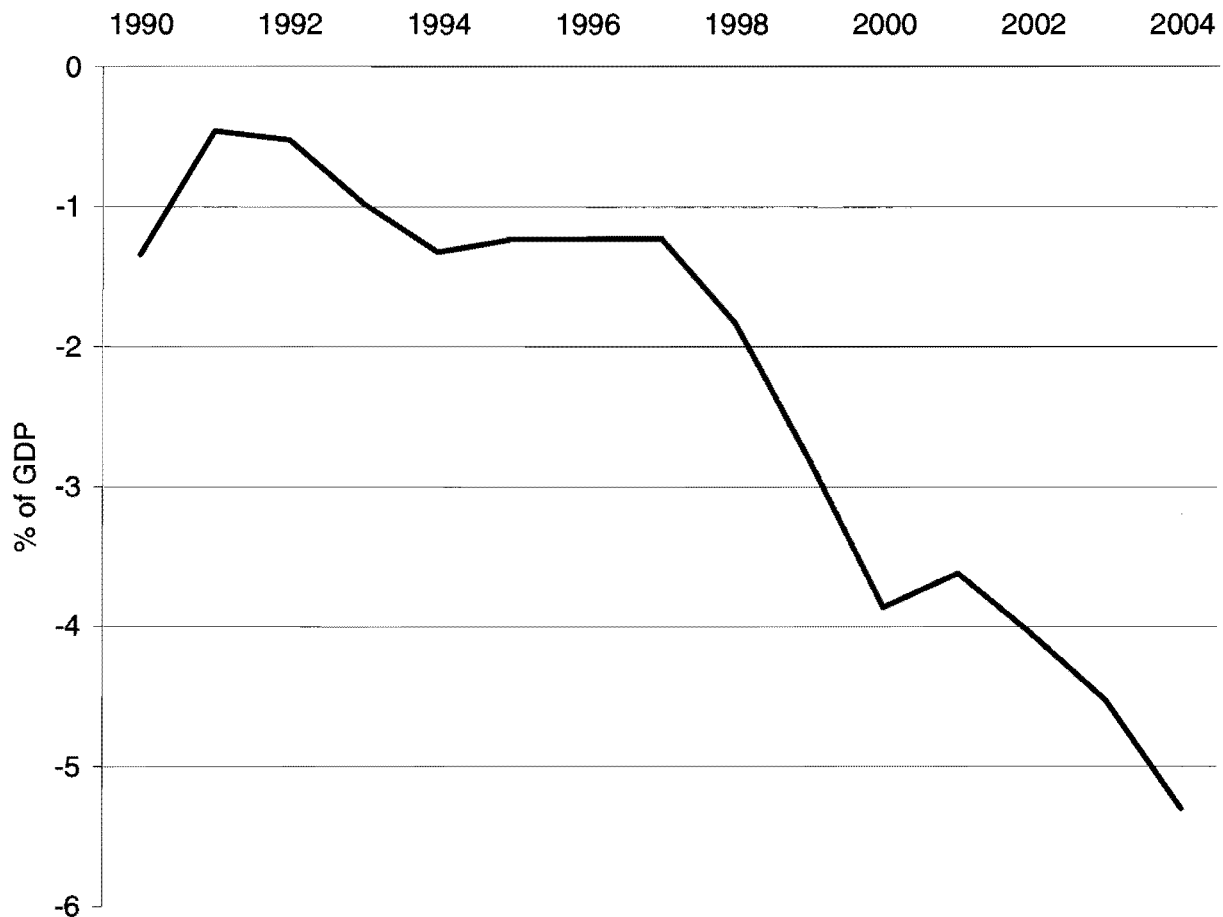
USA still has surplus on investment income

Pessimism on the American external payments position should not be over-stated. Although it has a large trade deficit (see p. 6) and is the world biggest international "debtor" (see p. 7), it has enormous assets as well as liabilities, and its citizens have been very successful in managing these assets profitably. In the year to mid-2004 it still had a surplus on international investment income. (See pp. 6 – 7.)

Sliding into the red

The USA's net exports as % of GDP

Chart shows exports of goods and services, minus imports of goods and services as % of GDP, using national accounts concepts current prices.

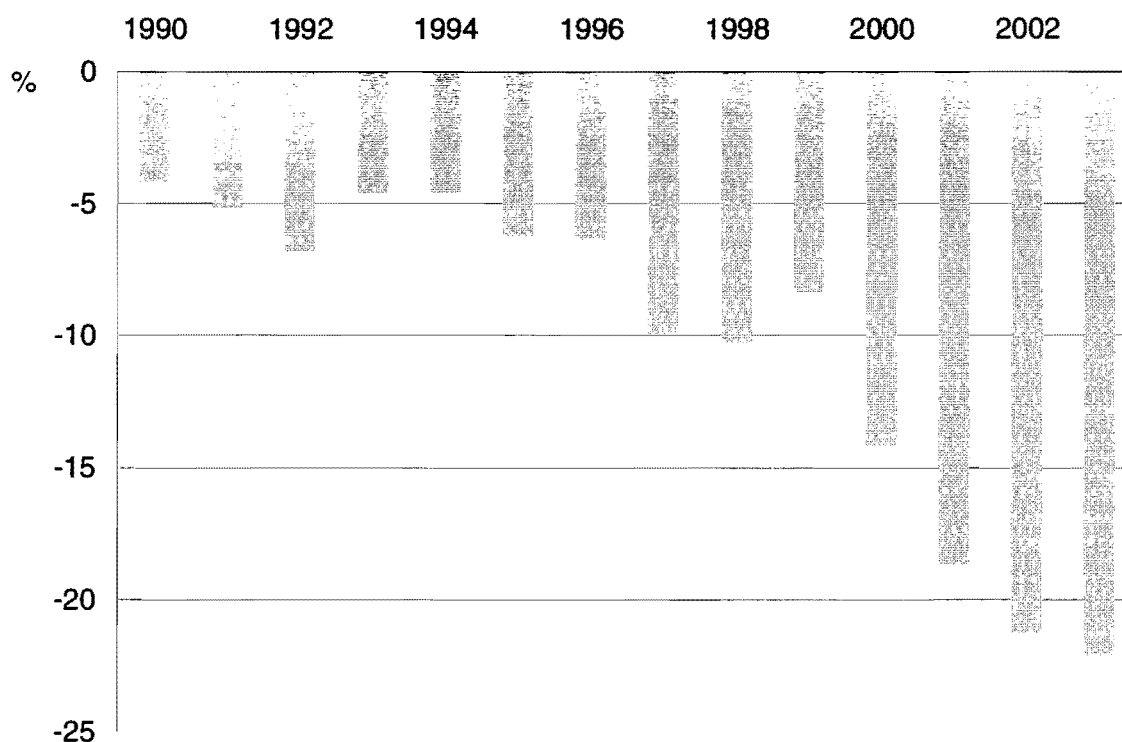


The USA has had a deficit on trade in goods and services without interruption since 1981. The deficit has fluctuated, depending on the level of the dollar and the USA's cyclical position. A sharp fall in the dollar from a peak in early 1985, and a mild recession in 1990 and 1991, curbed the trade deficit. It fell from just over 3% of GDP in 1987 to under 1% of GDP in 1991. The last downturn in the USA was not strictly a recession. GDP fell in two quarters (by 0.1% in the first quarter 2001 and by 0.4% in Q3 2001), but they were not consecutive. The extreme mildness of this quasi-recession may be part of the explanation for the negligible cyclical improvement in the trade position, but there is another and much more sinister interpretation. This is the dollar was so severely over-valued in 2000 and 2001 that the underlying trend in its external payments was for deterioration, and that this underlying trend dominated the favourable cyclical effect. On the trade-weighted index prepared by the Bank of England the dollar has so far fallen by about a quarter from its most recent peak in February 2002.

The world's biggest debtor

The USA's "net international investment" position

Chart shows the USA's net international investment position as % of US GDP, where NIIIP is assets minus liabilities and direct investments are valued at market prices

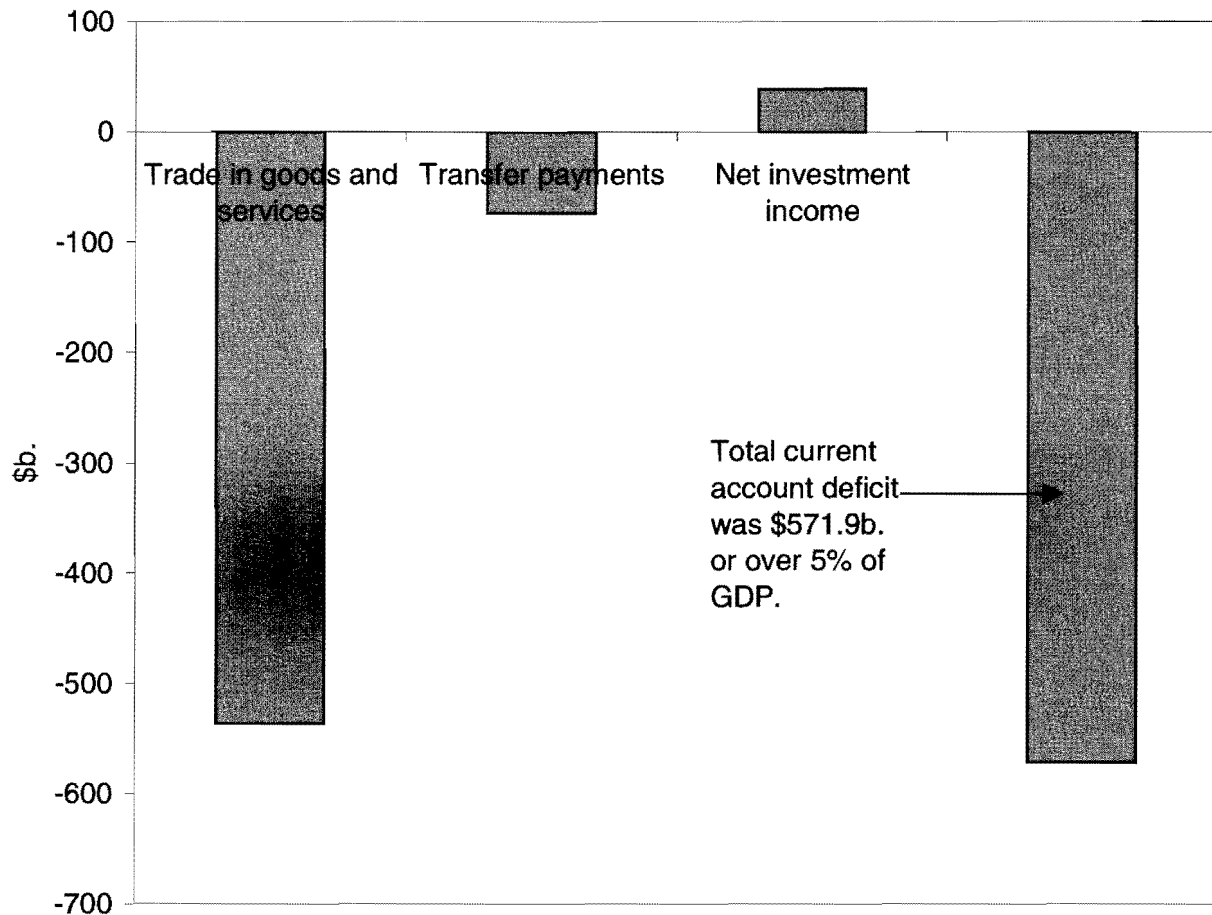


In the immediate post-war years the USA was the world's largest creditor nation by a very wide margin. The almost continuous current account deficits since the 1970s have transformed the position and the USA is now the world's largest debtor nation, again by a very wide margin. But it is important to keep the numbers in perspective. The value of all the capital assets in the USA is between \$50,000b. and \$60,000b., although the precise figure depends on how the calculation is done. At end-2003 the value of the assets owned by the rest of the world in the USA was \$10,514,958b., whereas the value of the assets owned by the USA in the rest of the world was \$7,864b. (Both these figures take direct investments at market value.) While the gross figures for external assets and liabilities are large, the net figure is quite small relative to all the capital assets in the USA. In a nation with a current account deficit equal to 5% of GDP and an investment ratio of 20% (roughly the USA's position), foreigners should eventually own about a quarter of the capital stock.

De-composing the deficit

Components of the USA's current account deficit in year to mid-2004

Chart breaks down current account deficit in year to mid 2004 into three components.

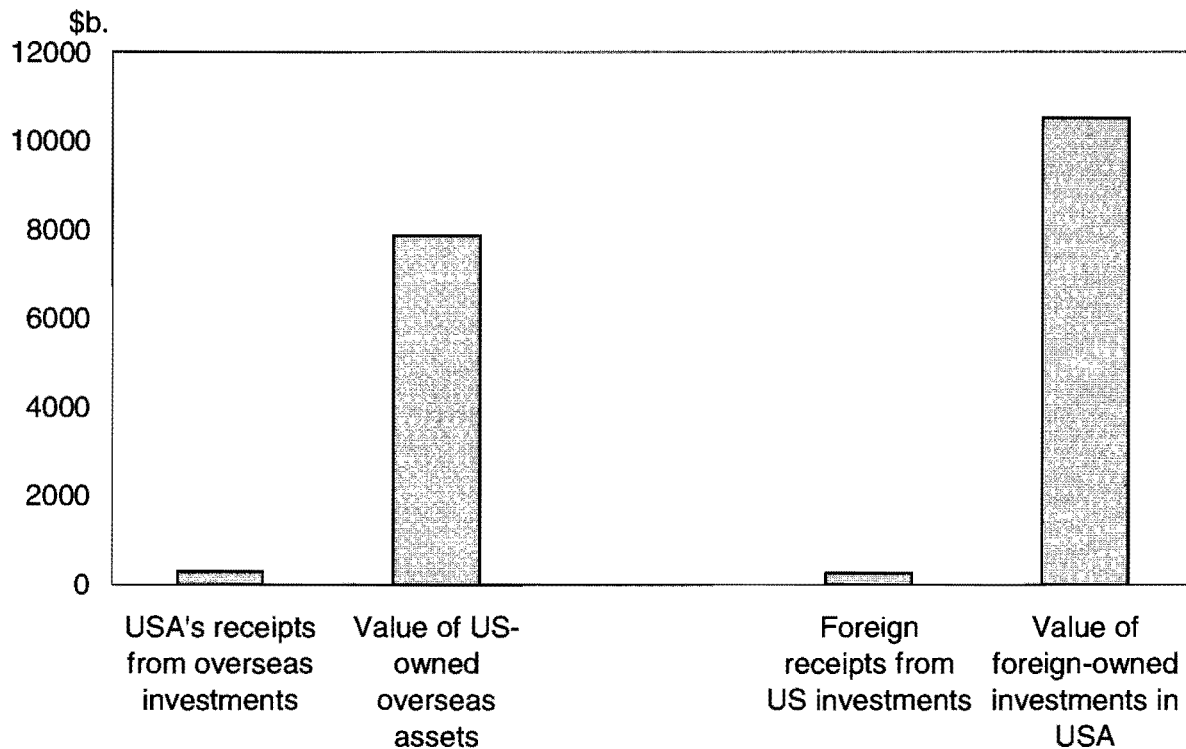


Concern has been expressed about the USA's external position for at least 20 years. In the late 1980s the Washington-based Institute for International Economics published several studies forecasting that the USA's net debt would approach 10% of GDP by a date in the 1990s, and proclaiming doom and disaster for the dollar as a result. In fact, the "net debt" (i.e., the negative "net international investment position") is now over 20% of GDP and life goes on. Part of the explanation for this apparent conundrum lies in the chart above. Despite two decades of virtually continuous current account deficits, the USA still had a surplus on international investment income in the year to mid-2004! This may seem puzzling, but American investors around the world achieve far better returns than foreign investors in the USA. (See the chart opposite.) It is very difficult to claim that a nation with a surplus on international investment income is insolvent (or anywhere near insolvency), whatever the excess of its measured liabilities over its measured assets.

Different investors, differing returns

Key items in the USA's international investment position

Chart compares receipts from international investments, for both the USA's foreign assets and foreign-owned assets in the USA, with estimated value of stock of such investments. Direct investments are valued at market prices.

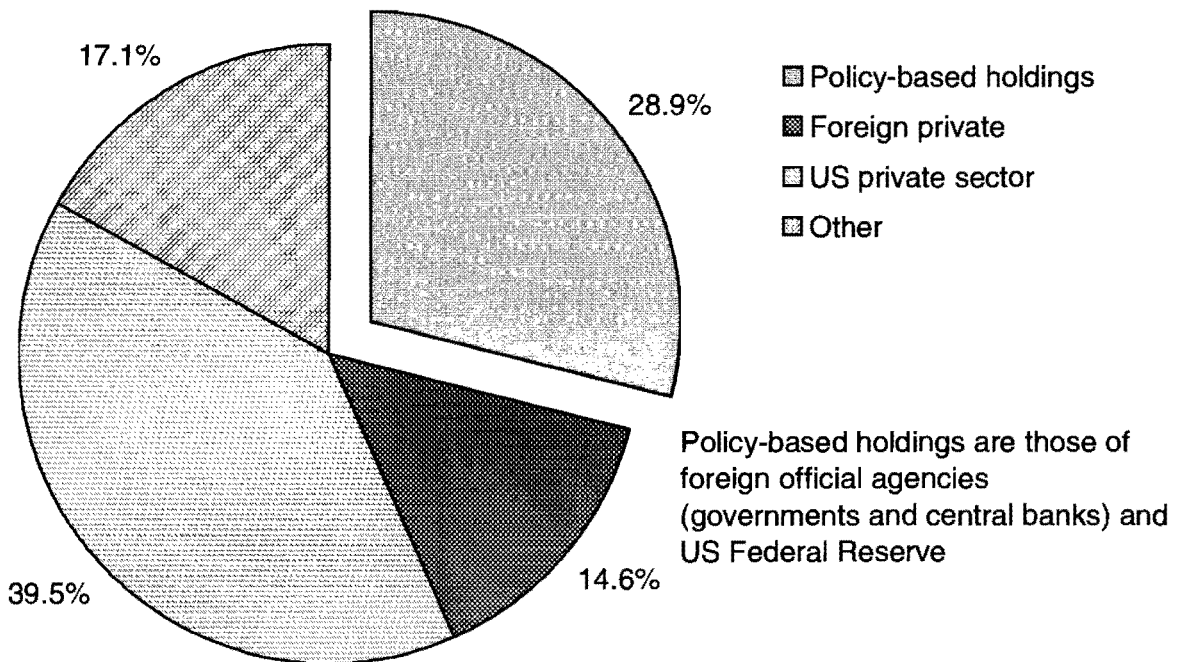


A reasonable approach to asset valuation is to say that assets are worth some multiple of income, with the multiple depending on the growth rate of the income stream and the rate of interest used to discount future income. At present the USA receives a higher income from its overseas assets than foreign investors in the USA receive on their American assets. A naïve view might be – therefore – that the USA's external assets are worth more than its external liabilities (or so-called "debt"). However, that is not the case. According to market valuations (including market valuation of direct investments), foreign investors have larger assets in the USA than American investors have around the world. This apparent conundrum is explained partly by the low-risk character of the assets held by foreign investors. Not only are they low-risk, they are also low-return. (Large Asian holdings of US Treasuries on yields of little more than 4% are an example. See pp. 8 – 9.)

This cannot continue

Main holders of US Treasuries at end 1998...

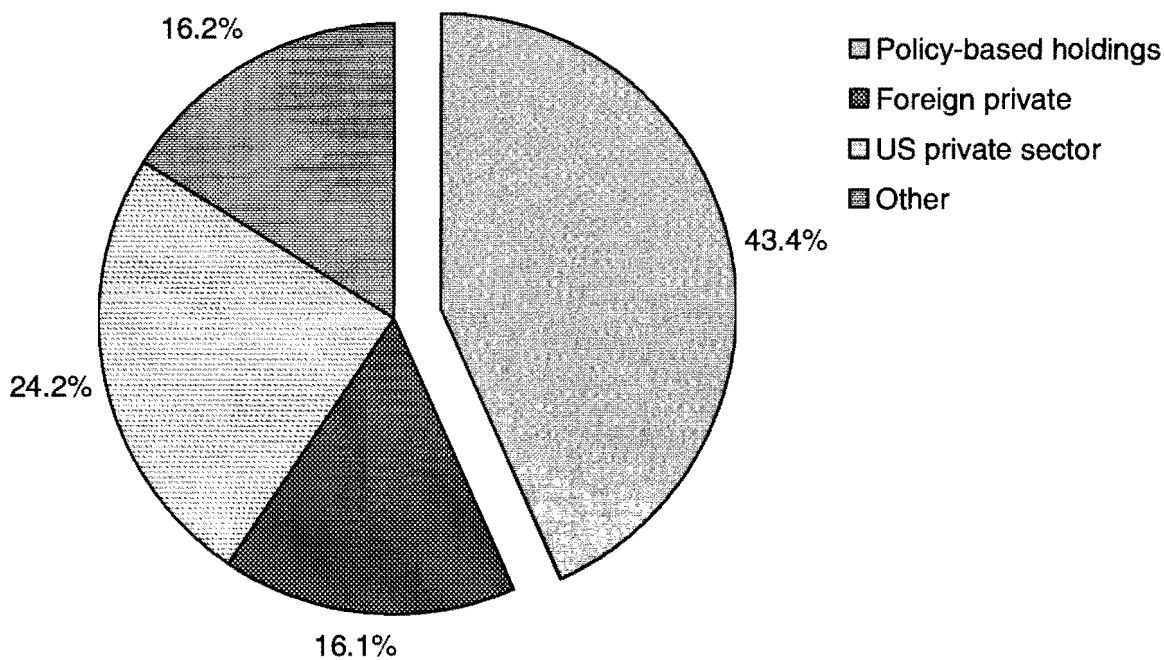
Chart shows main holders of US Treasury securities, with US pension funds, insurance companies, households and banks included under "US private sector".



The main point of the two charts on this and the opposite page is to show how artificial the demand for US Treasuries has been in recent years. Traditionally the bulk of the outstanding stock of US Treasuries has been held within the USA itself, partly inside the banking system but mostly with private sector non-banks. Twenty years ago (i.e., in mid-1984, to allow for the delays in compiling the data) the stock of US public debt held by private investors was \$1,102.2b. Of this \$171.6b. was with foreign investors, both private and official (i.e., central banks and governments). With US gross national product at \$3,772.2b. in 1984, foreign central bank holdings were quite small relative to American output and total financial assets. Even in the late 1990s foreign ownership of US public debt was not a major policy issue, since the USA was running a budget surplus. The largest single category of holder remained the USA's non-bank private sector.

... and at mid-2004

Chart shows main holders of US Treasury securities, on same basis as chart on previous page.

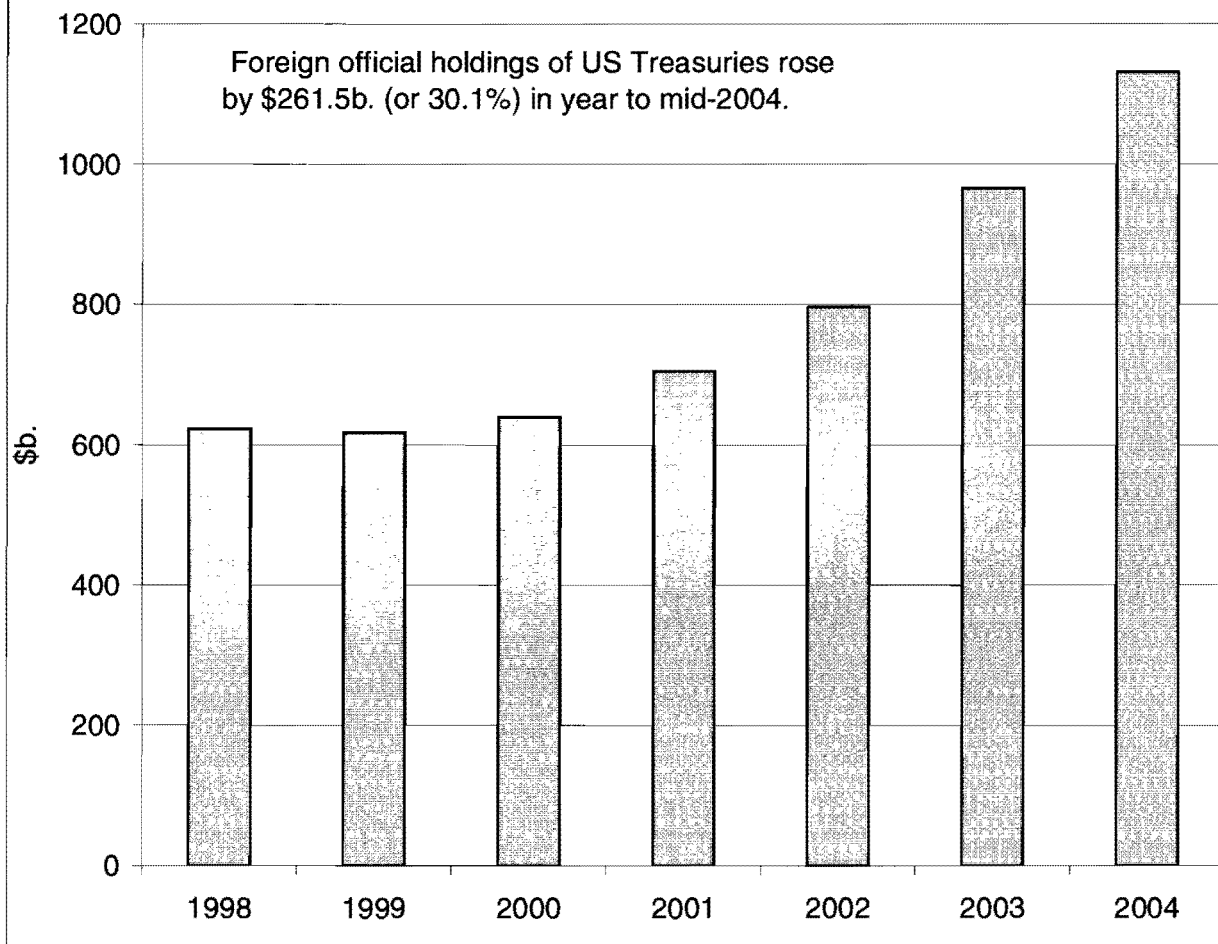


Two types of investor are deemed to be “policy-motivated”. First is the US Federal Reserve, which holds US Treasuries as backing for its high-powered money liabilities. Second, and more important quantitatively, are foreign central bank and governments. Nowadays these are predominantly Asian central banks. (Japan’s foreign exchange reserves exceed \$800b. These are held mostly in dollars, while the bulk of the dollar proportion is invested in US Treasuries. China’s foreign exchange reserves are over \$500b. and similar comments apply.) The Federal Reserve’s demand for US Treasuries is a by-product of American monetary policy; the Asian central banks’ demand for US Treasuries is determined by their nations’ monetary policies and, in particular, by the firmness of their commitment to a dollar peg for their currencies. The policy-motivated demand would evaporate if Asian nations broke their currencies’ link with the dollar.

An insatiable appetite for debt?

Foreign official holdings of US Treasuries

Chart shows foreign official (i.e., central bank and government) holdings of US Treasuries. The 2004 value relates to mid-year.

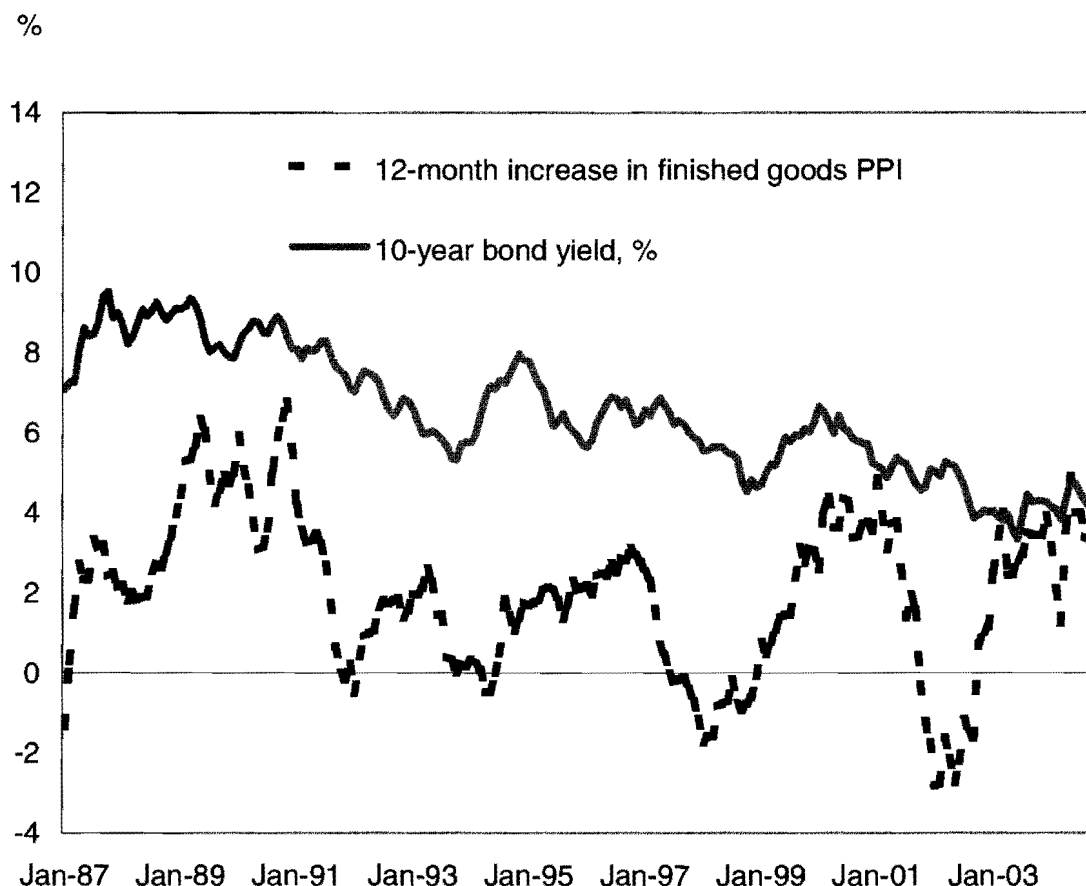


As explained on p. 9, much of the recent demand for US Treasuries has been motivated by policy, not by the prospective return relative to other assets by profit-seeking investors. This chart shows that foreign official holdings of US Treasuries virtually doubled from just over \$600b. at end-2000 to over \$1,100b. by mid-2004. The extra demand for US Treasuries came predominantly from Asian central banks, notably the Bank of Japan and the People's Bank of China, as they tried to prevent their currencies appreciating against the US dollar. Foreign official buying of US Treasuries in the year to mid-2004 (i.e., of \$261.5b.) represented roughly half of the USA's current account deficit in the period. If these purchases ceased (or if they were reversed by outright selling), the current account would either have to contract sharply or have to be filled by other capital inflows. The dollar might have to fall further.

A challenge for the bond market

US producer price inflation and yield on 10-year US Treasuries

Chart compares 12-month increase in finished goods producer price index with the monthly average of the yield on 10-year US Treasuries, as estimated (on a constant maturity basis) on the St Louis Federal Reserve website. Last value relates to October 2004. Data are monthly.

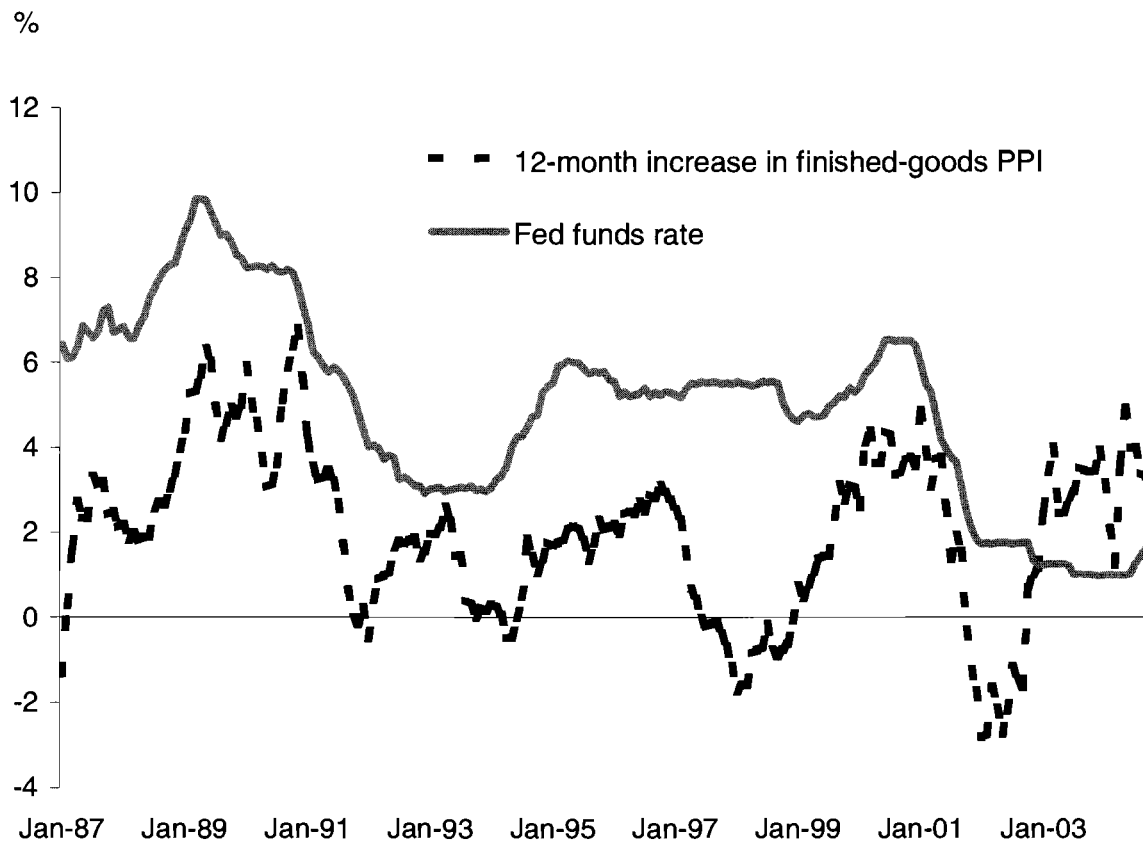


Much has been heard in the last few years about “the death of inflation”, following Roger Bootle’s 1996 book with that title. As the chart shows, finished goods from the USA’s factories did fall in price in 1998 and again, more sharply, in 2002. (The inflation measure here is the producer price index.) However, consumer price indices – which relate to prices “in the shops” rather than “at factory gates” – are higher in most industrial countries than in the mid-1990s. Inflation revived in association with the global boom of 2000 and has picked up again in recent quarters, as a surging world economy has boosted the demand for commodities. But investors in US Treasuries seem not to be awake. At yields of slightly above 4% 10-year Treasuries give a return similar to the increase in the finished-goods PPI in the year to October. The virtually zero real yield compares with a typical real yield in the last 20 years of about 5%.

Is Mr. Greenspan behind the curve?

US producer price inflation and the Fed funds rate

Chart compares 12-month increase in the finished goods producer price index with the monthly average of the Fed funds rate, according to the St. Louis Federal Reserve website. Last value relates to October 2004. Data are monthly.



When the US economy moved into recession in early 2001, Mr. Alan Greenspan and his colleagues on the Federal Reserve Open Market Committee decided to slash interest rates. The economy's recovery in 2002 was fitful and uneven, with many companies keen to maximise cash inflow and pay down debts incurred in the bubble years of the late 1990s. Worries that the American economy might suffer the same sort of deflationary problems as Japan stimulated the Fed to ease policy again and Fed funds rate fell to 1% in early 2003. But since mid-2003 the economy has rebounded. Real interest rates (as measured in the chart) have been negative for most of the last 18 months, in contrast to most of the Greenspan era at the Fed. (Greenspan's chairmanship began in January 1987.) Assuming that annual factory-gate inflation levels out at 2% - 4%, history suggests that the Fed funds rate should reach 5% - 7%.