

# Tea Leaf

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## Currencies

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Global swings in currency values are commonplace (although not as easy to predict or profit from as implied by all those newspaper, internet, and television ads promoting get-rich-quick currency trading schemes). Day-to-day currency gyrations tend to be very small in nature.

Over time, however, relative changes in currency values can be large. Fluctuation in the value of the euro since being officially introduced in 1999 saw its initial value equal to near \$1.18 in dollar terms. The euro soon fell to a value near \$0.83 (a major European political embarrassment), only to appreciate later, only to fall again. The euro currency more recently appreciated again, trading above \$1.30.

Different nations have different aspirations for their currencies. The Japanese tend to prefer currency stability or even a bit of yen weakness. They fear a stronger yen because it makes Japanese exports more expensive around the world, hurting domestic export industries.

The stronger Japanese yen of recent years does lead to lower import prices in Japan, helping to stretch consumer funds. However, lower prices are not necessarily viewed as a positive development in a country that experienced falling prices and a modest deflation during much of the past 10 years.

Euro weakness is viewed positively by European exporters, who can then sell their goods around the world at more attractive prices. A weaker euro also appeals to the European travel industry, which delights at the prospect of more Americans and Asians taking advantage of attractive vacation prices.

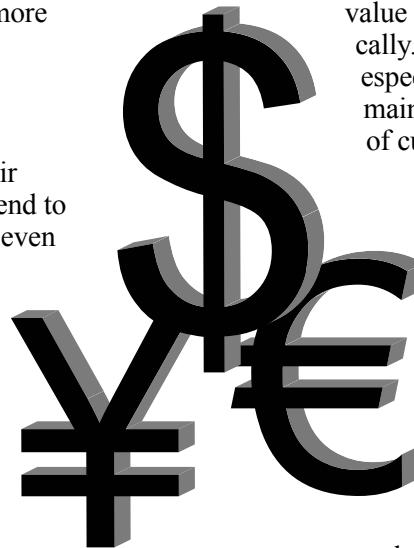
European travel industry executives fear a strong euro as it boosts the costs of a European vacation. Euro strength is also feared by goods producers as European

exports become increasingly expensive around the world.

An additional impact of a weak euro? Imports coming into Europe are more expensive—potentially pushing inflation higher—which just might need to be met with additional short-term interest rate increases by the European Central Bank.

### Currency Intervention

Why, for example, doesn't the Japanese government simply enter global currency markets to sell yen and buy dollars and/or the euro in order to help weaken the yen when market forces are pushing its value higher? They do periodically. In contrast, Europeans (and especially the U.S.) typically remain on the sidelines in the game of currency intervention.



The reality is that moves to strengthen or weaken currencies today by governments and central banks are largely ineffective. A market move, for example, by the Japanese to sell \$1 billion worth of yen to modestly weaken the currency has little impact in a global currency market where an estimated \$3 trillion changes hands daily.

### The U.S. Position

The "official" position of the U.S. Government relative to its currency is typically a preference for a "strong" dollar. At various times, the global community's belief in such a U.S. commitment is challenged.

At times in the past, the U.S. favored a decline in the dollar's value as a means of addressing global trade imbalances, including during the mid-1980s. Such a time is again at hand. One means of accomplishing such realignment is to have interest rate levels in Europe and Japan rising as U.S. rates are stable or expected to decline.

### Over Time

The easiest path to reducing the enormous U.S. trade imbalance with the

rest of the world is tied to a weaker U.S. dollar and correspondingly stronger global currencies. Additional moderate dollar weakness versus other major currencies in 2007 and 2008 would make U.S. exports more price competitive around the world, leading American exports higher. At the same time, more costly imports into the U.S. from around the world, resulting from the reduced purchasing power of a weaker U.S. dollar, would provide an incentive for American consumers to buy fewer imported goods and a greater share of similar U.S.-made goods.

If such currency realignment is viewed as a positive step (given the enormous U.S. trade imbalance), why doesn't the U.S. Administration voice its approval for such a move? Because such support for a weaker dollar could lead to a rapid fall in the currency, ultimately serving no nation's best interests. It seems best to talk a strong currency, but be comfortable with moderate dollar weakness.

## Holding Reserves

The U.S. dollar remains the global community's most desired currency, with the euro and the yen distant seconds. People around the world have traditionally saved "money" by holding U.S. dollars, either in the form of \$100 bills or dollar-denominated financial instruments.

People make intelligent decisions as to their financial well-being, with more than half of all U.S. currency now held overseas. The spread of U.S. dollars to more corners of the globe as "the currency of choice" is a validation of responsible U.S. monetary policy, political stability, and economic might in an enlightened global marketplace.

## Values

Over time, I look at the relative value of a currency to a country as similar to the value of a stock to a company. An investor wants to hold stock in a company that has solid growth potential and higher earnings prospects. In a similar way, one can view the value of a currency.

An investor prefers to own the currency of a nation that has solid economic fundamentals, a competitive economy, and liquid investment markets. Such a view favors the U.S. and its currency.

A number of "old Europe" nations such as France are not so globally competitive, preferring to use rules and regulations to protect such internal industries as farming. Other European countries, including many of the former Eastern bloc, have established policies to boost opportunities to be competitive with other nations and have welcomed their respective moves into the global mainstream.

## Dollar Flight?

Various critics of the U.S., both internal and external, decry the enormous trade imbalance the U.S. runs with the rest of the world. Such critics frequently talk of the impending dollar demise, where various central banks and investors around the world will soon dump the dollar and dollar-denominated assets.

I have less concern here. Any initial holders of dollars and dollar-denominated assets who wish to lighten up could easily sell select assets. However, in doing so they would depress the value of the dollar on global foreign exchange markets, as well as the value of select U.S. assets. Any subsequent sellers would have to ask themselves whether they really wanted to suffer losses resulting from a weaker U.S. dollar and reduced U.S. asset values. Most would likely maintain their holdings. If, for example, a South Korean investor wished to sell U.S. assets and made a deal with a Saudi investor, the transaction would have no real impact on the U.S.

In addition, where are investors who flee the dollar going to turn instead? Emerging markets, where bull markets can be powerful, but "Katy bar the door" in bear markets? A move into Japanese bonds yielding less than 2.00%? French growth stocks (yes, an oxymoron)?

Investors around the world will expand moves to diversify their global portfolios. Many major central banks have already begun this process. However, the U.S. dollar and U.S. dollar-denominated assets will continue to lead the way.

## "TEA"ser

I have left orders to be awakened at any time in case of national emergency, even if I'm in a cabinet meeting.

—Ronald Reagan



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