

The Financial Crisis

How far could the US dollar fall?

Jacques Sapir [EHESS-Paris and MSE-MGU Moscow]

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Paulson's bailout plan, and others that may now be proposed, raise significant questions for the weeks and months to come. The most important of these for the global economy is how far will the US dollar (USD) fall and to what extent will its decline alter the world's economic and financial structure.

Numbers

Already between summer 2007 and spring 2008 the value of the US dollar declined. Then in the wake of the collapse of Bear Stearns it sank to 1 Euro = 1.60 USD. Since then the dollar recovered partially, up to 1.39 for the Euro on the eve of the "crazy week" (September 15-19), and now, the morning after Congress's rejection of Paulson's plan, it stands at 1.46. The reasons explaining the limited dollar surge are easily traced.

1. Embattled US financial institutions were selling assets in other currencies to repatriate funds they desperately needed, thereby pushing up the value of the dollar.
2. 2nd quarter figures for the US economy were less bad than expected (and to some extent surprisingly good) making the US economy look a better place for profits than the Euro zone, where bad news was becoming more common.
3. Also the earlier major dollar devaluation temporarily boosted US exports (+13%), giving the US economy a small breathing space as the repatriation of sales revenues induced capital flows into the US dollar zone.

But none of these three reasons for the dollar's modest surge look likely to continue. The asset selling process has already gone quite far. The US economy's results for the 3rd and 4th quarters of this year are likely to be worse than those for Europe. The export surge has nearly exhausted its potential, and even if the US dollar were to go down sharply again, export elasticity looks like being much smaller than during the 2nd quarter.

Meanwhile new pressures on the USD have developed. The "crazy week" ended with an unprecedented US dollar injection through central banks and various bailouts commitments, which will push the US budget deficit to previously unseen levels. Even before the recent crisis, the budget for the fiscal year 2009 anticipated a deficit of 439 billion. Now significant amounts must be added to that figure.

1. The cost of the Fannie Mae and Freddie Mac bailout has probably been underestimated by 100 billion dollars¹.
2. Even if the FED has funded the largest part of the AIG bailout, the Treasury had to lend money to the FED and from that we can expect another drain of probably 50 billion dollars.

¹ J. Shenn, "Fannie, Freddie Subprime Spree May Add \$100 Billion to Bailout", on *Bloomberg.com*, September 22nd, 2008.

3. The cost of Paulson's plan, estimated at 700 billion dollars, or a similar one will have a tremendous effect on the US public debt². There are good reasons to think that nobody knows or could know how far it will go. One can probably estimate the amount of bad assets held by banks and insurance companies today, but if the economic situation degrades in coming months, household and enterprise solvency will decline. Debts assessed as "good" today could become "bad" by December or early 2009. For example, consider the consequences of a possible General Motors bankruptcy next spring. This huge and deeply embattled company has issued large amounts of debt and Credit-default Swaps (CDS). If General Motors or a similarly sized industrial company were to go under Chapter 11 protection, it would have a tremendous overall effect on debt quality. The point is that debt quality assessment can't be done without some forecasts of US economic activity in the months to come. The 700 billion dollar price tag on Paulson's plan was no more than a political rabbit he pulled out of his hat to get his plan moving³. Some people, like former IMF chief economist K. Rogoff, have estimated that the plan would turn out to cost between 1,000 and 2,000 billion dollars⁴. The truth is nobody really knows.
4. So far no one has raised the issue of diminishing US budget incomes. But if economic activity slows seriously in this year's 4th quarter and remains at a lower level in the first quarter of next year, one can expect federal and local tax income to be significantly lower than planned. Assuming a GDP depression of around -1.5% to 2.0% during the forthcoming winter, the total loss of budget incomes could be in the 80 to 100 billion dollar range.

If we add up these probable budget deficit sources, we obtain a figure of 930-950 billion dollars that needs to be added to the 439 billion planned deficit. The total US deficit for the fiscal year 2009 could easily be pushed up to 1,370-1,400 billion dollars or close to 11% of GDP.

Such estimates, of course, are highly dependent on the impact that the US economy's performance has on debt (and CDS) quality. If the government introduced a new economic activity-boosting package, the bailout cost could be reduced. However such a package would come at a cost, so I don't expect the deficit to go much under 1,250 billion dollars in the best-case scenario. But if economic activity decreases faster than expected and with a higher bankruptcy level than planned, then in the worst-case scenario the budget deficit could well reach 1,700 billion US dollars.

In any country but USA, such a budget deficit would push down the value of the national currency considerably. However, because of the US economy's central role in international flows of trade and finance, numbers do not tell the whole story.

² M. Benjamin, "Paulson Plan May Push National Debt to Post-World War II Levels" on *Bloomberg.com*, September 23rd, 2008,

<http://www.bloomberg.com/apps/news?pid=20601087&sid=anJ4Egj1nXS8&refer=home>

³ G. Robb, "Echoes of Iraq in Bush handling of mortgage crisis - News analysis: Another 'trust me' remedy is getting rushed before lawmakers" on *MarketWatch*, September 23rd, 2008,

http://www.marketwatch.com/news/story/echoes-iraq-bushs-handling-mortgage/story.aspx?guid=%7bEB54967E-258D-4650-BE95-2203FCA64AAA%7d&dist=morenews_ts&print=true&dist=printMidSection

⁴ K. Rogoff, "America will need a \$1,000bn bail-out", *Financial Times*, September 18th, 2008.

Strategic factors

Reasons for a downward movement of the US dollar in forthcoming weeks and months are obvious. Already it began to decline in value at the end of the “crazy week”. However the strategic dimension of US dollar foreign balances needs to be brought into the picture in order to assess not just how far the US dollar could fall, but, even more importantly, whether or not this movement can be kept under control.

The US dollar is a major capital asset for various sovereign and private funds in Asia, the Middle-East and Russia. These funds currently hold large quantities of US Treasuries and Agencies (the GSE issued bonds also known as A-bonds). Some of these countries are also important exporters to US internal markets. The financial and real economic relations are interlinked in a complex way that makes it impossible to estimate the outcome the current crisis on the basis of numbers alone.

There are several strategic factors weighing in favour of a not too low USD. The first obvious one is Asian countries’ trade interest. If the USD moved down significantly compared to the Yen and other Asian currencies, the competitive edge of these countries would be significantly reduced. True, some of them, mostly notably India and China, could substitute internal demand for exports on the US market. But such a move can not take place in weeks or months. Until a comprehensive strategic switch toward an internally-driven growth path has been implemented, these countries have a strategic interest to prevent the US dollar from falling too far and too fast. However to keep it from doing so, countries with large trade surpluses must buy large quantities of US T-bonds and A-bonds.

This raises the issue of the dollar’s role as a capital asset. Private and sovereign funds holding large quantities of US Treasuries and Agencies would suffer a significant capital loss if the USD fell significantly. But the situation is mixed. One could argue that to prevent further losses fund managers will increase their portfolio diversification and reduce their exposure to the USD risk. This raises however another issue. What could serve as substitutes for USD Treasuries and Agencies? Of course Euro-denominated bonds could be used, but the Euro zone has not issued bonds (and specifically T-bonds) in the quantities comparable to US T-bonds and A-bonds. Yen denominated T-bonds could be used to some extent but they clearly are no substitute for the USD. Russia so far has a very slim T-bond market and one can’t expect T-bond issuing from a country where the budget is displaying a 6% to 8% of GDP primary surplus. Of course, the Russian government could sponsor the local equivalent of GSEs and A-bonds. But even if such a decision could be taken quickly it would be some time before a significant quantity of such bonds would be available for fund managers. Some more risky substitutes could be found, ranging from Euro or Yen denominated equities up to commodities. They could be substitutes at the tactical level, but not at the strategic one. Hence, the capital asset argument is certainly leading us toward a more clouded conclusion. Sovereign funds will certainly be very cautious when implementing a portfolio diversification strategy, if only because reliable mid to long-term substitutes to US T-bonds and A-bonds are relatively scarce. Some private funds might act more aggressively. The addition of local strategies, each of limited significance, could then create a context that would lead large sovereign funds to increase the rate of their diversification

A third strategic factor to consider is a political one. People are confident in US bonds because of the USA’s political leverage. To some extent the leadership factor is probably more relevant than interest rates in determining the value of US bonds. So far no country

could directly challenge US power. But US power has been globally eroded from the 1998 crisis up to the present one to such an extent that US leadership looks weak and very unstable. The way the current US administration has managed the current crisis has definitely not improved the situation.

Two strategic factors are now pushing toward a lack of confidence in the US debt. The spread on CDS for Treasuries in the wake of the “crazy week” suggest that this lack is on the increase among financial actors.

The first and most obvious factor is the feeling that the former “hyper-power” is now dramatically over-extended. Even if it is true that the military situation has been stabilised in Iraq, it is degrading rapidly in Afghanistan and is now spilling over into Pakistan, where the stakes are even higher. The US administration has been unable to decisively support Georgia during the stand-off with Russia on South Ossetia and has clearly “lost face” in the region (Turkey and Azerbaijan). This loss of face is also pretty obvious in Ukraine where Mrs. Iulia Timoshenko has switched sides and broken with the “Orange Coalition”.

The second factor is the crisis in internal leadership: the very bad crisis management so far, the high uncertainty level about the bank bailout cost, and now when, how and if a bailout will take place. As explained in a previous article, vacillation in the US administration, and now in its legislature, about a bank bailout has eroded confidence in the nation’s ability to manage a major crisis. Nor did the way the FED chairman presented the case about Lehman Brothers at the September 23rd US Senate Hearings foster confidence.⁵ The forthcoming Presidential election is also adding to the uncertainties, be they real or not.

A closely related fact is that, as explained above, the 700 billion dollar price tag for the bailout presented by Henry Paulson is at best a mere guess. The same guess-mate approach is likely to be behind any plan B that is offered. Financial actors would love to believe that the cost will be limited to 700 billion, but the question is how they will react when they learn that the actual cost is far above the promotional figure. And of course delays in implementing Paulson’s plan or something similar add to the current feeling of uncertainty. Although any Paulson-type plan is far from perfect, it would nonetheless offer a quick answer to an immediate problem. If instead of an immediate response, US authorities delay action in trying to design and implement a better plan, this will create an uncertainty much worse than the one induced by the budget deficit figures implied by a Paulson-type plan.. In an emergency what matters is not an “optimal” fix but a quick and effective one.

The level of strategic uncertainties pervading the current situation is opening the door for significant “surprises” to take place⁶. Financial community expectations could be so severely shaken that we could see a massive process of expectation divergence. If so, the possibility of a run against the USD can’t be dismissed. The USD could then fall very low indeed and even a huge interest rate rise by the FED would be hard pressed to stop the process without completely destroying what is left of the US financial system.

⁵ Scott Lanman and Craig Torres, “Bernanke, Paulson Urge Skeptical Senators to Pass Rescue Soon” in *Bloomberg.com*, September 23rd, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=ajwx.ppt3pQl&refer=home>

Ben Bernanke stated that “the troubles at *Lehman* had been well known for some time” and FED officials had judged “that counterparties had time to take precautionary measures”. On such a decisive decision of supporting or not supporting a bank with assets disseminated in other financial institutions, checking what “precautionary measures” have been implemented should have been mandatory before taking the fateful decision to let Lehman go down the drain.

⁶ The word “surprise” is used here in G.L.S. Shackle’s sense, that it is the occurring of an “unexpected” event. See G.L.S. Shackle, *Expectations in Economics*, Cambridge University Press, Cambridge, 1949.

Conclusion

Trying to answer the question raised in this paper's title is not easy to do. There is no doubt that the USD will go down relative to the Euro and the Yen. It is highly probable we will see a 5% to 10% fall in the value of the USD in forthcoming weeks (somewhere like US 1.55 to 1.62 for 1 Euro), coupled to an inversely correlated rise in the price of oil. The USD fall could be greater against the Yen and Asian currencies than against the Euro (maybe 1 JPY = 0.0115/0.0120 USD).

What is now open to question is whether the USD will stabilise at this new level for some months before beginning to slowly move up probably by spring or early summer 2009, or will a catastrophic chain of events take place creating the psychological context for an uncontrolled decline in the value to the US dollar. The best case scenario is supported by the fact that most of the uncertainties regarding the US economy will be resolved by next spring and when the Euro Zone economy is expected to be at its worst. The USD value could then begin to increase slightly. However, as interest rates will still be low, and the budget deficit a major issue, the USD will not in 2009 regain its average 2007 value, let us say stabilization at USD 1.40 for 1 Euro by the end of 2009. But even this would be pretty dramatic for a large share of the European industry.

Whether or not the "worst case" scenario unfolds depends on the way private fund managers in Asia and the Middle-East decide to revamp their portfolio strategy. If for these managers the feeling of uncertainty about US leadership and its ability to manage the current crisis comes to out-weigh its feeling of confidence (even of "troubled confidence"), leading them to dispose of their USD assets, then sovereign funds would have to follow quickly to prevent huge capital losses. A fall of 25% to 35% of the USD value against other currencies, coupled with dramatic changes in capital flow movements and commodity prices then becomes a distinctly possible event. This would create huge uncertainty all over the world and push toward a greater and greater fragmentation of the financial space, with the possible emergence as a consequence of regional reserve currencies.

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