

The “Real” Value of a Dollar

By

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In a January 4 speech this year, Federal Reserve Board of Governor Bernanke opined that the rising gold price was caused by terrorism. Geopolitical tensions, he said, “account for the bulk of the recent increase in the real price of gold.” He also downplayed the weakness of the dollar. Weakness against the euro was less important than the fact that the dollar’s “real value against the currencies of important U.S. trading partners, weighted by trade shares, has fallen only about 12 percent from its peak in the first quarter of 2002.” Bernanke’s remarks in total formulate the rationale for the Fed’s easy money policy. As such, they illuminate reality as perceived by the Fed versus reality as perceived by the rest of humanity.

Bernanke’s references to the “real” price of gold and the “real” value of the dollar suggest that he and his colleagues have access to information and knowledge unavailable to ordinary citizens. Policy decisions, and most specifically, the Fed’s ultra easy money stance, are based on these “realities.” Those of us who believe the price of gold is rising in response to easy money as well as repeated interventions in past and prospective capital market crises have got it all wrong. Those who fear that the overvaluation of the dollar and resulting capital market imbalances may spell trouble for the financial markets and the economy can toss out the tranquilizers.

There are three ways to assess the Fed’s worldview. First, they are indeed right. Critics should just simmer down. Second, what the governors say for public consumption (and the Fed has become increasingly vocal in recent years) is primarily designed to affect the behavior of consumers, corporations and other governments in order to achieve desired results such as economic growth, financial market tranquility, and retention of dollar holdings by foreign central banks. In other words, they don’t believe what they are saying but are using the Fed pulpit to achieve policy objectives. Third, and most disturbing: they actually believe what they are saying.

What is the “real” value of a dollar? It is a question of metaphysical dimensions. The dollar is the unit of account by which all participants in the economic process make decisions. Whether or not to buy, hire, produce, or invest depends on millions of daily calculations measured in dollars. Decades ago, thirty-three years to be exact, dollar centric decisions were pretty much confined to the borders of the United States. The 1971 decision to decouple the dollar and gold marked the beginning of an explosion of international dollar reserves. It gave birth to the dollar-based system of global credit and an era of unprecedented world prosperity. Today, the preponderance of global economic decision-making is rooted in some notion as to the intrinsic value of a dollar expended, received, or held as an investment.

For the dollar to continue as the global *numeraire*, it is essential that its value remain stable. What participants in the economic process believe the value of the dollar to be has the power to affect global economic activity. There can be no room for doubt as to the dollar’s value either in the present or in the future. The enticing question is what information should the market utilize to assess the dollar? Should it use the price of gold? Not according to Gov. Bernanke. Should it use exchange rates? Again, the answer is no.

Let us then turn to the mini-maestro for the correct answer. He concludes his January 4th speech:

“The achievement of price stability must not and will not be jeopardized. We at the Federal Reserve will closely monitor developments in prices and wages, as well as conditions in the labor market and the broader economy for any sign of incipient inflation. We will also look at the information that can be drawn from surveys and financial markets about inflation expectations. For now, I believe that the Federal Reserve has the luxury of being patient. However, I am also confident that, when the time comes, the Fed will act to ensure that inflation remains firmly under control.”

In other words, “trust us” to get it right. But is Bernanke’s confidence that the Fed will act appropriately to maintain the dollar’s value enough to dispel all doubts? Perhaps central bankers in Asia have not yet had a chance to digest Bernanke’s words. This might explain the January 28 comments of Japanese Finance Minister Sadakazu. He said he wanted to carefully consider whether to change the weighting of gold in Japan’s foreign reserves, which are “mostly made up of dollar denominated assets.”

Japan’s reserves reached a record high of \$673 billion at the end of December, 2003. Zhu Min, general manager and advisor to the president of the Bank of China, the largest holder of dollar reserves in China, recently stated: “all the Asian countries hold dollars for security reasons, but at some point, this has to end.” Speaking at the Davos World Economic Forum in January, he added, “Over time, China’s pace of export growth would wane, weakening its ability to buy dollar denominated assets.”

Central bankers, upon concluding that they hold more of a particular reserve asset than they desire, have been known to act without any consideration of intrinsic value. One need only recall the relentless divestment of gold holdings by European central banks at prices well below the current market. That episode alone suggests that central bankers are either incapable of judging or indifferent to matters of valuation.

By now, any literate investor knows there are too many dollars held by Asian central banks, but nobody can figure out what happens next. It is obvious, for example, that if they were to sell, or even stop buying, the ever-increasing supply of treasury debt, interest rates in the United States would rise substantially. The less obvious but inescapable side effects would be lower stock prices, higher inflation, and a softer economy. It could also cause dislocations in China, which needs the US market to provide job growth.

In a recent article in *Foreign Affairs* (Nov/Dec ‘03) David and Lyric Hughes Hale wrote “the unemployment rate in (Chinese) urban areas is estimated at more than 8 percent; there may be an additional 200 million jobless workers in the countryside. According to Zhai Zhenwu, the director of the Population Research Institute at China’s Renmin University, China will need to create 20 million new jobs a year to absorb the 8 million people who have lost their jobs in state-owned enterprises.”

It seems unlikely that Chinese bureaucrats would initiate any precipitous move away from the dollar, either in the composition of their reserves or in the manipulated peg of 8.3 renminbi/\$. It is more plausible that external events will impose change. Still, financial officials in Asia are telegraphing creeping abandonment of the dollar. Stephanie Pomboy of Macromavens notes that the percentage of Chinese FX reserves recycled into Treasuries declined to 24% in the second half of 2003 from 54% for all of 2002. These signals, alone, may prove sufficient to accelerate the dollar’s slide from its perch as the global *numeraire*. Perhaps a resurgence of US protectionism based on the issue of job

losses will add momentum. Spreading credit worries tied to deflation of the Chinese bubble, an unexpected global downturn, or a sharp rise in interest rates are also capable of greasing the skids.

One could speculate endlessly on the scenarios. It is impossible for anyone to write tomorrow's headlines. What is absolutely and irrefutably certain, however, is that oversupply, a term without which it would be impossible to describe the dollar, will be corrected by market forces in due course. The Fed, notwithstanding its privileged knowledge of the true value of the dollar, is powerless to dictate that the dollar will trade for one penny more than its market-clearing price.

The presence or absence of value cannot be determined apart from a context of scarcity or abundance. Value is also inextricably tied to usefulness. Water may be cheap in most parts of North America, but in the Sahara, it can be priceless. The hard-pressed debtor may thirst for a few dollars, but not the rock star. While the principle is easy to apply locally, it is more challenging on a global scale. The earth is 80% water and so, for most, it is relatively cheap. Essential to life itself, water can be very expensive.

The value of money is fundamentally different from all other daily necessities. Money is useful both for its current transaction value and for its future purchasing power. While its transaction value can be known at any given moment, future purchasing power is a matter of speculation. Money should not be confused with currency. Real money is scarce. A Turkish five million lira note sits on my desk. There are plenty more where it came from. Its utility ends with its curiosity value (and its transaction value for those in Turkey.) Otherwise, a low opinion of the Turkish Lira is shared universally. No central bank accumulates the Turkish lira as a reserve asset. Its future purchasing power is expected to decline because the issuing authority lacks any credible commitment to maintaining its current value. To hold more of a currency than one requires for daily transactions, one must believe that its future purchasing power will approximate that of today.

The Federal Reserve would have us believe that the inherent value of the dollar is best represented by the Consumer Price Index. The American Institute for Economic Research informs us (January 12, 2004 Research Report) that this measure of the general price level was first introduced in World War I at the request of President Wilson to help mediate disputes between labor and management in defense related industries. Its usage spread over the next several decades, almost always in relation to wage issues.

By the 1960's and 1970's, it became the basis for cost of living adjustments for benefit packages including social security. The index, compiled and published by the Bureau of Labor Statistics (BLS), is the most widely used and trusted barometer of the dollar's value. It is the basis for calculating the excess return on Treasury Inflation Protected Securities (TIPS) and real interest rates (T-bills minus trailing twelve month CPI). It is the method by which investors calculate their inflation adjusted returns from government bonds and private sector debt securities. Since short-duration government bonds approximate risk free return, the CPI indirectly but most powerfully influences the valuation of the entire equity market.

What started out as a fairly simple and pragmatic attempt to hammer out equitable wage settlements some 90 years ago has become a highly complicated, politically charged, and controversial cornerstone for the capital markets. The BLS, in a never-ending and earnest effort to keep up with the times, has changed the items, the composition, and the pricing methodology of the CPI components. It has distinguished between core inflation and reported inflation to iron out unsustainable fluctuations in

commodities. It has introduced seasonal adjustments to smooth out comparisons on a month-to-month basis. The index currently contains 400 items thought to approximate a market basket of goods and services that best represent the general price level.

In recent years, the index has been tame, advancing at a rate of 1.9% for the last twelve months, and down from 2.4% for 2002. The signal transmitted to the capital markets is that there is little or no inflation and therefore the value of the dollar is rock solid. In fact, the Federal Reserve has been more preoccupied with potential deflation, or a general decline in the price level. The expectation of low CPI readings for the foreseeable future is a key justification for the Federal Reserve's aggressively accommodative stance on interest rates, the lowest bond yields since the 1950's, and the highest equity market valuations since the dot-com crash of 2000.

Arnirvan Banerji, Director of Research at the Economic Cycle Research Institute, scrutinizes CPI data for hints about potential changes in direction. The Future Inflation Gauge or "FIG" has fairly reliably anticipated changes in direction with lead times of several months. The "FIG," according to Mr. Banerji, is currently forecasting a further decline in the CPI, more good news for the capital markets, or so it would seem. He hastens to add that the FIG is helpful only in pinpointing changes in direction of the CPI. It does not capture the amplitude of an imminent rise or decline in the CPI. It also cannot detect secular shifts in magnitude that span more than a single business cycle.

This leading analyst of the CPI questions whether the information conveyed by the series is as meaningful as the financial markets take it to be. In a very effective sound bite heard by this listener on Bloomberg radio, Banerji said that a person with one foot in boiling water and the other in a bucket of ice is on average perfectly comfortable. So it would seem that the tranquility of the CPI does not capture underlying turbulence. The thematic cross current would be one of rapidly escalating price levels for goods and services that are in scarce supply or have some measure of pricing power such as health care or raw commodities.

On the other hand, price deflation is evident in many consumer goods. 16% of Wal-Mart's (purveyor of many of the 400 items measured in the CPI) 2003 sales were sourced in China. At the current exchange rate for the renminbi, this percentage will undoubtedly grow and keep a ceiling on consumer good prices. Thanks to Asian outsourcing, the BLS was able to report declines of 83% in computers, 56% in televisions, 18% in women's dresses, 7.8% in sports equipment, and 1.7%-5.1% in other apparel categories for the period 1990-2003. For the same period, the all-item average rose 46%. Over the same period, college and tuition fees rose 171%, cable television plus 114.7%, bank services up 104.5%, motor vehicle insurance up 85.2%, and movie, theater, and sporting event tickets plus 81.8%.

But there is more to this than simple crosscurrents, according to Banerji. Several years ago, the very important housing component of the CPI was increasing at an annual rate of 4%. Today, that number is 2.2% and heading lower. Housing is weighted at 40.85% of the total CPI. How is it falling when house prices are rising? Simple. The BLS calculates this important component on the basis of "imputed rent" rather than the capital cost of buying a new home. Imputed rent synthesizes the cost of home ownership into a rental factor putting all citizens, both renters and homeowners, on the same footing.

The BLS gathers the information for imputed rent, or the "Owners' Equivalent Rent Index," by asking "each homeowner (surveyed) for their estimate of the house's implicit rent and what the occupants would get for their rent if the owner did rent their home."

(See: U.S. Department of Labor Program Highlight-Fact Sheet No. BLS 96-5.) It should be noted that in light of the Federal Reserve's highly expansionary monetary policy, single-family owner-occupied housing has enjoyed an unprecedented new construction boom. Mr. Banerji observes that a felicitous (for the CPI) consequence of the single family housing boom has been a rise in vacancies and a decline in rental rates for apartment properties. Pressure on the rental market appears to go a long way towards explaining the mystifying decline in the housing component of the CPI. Could it be that the sagging apartment rental market also explains rising bond and equity markets?

There is still more to the tale. Gertrude Stein's famous dictum: "Rose is a rose is a rose" speaks to the mutation of a word's meaning over decades or centuries of usage. We can surmise that Big Brother is alive and well at the BLS where a computer is not a computer is not a computer. In other words, added features, memory capacity, and random bells and whistles are not captured in the straightforward list price of a computer. To expunge all continuity of meaning, the BLS brought forth "hedonics," the science of measuring the value of a product or a service after allowing for qualitative improvements.

A laptop with twice the memory as last year's model sold at the same price this year is counted as a 50% price reduction. This sort of analysis was applied initially to computers and IT equipment. More recently, a broad range of consumer goods including electronics and automobiles has been subjected to hedonic measurement. Health care has been a particularly ill-behaved sector of the CPI. Hospital services, nursing homes and adult day care, for example, increased 141.4% over the period 1990 to 2003, versus an average of 46% for all items measured. It should come as no surprise, then, that the Bureau of Economic Analysis is considering adjusting prices of medical services for quality changes (See: *Grant's Interest Rate Observer*, 1/30/04.)

Proponents of hedonic price measurement admit that the process is not without flaws. In a July 12, 2001 paper, Jack Triplett of the Brookings Institution found that "the hedonically based computer equipment deflators in the national accounts of OECD countries recorded ... ranged from +80% to - 72% for the decade of the 1980's." Happily, after the misadventures of the 1980's, the European practitioners of hedonics achieved a "smaller dispersion" by the early 1990's when the computer deflators ranged from "-10% to - 47%."

The notion underlying hedonic adjustment is that normal price measurement techniques fail to capture qualitative improvements. However, we are entitled to ask whether there are any objective standards by which these price adjustments are applied. Why should an increase in memory capacity or a ramp up in processing speed equate to a price reduction? By what factor are auto prices reduced because of airbags, catalytic converters, seat warmers, or tinted glass? Should health care costs be adjusted downward because patients are discharged in two days rather than three?

Hedonic adjustments, as with pro-forma earnings, require a great deal of subjectivity to rearrange reported information into a new kind of reality. Slashing reported list prices for a computer because of advanced specifications over last year's model implies there is quantifiable improvement in productivity or output. As noted in *Grant's* (Feb. 16, 2001) a computer "like a piano depends on the individual at the keyboard: He may play the 'The Moonlight Sonata' or 'Happy Birthday.' The implication of hedonic adjustment is that the computer-using U.S. workforce studied at Julliard."

We must address one final layer to understand the mystery of price stability in the midst of a falling dollar, rising deficits, and ongoing trade imbalances. The problem goes

further than the constant rejiggering of the index or the application of abstruse price measurement techniques. The problem is that the prices that are being measured are themselves fake. Preposterous? Blame it on manipulated exchange rates. Does the dollar trade at 8.3 renminbi or 105 yen because of intrinsic value?

Asian governments that peg or manipulate their currencies to these levels have no interest in value. An undervalued renminbi is needed to create jobs and investment. It is for the United States, “an unholy partnership with its Asian creditors. They would produce; we would consume.....the United States and its lenders have entered into the biggest vendor-financing scheme in the history of borrowing and lending.”

As a result, “the prices are fake. The exchange rates are manipulated, the interest rates are adulterated and the product prices are contrived.” (*Grant's* 1/16/04) What prices would the CPI measure if the US dollar bought only half as many renminbi, rupee, or yen? The valuation of the dollar as supported by the CPI is a testament to institutional inertia, delusions of elitist intellectuals, and public gullibility. The myth of price stability conveyed by the CPI would shatter upon contact with freely floating exchange rates.

The CPI was conceived to measure price levels within the borders of the United States. It was thought to convey helpful information to consumers, managements, and investors as to the presence or lack of price stability. It did so in a context of stable exchange rates and international trade flows that are miniscule by today's standards. Thanks to the evolution of financial markets and trade reform, the dollar is a borderless currency. For the substantial holders of dollars outside of the U.S., the notion that a benchmark so flawed as the CPI should be the preeminent measure of value is laughable. Extra territorial dollars are held not for consumption but for investment.

The more astute holders of these dollars must look beyond the CPI to the future supply and demand for the currency. In assessing those fundamentals, they must take into account the integrity of the issuing authority. They must also evaluate the suspect reliability of the principal and the only readily available measure of the currency's value, the consumer price index. As for future supply and demand, Richard Duncan remarks in the *Financial Times*: “The amount of new yen that Japan ‘printed’ and converted into dollars during January 2004 alone was enough to finance 13 per cent of the U.S. budget deficit.” Earlier in the column, he states: “It is inconceivable that economic policy makers in Tokyo and Washington do not understand the impact that this unprecedented act of money creation is having on global interest rates and economic output.”

In its infancy, the CPI was a tool for settling disputes, not a measure of the dollar's value. In those days, twenty dollars bought an ounce of gold and that was the measure of the currency's value. It was simple to understand for one and all. Armies of bureaucrats, statisticians, and academicians were not required to collect, massage, interpret or invent obscure information in order to divine the dollar's value. No financial high priests comparable to today's Fed were needed to reveal the truth. Credibility of the currency rested simply on its link to gold. The dollar's viability as the cornerstone for international credit is in jeopardy. The over valuation of the dollar cannot help but breed further capital misallocation, production overcapacity, inflation of asset values and debt buildup, all precursors to another bubble.

How will world financial authorities orchestrate a graceful retreat for the dollar from center stage? The possibility of an orderly, well-choreographed exit seems remote. Whether it goes out with a bang or a whimper, the end game will be deflationary. Bob Hoye of Chartworks (February 6) observes: “central bankers merely assist the credit

expansion that, by necessity, is hypothecated against rising asset prices. Once the top is in, the power inevitably shifts to margin clerks (whose) mandate is to get the accounts on side and, after rampant speculations, that means selling into a collapsing market.”

The perceived safe havens offered by the euro or the yen will eventually yield only losses. While these currencies provide a liquid alternative in the short run, their fate is inseparable from the dollar. The three are like inebriated celebrants wobbling home, propping each other up and incapable of orbiting too far from their collective gravity. The day when each becomes confetti is within sight.

What is the value of a dollar? For us, the simplest and most reliable measure is the amount of dollars required to buy a fixed quantity of gold. We respectfully disagree with Mr. Bernanke. Whether he and his fellow governors are hypocritical or delusionary in their assessment of the dollar’s intrinsic worth is of no matter. What is important is that they are flat out wrong.

As anyone can see, the dollar is falling against gold and has been doing so for almost five years, long before terrorism became a front-page item. As we are very busy figuring out how to profit from the view that it has much further to fall, we have given little thought on how to fix the mess. Let us leave financial diagnosis and prescriptions to those wise policy makers who got us here. Still, we cannot resist offering some friendly advice. The next time around, respect history. Anchor a new global currency to something that has real monetary value.

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