

Editorials

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The Dollar, the Euro and Gold

Many analysts had originally anticipated that the Euro would pose a serious challenge to the Dollar simply because the population and GDP of the Euro pool of countries exceeded those of the US. This line of thought proved to be completely off-the-mark because it ignored the critical role played by confidence in determining the relative values of fiat currencies.

The Dollar was convertible into gold for more than 100 years, so for much of its history it was almost 'as good as gold'. By the time it became a non-convertible monstrosity it had already gained acceptance throughout the entire world. The profligate spending and economic/political fumbblings of successive US governments in the 60s and 70s dented the Dollar, but were unable to dethrone it. Since the early 80s confidence in the US Dollar has waned from time to time, but the structural superiority of the US economy versus those of Europe and Japan (lower taxation and less government regulation), and a level of acceptance established over the course of a century, have ensured that the Dollar has retained its position as king of fiat currencies. It was always absurd to think that a group of economically, politically and socially disparate nations could band together and manufacture a new fiat currency that would challenge the Dollar's leadership. Governments can mandate many things, but they cannot mandate confidence.

The confidence issue with the Euro could have been addressed by making the new currency convertible into gold or, if that was too radical a proposition, giving it a substantial gold backing (at least 50%). In such a case the Euro would have been seen as real money rather than a political concoction. But then again, currency strength was not a goal of EMU.

Rather than detracting from the Dollar's standing in the world the Euro's advent has, in actual fact, been a boon to the Dollar. This has happened because the Dmark, an historically-strong currency and a credible alternative to the Dollar, has been eliminated as a competitor. Furthermore the unstated (but obvious) policy of the Swiss to bring their currency into line with the Euro in the foreign exchange markets has seen the Swiss Franc removed as a viable Dollar alternative. **With the Japanese private and public sectors mired in enormous debt and with the BOJ facing the need to accelerate the expansion of the Yen supply, gold stands alone as the Dollar's only serious competitor for investment.**

We were negative on the Euro's prospects from the beginning and in a

January 1998 article at Gold-Eagle ("Currency Turmoil in 1998") stated that: *"although some unknowns will be clarified during the next 6 months is difficult to see how the Euro could ever be stronger than its weakest li* However, despite correctly concluding that the Euro's introduction would increase the flow of investment capital into the US we did not connect all the dots and failed to appreciate the consequential negative implications the USD gold price. If not for the 'Euro-effect' we have no doubt that gold would presently be trading substantially above its current price.

Further Dollar strength at this time is not bullish for the US stock market. Capital flooding into the US has certainly boosted US stock prices over the past few years, but there is a trade-off. Many large non-tech multi-national corporations have seen their stock prices stagnate since mid-1998 due to a reduction in foreign-based revenue growth (foreign revenues and earnings are lower when converted to Dollars). Large technology companies such as Microsoft, Oracle, Intel and Cisco have not suffered from a strengthening Dollar because they have little or no foreign competition and are involved in businesses that are growing at rates that are orders of magnitude faster than the rate of global GDP growth. However, the large-cap tech stocks are already fully priced (some would say more than fully priced) and thus cannot be relied upon to drag the overall market to higher levels. A sustainable rally in the major US stock market indices at this time requires a significant contribution from the 'old economy' behemoths (a continuation of what we have been seeing over the past few months). A surging US Dollar would prevent, or at least limit, such a contribution. Ideally the US Dollar will remain stable, that is, it will trade within a narrow range.

While the US stock market will benefit from a stable Dollar (not too high, too low) the world, including the US, will benefit from a stronger Euro. Investment flowing out of Europe and into the US is fine up to a point, but an acceleration of this trend would risk seeing European financial markets go the way of the US markets in 1987 (plummeting stock and bond markets). A currency-induced collapse in European stock and bond markets would set off a chain reaction throughout the world where the original beneficiary would likely be US government debt (the USD gold price would fall with the Euro).

The Euro is showing signs of having bottomed, with the recent decline potentially being a successful re-test of the May low. However, a decisive break of the May low (for example, a close below US\$0.88) could be disastrous. Let's hope that the ECB and the Fed are aware of the gravity of the situation.

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