

Encima Global
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The Dollar Crisis

The Fed's June 25 statement again failed to make even the most minor mention of the dollar. This reinforced the dovish impression of the Fed. As a result, the dollar weakened against gold and oil and against foreign currencies, driving equities down sharply.

While the Fed's passivity on the dollar is deeply harmful to the U.S. economy and financial markets, **our view is that economic and market conditions aren't as unstable as they're made out to be.**

- Dollar weakness and the resulting rise in oil are an incremental drag on the economy and markets, but shouldn't cause a tipping point. Some money is being dead-ended in zero-sum commodity speculation, a clear negative. However, in 1987, when dollar weakness led to a stock market crash, other problems contributed, including the express U.S. policy of further weakening the dollar plus the high level of nominal and real interest rates at the time of the crash.
- This time, some of the negative impact from dollar weakness is dulled by low interest rates, growth abroad, and the reservoirs of liquidity built up in recent years.

There's plenty of bad news. The financial sector is still reeling and losing equity value. The housing and auto sectors have been in a nearly three-year recession. Regulatory over-reach is weighing heavily on banks and insurance companies through the mark-to-market process (accountants gone wild.) We expect inflation to remain elevated for many quarters, the pay-back from years of dollar neglect (see David's 6/14/04 WSJ piece, The "I" Word: Dollar Stability Is the Best Way to Control Inflation.)

- However, while most rates of change have deteriorated (the rise in the unemployment rate, the shift toward expectations of Fed rate hikes, the slowdown in GDP growth since September), we think the levels of these economic indicators are less disturbing. Interest rate expectations are rising, but from a low level; unemployment has risen, but from a low level; GDP growth has slowed, but from a high level.
- The negative level of real interest rates, only imposed in the first quarter, has hammered the dollar but will provide powerful short-term stimulus. This much stimulus has only occurred twice before, in 1977 and 2003, and was followed by growth. While some banks won't participate in this stimulus, others will, by lending either in the U.S. or abroad. The prime rate has fallen sharply, and auto rebates have started to reach critical mass (the consumer bides time well). In

addition, the combination of inflation and negative real rates shifts the balance toward consumption from savings, causing a short-term demand-side stimulus – which is it, save the money at 1% interest or spend it before prices go up.

- The level of unemployment is not out of line given the severe financial shock in August 2007. Jobless claims at 384,000 are not showing recession signals, and much of the increase in unemployment over the last year has been in the 16-24 age bracket, which has less impact on consumption trends. Unemployment will likely fall materially in June from its 5.5% rate in May due to the statistical aberrations in May (early Memorial day, earlier-than-usual labor force entry by young workers). Whatever the June result, unemployment is higher than we would like, but below the levels that create economic instability.
- Although consumer confidence is abysmally low, it hasn't been a good leading indicator of output, consumption or stock markets. The level of GDP is still high. GDP rose sharply in the second and third quarters of 2007 and continued growing in the fourth and first quarters (and will probably gain another 1% or more annual rate in the second quarter.) Despite the gloom, U.S. GDP in June 2008 is above the levels that would have been expected or forecast a year ago.

Why the Dollar Crisis Persists – No One's Tried to Stop It

The common perception is that it would be hard for the Fed or the Administration to strengthen the dollar. We won't know until they try, which they haven't.

- On March 12, President Bush, speaking on the Nightly Business Report, said that he would absolutely like the dollar to strengthen, complaining that the weak dollar contributes to high oil prices and inflation. It was a fleeting moment, though. By the morning of March 13, Treasury and the White House clarified that there had been no change in dollar policy and reiterated the meaningless, decade-old phrase that "a strong dollar is in our national interest."
- On June 3, Fed Chairman Bernanke used a significant new phrase "strong and stable" in relation to the dollar. "Over time, the Federal Reserve's commitment to both price stability and maximum sustainable employment and the underlying strengths of the U.S. economy--including flexible markets and robust innovation and productivity--will be key factors ensuring that the dollar remains a **strong and stable currency.**"
- We had mistakenly thought that June 3 marked a positive inflection point in the rhetoric on the dollar. However, the June 14 G7 statement ignored the dollar, undercutting Bernanke's tougher stance. The June 25 FOMC statement, again ignoring the dollar, seemed to be the final straw for markets, making it look like Bernanke hadn't intended to strengthen the dollar on June 3.

How Will This End?

- Prior to 1971, the value of the dollar was fixed. Since then, the Fed has maintained that it is not responsible for the value of the dollar. As a result, it avoids taking responsibility -- for the weak-dollar inflation of the 1970s, the strong-dollar deflation of the 1990s, and now the weak-dollar inflation this decade. It further contends that the value of the dollar has only a limited impact on inflation -- the Fed almost always uses the trade-weighted value of the dollar, rather than the absolute gold-weighted value of the dollar; the former mixes together the changes in foreign currencies with changes in the dollar and therefore doesn't have much connection to U.S. inflation. Though an over-simplification, the Fed tends to blame high oil prices on supply-demand rather than dollar weakness, and then blames inflation on high oil prices.
- The Bush Administration has favored (or acquiesced) to dollar weakness on the theory that it will help the trade deficit. (Our view: the trade deficit isn't very responsive to the dollar; it responds to growth, demographic and investment climate differentials between the U.S. and the rest of the world; the recent shrinkage in the U.S. trade deficit is mostly the result of the U.S. slowdown, as occurred in the 1990 recession, not to the weaker dollar.)
- We think Washington is the 800 pound gorilla in setting the value of the dollar and this in turn has a major impact on both oil prices and future inflation. Markets like to think they analyze fundamentals and calculate currency values, but the reality is that the Fed has total control over the future supply of dollars and therefore over the demand for the dollar and the future value of the dollar. This makes currencies completely different than other financial instruments -- currencies can't be market-based because the future supply is 100% subject to the central bank.
- **The market issue is whether Washington's passive point of view on the dollar will persist in the face of clear market behavior connecting Fed and Treasury statements to the value of the dollar and the price of oil.**
- The markets have the perception the Fed is in a box -- can't hike because the economy would crash; can't stand pat because the dollar is so weak and oil so high. We think the Fed has more power to support the dollar (and drive oil down) than it is letting on. It's just choosing not to use that power.
- To the extent that the value of the dollar relates to perceptions of the future supply of dollars, it means that Washington's control over the value of the dollar is somewhat distinct from its choice of current interest rates.

- This means there's upside potential (a plausible way out of the box) if the Fed or Bush Administration chooses dollar-supportive policies. This argues against the current disarray being a negative tipping point.
- In sum, the current market meltdown looks to us like a patient deterioration of economic and market conditions waiting for the Fed or the Bush administration to support the dollar.

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