

OPINION

Lifelines for the Drowning Dollar

By David Malpass

Dollar weakness is neutralizing the positive effects of the Federal Reserve's interest-rate cuts. As the dollar spirals downward, weakened by Washington's indifference and market expectations of more rate cuts, liquidity drains from the U.S. into inflation hedges like gold and, in the case of entrepreneurship and risk-taking capital, to countries with strengthening currencies. This drain undercuts the growth impact of the Fed's recent rate cuts, complicating the recovery from the August credit-market turbulence. Question: What's harder to sell than a complex loan during a credit crunch? A dollar-denominated one.

Confidence in low future tax rates would attract investment in dollar-denominated assets.

Foreign countries are suffering the opposite phenomenon. Global investors want to buy more in strong-currency countries, heating up those countries' economies, land values and stock markets. If their central banks hike rates, as China has been doing and Australia did on Nov. 7, it invites even more capital inflows in search of higher yields and currency appreciation, reinforcing the upward currency spiral.

Europeans, Canadians and others revel in their wealth relative to Americans. It's their chance to grow their risk-taking capital base, set global standards, and begin to dominate geo-

political issues. But ever-strengthening currencies run risks as well, as the U.S. found in the economic boom/recession cycle of the late 1990s, when stock prices were bid higher despite declining profits.

The U.S. should stop the currency roller-coaster. Other countries would applaud. On Nov. 8, the head of Europe's central bank called the euro's upward spiral "brutal." It's never been clear to them why the U.S. wanted a super-strong dollar in the 1990s, at the expense of global deflation, and now wants a super-weak dollar, driving innovation away from the U.S. and enriching our competitors.

The Bush administration frequently repeats the Clinton-Rubin policy position that "a strong dollar is in our national interest." By any measure, though, the dollar has weakened steadily under this administration's policies. The impression is that the "strong dollar" phrase is a throw-away, or worse, cover for a weak-dollar policy.

Currency momentum can be broken. The dollar wouldn't be hard to strengthen if the Treasury included dollar weakness in G-7 discussions, and the Fed singled out dollar weakness as a concern. Fed Chairman Ben Bernanke passed up an opportunity to change the dollar's direction in his testimony yesterday to Congress's Joint Economic Committee, noting mildly that the rise in the price of oil and other commodities, and weakness in the dollar, "were likely to increase overall inflation in the short run and, should inflation expectations become unmoored, had the potential to boost inflation in the longer run as well."

The Fed's in a good position if it wanted to strengthen the dollar. By cutting rates well be-



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fore economic weakness, it has room to express stronger interest in the dollar's recovery even if that comes across as hawkish. A clearer preference for dollar strength would increase the demand for dollars, breaking the weak-dollar momentum without requiring currency intervention or rate hikes. As the dollar strengthens, capital would return to the U.S., providing extra liquidity and making the Fed's stimulus job easier.

Answering a question at the Economic Club of New York on Oct. 15, Mr. Bernanke said: "No central banker can be entirely indifferent to the exchange value of the currency of their country and we certainly will pay attention to that issue." But the formal statement accompanying the Fed's Oct. 31 rate cut was careful not to mention the dollar in the inflation discussion: "Recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation."

The market's view is that the Fed has been proactive in providing liquidity but less so in creating conditions to keep it in the U.S. With gold topping \$830 per ounce and the once-meek euro now weighing in at \$1.47, it's simply not clear whether the Fed envisions any bounds to the dollar's slide.

Adding to the dollar's latest sell-off, the Oct. 19 G-7 statement said the group's finance ministers "reaffirm that exchange rates should reflect economic fundamentals." Rather than "reflecting economic fundamentals," which are code words for the acceptance of instability, currencies should be "strong and stable" in order to create good fundamentals for private-sector growth.

The market's clear reaction to Washington's reliance on "fundamentals" has been to sell the dollar on the view that U.S. economic fundamentals are bad and getting worse. The communiqué pointedly left out any confidence-building phrases—like the one in the 1992 G-7 statement that "the ministers and central bank governors . . . will take appropriate additional actions as needed to achieve sustained growth and greater currency stability."

Some argue that dollar weakness helps the economy by making our goods, workers and houses cheap enough for foreigners to buy or hire. This hasn't worked in practice because investors are momentum oriented—they want assets that are going up, not down. The weaker the dollar in recent years, the more quickly capital

has flowed out—to emerging markets, commodities and foreign real estate. Cheap is assumed to become cheaper when a currency is weakening.

While the U.S. trade deficit has declined some over the last year, most of that reflects the U.S. housing bust—home-building is import-intensive—and the foreign economic boom. The trade deficit is likely to remain wide regardless of the dollar's value. It reflects a huge demographic differential—our major trading partners are aging much faster than we are, requiring them to save more while building and importing less.

Prolonged dollar weakness creates a multitude of problems. Companies have to devote an increasing portion of their time and energy to currencies rather than their operating business. Foreigners, not always friends, are gaining wealth relative to Americans. Rather than making the U.S. more competitive, the dollar's weakness makes it harder to justify investments in the U.S., where growth is slowing and interest rates are higher than in Europe or Japan to compensate for the weakening dollar. The investment killer is that assets in the U.S. keep losing value in foreign-currency terms, so U.S. opportunities have to be significantly better to entice investment in the face of a weakening dollar.

This doesn't mean the Fed was wrong in its Sept. 18 and Oct. 31 interest-rate cuts. By 2007, the Fed probably didn't have the option of undoing its 2003-2005 mistake of keeping interest rates too low too long—the inexplicable "measured" hikes from a 1% interest rate during a U.S. and global boom. The damage in terms of dollar weakness, the housing bubble and credit market distortions was substantial, and the Fed's rate-cutting action appropriately lowered the recession risk.

The goal now should be to create the best future environment for growth. Alan Greenspan's new book conveys a long-term pessimism about the value of the dollar in an entitlement-heavy society. That should be addressed. The remedy is clear—a new "strong and stable" dollar policy, personal accounts for Social Security, productivity improvements in medical care, and confidence in low future tax rates to restore growth and invite investments in dollar-denominated assets.

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