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The Weak-Dollar Threat to Prosperity

Measured in euros, U.S. per capita GDP is down 25% since 2000.

By DAVID MALPASS

If you want to know why the dollar has been falling this week and gold hit a new high, look no further than the weak jobs numbers last Friday and the weak communique issued over the weekend at the G-7 meeting in Istanbul. Deploring "excess volatility and disorderly movements in exchange rates" isn't exactly a ringing defense of the greenback. And 9.8% unemployment convinced markets that monetary policy will remain loose regardless of dollar weakness.

Bond buyer Bill Gross of the Pimco fund summed up the situation nicely in a recent CNBC interview. Asked whether low interest rates will weaken the dollar, the influential allocator of global capital said: "I think that's part of the administration's plan. It's obviously not announced—the 'strong dollar' is always the policy, so to speak. One of the ways a country gets out from under its debt burden is to devalue."

On the surface, the weak dollar may not look so bad, especially for Wall Street. Gold, oil, the euro and equities are all rising as much as the dollar declines. They stay even in value terms and create lots of trading volume. And high unemployment keeps the Fed on hold, so anyone with extra dollars or the connections to borrow dollars wins by buying nondollar assets.

Investors have been playing this weak-dollar trade for years, diverting more and more dollars into commodities, foreign currencies and foreign stock markets. This is the Third-World way of asset allocation.

Corporations play this game for bigger stakes, borrowing billions in dollars to expand their foreign businesses. As the pound slid in the 1950s and '60s and the British Empire crumbled, the corporations that prospered were the ones that borrowed pounds aggressively in order to expand abroad. Though British equities rose in pound terms, they generally underperformed gold and foreign equities. At the end of empire, the giant sucking sound was from British capital and jobs moving offshore as the pound sank.

Some weak-dollar advocates believe that American workers will eventually get cheap enough in foreign-currency terms to win manufacturing jobs back. In practice, however, capital outflows overwhelm the trade flows, causing more job losses than cheap real wages create. This was the lesson of the British malaise, the Carter malaise, the Mexican malaise of the 1990s, Yeltsin's Russian malaise through 1999 and the rest. No countries have devalued their way into prosperity, while many—Hong Kong, China, Australia today—have used stable money to invite capital and jobs.

The more the dollar devalued against the yen in the 1970s and '80s, the more Japan gained share in valued-added manufacturing, using the capital from weak-currency countries to increase productivity. China is doing the same now. It watches in chagrin as the U.S. pleads with it to strengthen the yuan, adding productivity fast with the dollars rushing its way in search of currency stability.

If stocks double but the dollar loses half its value, who beyond Wall Street are the winners and losers? There's been a clear demonstration this decade. The S&P nearly doubled from 2003 through 2007. Those who borrowed to buy won big-time. Rich people got richer, seeing their equity bottom line double. At the same time, the dollar's value was cut nearly in half versus the euro and other stable measures. Capital fled, undercutting job growth. Rent, gasoline and food prices rose more than wages.

Equity gains provide cold comfort when currencies crash. From the euro perspective, the S&P peaked at 1700 in 2000, finally reattained 1100 in the 2007 bubble, fell below 600 in March and now stands at 700 (see nearby chart). With most of the market capitalization of U.S. stocks held by Americans, the dollar devaluation has caused a massive decline in the U.S. share of global wealth.

Measured in euros (a more stable ruler than the ever-weakening dollar), U.S. real per capita GDP is down 25% since 2000, while Germany's is up 4% and tops ours.

The solution is a strong U.S. jobs and wealth program. It has to include stable money, a flatter, more competitive tax structure, spending restraint, and common-sense bank regulation so small business lending can restart. Treasury has to rapidly lengthen the maturity of the national debt and take steps to protect the Fed from market losses on its long-term debt holdings.

Instead, Washington's current economic program pushes capital away by weakening the dollar, threatening higher tax rates, borrowing short (the Fed's near trillion-dollar overnight debt, Treasury's mounds of bill and note issuance) to lend long (mortgages, student loans, entitlements), doubling down on government subsidies, and rechanneling bank loans to governments and big businesses instead of the small business job-growth engine.

It's possible global bond vigilantes will call Washington's bluff, reducing their bond purchases until we stop devaluing and restart job growth, which is the ultimate source of tax revenues to repay our bond debt. This would create a Volcker moment when the U.S. might tighten even as the economy slowed (as then Fed Chairman Paul Volcker did back in 1979).

But the accepted outlook is the almost-as-gloomy new norm. If all goes according to current plans, the dollar devalues slowly and bond buyers come back for more even as national debt heads toward $15 trillion. World living standards grow faster than ours, as does global wealth. The Fed chases inflation as the dollar sinks, but not so fast as to stop the recovery. More capital moves abroad, leaving U.S. unemployment too high too long.

A better approach would start with President Barack Obama rejecting the Bush administration's weak-dollar policy. This would invite capital and jobs to come back before interest rates have to rise.

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