

OPINION

Markets and the Dollar

By David Malpass

High-profile foreign investments in U.S. financial institutions have been making headlines recently. But those capital injections are a trickle when compared to the outward flood of dollars from U.S. companies seeking to increase assets and earnings in some currency other than the sinking dollar.

To fight financial market turbulence and a slowing economy, the Fed has injected extra liquidity, cut the discount rate, and cut the fed funds rate a full percent. As it prepares to hit the rate-cut panic button harder, the Fed should also try using its most powerful tool, a stronger dollar, to draw liquidity into credit markets, reduce oil prices, and restart economic growth.

The best stimulus policy is a sound currency.

At 4.25%, the fed funds rate is now below both the 4.3% consumer price inflation rate and the 4.9% third-quarter real growth rate. That's a more proactive interest rate stance than any previous pre-recession environment. The Fed is trying to make the best of a bad monetary situation. Most of the damage was done once the fed-funds rate was forced down to 1% in 2003 and held artificially low as the value of the dollar evaporated and housing bubbled through 2005.

The Fed's late-December policy innovation—auctioning funds through the discount window—will gradually shift as much as 7% of the Fed's \$900 billion in assets from Treasury bills to collateralized bank loans. This is constructive medicine. It should help deposit-taking banks finance mortgages, and also leave sought-after Treasury bills in the market.

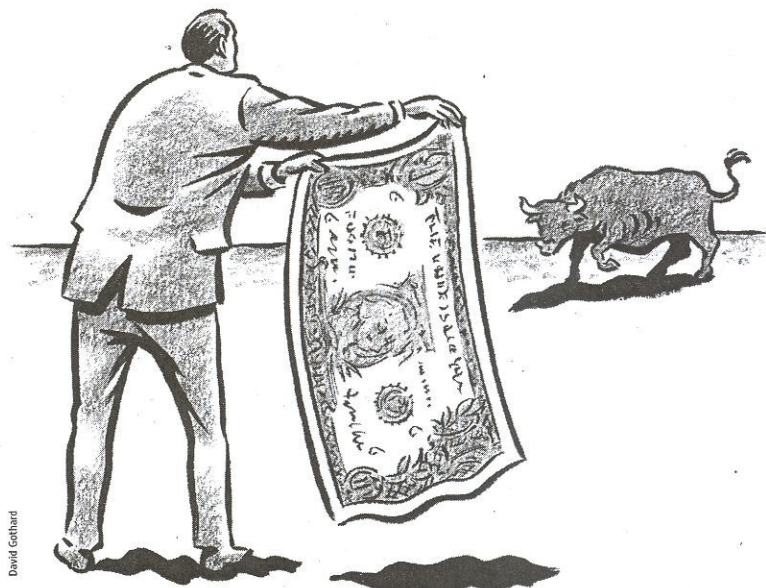
While some worry that central banks are losing their power due to the size and complexity of global markets, the more likely problem is too much power. Central banks cause wide swings in interest rates and the value of their

currencies. With a delay, the swings penetrate the price level as inflation and deflation. Central banks are the only institutions that have a literally unlimited balance sheet—in the case of the Fed, the ability to instantaneously create and inject into the economy as many billions of dollars as it determines useful (by buying Treasury bills or acquiring temporary control of mortgage-related securities).

The elephant in the living room—the topic Washington won't broach—is the dollar itself as a powerful but unused monetary policy tool. The Fed didn't mention the dollar in its Dec. 11 rate-decision communiqué, nor in its November economic forecasts. In his recent 500-page memoir, and his Dec. 12 opinion piece on this page, former Fed Chairman Alan Greenspan barely mentions the wide swings in the value of the dollar—probably the most important economic and investing variable in the last decade—and their causal connection to first deflation and now inflation.

President Bush showed no embarrassment over dollar weakness in a November interview with Fox Business News. He was asked: "Even if the economy is weak, shouldn't the dollar be strong?" Rather than a simple "yes," the president said: "All I can tell you is the policy of this government is a strong dollar. We believe the marketplace is the best place to set the exchange rates." Pressed if he was satisfied with where the exchange rates are now, he replied: "Well, I am satisfied with the fact that we have a strong-dollar policy and know that the market ought to be setting the exchange rate between the U.S. dollar and other currencies."

Current U.S. dollar policy leaves only "the market" responsible for the dollar's collapse. Not known for deep thinking, the currency markets tend to sell currencies issued by countries which make markets responsible for currency values. The euro found this out the hard way in 2000 when Wim Duisenberg, then head of the European Central Bank, invited markets to set the value of the euro based on Europe's economic fundamentals. Look out below. The free fall didn't stop until Jean-Claude Trichet took over and installed policies to preserve the euro's



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value regardless of the market's view of economic fundamentals.

There's no reason to think markets set currency values based on economic fundamentals anyway. In the early 1990s, Japan's yen was superstrong through 1995 even though it pushed Japan into a decade-long deflation spiral. Currency markets are famous for going to extremes, distorting economies and people's lives without any qualm of conscience or reference to value.

One of the Fed's main explanations for its hope that inflation could moderate despite dollar weakness—the same explanation it used in the late 1990s for claiming that dollar strength wouldn't cause deflation—is its research showing that the "trade-weighted" value of the dollar is not well-correlated to U.S. inflation. The obvious problem with this approach is that the trade-weighted dollar mixes together changes in the dollar's value with changes in the value of foreign currencies.

The dollar's trade-weighted value can be down due to foreign currency appreciation, and vice versa, with little impact on U.S. inflation. In contrast, the connection between gold-measured changes in the value of the dollar and the U.S. inflation rate is too clear to keep ignoring.

The relationship between currency values and inflation or deflation is equally strong in other countries. China is suffering high inflation now because the gold-measured value of the yuan is weak (even though the trade-weighted yuan is strong due to dollar and yen weakness). Yen strength in the late 1980s and early '90s drove Japan into a deflation spiral, the same process that struck the U.S. in the late '90s.

By saying they want a stronger dollar, the Fed, the president or the Treasury could make it hap-

pen. Government policy makers have almost absolute control over perceptions of the future scarcity of dollars. This controls the demand for dollars almost as much as it does the supply, setting its value as much or more than rates do.

But world markets expect a dovish Fed now and in the future. This is driving capital away from the dollar. Washington can easily change this perception by linking a stronger dollar to its much-needed fight against inflation. Coordinated currency interventions are a helpful and decisive signal of a monetary policy change, but aren't required. The necessary policy change is a top-down U.S. policy decision in favor of a stronger, more stable dollar as a core U.S. growth policy.

As a next step in addressing financial-market turbulence, the Fed and the administration should say they want the dollar to strengthen in order to attract capital, spur U.S. growth and slow the inflation rate. There's still time. Jobless claims are not yet at recession levels, stock prices are high, and exports are booming. The weak dollar doesn't seem to be at a tipping point—it's more of a constant drag on the economy, like American litigiousness and the anti-growth tax code.

But the harder the economy works to repair the weak-dollar damage from the bottomless liquidity punch bowl of 2004, the deeper the urge for the "hair of the dog" medicine of more rate cuts. Those may weaken the dollar more, adding to inflation. The clear alternative is to strengthen the dollar first.

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