SPECIAL FX

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Race to Debase?

There seems to be a rough agreement that the world economy is on the mend. Earlier this year the focus was on the turning of second derivatives, which is how some economists refer to the pace of economic contraction slowing. Increasing amounts of data from a broad array of countries suggest positive growth is at hand; the world economy seems poised to expand for the first time in a year.

The currency of the world's largest economy has not benefited from the economic conditions shifting in a more positive direction. In recent days, the greenback has recorded new lows for the year against the Australian, New Zealand, and Canadian dollars. It neared its worst levels against a broad swath of other currencies, pushing the dollar-index (DXY) to the lowest levels since the week before Christmas. Consistent with the recent trend among economists to emphasize the psychological dimension of economics, sentiment appears to be one of the key drivers of the dollar's under-performance.[i]

Numerous investors, speculators, and even some foreign officials are worried that the current mix of aggressive monetary and fiscal policy will result in higher inflation, which will erode the dollar. Many observers believe that the U.S. actually seeks a weaker dollar in order to boost exports and/or deliver what some regard as a stealth default.

The debasement of the dollar would reduce the value of U.S. debt to numerous foreign investors, including central banks. China, the single largest foreign holder of Treasuries, has expressed such concerns, sending a powerful signal to other investors.

Who Wants a Weak Currency?

In recent weeks officials from numerous countries have verbally warned about the impact of their currencies strength, but not U.S. officials.

Switzerland, having among the largest current account surpluses of industrialized countries, has intervened, selling its currency for euros and dollars since late March. The Swiss National Bank's recent report indicated that euro and dollar holdings rose by €32 billion and $20 billion in Q2. This is not necessarily all from intervention; there are a number of factors which influence these figures. However, one Swiss bank estimated intervention has probably accounted for $32 billion.

This represents a version of quantitative easing. For example central banks in the U.S., Japan, and UK are purchasing their own government bonds. The SNB says their bond market is too small for this approach; to resist deflationary forces they will sell Swiss francs and buy European and U.S. bonds. Additionally, officials have warned that Swiss franc strength is contributing to those very deflation forces. Switzerland is an unequivocal case of both declaratory and operational policies resulting from a weak currency.

Following a recent meeting, the Reserve Bank of New Zealand governor said the official economic forecast was predicated on further easing of monetary conditions. The New Zealand dollar's strength, which has risen more than 20% on a trade weighed measure since early February, is tightening those very monetary conditions. Governor Bollard implied if the currency's strength jeopardizes recovery, the central bank must consider cutting rates again. The market understood precisely and quickly took the Kiwi down against the U.S. and Australian dollars by about 1.5% and 2.0% respectively. There is no doubt the RBNZ wants a weaker currency.

A number of other countries also want weaker currencies. Canadian and UK central bank officials have warned the strength of their currencies could delay recovery. Yet over the past year the Canadian dollar has lost about an eighth of its value against the greenback, while sterling has lost roughly a sixth.

For its part, the euro is essentially flat against the dollar thus far in 2009, having finished 2008 just below $1.40. Yet some European officials have cautioned against further euro strength. Norway's central bank has warned about the strength of the krone, even though it has lost more than a fifth of its value over the past four quarters.

This is not even discussing the numerous emerging market countries which have intervened by selling their own currencies and buying dollars, especially in East Asia, but Brazil intervenes daily to sell reais. Let's not forget China in this context. For all practically purposes it has re-pegged the yuan to the dollar. Thus far in 2009 the yuan/dollar range is about 0.7%. Under Bretton Woods a 1% band was regarded as fixed.

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Meaning of Strong Dollar Policy

The U.S. declaratory policy is for a strong dollar. This has been the case, without failure, for the past 14 years across both Republican and Democrat Administrations. Ironically since the policy was first articulated in 1995, the U.S. has intervened twice in the foreign exchange market, and both times were to sell the dollar. The first was in 1998 by Robert Rubin against the yen in coordination with Japanese officials, and the second was in 2000 by Lawrence Summers as part of a G7 effort to support the euro. George W. Bush was the first president since before Bretton Woods crumbled not to intervene in the foreign exchange market.

Nevertheless the strong dollar policy is significant. Even the ECB's Trichet recognizes this and has often indicated he welcomes it. To appreciate this insight, recall two events. In the summer of 1987, Treasury Secretary James Baker essentially threatened Germany with a weaker dollar if they did not take additional measures to stimulate their economy. Some economists link this to the October 1987 equity market crash. A few years later, in February 1994, Treasury Secretary Lloyd Bentsen was understood to have threatened Japan with a weaker dollar as part of difficult trade talks.

Rubin's formulation was designed to signal a break from the use of the dollar as a weapon. The significance of the strong dollar declaratory policy is that no Treasury Secretary since Rubin has threatened to purposely debase the dollar.

Even if the U.S. says it wants a strong dollar, many critics believe that operational policy, by deeds not words, seeks to depreciate the dollar. This assumption, that the U.S. seeks or has an intention about the dollar, spurs part of the negative sentiment.

This understanding seems faulty. It cannot be demonstrated, intentions and motivations are often difficult to ascertain. It concedes too much power to intentions in any event. Of the myriad of factors capable of influencing currency prices, official intentions do not appear very salient.

The SNB is trying, with material intervention to drive the Swiss franc down; it is struggling to accomplish this. Are we really to believe that the possible intention of a U.S. official can succeed where billions of dollars have failed for Switzerland? Color me skeptical.

Most importantly, the assumption is mistaken because it misconstrues the dollar's role. Outside of forswearing the use of the greenback's value as a policy lever, the U.S. dollar is a residual of the pursuit of other policies. Barring a dramatic destabilizing movement, U.S. policy makers do not place much significance on bilateral nominal exchange rates. The U.S. economy, employment, consumption, investment, inflation, and equity market performance cannot be deduced from the dollar.

Sentiment toward the dollar may turn around when investors and speculators are no longer paid to be short the greenback, and U.S. interest rates rise above those in Europe. Sentiment may turnaround when the sales no longer generate satisfaction. Sentiment is likely to change before U.S. dollar policy.

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[i] See the recently published, Robert Shiller and George Akerlof's Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for the World and David Adler's Snap Judgment; When to Trust Your Instincts, When to Ignore Them, and How to Avoid Making Big Mistakes With Your Money.