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Currency Confusion

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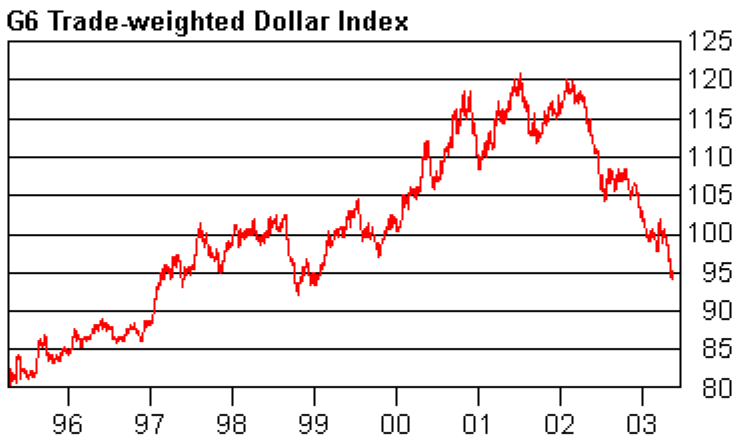
John Snow's loose lips rocked the boat, but the Fed is the captain of the dollar's fate.



Amidst the furor touched off by **Treasury Secretary John Snow's** ill-considered remarks about US dollar policy, we'd advise maintaining a sense of perspective. At current values against its major-currency counterparts, the dollar has only retreated to levels last seen in early 1999, which was up some 10% from its position in late1996 at the outset of what was to become a nearly uninterrupted five-year stretch of dollar appreciation. That appreciation, of course, was the product of **the Fed's** calamitous deflationary error, which led to the dollar's revaluation by upwards of 30% against gold, commodities and foreign exchange, and ultimately put an end to one of the past century's great eras of economic expansion. At this point, then, the dollar can only be considered "weak" relative to its earlier deflationary heights, and actually is now in a vastly more growth-friendly position than it was at its peak 15 months ago.

That's not to excuse Snow's ham-fisted attempt to extemporaneously improvise a new dollar policy. Our hunch is that Snow was responding primarily to the current deflation obsession in the media and certain corners of the financial community, and probably felt he was doing his part by posing a contrast with the Rubinesque embrace of a "strong dollar," forever and always. His alternative, however -- to define the currency as "strong" based on confidence in its function as a medium of exchange and store of value -- could only sow confusion and encourage speculation that the **Bush administration** seeks a weaker dollar (and further shake confidence in the administration's ability to choose strong players for its economic team).

For our purposes, the **Robert Rubin** mantra that a "strong dollar is in the national interest" was greatly overrated as a source of dollar strength in the 1990s. Treasury secretaries can only influence currency values at the margin, with their statements either enhancing or diminishing market confidence in the unit of account. In the face of the sustained, Fed-engineered scarcity of dollar liquidity, Rubin would have been made to look superfluous had he done anything other than support a strong currency. In the current context, though, with the Fed maintaining an expansive posture and the dollar reflating as a consequence, such Treasury free-lancing cannot be considered salutary. For one thing, should such rhetoric trigger a loss of confidence in the currency, the Fed would likely be compelled to reverse course and tighten the availability of liquidity to restore forex market stability.

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Fortunately, *that* appears to remain a remote possibility. Following the **White House's** implicit mid-day rebuke of Snow, insisting that dollar policy remains unchanged, the dollar came well off its lows for the day, amid fresh speculation that the currency may have already overshot to the downside. Meanwhile, one unintended benefit from the blowup over Snow's clumsy statements could be seen in the belated recognition in some press reports that a falling dollar is inconsistent with rampant worries over the possibility of deflation. Indeed, even prior to the Snow *contretemps*, the dollar's continuing softening since the **FOMC** meeting earlier this month likely was not going unnoticed at the Fed, and policy makers who were inclined to support further easing could well be reconsidering. TM