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Geithner and the Dollar: That's Not My Job

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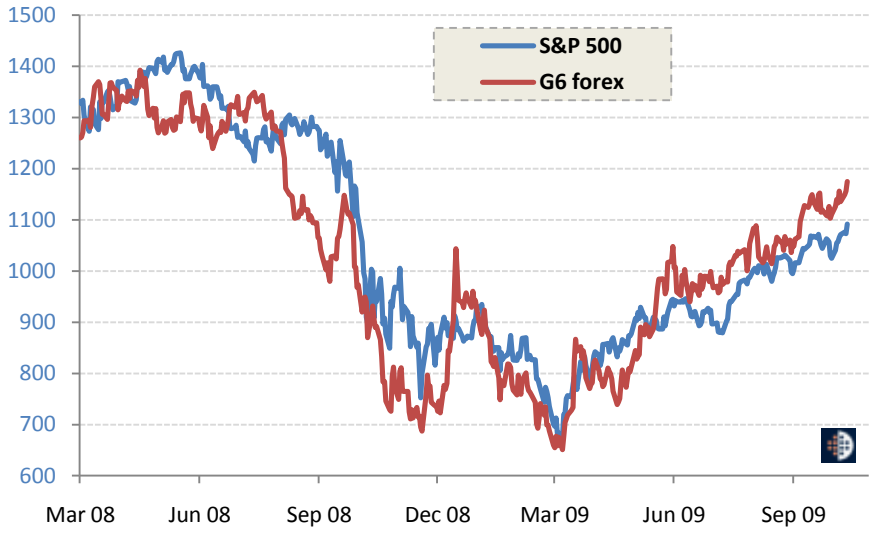
Donald Luskin

For Treasury, it's not a problem at all -- and even if it is, it's the Fed's.

We met with Treasury Secretary Tim Geithner yesterday, and asked him how far he was prepared to let the dollar fall. He said he wouldn't talk about the dollar at all, because the subject is "too interesting" -- but then proceeded to say a great deal. Everything he said was quite sensible by our lights, but none of it was one bit encouraging to those who are distressed by the ongoing decline of the dollar. In our conversation Geithner never offered even the stereotypical bogus boilerplate assurances of a "strong dollar policy."

Update to strategic view
US DOLLAR: With panic demand abating and inflation risks rising, the course of least resistance for the dollar is lower. The Treasury sees no role for itself in resisting the decline, and indeed will continue to quietly encourage China and other export giants to let their currencies appreciate.
[see Investment Strategy Dashboard]

Geithner said he thinks that the dollar's recent drop -- 15% drop over the last seven months on a trade-weighted basis -- represents the restoration of confidence in the global financial system, recovering from a panic which drove extraordinary demand for dollar liquidity. He's right: throughout the crisis the dollar has been a barometer of fear, with the high made on March 9, the same day that US stocks made their bear market low.



As the chart below illustrates, this relationship has been quite persistent, and is so self-evidently event-driven that it probably doesn't say much about the dollar's intrinsic long run value.

But while we shouldn't be unduly distressed by this latest dollar drop, we shouldn't be falsely comforted by focusing only on the context of the financial crisis and its resolution. Taking the longer view, the recent drop

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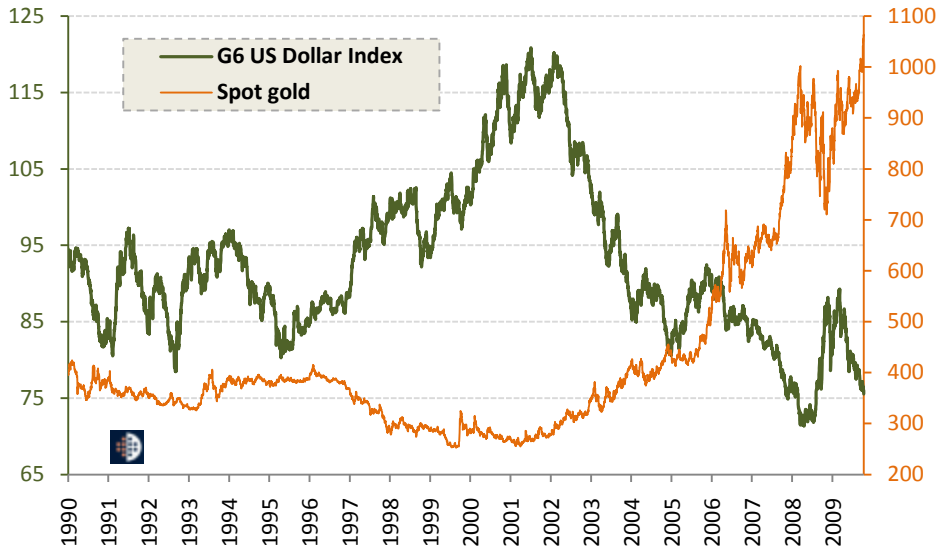
just re-establishes the dollar's long term declining trend from its 2000-2001 top, which was well in place long before the crisis (see the chart at right). That is something that Geithner seems to take no responsibility for trying to ameliorate. This is not so much a posture of so-called benign neglect as it is Geithner's conviction, which we share, that the primary responsibility for the dollar's value rests with the Fed.

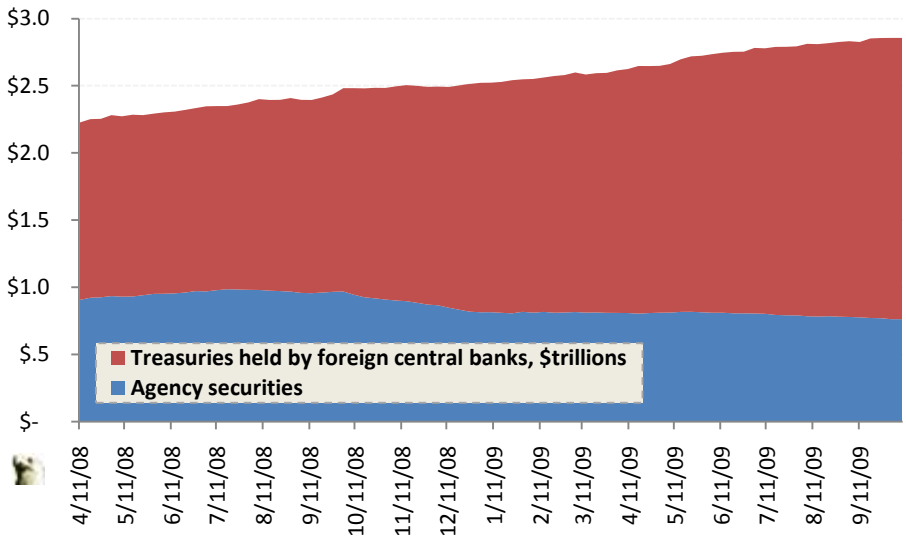


If inflation is "always and everywhere a monetary phenomenon," then the Fed controls the purchasing power of the dollar, and ultimately purchasing power is what controls the value of any currency. That view doesn't bode well for the dollar, considering that the dollar's rise to its 2000-2001 high coincided with a period of excessively tight monetary policy, and its decline since has coincided with a period of excessively loose monetary policy. We can see this relationship clearly in the chart above, using changes in the gold price as a yardstick for measuring the tightness or easiness of monetary policy, as indeed Alan Greenspan did during his early years as Fed chair (see "The Maestro's Golden Years" September 11, 2009). Based on seeing gold at all-time highs, we would expect, all else equal, the dollar to move to new all-time lows.

All else is never equal when it comes to exchange rates, and here Geithner is likely to try to make matters worse for the dollar. With respect to exporting nations seen as intervening to keep their currencies artificially weak relative to the dollar, Geithner intends to continue -- though more quietly -- the policy of his predecessors in the Bush administration, to urge setting those currencies free to float at market prices, presumably then to appreciate versus the dollar. Geithner understands that, of necessity, this will weaken the dollar exchange rate. But in his mind, that's not intrinsically a matter of the dollar at all, but rather of, say, the Chinese yuan.

But here, too, Geithner sees himself as powerless. He acknowledges that the US is in no position to dictate currency policies to anyone, and can only try to convince other nations that it is in their own self-interest to float their currencies. For Geithner it's part of an overall posture of advocacy for free trade and sheer mutual pragmatism, not an attempt to pro-actively adjust so-called "global imbalances" of trade, savings and consumption. Despite the obsession about this among Geithner's fellow global technocrats on the G20, he says he simply doesn't buy into that "existential narrative."

Despite talk about the potential declining role of the dollar as the world's reserve currency, the Treasury doesn't appear to be concerned at all with US's ability to fund its debt. Geithner's senior staffer responsible for funding policy argued that there has been no difficulty whatsoever in recent financing operations, despite their increasing size and the Treasury's strategy to quietly begin to extend the average maturity of outstanding debt from its panic low a year ago.



He pointed out to us that foreign holdings of US Treasury debt are at an all-time high, reflecting confidence in the dollar.

We think the Treasury ought to be somewhat more concerned. Foreign holdings are indeed at an all-time high in absolute terms, but not in percentage terms (that high was made in the panic of this year's first quarter). At that, the Fed's purchase of about $900 billion so far of agency mortgage-backed securities, at the same time as foreign central banks have liquidated about $300 billion, likely facilitated foreign purchases of Treasuries (see the chart above). And meanwhile, the Fed bought $300 billion in long term Treasuries -- and while that wasn't enough to even restore its overall Treasury holdings to pre-panic levels, and probably damaged confidence while it was being carried out (see "The Fed's Bond Boo Boo" July 24, 2009), it did create an increase in the Fed's holdings three times greater than the increase in foreigners' holdings.

The Treasury is not alone in drawing confidence, perhaps false confidence, from the Treasury bond market. The Fed -- which as Geithner says, is ultimately responsible for the dollar -- is watching it, too, for evidence that its ultra-accommodative policy stance has gone too far for too long -- and at the moment it is giving what appears superficially to be an all-clear signal. This gives the Fed the scope to believe seemingly quiescent official core inflation statistics, and to turn a blind eye to the inflation warning being given by gold at all-time highs (see "Gold Above $1,000: What Took So Long?" September 16, 2009). In other words, it gives the Fed the scope to let the dollar continue to fall.

BOTTOM LINE: With panic demand abating and inflation risks rising, the course of least resistance for the dollar is lower. The Treasury sees no role for itself in resisting the decline, and indeed will continue to quietly encourage China and other export giants to let their currencies appreciate.