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Whose Dollar Is It, Anyway?

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The world fumes while Geithner says it's Bernanke's problem and Bernanke says its Congress's problem.

Update to strategic view

US DOLLAR: US officials pass the buck on the continuing drop in the US dollar. Europe and the emerging nations are gearing up to defend themselves as best they can, but the dollar is headed to challenge all-time lows.

[see Investment Strategy Dashboard]

Howls of alarm about the steady deterioration of the dollar are spreading in international capitals, but they're unlikely to get the attention of those at the controls of the monetary levers that determine the currency's value. In fact, Fed chief Ben Bernanke made remarks this week that could be read as welcoming the impact of the dollar's decline on the trade deficit.

As the euro breached $1.50 for the first time in 14 months -- it's appreciated about 20% off its lows in March -- European officials expressed deepening unease about the impact that the strengthening would have on their export-driven economies. Henri Guaino, a senior aide to French President Nicolas Sarkozy, said the euro at $1.50 "is a disaster for the European economy and industry." He said at some point the dollar's weakness would become "unbearable" and Europe would have to respond, most likely by easing policy which will lead to higher inflation. At a meeting of euro-zone finance ministers in Luxembourg, Jean-Claude Juncker of Luxembourg said, "it's a problem that worries us." European Central Bank President Jean-Claude Trichet said that "excessive volatility" in exchange rates is "bad for economic development."

Europe's concerns come within weeks of a concerted move by central banks in Asian emerging markets including Singapore, the Philippines, South Korea and Thailand to buy billions of dollars to limit the appreciation of their currencies against the dollar. Reserve levels across the emerging market economies have been bulging the past several months, setting the stage for a bout of inflation down the road. China, which for the last 13 months has effectively pegged the yuan at $6.83, is already seeing a significant shift higher in its inflation environment. After enduring a deflation which peaked at a three-month annual rate of nearly 15% early this year, consumer prices in China are up at a rate of 3.7%. China's reserves climbed by more than $140 billion in the third quarter, and its dollar hoard now totals $2.273 trillion, by far the largest in the world.

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One developing country that has allowed its currency to appreciate against the dollar has been Brazil, with the real up by nearly 20% since March. In an effort to at least slow the currency's rise, the Finance Ministry this week imposed a 2% tax on foreign purchases of fixed income securities and stocks. By late in the week, however, Brazilian President Luiz Inacio Lula da Silva was saying that the levy could be dropped if it fails to halt the currency's rise. After a sharp selloff on the announcement of the tax, the real rallied back, and was down on net about 1.4% for the week.

If the Fed is cognizant of the difficulties its weak dollar posture is posing for other countries, there has been no sign of it. In his speech this week, Ben Bernanke said "we must avoid ever-increasing and unsustainable imbalances in trade and capital flows." He noted that as a consequence of the recent credit crisis, the US current account deficit fell from about 5% of GDP in 2008 to less than 3% in this year's second quarter. But he warned that as the global economy recovers and trade volumes rebound, "global imbalances may reassert themselves." Policymakers, he said, "must guard against such an outcome." Bernanke did not specifically mention the dollar in this context, but clearly if his objective is to keep the current account deficit from rising, it's unlikely that he's terribly anxious about the currency's decline, or believes it ought to be reversed.

In response to a question, he suggested that the fate of the dollar hinges on Congress getting control of the federal budget deficit. "It’s important, and I think policy makers recognize we need, to develop a fiscal exit strategy which will involve a trajectory toward sustainability," he said. "That's critically important in order to maintain confidence in our economy and confidence in our currency." Surely Bernanke understands that the performance of the dollar is tied much more directly to the conduct of monetary than to fiscal policy. As we discussed last week, Treasury Secretary Tim Geithner sees it that way, too (see "Geithner and the Dollar: That's Not My Job" October 15, 2009). In fact last year, during the period of extended dollar weakness before the onset of the credit crisis, Bernanke said, "We are attentive to the implications of changes in the value of the dollar for inflation and inflation expectations" (see "The Bernanke Awakening" June 5, 2008).

So Geithner thinks the dollar is Bernanke's job. Bernanke thinks the dollar is Congress's job. All we don't know is whose job Congress thinks it is. No wonder the dollar hovers just 5% above all-time lows.

BOTTOM LINE: US officials pass the buck on the continuing drop in the US dollar. Europe and the emerging nations are gearing up to defend themselves as best they can, but the dollar is headed to challenge all-time lows.