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ECONOMIC NEWS UPDATE

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The Dollar: Gradual Decline or a Rout?

When anyone from the Bush administration reiterates the government's belief in a strong dollar he is now greeted with derisive laughter, rather than a mere behind-the-hand titter. The actual White House position is best summarized as favoring a dollar as strong as market forces permit. And that is very weak indeed. So weak, that India will no longer accept dollars in payment for admission fees to the Taj Mahal and other sites: they want a hard currency, their very own rupee. And famous supermodel Gisele Bundchen is demanding payment in euros, rather than dollars, for slouching down the world's runways.

Almost every dollar indicator points downward. Start with Ben Bernanke and the Federal Reserve Board's monetary policy committee. It is true that some Fed governors are worried that oil, food, and commodity prices are rising so rapidly that inflation is the number one threat to the US economy, even though "core inflation" (excluding food and energy prices,

which makes the core inflation rate irrelevant to anyone who eats and drives) remains "relatively restrained", in the words of Goldman Sachs' analysts. But the inflation hawks are in the minority. The chairman is under pressure to lower, not raise interest rates.

For one thing, the economy is slowing, and Bernanke has to worry that the deteriorating housing market will convert the anticipated slowdown into a major recession. The rates on some two million subprime mortgages are due to jump next year from the 7-8 percent range to 9.5-11 percent, raising the monthly payment of the typical subprime borrower by about \$350. Many just won't be able to come up with the money, and others will have to cut back on purchases of consumer goods, especially if gasoline stays around \$3 per gallon.

Even homeowners with fixed-rate mortgages are expected to find high gasoline prices putting a crimp in their budgets. And they won't be able to

count on borrowing against rising equity in their homes, because past days of ever-rising prices have been replaced with drearier present-day falling values. Add to that a softening of the jobs market that is likely to drive the unemployment rate up, and you have a prescription for at minimum a slowdown, at worst the recession that one-third of the economists surveyed by The Wall Street Journal are now predicting.

The Fed also has to worry about the on-going problems of the financial markets. As banks write off billions of dollars, with unknown billions more to come, their willingness and ability to lend even to credit-worthy businesses and individuals shrinks. That will add to the drag on the economy, and increase the pressure on the Fed to cut interest rates, and cut them more than once.

Which bodes ill for the value of the dollar. Stephen Jen, head of currency research at Morgan Stanley told the Financial Times, "This is the first time in my career that I am really worried about the dollar. The dollar is in trouble." Foreigners, watching the returns on their investment hit by lower interest rates and fearing an economic slowdown, and noticing that even though the US trade deficit is narrowing it remains large, want to dump dollars. Or, to use the more sophisticated phrasing of economic forecasters such as those at Citigroup Global Markets, "US asset markets are unlikely to offer risk-adjusted returns that are sufficient to finance the external deficit with further USD [dollar] depreciation."

Consider only the losses the Chinese have taken on their investment in Blackstone, or the decline in the value of the dollars stored in the vaults of the central banks of China and Middle East oil producers, or the complaints by

rapacious Middle East oil producers that the dollars they are paid for their crude oil are buying less in world markets. Indeed, at last week's meeting of the OPEC cartel, the price-fixers were unaware that their mikes were on, and inadvertently broadcast a Venezuelan and Iranian demand that the communiqué include a complaint the weakness of the dollars they are getting for their oil. Only Saudi insistence that such a statement might cause a stampede out of dollars headed off that public complaint. But the dollar peg is fueling inflation in many Middle East countries; ever-grateful Kuwait has already abandoned the dollar in favor of a mixed basket of currencies to value its currency.

Not all of this is bad news for the American economy. Conservative economists, and hard-money advocates such as the editorial-page writers in The Wall Street Journal, argue that no country ever got rich debasing its currency. But so far, the falling dollar has stimulated exports sufficiently to offset some of the downward pull of the housing market's problems. With the dollar headed towards \$2.10 to the pound, and closing on \$1.50 to the euro, Americans are staying at home, Europeans are flooding into American cities to do their Christmas shopping, and buyers of business equipment are finding that US suppliers can offer more favorable prices than their German and French competitors. Which is why Nicolas Sarkozy warned the US congress that an economic war might break out, although just how he would wage it is unclear -- unless he tips the EU into the protectionist camp.

That, of course, is no longer out of the question. With the Chinese currency more-or-less pegged to the

dollar, so that Chinese exports are not disadvantaged by the dollar's weakness, the brunt of the adjustment to America's weakening currency is falling on Europe. The EU is now talking about slapping tariffs on Chinese goods that benefit from subsidies, which would include just about everything China sells since its currency peg to the dollar does, in effect, subsidize all of its exports.

Worse still, America is headed for a bout of protectionism. Almost all candidates for the Democratic nomination are opposed to any new trade agreements, and all are hinting that if elected they will impose restrictions on imports, perhaps through the indirect mechanism of insisting that America's trading partners raise their costs by introducing tighter environmental and labor standards. Democrats are also threatening retaliatory, offsetting tariffs on Chinese goods if the regime continues to cling to its dollar peg. And both political parties are increasingly nervous that the accumulated capital of the so-called Sovereign Wealth Funds will be used to "buy up America" -- never mind that we have been there before when Japan bought Rockefeller Center and other iconic assets, and that America needs a steady flow of inward investment to offset its trade deficit.

Despite all of this, a dollar rout remains unlikely. For one thing, it is not at all certain that the US economy is tipping into recession. We will know more after the Christmas shopping season, which might well turn out to be a rather good one for merchants. Benchmark retailer Wal-Mart is predicting a "solid" holiday season, and the National Retail Federation is predicting sales will be 4 percent up on last year. That's not something to elicit

wild cheering from shopkeepers who are already cutting prices, but neither is it a calamity for the economy.

More important, there are signs that the housing market's problems have finally caught the attention of the Bush administration. Some officials are proposing a moratorium on interest rate re-sets until a case-by-case review enables lenders to identify borrowers who, with a little bit of flexibility on lenders' part, can avoid foreclosure. Others want to extend the activities of institutions such as Freddie Mac, Fannie Mae and other government agencies already involved in the housing market. Cataclysm might not, after all, be just around the corner.

And the Fed just might not capitulate to the panic being promoted by the CEOs of investment banks, eager to avoid following Merrill Lynch's Stan O'Neal and Citigroup's Chuck Prince into involuntary retirement, and moderate the pace of the dollar's decline by holding the line on interest rates. Throw in what appears to be slowdowns in the UK and euroland, and there is reason to doubt whether the dollar bears will have the rout on which they are betting. They might have to settle for continued gradual decline.

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