

FED SHADOW

Dollar Delusions

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It looks like the Fed may have found a new reason to stay too easy for too long.

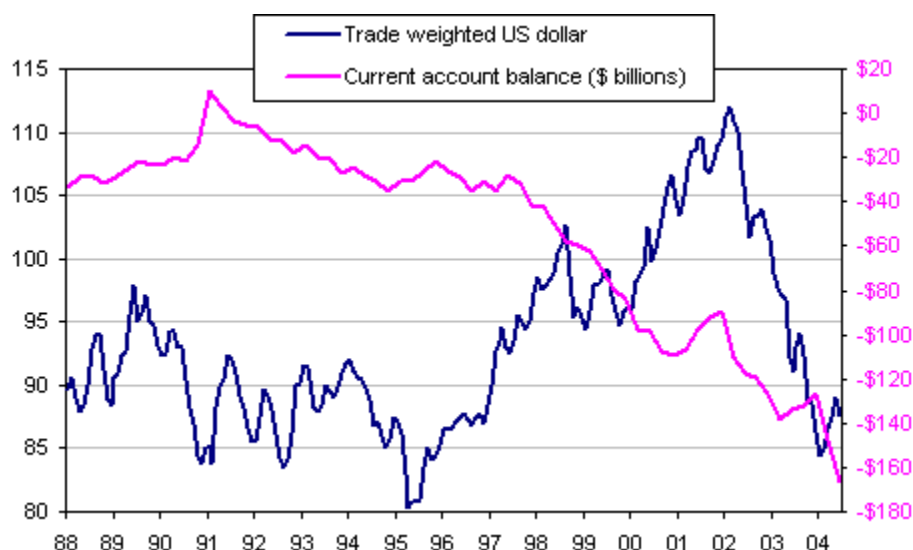
At yesterday's close, the trade-weighted foreign exchange value of the dollar was even lower -- and the dollar price of gold, at above \$428, was even higher -- than they were at their extreme points early this year when **the Fed** was expected to indefinitely maintain its hyper-easy stance. While we have warned that the Fed's "measured" shift toward policy normalization in the months since hardly foreclosed the possibility of inflationary error, the dollar's recent deterioration reflects an unwelcome new element in the matrix of monetary risks. None too subtly, policymakers are now flirting with the dangerous proposition of intentionally fostering dollar depreciation for trade-balancing purposes.

In the past month, no fewer than five senior Fed officials have broached the prospect of a weaker currency tied to the **US** current account deficit. The theme first gained significant attention on October 7 when **Dallas Fed president Robert McTeer**, referencing the current account, asserted "there's only one direction for the dollar to go -- lower" (see ["Scary Kerry"](#) October 8, 2004). In the weeks since, the G-6 trade-weighted dollar index has fallen nearly 4%.

But of the central bank's recent dollar musings, a particularly troublesome note was sounded in a speech late last week by **San Francisco Fed president Janet Yellen**. After bemoaning the "trade gap" as a negative for GDP growth, Yellen turned to the dollar, which she said "has remained relatively high despite our large and growing trade deficit." Yellen, a former Fed governor recently appointed to the San Francisco post, then went on to declare that "interest rates must be lower than would otherwise be necessary" in order to offset the drag on "domestic demand" resulting from a "high dollar."

It would be difficult to overstate the wrong-headedness of this formulation. For one thing, although the trade deficit shows up in GDP as a subtraction from output, it's only through the opaque prism of **Keynesian** accounting conventions that such an "imbalance" can be seen as a drag on growth. The growth of imports over exports is a manifestation of the reality that US growth exceeds that of its trading partners. All else equal, a slowdown in imports would improve the "net export" position in the GDP tables, but would most likely be symptomatic of a considerably greater deceleration in overall growth.

Moreover, like any ledger, international accounts must balance, and the current account *deficit* is the precise mirror of the capital account *surplus* which represents net foreign investment in the US. In large measure, the current account deficit can be seen as the tool for financing the capital surplus. That surplus has contributed to expansion of the domestic capital stock and enhanced, not subtracted from, US growth. The view, meanwhile, that a "positive" trade balance is an unalloyed virtue is belied by the fact that the current account was last in surplus during the recession of 1990-91.



As for the notion that the dollar is "relatively high," one has to wonder what it would take for Yellen to view the dollar as low enough. As it is, at about \$1.28, the currency is now challenging all-time lows against the euro, and yesterday gold made new 16-year highs. The chart at left should also serve as a reality check on the supposition that

some reliable relationship can be divined between the trade balance and changes in the dollar's foreign exchange value. Since early 2002, the dollar's forex value has fallen nearly 25% against the major currencies, a period during which the current account deficit has grown by more than 50%. To be sure, we don't doubt that a serious threat of dollar devaluation would trigger wholesale liquidation of foreign-held US assets, reversing capital inflows and inevitably turning trade deficits into surpluses. The inflationary consequences of such a dollar rout, however, would only serve to underscore the pointlessness of shaping policy to achieve positive balance in an utterly inconsequential accounting identity.

Janet Yellen, of course, is hardly the most influential of Fed policymakers, and we don't mean to suggest otherwise. It's also the case, however, that she is a participant in the Fed's policy deliberations, and it's unlikely that she would have made last week's comments entirely on her own account. And, as noted, she has not been alone in offering her ruminations on the theme of a cheaper dollar. At this point, with the central bank ostensibly seeking to restore policy equilibrium after a sustained period of extraordinary accommodation, it would seem a distraction policymakers could best do without. But, then again, it could be that the Fed is moving on a dangerous new agenda about which, at this point, we can only garner the most vague glimpses. Needless to say, we'll be watching closely. **TM**