TrendMacrolytics

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Dollar and Deficits: Fables, Fallacies and Foolishness

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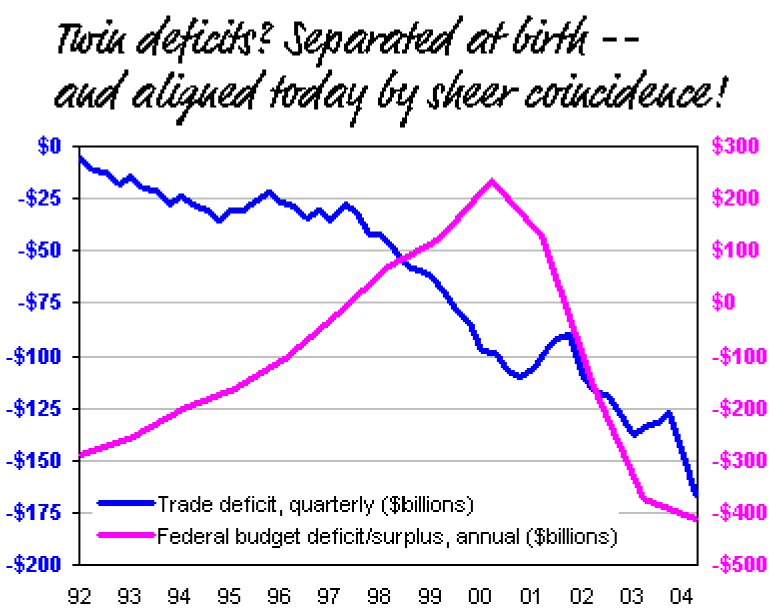
The conventional wisdom is always wrong -- but when it comes to the dollar, it's dangerously wrong.

According to the analysis now reaching saturation levels in the economic/media mainstream, a weaker dollar is both a natural market "corrective" for the current account deficit as well as a threat to trigger a crisis in financing the current account. Obvious logical contradictions like this one -- the dollar's decline can't be both an agent for current account rescue and potential disaster -- are standard fare in organs such as the ***New York Times***, ***Wall Street Journal***, ***Washington Post*** and ***Financial Times***, as well as the Wall Street economics establishment. But this is just one of the fallacies suffusing conventional wisdom and sowing considerable confusion about available policy options. Consider another: if the trade deficit causes the dollar to go down, it follows that a reversal of the deficit would cause the dollar to go up. To believe this cause-effect relationship is determinative of the currency's value is equivalent to arguing the impossible -- that the dollar falling makes the dollar rise.

Somehow, such nonsense has become accepted wisdom despite the overwhelming absence of empirical support not only in historical **US** experience, but in present day reality in a number of other countries. **South Africa**, **New Zealand** and **Australia**, for example, have had among the strongest currencies in the forex market even as their current account deficits have been rising. In the US, meanwhile, the purported causal link between these variables is entirely nonexistent in time series data. The current account deficit more than tripled during the episode of deflationary dollar appreciation between 1996 and 2001, and has continued to grow even as the dollar since early 2002 has weakened by nearly as much on a trade-weighted basis as it strengthened the previous six years.



While exploding these hoary myths provides some satisfaction from a purely intellectual perspective, much more than abstract analytical correctness is now at stake. The harangues of the self-styled elite point to the dollar's decline as condign payback for the sins of over-consumption and under-saving -- by which they mean it's time to raise taxes. The payback fable, of course, is meant to link the current account and

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federal budget under the "twin deficit" myth, evidence for which also is entirely lacking. As we have noted previously, the period of greatest growth in current account imbalances occurred through the 1990s and into this decade as the budget deficit shrank and turned to surplus (see "Passing the Buck" November 22, 2004). The fact that the direction of the two deficits has coincided during the past two years proves nothing: economics is concerned with causality, not coincidence.

But for many of those making the twin deficit case, such empirical difficulties are a mere formality in the context of the political axe they have to grind. Writing in the *Financial Times* last month, **Steven Cecchetti**, former research director of the **New York Fed** and now a **Brandeis University** professor, harkens back to the halcyon days of **Rubinomics** and the **Clinton** economic nirvana. "Five year ago, the stock market was booming and the federal government budget was in surplus. Then," Cecchetti oozes, "the current account deficit could be explained as reflecting the capital flowing into the US because foreigners saw it as a good place to invest." But those days are long gone, and the dollar is proof of the "limit to foreigners' willingness to finance American consumption."

The only way out is a tax increase, according to Cecchetti, which will "decrease domestic consumption, reducing the current account deficit, reduce the issuance of treasuries, and make the US a good place for long-term investment the way it was in the 1990s." So, raising taxes in order to rein in the US economy and pare back the trade deficit will also make this a "good place" for investment? Even if such a thing were possible, wouldn't it lead to the current account deficit rising all over again? Rather than attempting to parse such incoherence, perhaps we should consider ourselves fortunate that brilliance such as Cecchetti's is available to differentiate between good and bad current account deficits, and direct us to the appropriate response in each case.

The widely accepted notion, meanwhile, that the US has become inhospitable to foreign investment and manages to finance the current account only through foreign central bank treasury purchases is another urban legend entirely unsupported by the facts. According to **Treasury Department** data, in the 12 months ended in September, net investment flows into the US totaled more than $833 billion, of which $647 billion was accounted for by *private* investment. This amounted to an increase in private investment of more than $55 billion from the year-earlier period. Fact is, the dollar's recent depreciation can be seen providing foreign-currency-based investors with a significant discount on dollar-denominated assets, which likely will lead to increased inflows.

Despite the abundant and growing evidence that the supposed linkage of dollar weakness to current account and budget shortfalls are illusory, there are signs that the scare stories are affecting even those who should know better. **Bruce Bartlett**, a usually reliable supply-sider who was a top staffer to **Jack Kemp** during the tax cut crusades of the 1970s and early '80s, recently forecast that "a significant tax increase" is likely. Even Bartlett resorted to the false twin deficit premise that higher taxes would strengthen the dollar by shrinking the budget deficit and, thereby, improve the current account balance.

But the most troubling aspect of the myths being propagated to explain the dollar's weakness is the extent to which they distract from the real cause of the currency's decline -- inflation-biased **Fed** monetary policy. As noted above, the course of the dollar over the last decade or so was completely unrelated to the current account. It has been explained, rather, by the evolution of Fed policy, from appropriately tight to excessively tight through the late 1990s and into the early part of this decade. That has now been matched by the exceptionally accommodative policy posture in place for most of the past three years. In the past week, the dollar has come off its lows in forex markets, matched by an approximately $15 rollback in the gold price from its highs above $450. It appears that this reversal was spurred at least in part by reports that the Fed is becoming more cognizant of growing inflation risks, and is preparing to signal its concern, implying a more assertive policy posture could be adopted going forward. We're skeptical, however, that any substantive change will yet be reflected in tomorrow's **FOMC** meeting statement, which suggests the dollar's recent gains could be reversed. TM