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The Dollar Adrift

A global vote of non-confidence.

The biggest story in the world economy is the continuing fall of the U.S. dollar, or at least it is everywhere outside of Washington, D.C., the place most responsible for its declining value. For good reason, the world is wondering if America has cast the dollar adrift.

A passel of Asian central banks—South Korea, Taiwan, the Philippines and Thailand—intervened yesterday to stop the greenback's fall against their currencies. European Central Bank President Jean-Claude Trichet also tried to buoy the buck, telling reporters that "A strong dollar is extremely important in the given circumstances." Neither effort made much difference.

Meanwhile, the London Independent created a splash this week with a thinly sourced and not very credible story that several nations were working secretly to trade oil in currencies other than the dollar. The alleged conspirators all quickly denied it, but the tizzy the story created suggests the global mood of concern about holding American currency.

The attempts at intervention are probably futile, save for the short-term scare they give to currency traders. Currency interventions are typically "sterilized," which means that while a central bank extinguishes a currency (say, Thai baht) in the foreign-exchange markets it creates more baht through domestic monetary operations. Thus there's no underlying change in the relative supply of baht versus dollars. The point of intervention is to frighten traders about the risks of speculating and getting burned. Everything else is commentary.

The value of any currency is ultimately determined by the supply and demand for that currency. And the problem for the dollar at the moment is that there is a much larger supply of dollars than there is global demand for them. The solution rests not in Manila, Bangkok or Paris, but in Washington.

Start with dollar supply, which is entirely a function of America's central bank, the Federal Reserve. The Fed has been flooding the world with dollars in the name of preventing a U.S. deflation after last year's panic, and it shows no sign of tightening any time soon. Last week's awful September jobs report convinced markets that the Fed will keep the money spigot wide open well into 2010. And yesterday, Richard Fisher, president of the Dallas Fed and thought to be a rare hawk on the Fed's Open Market Committee, chimed in that no one at the Fed thinks this is the time to raise interest rates.

All of this is a signal to world markets that holding dollars is a risky proposition, which in turn contributes to falling global demand for dollars. The Fed is telling the world that it is concerned primarily—perhaps only—with the domestic U.S. economy. If the dollar falls against other currencies, that's their problem. The Fed will let the dollar fall.

For a time in the wake of the panic, the dollar benefitted from a flight to the relative safety of U.S. Treasurys and other dollar assets. (See the nearby chart.) In a storm, the dollar was thought to be less risky than other investments. But as this overall global risk aversion has ebbed, the risk calculus has turned and the dollar itself has become more dangerous to hold than nondollar investments.

The world's investors can also see the arc of overall U.S. economic policy, which is becoming less inviting to global capital. Higher taxes on capital gains and income; new entitlements that will require trillions of dollars in new U.S. borrowing; a wave of new antitrust enforcement, more telecom regulation ("net neutrality") and trade protection, new restrictions on energy production, easier rules for union organizing, and so much more. All of these are signals that U.S. growth is likely to be slower than it otherwise would be, and that the returns on investing in America will be lower than they should be. This too is a reason to sell greenbacks.

For many in the Washington establishment, alas, the falling dollar is considered a virtue. They believe it will help U.S. exports and therefore reduce the trade deficit and bring back manufacturing jobs. But as David Malpass argued on these pages yesterday, capital flows dwarf trade flows as a source of wealth creation. The only way to build wealth and create more high-paying jobs over time is through the productivity gains that come from greater investment and innovation. As the dollar falls and capital flees the U.S. for other countries, those global competitors reap its benefits and become more productive and relatively more prosperous.

The more immediate danger—in the coming months—would be if the fall of the dollar becomes a rout. This could cause a spike in commodity prices, such as oil, that are traded in dollars and jeopardize the nascent economic recovery. But even if there is no dollar panic, the volatility of currency markets is distorting investment decisions and creating more economic uncertainty. It could also lead to a round of competitive devaluations, as other nations try to placate their own domestic export constituencies.

Washington may not care to notice, but the sell-off in the dollar is a daily global vote on U.S. economic policy. It is not a vote of confidence.

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