



## Why the Dollar Is Rising . . . Again

By John H. Makin

Let's begin with a riddle: Why is the dollar like a Republican president? Answer: Because the dollar faces incessant predictions of imminent collapse, but in the end it wins out over weaker alternatives.

Since a low point this past January, the trade-weighted dollar has risen by more than 14 percent to surpass its May 2004 high. Against its major competitors as global stores of value, the euro and the yen, the dollar has risen even more—by 16 percent and 17 percent respectively.

During this same ten-month span, foreign central bank purchases of dollar assets have actually slowed, while private foreign buying has increased. To be sure, a large share of the rise in private foreign buying of dollars has come from petroleum exporters who, in reality, are government buyers. This marks a return to the petrodollar flows into the United States that emerged in the first oil crisis of 1970s. That said, the oil exporters could just as well be purchasing more euros or yen—and to listen to the widespread cries of the imminent demise of the dollar, one might think they would. Instead, they are buying dollars as the preferred “paper currency” store of value while buying more gold as a hedge against the low probability of a broad debasement of paper currencies by overstretched governments in Europe, Japan, and the United States.

At close to \$500 per ounce (as this Outlook goes to press in late November) the price of gold has risen by about 16 percent since January against the world's most favored paper currency—the dollar. Of course with the dollar appreciating by

16 percent against its alternatives—the yen and the euro—the compound increase in the value of gold against the dollar's top competitors as paper stores of value is over 34 percent. Clearly, the countries with large current-account surpluses (that is, the OPEC nations and Asian exporters) have been accumulating dollars and gold at the expense of yen and euros.

### Basic Currency Principles

Currency values are broadly determined by three factors: the performance of the issuing country's economy, the credibility of its central bank, and the size and liquidity of markets for financial assets denominated in the currency in question. In view of these criteria, we shall argue that it is surprising that the dollar has not risen further. It may well yet do so.

The contrary proposition—that a large and rising current-account deficit, actually a measure of the supply of dollars flowing into foreign exchange markets, will weaken the dollar—has to be the claim that the same phenomenon, the large and rising U.S. current-account deficit, will somehow reduce the level or growth of global demand for dollars. The actual rise in the dollar, as the current-account deficit has risen, suggests that other determinants such as those mentioned above have been at work to boost the demand for dollars by even more than the substantial rise in its supply and thereby produces persistent dollar appreciation.

The global growth of demand for dollars will someday slow and the dollar will then fall in value. The size of the U.S. current-account deficit is obviously not a good predictor of such a

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change. During most of the last decade, as the U.S. current-account deficit has risen steadily toward 7 percent of GDP, the dollar has alternatively risen and fallen, but the most recent rise this year has occurred when the current-account deficit was continuing to rise and even as foreign official dollar purchases slowed. The corollary is, of course, that foreign private dollar purchases have accelerated more rapidly than the outflow of dollars has risen through the U.S. current-account deficit.

One of the most basic explanations for the dollar's persistent strength in the face of a steadily rising current-account deficit goes beyond the usual fundamentals of economic performance and central bank credibility: that is the ability of dollar-based asset markets, especially U.S. bond markets, to serve as a vehicle to store wealth on a massive scale.

Petroleum exporters need to store tens of billions of dollars' worth of currency, and they need to have ready access to the funds they choose to store. New Zealand, for example, may offer an attractive rate of return, a solid central bank, and strong economic performance. But an attempt to move the equivalent of tens of billions of U.S. dollars into or out of New Zealand's financial markets would swamp them. Such huge inflows would wreck the ability of the central bank to control New Zealand's money supply, interest rates, and fixed-exchange rates. Alternatively, flexible exchange rates would gyrate wildly under the pressure of huge flows on a scale that represents a multiple of the domestic money supply in a small country like New Zealand.

There are only three currencies in the "global store of value" league: the dollar, the euro, and the yen. It is a comparison of these economies and, more importantly, the central banks of these three regions that explains the persistent dollar strength in recent years.

## Comparing Major-Currency Economies

First, consider basic economic performance. Aggregate growth rates in the United States have persistently exceeded those in Japan and the euro area by a fairly wide margin, largely with the help of outstanding productivity increases and steady employment growth. During 2005, for example, U.S. growth will probably be about 3.6 percent while growth in a recovering Japan will be about 2.3 percent, and the euro area will be lucky to manage 1.4 percent. True, overall U.S. inflation is higher, with the Consumer Price Index about 3.8 percent higher in the third quarter of this year than in the

previous year. Comparable inflation figures for Japan and Europe are about zero for Japan and about 2 percent for Europe. That said, much of the rise in U.S. inflation comes from higher oil prices, which produce larger percentage increases in the United States because its energy prices are not saddled with the very high taxes placed on energy products in Europe and Japan. Higher U.S. energy inflation notwithstanding, U.S. inflation expectations for the coming decade have been well contained over the past year at about 2.4 percent. Short-term U.S. inflation expectations for the next year jumped sharply from a summer low of 2.2 percent to 3.4 percent in September. Since then, even short-term inflation expectations have come back down to 2.4 percent.

Investors searching for very-low-risk assets can still earn a higher inflation-protected return in the United States than they can in Europe or Japan. In mid-November, the yield on U.S. ten-year inflation-protected bonds was 2.02 percent versus 1.36 percent in Europe and 0.95 percent in Japan. Add to this the superior size and liquidity of U.S. asset markets, and it is not surprising that the surplus countries are building portfolios of dollars and gold at the expense of significant additions to their holdings of euros and yen.

## Central Bank Credibility

Another important determinant of a currency's value is the credibility of the manager of that currency—the central bank. Here, a comparison of the United States, the euro area, and Japan reveals an even clearer advantage for the United States.

The U.S. Federal Reserve has skillfully managed monetary policy since 1980 when its newly installed chairman, Paul Volcker, convincingly squeezed inflation out of the U.S. economy. Following Volcker's leadership, Alan Greenspan, who took over the helm at the Fed in 1987, has consistently managed monetary policy in a way that has produced low and stable inflation alongside a 3.5 percent trend growth rate that substantially outstrips the rates of Europe and Japan.

Another test of a central bank's staying power is the ability to effect a smooth transition from one central bank leader to another. The Volcker-Greenspan transition was undertaken at a time when U.S. inflation credibility was somewhat under fire, the dollar was falling, and interest rates were rising. The Fed rate increases initiated by Greenspan, early in his term, were followed by a sharp drop of stock prices in October 1987. The Fed

responded promptly to prevent a liquidity crisis from growing and harming the real economy. It lent freely for two weeks with no target interest rate and held its benchmark rate—the fed funds rate—about 50 to 75 basis points below the 7.25 percent mark that prevailed before the stock market crash. Final sales growth slowed sharply during the fourth quarter of that year and inventories surged, but growth recovered to a strong 3.7 percent rate during 1988. Stocks regained their pre-crash highs by mid-1989.

The transition from the Greenspan Fed to the Bernanke Fed will probably be smoother in terms of market behavior than the Volcker-Greenspan transition period was. President Bush has selected a candidate for Fed chairman who has built a distinguished academic career on the analysis of the relationship between monetary policy and business cycles. Ben Bernanke is eminently qualified to be Fed chairman, and his rapid confirmation by the U.S. Senate Committee on Banking, Housing, and Urban Affairs will be followed by the approval of the full Senate in January—in time for him to assume the leadership of the Federal Reserve on February 1, 2006.

Beyond its more successful pursuit of stable growth and low inflation, the Fed enjoys another important advantage over the central banks of the euro area and Japan: absolute independence from government interference. Ever since the presidency of Ronald Reagan, American presidents have learned that supporting the independence of the Federal Reserve as a protector of price stability has paid dividends in the form of stronger economic performance and a sounder currency. The governments of Europe and Japan have not yet fully learned this lesson.

The European Central Bank faces the difficult task of running monetary policy over an unwieldy currency area. The monetary policy that works for Germany does not work for Italy. However, the fact that both use the euro as their currency means that both must function under the same monetary policy. At the present time, monetary policy should be considerably tighter for Italy than for Germany in view of Italy's weak performance in lowering its unit labor costs and managing its budget deficit. Unfortunately, nothing really prevents the Italian government from running ever-larger budget deficits and

borrowing at bargain rates, essentially using the hard-won superior credit rating of the German government.

The disparate requirements for sound monetary policy across different regions of Europe create tensions flowing from European governments to the central bank. Added to this underlying problem are the rising political tensions in Europe tied to the failure to approve the European constitution this spring and the election of an unstable German government in September. Consequently, the fall in the euro against the dollar has accelerated as uncertainty concerning Europe's political and monetary future has risen. Simultaneously, European finance ministers have openly pressured the European Central Bank not to raise interest rates, despite other problems of unrest such as the rioting in France and signs of weak economic performance. A single central bank like the European Central Bank, which faces twelve separate finance ministries, each with its own special problems, is hard-pressed to inspire confidence in its long-run independence.

The Bank of Japan was granted nominal independence from government interference during the 1990s. But recently the Bank of Japan's plans to remove an extreme form of monetary accommodation called "quantitative easing" has led to open criticism from Japan's government. The leader of policy formation in the Liberal Democratic Party (Japan's ruling party) openly suggested in November that the basic law for the Bank of Japan may need to be rewritten to curb the bank's independence. Even the prime minister and several other politicians chimed in to criticize the bank for its proposal to begin to remove monetary accommodation.

The merits of the case aside, the Bank of Japan has a history of tightening too soon, and open confrontation between the central bank and the government is never good for the credibility of the central bank. It underscores the possibility that governments will force the central bank to buy large quantities of government debt to underwrite heavy spending by the government in excess of tax receipts, which in turn, may eventually be inflationary. This is an especially sensitive point in Japan, where budget deficits are still running above 6 percent of GDP, double the U.S. level, and government debt totals well over 140 percent of GDP. As the Japanese economy recovers

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and Japan's savers seek alternatives to Japanese government debt as a store of value, a persistent effort by the central bank to support the government bond market would ultimately be inflationary and thereby a source of weakness for the currency.

## The Future of the Dollar

To say that the behavior of the dollar's value in world currency markets is unrelated to the size of the U.S. current-account deficit is not to say that the dollar can never go down. The dollar could, in fact, fall in value even as the current-account deficit was reduced. This would occur if there were a U.S. recession and a sharp slowdown in U.S. spending reduced the country's imports, cut its current-account deficit, and weakened its prospects for economic growth and, consequently, the appeal of some U.S. assets.

Alternatively, the U.S. current-account deficit could continue to rise, and even with a strong U.S. economy, an episode of dollar weakness could ensue. In particular, if especially attractive investment opportunities emerged in Japan, for instance, owing to a strong and sustainable economic recovery that enhanced the attractiveness of investing in Japanese stocks, then more global flows would move into Japan and the yen would strengthen against the dollar. Those who have been calling for a weaker dollar would declare victory in the face of a rising U.S. current-account deficit that was accompanied by a falling dollar.

The reality would be otherwise. Higher returns in Japan would attract funds out of the United States, and, given the large supply of dollars pooled in foreign exchange markets as a result of the U.S. current-account deficit, the dollar would have to depreciate in order to clear markets. That said, the degree of the dollar's weakness would probably be somewhat less than it otherwise might be under similar circumstances thanks to the strong reputation for independence of the Federal Reserve. That reputation, in turn, underwrites the value of U.S. government securities as a solid store of value in a highly liquid and an accommodative market for U.S. government bonds.

While the dollar's value will continue to fluctuate in global currency markets, the factors underscoring its long-run attractiveness will probably remain. On the economic front, these include sustained superior productivity growth, which means that a more rapidly expanding U.S. economy is less likely to see rising inflation. Beyond that, the U.S. Federal Reserve remains the most powerful and independent central bank in the world, with an enviable record of managing to maintain low and stable inflation rates that contribute mightily to higher growth rates. The

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Fed has also been blessed by the realization in the executive and legislative branches of the U.S. government that tampering with Fed independence, or even talking about it, is ultimately counterproductive. Finally, the sheer size and flexibility of U.S. financial markets is unrivaled. The ability to move tens of billions of dollars into and out of U.S. markets without fear of interference or untoward pressure on interest and exchange rates is valuable for global investors.

Beyond all these factors, the dollar gains considerable support from the fact that the concentration of strong demand growth in the U.S. means that neither export-dependent Japan nor Europe wants to see a weaker dollar that might slow their exports to the United States. Rather, they are happy, if perhaps a bit surprised, to see the dollar rise. The Japanese see an extra bonus from a weaker yen that helps lift Japan out of deflation.

One final irony emerges from the dollar's defiant strength this year. America's two richest men, Bill Gates and Warren Buffett, are losing hundreds of millions of dollars having bet against the dollar on the premise that rising U.S. current-account and budget deficits would have to weaken it. Maybe these two remarkable men should have pondered a little more the question of whether they could have become multi-billionaires in Europe or Japan, where the environment for growth and innovation is far less friendly and the underlying vigor of the economy is less conducive to a strong currency. Beyond that, I guess they did not notice that the budget deficits and government debt are considerably larger in Europe and Japan than they are in America. Betting against the dollar meant that Gates and Buffett were betting against themselves. I can't see why they would want to do that.