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# The Bottom Line

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## The U.S. Dollar's Decline Is Not Such a Bad Thing

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Many have suggested that the fall in the U.S. dollar is reflective of the sad state of American economic affairs replete with surging budget deficits, profligate consumer spending, overleveraged banks, enormous current account deficits and an increasing reliance on foreign capital inflows to finance the overspending. I view this differently. The role the U.S. dollar plays as the world's sole reserve currency ensured that such imbalances developed, otherwise the growth in global reserves would have been impossible. Think of it this way: a growing global economy requires a growing global money supply to provide the liquidity necessary to finance rising activity. The U.S. provides that underlying liquidity to the world by spending more than it saves or, in essence, spending more than it can finance domestically. The U.S. became the consumer (importer) of last resort, providing currency to the rest of the world. This currency has been at least partially re-cycled back to the U.S. in the form of foreign purchases of private and U.S. government and agency debt. Without this recycling, the other currencies of the world would strengthen rapidly vis-à-vis the U.S. dollar, rendering these foreign exporters less competitive, returning the system to balance. The fall in the U.S. dollar is the equilibrating mechanism that reduces the net imports of the U.S., thereby reducing its current account deficit and ultimately, its demand for foreign capital.

The broad trade-weighted U.S. dollar began falling in February 2002 and bottomed in July 2008 at under 95. With the onslaught of the credit crisis, the flight to quality (safe-haven flows) into Treasuries boosted the trade-weighted dollar to a peak of roughly 115 in March of this year when the stock markets bottomed. As the financial crisis dissipated and stocks rebounded sharply, the dollar resumed its decline, reflecting the success of the global authorities—especially the Fed and the U.S. Treasury—in averting disaster. The recovery in economic activity was beginning, as reflected in stocks and commodity prices. The reduction in the U.S. trade deficit has been an important contributor to GDP performance.

Even with the dramatic decline in the U.S. dollar since March, the trade-weighted dollar is still about 5% above its summer-'08 trough. Year-to-date, the Canadian dollar has risen almost 20%, but that is less than a number of other major currencies, particularly the Aussie dollar, which is up over 30%. These commodity-related currencies have benefited from the economic revival, especially in China. Even so, the Canadian dollar, at just over 97 cents, remains below the peak of \$1.10 hit in November 2007.

I expect the U.S. dollar to continue to decline—not because of American profligacy per se, but because under the current global monetary system, a fall in the dollar is the only way to reduce the global imbalances. The huge net inflow of foreign capital to the U.S., especially from China, facilitated America's over-leveraging and underpricing of risk.

Ever since the Asian crisis in the late 1990s, the emerging world (China) has been pursuing a policy of export-led growth by maintaining their currencies at undervalued levels. The U.S.'s consumption-led growth is the flipside of China's export-led growth, taking consumption to a record high 70% of U.S. GDP. Thanks to enormous foreign capital inflow, capital in the U.S. was cheap and plentiful and risk was woefully underpriced so consumers were incentivized to borrow. And borrow they did—extracting homeowner equity and running up huge credit card bills. Similarly, because of the inordinately low interest rates and risk premia, investor demand for higher-yielding assets such as CDOs and CDSs surged, financing the subprime mortgage debt and housing bubble. The rest is history.

Being the sole reserve-currency country forced the U.S. into a current-account-deficit position, which by definition, ironically, weakens the currency over time. As long as the U.S. economy was strong, and the federal budget deficit was under control, no one worried much about the safety and soundness of the U.S. dollar. But with the explosion in U.S. government spending that was precipitated by the crisis and subsequent recession, the government deficit skyrocketed. Many began to worry about the ultimate inflation that might result if it were the only way to finance the deficit and so the currency weakened.

As the reserve-currency nation, the U.S. is the lender of last resort to the world. The Fed and the Treasury had to spend whatever it took to avert a global financial meltdown. Thus, in bad times, the dollar is necessarily vulnerable to inflation worries and ultimate devaluation. Right now, there are no other serious contenders to replace the U.S. dollar as the world's reserve currency—certainly not the renminbi or even the euro or yen.

It is essential that the Fed remain independent with no predilection or authority to conduct monetary policy in response to the dollar's fate; it is also required that the U.S. federal government remains solvent. That is certainly the case now, and will be for the foreseeable future. But the pessimists are very vocal and the media is increasingly espousing their views that the Fed will run the printing presses for too long, thereby devaluing the dollar and using inflation to reduce the cost of deficit financing. Never mind that inflation is nowhere to be seen.

The enormous excess capacity in the U.S. economy and the downward pressure on real wages suggest, as the Fed avers, that there is a greater likelihood of falling inflation than rising inflation in the U.S. The lower dollar helps to reverse these disinflationary pressures and improve the U.S. trade deficit, thereby boosting the U.S. economy. But sentiment is important, and the growing sense that the U.S. dollar is a "debauched" currency (similar to

those in the 'Banana Republics' of the past) can become self-fulfilling if it triggers a dollar crisis. The unlikely, but possible, rout in the dollar could drive U.S. interest rates high enough to snuff out the recovery, debilitating the rest of the world's recovery. That is why it is so important to discredit the Chicken Littles.

**Bottom Line:** An orderly decline in the U.S. dollar is necessary to a sustained re-balancing of the global economy. This re-balancing is a necessary precursor to a sustained global economic and financial recovery. The only way the American economy can de-leverage gradually overtime is for the overspending to cease, which also goes hand-in-hand with a weaker American dollar. The U.S. must encourage some export-led activity and China must encourage some consumer-led activity, which means a smaller U.S. trade deficit and a smaller trade surplus in the rest of the world. We see this in spades in Canada where our record trade surplus has now melted into a record trade deficit. Our exporters have been adjusting to this new reality since 2003 and further adjustment is necessary. Canadian business must continue to raise productivity growth and add value to the goods and services we export. We must also broaden our export horizons, especially to the rapidly growing emerging economies of Asia.

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