



SAYONARA TO THE "STRONG DOLLAR"?

Every word uttered by the new Federal Reserve Chairman, Ben Bernanke, is now scrutinized by the financial community for any possible nuance about the new Maestro's thoughts on monetary policy. In the meantime, financial markets

pay almost no heed to the thoughts of those, who but for a twist of fate, might otherwise be sitting in Mr. Bernanke's chair.

That may be a mistake because "also-ran" contenders for the Fed post are now free to speak far more frankly than Mr. Bernanke about matters of economic importance. With that in mind, we believe that some recent speeches and articles by economist Martin Feldstein of Harvard University on the case for a "competitive dollar" – i.e. a much weaker U.S. dollar – merit special attention. Prof. Feldstein was widely believed to be on the short list for the top Fed job and is one of the nation's most influential economic thinkers. He was also considered to be a leading candidate to replace U.S. Treasury Secretary John Snow. And while there is no guarantee that his ideas will hold sway with Mr. Bernanke and his colleagues, we suspect that they are likely to be considered quite seriously.

In a nutshell, Prof. Feldstein believes that the risks posed by the huge U.S. trade imbalance have become so large that a new policy of a "competitive dollar" is necessary to reduce the imbalance. In addition, he believes that the correct time to embark on this new policy is as soon as possible. Although he refuses to speculate exactly on how much of an adjustment in the dollar's value is required, he lends his authority to the views of other experts that an adjustment of 40% or more could ultimately be required. His views on this topic were first publicized in early March (see <http://www.nber.org/feldstein/siepr319.pdf>) and have since been carried in the *Wall Street Journal* and other major publications.

If his views were to be accepted by major global policymakers like Mr. Bernanke and the leaders of other central banks, the implications for investors would be enormous. So we believe it is worth summarizing his argument and considering some of the investment implications. We will also highlight some of the potential weak spots of his arguments, because on matters as speculative as the fate of the U.S. dollar, even famous professors can sometimes get it wrong.

From "Strong Dollar" to "Competitive Dollar"

For years, under both Republicans and Democrats, official Washington has emphasized that "a strong dollar is good for America" – even when the policy was observed more in the breach than in practice. In contrast, Feldstein believes the message should be that America needs a competitive dollar abroad and a strong dollar at home.

Feldstein's challenge to America's policymakers is to create a situation in which the dollar's purchasing power at home is not eroded by high inflation – hence a strong dollar at home – even as its exchange rate against foreign currencies weakens substantially. The goal of a competitive dollar, he argues, should be for American goods to become more attractive to foreign buyers while American consumers and firms are induced to choose American-made goods and services.

Why is this policy necessary? He doesn't go into detail on this point other than to mention the risk that an attempt by foreign governments and private investors to curb exposure to U.S. dollars could result in a very rapid and damaging rise in U.S. interest rates. With the U.S. having posted a current account deficit of \$800 billion for 2005 – or more than 6% of GDP –

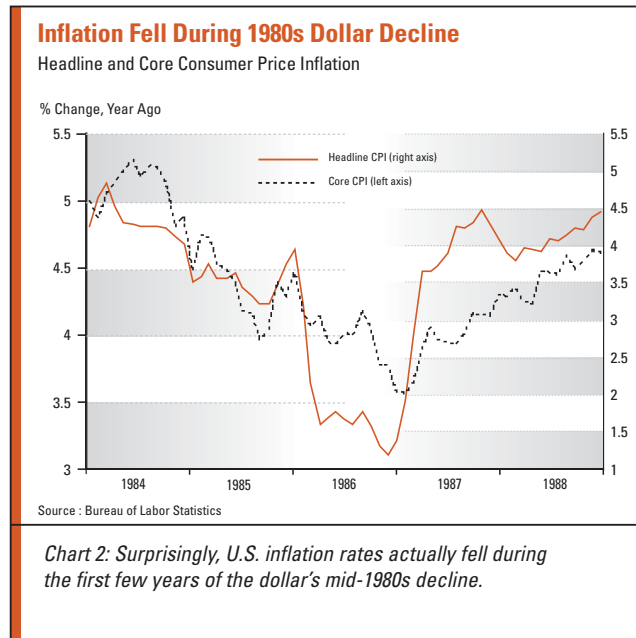
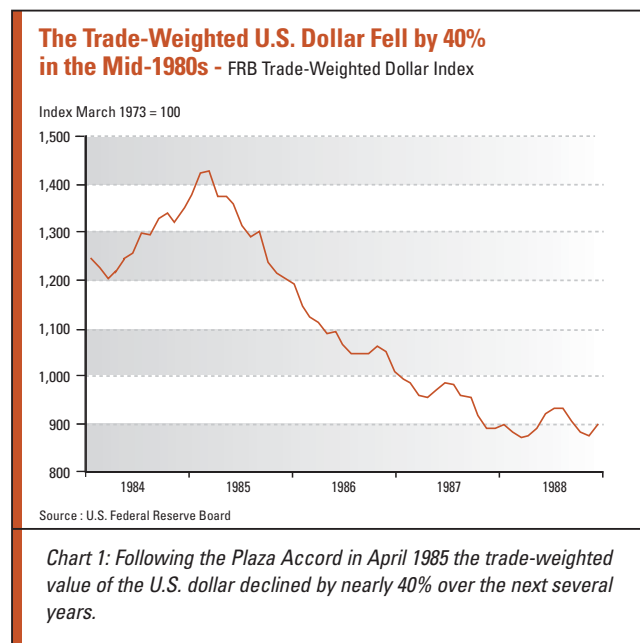


he clearly is making the judgment that the risks of a “hard landing” are now sufficient to warrant a major realignment of the dollar.

The obvious question arises: Couldn't the attempt to adjust the value of the dollar bring on exactly the serious consequences that the U.S. is attempting to avoid? In other words, if foreigners are convinced that the U.S. is about to embark on a deliberate attempt to weaken the dollar, won't they withhold funds and cause the sharp rise in interest rates that is feared? And won't a weaker dollar in turn create inflation pressures in the U.S. that will justify much higher interest rates?

Been There, Done That

With respect to such concerns, Feldstein recaps the experience of the 1980s, when there was a sharp decline in the value of the dollar without significant negative consequences for inflation or financial markets. After rising sharply in the early-to-mid 1980s, the value of the dollar started a sharp decline in April 1985. By early 1988, the trade-weighted value of the dollar had fallen by 37% from the peak (See Chart 1). Over that period, however, U.S. consumer price inflation actually declined to an average of 3.1%, compared with 3.9% in 1984 and 3.8% in 1985 (See Chart 2). Bond yields fell over



that period, from 13.5% in June 1984 to 7.1% in January 1987, while the value of the S&P 500 index rose by 40% between 1985 and 1988.

The economic logic behind such a successful transition hinges on Feldstein's view that domestic inflation ultimately reflects domestic monetary policy: “With sound monetary policy, increases in import prices are offset by lower inflation for domestically produced goods and services. So we can have a strong dollar at home and simultaneously a competitive dollar abroad. This is true not just in the long run but, as the experience of the 1980s demonstrated, during the transition as well.”

There are several reasons for reflecting for a moment on this quote. First, it is hard to argue with the “been there, done that” logic. History shows that Feldstein is correct. Secondly, however, investors may wish to consider that making the transition Feldstein is proposing would represent a radically different investment environment than the one that has prevailed over the last several years.

Instead of a consumer-led economy, fuelled by booming real estate markets and consumers gleefully using their homes as

ATM machines for financing a surge in consumer spending, Feldstein envisages a producer-led economy with a renaissance for manufacturing and capital goods industries whose competitiveness is aided by a weaker dollar. The Fed's job under this construct would be to keep monetary policy tight enough to free up resources in the economy that could be used to produce goods and services sold in overseas markets instead of to U.S. consumers.

Feldstein does not elaborate on some of the finer details of the 1985-1988 experience, but we would be remiss if we did not point out that a major part of the benign inflation outcome during that episode was due to the crash in oil prices in 1986. And while Fed policy in engineering a "mid-cycle pause" in 1985 clearly helped set the stage for that downdraft in inflation, it is by no means clear that the Fed will have as much luck this time around in a world where Chinese credit policies may be as important to oil markets as is the U.S. business cycle.

Real Estate's Critical Role

Feldstein's argument goes beyond the logic of why such a transition is desirable by arguing forcefully that the time to begin this transition is as soon as possible. One reason for beginning as soon as possible is that the longer the U.S. waits, the larger its accumulated debt to the rest of the world will become. However, Feldstein's primary argument for wanting the dollar to become more competitive in the near future is his belief that America may need an increase in exports this year and in 2007 in order to sustain the economy's current pace of expansion.

Why? According to Feldstein, "There is a serious risk that a sharp decline in consumer spending will cause an unwanted GDP slowdown or even an economic downturn. The principal reason for this concern is the low level of the U.S. savings rate." He goes on to focus on how the sharp drop in the U.S. savings rate over the last several years has been related to the enormous rise in home prices associated with an explosive rise in mortgage borrowing, which grew from \$800 billion in 2002 to an annual rate of \$1.5 trillion in 2005.

With mortgage borrowing now slowing in response to tighter monetary policy, Feldstein believes that the U.S. savings rate is likely to begin to reverse its multi-year decline: "Even if the savings rate returns only to the low 2.5% level that we had in the summer of 2003, the rise in saving will be about 3.5% of disposable income or about 2.5% of GDP. This relative fall in consumer spending would be a very large drag on overall aggregate demand."

With housing investment already in decline and with business investment unlikely to accelerate if the consumer slows, Feldstein believes that the key to maintaining the U.S. expansion is to engineer a shift in the trade balance – in the form of increased exports, lower imports, and a shift in consumer spending away from imports and toward goods and services produced in the U.S. For this to occur, he concludes, "the dollar must decline to make U.S. goods and services more attractive."

If he is wrong, and the consumer continues to chug along and real estate markets continue to defy gravity, then a decline in the value of the dollar would not be warranted. Due to the considerable uncertainty regarding his scenario for real estate and consumer spending, Fed policymakers must be far more circumspect in their own comments.

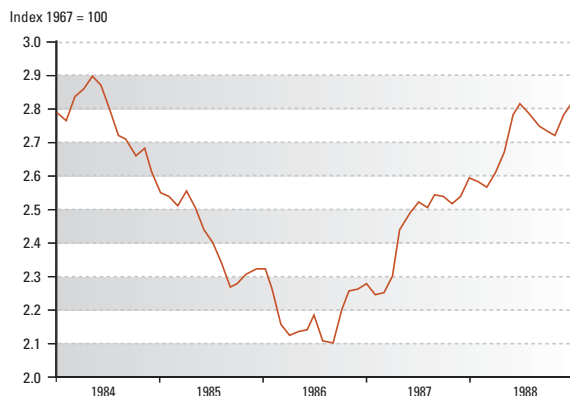
That said, if Feldstein is correct and consumer spending slows by as much as he anticipates, then Mr. Bernanke and his colleagues could rapidly begin to embrace Feldstein's logic. From that point of view, we suspect that monitoring developments in U.S. housing markets and consumer spending will be critical for understanding the dynamics of the U.S. dollar in coming quarters. Given that there are multiplying signs of weakness in U.S. real estate markets, the currency markets may be entering a mode of "shoot first, ask questions later."

Indeed, Feldstein argues that speed is of the essence in engineering the dollar's decline, because it may take a year or more for imports and exports to respond to a decline in the dollar.



Commodity Prices Initially Fell During 1980s Dollar Decline

CRB Commodity Index



Source: Commodity Research Bureau

Chart 3: Led by a fall in oil prices, commodity prices also declined during the first few years of the dollar's mid-1980s decline.

Will Asia Co-operate?

Right or wrong, we suspect that Feldstein's provocative views will be quite influential among U.S. policymakers. One major complication in the current environment is whether U.S. policymakers actually have the ability to engineer a decline in the dollar along the lines he envisages. The reason has to do with Asian central banks, especially the People's Bank of China, which for years have resisted calls for revaluation of their currencies. Instead, they have purchased huge amounts of U.S. Treasury bonds to keep their currencies weak and help stoke the engines of their export machines.

For them to revalue their currencies at a time when U.S. consumer spending is set to slow down substantially could represent a "double whammy" to their export industries – they would suffer from a U.S. slowdown and from reduced competitiveness resulting from currency adjustments.

If global economic trends develop along the lines that Feldstein foresees, who will be the winners and losers? Winners would be U.S.-based capital goods producers and other export-oriented industries. Losers would include U.S. retailers, homebuilders, and real-estate lenders. In overseas markets, the tables would be turned. Winners would be

companies focused on domestic demand expansion in Europe, Japan and the emerging markets. Losers would be export-oriented firms that have focused on catering to U.S. consumers, which would clearly include many Asian industries. While a weaker dollar has historically been associated with stronger commodity prices, the shock of a U.S. consumer slowdown and the deflationary impact of a weak dollar on many foreign economies may well be associated with a substantial weakening in commodity prices, as was the experience in 1986 (See Chart 3).

Stay tuned. With the recent Group of Seven meeting explicitly pointing to the need for China to revalue the yuan, the odds are rising that Prof. Feldstein's theories are about to be tested in the real world.

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