A Stronger Dollar Requires Tighter Money

For many years top-level policymakers from around the globe bemoaned the US trade deficit and implicitly suggested they would like to see the dollar lose value against other major currencies. Now, the dollar has been beaten down so much they are talking about stability and hinting that governments may “intervene” in the currency markets if the dollar keeps falling.

The problem is that when it comes to the value of the dollar no policymakers matter as much as those at the Federal Reserve. Ultimately, the value of the dollar versus other major currencies depends on shifts in monetary policy both here and abroad.

Just follow the path of the Euro over the last decade. When it was first introduced on January 1, 1999, the exchange rate was $1.18/Euro(€). Although many analysts predicted the dollar would weaken against the new currency, the opposite occurred. The dollar appreciated 44% against the Euro in less than two years. At $0.82/€ in late 2000, the Euro was so weak that some thought it would not survive. That, of course did not happen. Since then the dollar has depreciated 48% and today stands at $1.58/€, an all-time low.

None of this is a mystery. The Fed was too tight in the late 1990s, culminating with unwarranted rate hikes between 1999 and 2000, which caused the dollar to soar. These rate hikes also pushed the economy into recession and caused deflation.

Then the Fed panicked, cut rates to an absurdly low 1%, and held them there too long. This excessively accommodative monetary policy led to a sharp decline in the dollar.

Interestingly, after the dollar had dropped to $1.34/€ in December 2004, it stabilized and did not approach that level until mid-2007. But once the Fed started cutting rates again in September 2007, the dollar dropped like a rock. In fact, it has now fallen so rapidly that some analysts think we are witnessing a currency crisis and are arguing that the US Treasury and other major Financial Ministries around the world intervene on the dollar’s behalf – buying dollars and selling other currencies.

We believe these efforts would be futile. As long as the Fed targets interest rates, currency intervention must be “sterilized.” Intervention means that dollars would be taken from the market, increasing scarcity. This would push US interest rates up as liquidity was squeezed. But in order to bring interest rates back down to the target rate the Fed would have to inject liquidity.

In other words, the only way to permanently reduce the amount of dollars in the system and force up the value of the dollar is for the Fed to raise the target rate.

In the pursuit of a stronger dollar there is no substitute for tighter monetary policy. That policy shift is not going to happen in the next couple of months. But the Fed will not stay loose forever. Once it shifts gears, we expect it to be aggressive, helping provide some real lasting buoyancy for the dollar, not just hot air.