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How to prevent a rout of the declining dollar

Jeffrey Garten

When Hank Paulson, US Treasury secretary, says the US believes in a strong dollar, he is merely repeating an empty mantra, for the Bush administration continues to rely almost entirely on an ever weakening dollar as the central thrust of its international economic policy.

When a European leader such as Jean-Claude Juncker, chairman of the group of 13 eurozone ministers, publicly demands discussions of the soaring euro at the upcoming Group of Seven industrial nations meeting in Washington, he is just venting his frustration, for it has been decades since the G7 accomplished anything on currency misalignments.

The fact is, words hardly matter in today's gigantic marketplace. Only action does.

Leaders are behaving like deer caught in the headlights. Yet some action is crucial now because the dollar's orderly retreat could at any time change into a chaotic rout, given the uncertainties and anxieties in today's markets. The danger is enhanced as every sign – financial, economic and political – points to a dollar that will continue to drop, making a bet on a weaker dollar nearly a risk-free proposition.

Moreover, while the Bush administration exalts the export stimulus from a weakening dollar, the overall effect of continuous devaluation will be highly detrimental to America. It will be inflationary, because it will raise the price of imports, including oil and other commodities. At a time when the US needs to borrow $2bn a day to finance its current account deficits, a depreciating dollar will act as a disincentive to foreign investment in US government securities unless American interest rates are raised. A weakened greenback will also expose US industries to foreign takeovers at bargain basement prices. Admittedly, conflicting interests among countries make any grand scheme, such as the Plaza Accord that realigned and stabilised currencies in 1985, a non-starter. There are, however, at least four moves that finance ministers and central bankers should make soon.

Intervention could boost prospects for an orderly dollar fall and show that the US and the EU can use powerful policy levers

At an opportune moment, they could make a sharp and powerful coordinated intervention in the currency markets to buy dollars. This surprise move would not change long-term trends, but it would show speculators that shorting the dollar is not always without consequence. The intervention could therefore bolster prospects for an orderly dollar decline and demonstrate that the US and the European Union are capable of jointly using powerful policy levers.

Next, the US could temporarily turn off its relentless pressure on Beijing to revalue the renminbi (and thereby further weaken the dollar). Over the long term, a floating Chinese currency is important, but for now a stronger renminbi adds petrol to a raging fire. Instead, discussions with the Middle Kingdom need to focus on something else: what stabilising role should China play if there were a major cur-

Third, the US needs to be prepared for a large increase in foreign acquisitions. While protectionism would be a disaster, allowing many of the new, cash-laden foreign government investors in the Persian Gulf and Asia to use America as a bargain basement would itself result in a nasty nationalistic reaction. US Treasury officials should be confidentially talking now to the big sovereign wealth funds to develop a mutual understanding of some US rules concerning transparency, maximum ownership percentages and sectoral sensitivities. The aim: to facilitate investment in a highly charged political environment.

None of these measures deals with important longer-term questions. That is why the Bank for International Settlements ought quietly to undertake a thorough examination of the future of the dollar in the international economy. With the growing power of the euro, the escalating importance of London as a global financial centre, the inevitability of the renminbi becoming a big global currency and the long-term deficits and foreign debts America faces in financing a burgeoning social safety net and massive military burdens, it is unlikely that the dollar will remain as central to global commerce as it has been for more than half a century. It is too late for the lame-duck Bush team to care about this, but in 2009 a new US administration – not to mention the rest of the world – should have great interest in the results of this project.

The writer is the Juan Trippe professor of international trade and finance at the Yale School of Management