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Lesson in Values

As Dollar Weakens, Hidden Strengths May Stave Off Crisis

'Twin Deficits' Would Sink
Other Currencies, but U.S.
Is Clearly a Special Case

Brazil Takes Tough Medicine

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(See *Corrections & Amplifications* item [below](#)⁰.)

Up to a point, a falling currency is a blessing. After that, it's a curse.


The dollar has fallen 16% against a basket of its trading partners' currencies over the past three years. In theory, that should, with time, make U.S.-made goods more competitive with those made abroad, boosting U.S. growth and employment.

But a growing chorus warns that the U.S.'s gaping budget and trade deficits will lead to a crisis in which the dollar falls much more sharply, driving up interest rates and squeezing the economy.

There are plenty of troubling precedents. Over the past decade, a dozen smaller economies from Mexico to Thailand have gone from growth to deep recession when their currencies collapsed. Even rich countries like Canada have been forced to adopt austere budget policies to cope with currency-induced turmoil. "We are increasingly vulnerable to the kind of sudden stop, where the capital inflows dry up all at once, that's been the bane of emerging markets over the years," says Barry Eichengreen, an economic historian at the University of California at Berkeley.

Could it happen here? It certainly hasn't yet. In a crisis, foreign investors dump stocks and bonds, fearing depreciation will cause further losses. Yet U.S. Treasury bond prices, and thus long-term interest rates that move in the opposite direction, have changed little in the last year -- and stocks are higher. A review of past

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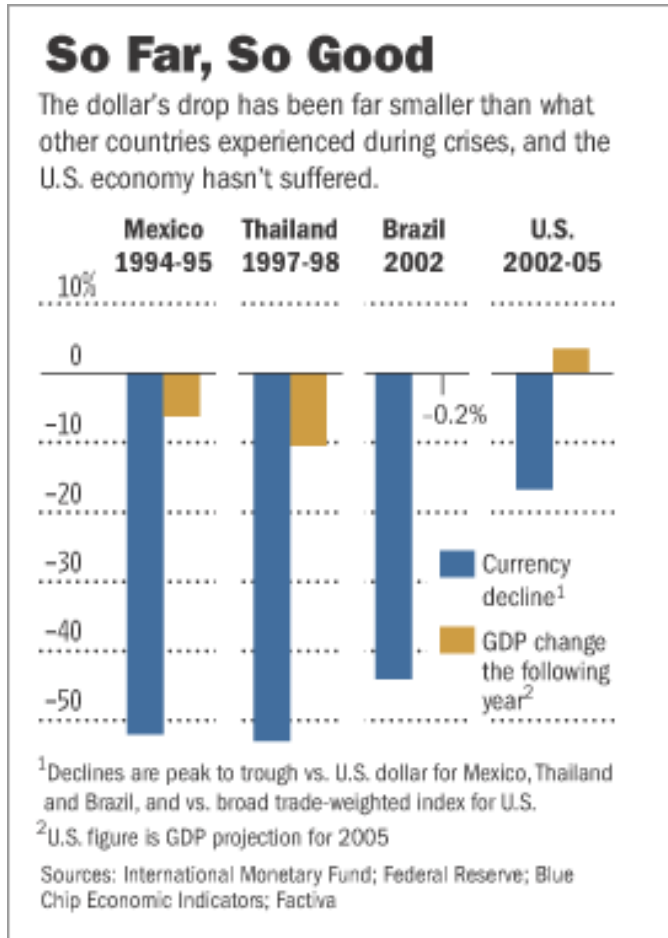
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crises world-wide suggests the U.S. has enough going for it now to avoid a similar fate. Yet the magnitude of the imbalances hanging over the dollar is also without precedent, suggesting a crisis remains possible.

'70s Flashback

The contrasts with the last dollar crisis, in the late 1970s, are both encouraging and unsettling.



Between September 1977 and October 1978, the dollar fell 16% against major currencies, slammed by rising oil prices and sluggish economic growth that pushed the U.S. from a trade surplus to a trade deficit. The weaker dollar helped boost the price of imports, and inflation jumped to over 8% from 6%.

Worried the falling dollar was undermining its anti-inflation efforts, the Carter administration announced a multipart support package on Nov. 1, 1978: The Treasury would use gold sales and foreign borrowing and draw on its reserves with the International Monetary Fund to defend the dollar. At the same time, the Federal Reserve raised its discount rate a full percentage point.

The dollar stabilized but remained weak, and inflation rose to 10% by late 1979. In the summer of 1979, Mr. Carter took what turned out to be a more substantial step. He installed Paul Volcker, then president of the New York Federal Reserve Bank, as Fed chairman. Mr. Volcker concluded that dramatic action was needed to break the back of inflation.

On Oct. 6, the Fed adopted an unorthodox new monetary policy for strangling inflation by clamping down on growth in the money supply, knowing that would send interest rates soaring. Mr. Volcker's new strategy did bring down inflation and eventually bolstered the dollar, but the price was high: the deepest recession since the Great Depression.

A lot has changed since 1978. At the time, the falling dollar was both a cause and consequence of high inflation, which corroded its purchasing power at home and abroad. Today, inflation is much lower and investors believe the Fed will keep it that way. While the falling dollar and high oil prices have boosted inflation a bit lately, investors believe that will be temporary. Ten-year Treasury-bond yields remain near 40-year lows of 4%, compared with 9% in 1979. The Fed thus believes it can gradually raise its short-term interest-rate target, still very low at 2.25%, without slowing the economy in the process.

But some things are worse. In 1978, the U.S. current account deficit -- the balance on goods and services trade plus the balance on investment income between the U.S. and its trading partners -- was less than 1% of gross domestic product. It is now approaching 6%. That deficit represents the extent to which U.S. households, corporations and governments spend and invest more than they earn. Compared with 27 years ago, U.S.

households save far less of their after-tax income, and thus must borrow more to finance their housing and consumption. The federal government also borrows more; its budget deficit was 2.7% of GDP in 1978 but was 4.5% last year.

Just as an individual who spends more than he earns must borrow or sell some of his assets to pay his bills, the U.S. finances its current-account deficit by either borrowing or attracting foreign investment in its businesses and stock market. Lately, it has borrowed heavily by selling Treasury bonds and other IOUs, often to foreign central banks. As a result, the U.S. has gone from having net foreign assets equal to 9% of GDP in 1978 to net liabilities equaling about 25% now. Mr. Eichengreen says there is no historical precedent for such a large economy being so heavily in debt to the rest of the world. Timothy Geithner, current head of the New York Fed, recently highlighted the risks: "We are significantly more dependent today on the confidence of the rest of the world in U.S. economic policy."

Real Emergency

The rash of crises that struck emerging markets in the last decade demonstrates the consequences of a sudden and severe loss of investor confidence. Brazil had moderate inflation in 2002 but large current-account and budget deficits. The rise of a leftist presidential candidate, Luiz Inacio Lula da Silva, undermined investors' faith that Brazil would keep inflation down and repay its debts. The government struggled to sell bonds. "All of a sudden, people who thought they had a safe investment started to run," says Arminio Fraga, then the central-bank governor and now head of his own investment firm, Gavea Investimentos. Between April and October Brazil's currency, the real, plunged 40%.

Mr. Fraga and his colleagues, after meeting with Mr. da Silva's advisers, assured officials overseas that Mr. da Silva would pursue "sensible" policies. Still, as the currency plunged, investors were steadily ratcheting up expectations of inflation. Given Brazil's history of hyperinflation in the late 1980s and early 1990s, Mr. Fraga knew those expectations had to be squelched. But at what cost?

Mr. Fraga concluded that "a recession was pretty much in the cards. Given the loss of confidence Brazil was experiencing, we felt: better a managed slowdown with no threat of hyperinflation than a total loss of control which would have led to a depression." So the bank jacked up its target for overnight interest rates to 25% from 18% in just three months.

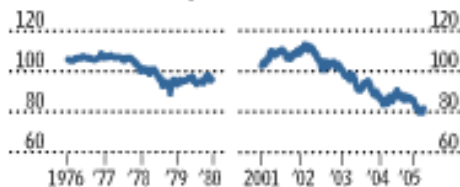
Brazil went through a recession, though it was relatively mild; growth was flat in 2003. By comparison, Mexico's economy shrank almost 7% after its currency collapsed, Thailand's by 10% and Argentina's by more than 20%. Economists Nouriel Roubini at New York University and Brad Setser have identified several common factors in 14 emerging-market crises from Mexico in 1994 to Brazil in 2002. Among them: large current-account or budget deficits, financing of those deficits with foreign "hot money" that can leave as quickly as it comes in and political uncertainty.

Sliding Dollar: For Better and for Worse

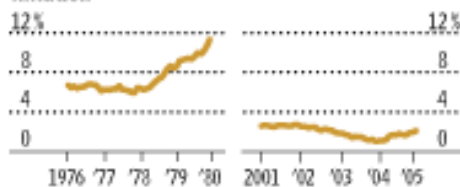
Inflation stays in check...

The dollar's recent fall matches its drop in the late 1970s, but inflation has stayed far lower. Index of the dollar's value against major currencies vs. the annual change in consumer prices¹

Dollar index vs. major currencies



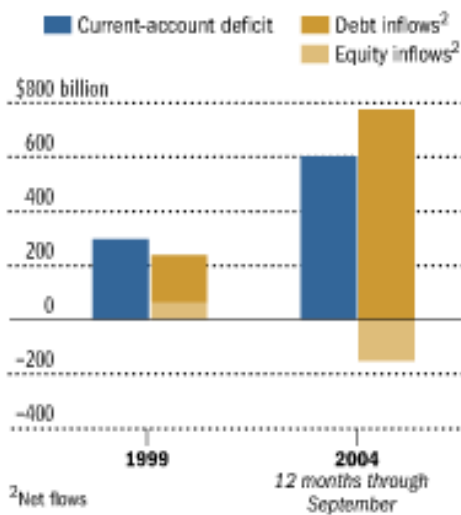
Inflation



¹For the dollar index, March, 1973=100; Consumer price index, excluding food and energy

But trade deficit is rising ...

The U.S. current account deficit has almost doubled since 1999, and it is now financed entirely by borrowing



²Net flows

And foreigners gain clout

Cross-border securities trading has soared in recent decades, both a support and a risk for the dollar. Foreigners' purchases and sales of U.S. securities as percentage of GDP



Sources: Treasury and Commerce departments

Mr. Roubini says the U.S. shares several of these vulnerabilities: large current-account and budget deficits -- nicknamed "twin deficits" -- with little prospect of resolution, and a growing portion of those deficits financed with short-term borrowing from foreigners. "The average emerging economy would have already gone belly up with these twin deficits," Mr. Roubini says. The U.S. has been spared, he says, because it can still borrow in dollars instead of foreign currency, meaning others bear the pain if the dollar depreciates. By contrast, developing countries often borrowed in dollars to take advantage of lower interest rates but faced a crushing repayment burden when they could no longer keep their currency pegged to the dollar. Brazil's Mr. Fraga notes fear of government default was a key contributor to its crisis, but that has "zero probability" in the U.S.

"We have some residual credibility," says Mr. Roubini. Nonetheless, U.S. dependence on short-term borrowing from foreigners "is becoming increasingly dangerous."

Rich-Country Woes

Even rich countries can be rocked by a run on their currencies. It happened to Britain in the 1970s. Several times in the early 1990s, Canada's dollar came under pressure because of big current-account and budget deficits. The central bank raised interest rates in response, but that worsened the budget deficit by adding to interest on the public debt. Don Drummond, a top finance-ministry official at the time, remembers being bombarded by reporters' questions the day Standard & Poor's reduced the credit rating on Canada's foreign-currency debt. They thought "we were bankrupt internationally. It was a real blow to the Canadian pride."

Mr. Drummond, now chief economist at TD Bank Financial Group in Toronto, says the Canadian government used the crisis atmosphere to muster support for sweeping tax measures and spending cuts that eventually produced budget and current-account surpluses. The U.S. today "spookily" parallels Canada of 10 years ago, he says, with both current-account and budget deficits about the same size relative to GDP.

Canada never faced a single "crisis" moment at which investors balked at buying Canadian bonds, and even the S&P downgrade had negligible financial impact. The lesson for the U.S. is not to expect a "catalytic" event, Mr. Drummond says. "It's more of a drift where you pay more and more of a cost. Nothing changes dramatically in one day."

Foreign Aid, Deep Markets

The U.S. has an additional advantage over any other country when it comes to crisis prevention: Its economy is too important for the world to passively accept a dollar collapse.

That's one reason many countries prop up the dollar. China runs a large trade surplus with the U.S., something that would normally force its currency, the yuan, to rise against the dollar. To prevent that, China buys billions of dollars in Treasury securities. That protects its exports and helps keep U.S. interest rates low.

The increased depth, reach and sophistication of markets is one reason Federal Reserve Chairman Alan Greenspan is optimistic the U.S. can avoid a crisis. "An ever more flexible international financial system" means global imbalances are more likely to be "defused with little disruption," he argued in November 2003.

Indeed, as imbalances have grown in the past decade, currency markets, by some measures, have become more orderly. It's been a decade since the dollar's drop seemed dangerous enough to spark a concerted response from the U.S. and its allies. On the morning of March 2, 1995, Ted Truman, then top international staffer at the Fed, was getting reports of massive dollar sales, some triggered by derivatives strategies, driving the U.S. currency down sharply against the deutsche mark and yen. Bond yields were rising. Mr. Truman went to see Mr. Greenspan and recommended the Fed and Treasury intervene in the markets to buy dollars. "I don't think it's going to do any good," Mr. Truman recalls telling Mr. Greenspan. "But by not being there we are saying we totally don't care what the conditions of the markets are."

Mr. Greenspan agreed, and that afternoon the Fed and the Treasury waded in, buying \$600 million worth of dollars in exchange for marks and yen. The next day it repeated the action, joined by 13 central banks. The dollar stabilized. Bond yields dropped.

The U.S. intervened to support the dollar a few more times that year, but hasn't done so since; markets have generally been smooth, and the Clinton and Bush administrations came to see intervention as being of limited use.

Mr. Truman, now a scholar at the Institute for International Economics in Washington, predicts that in the next five years, the U.S. will have to intervene again "either because it's a period of disorder or because we can't withstand the political criticism from our partner countries." He adds: "The very richness and increased flexibility of markets that Alan Greenspan has emphasized probably translates into fewer episodes of disorder, but when they come, they're going to be bigger."

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Corrections & Amplifications:

The U.S. Treasury and Federal Reserve on March 2, 1995, intervened in currency markets to support the dollar, selling deutsche marks and yen valued at \$600 million to buy dollars. This article incorrectly said the Treasury and Fed bought \$600 million of marks and yen. In addition, the U.S. federal budget deficit in fiscal 2004 was 3.6% of gross domestic product. The article incorrectly said the deficit was 4.5% of GDP.

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