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CURRENCY

The Strong, Weak Dollar

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By Justin Fox a A

Currency markets work on pretty short time horizons. Remember when Harvey Schwartz, the chief financial officer at Goldman Sachs, said the Swiss franc's sudden rise against the euro in January was "something like a 20-plus standard deviation move"? He couldn't have possibly meant that it was the kind of thing that could only happen once in several trillion or quadrillion or whatever number of years, given that the franc had experienced nearly as dramatic a rise and then fall against the euro in 2011.

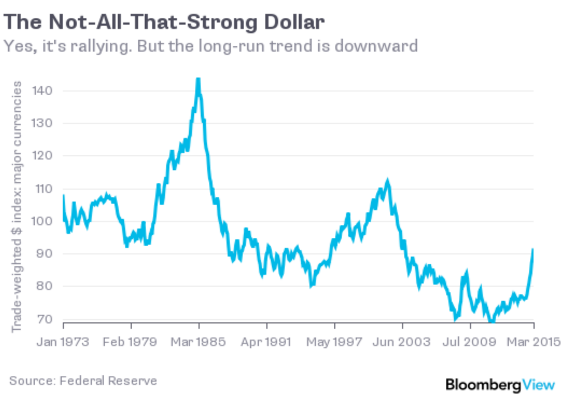
But from the perspective of a currency trader, really, what's the difference? Four years, a quadrillion years -- it's all indescribably far off.

That's why, when there's a significant currency move like the dollar's rise against the euro over the past couple of weeks, it tends to be discussed in near-apocalyptic language. We are witnessing the euro's "collapse," or maybe its "demise," at the hands of a "rampant U.S. dollar," to borrow the words of one especially dramatic currency analyst.

Demise? Really? It's fine that currency people think that way, I guess. And the euro's complicated political underpinnings are indeed a bit fragile. But for those of us who don't think four years is an indescribably long time, here's a chart of the dollar-euro exchange rate since the inception of the common currency.

The recent move is dramatic, but it has merely brought us back to about where we were when the euro came into being on Jan. 1, 1999. The dollar has been much higher against the euro than this, and it has been much lower. Perhaps the two currencies are now finding their true nature.

Looking at the performance of the dollar against the world's other major currencies since the collapse of the Bretton Woods system of managed exchange rates in 1973 gives a different picture, one of a long-run decline in the dollar's value. (I double-checked my eyes on this by having Excel draw a trend line, which I couldn't reproduce in this chart, and it's definitely downward-sloping.)



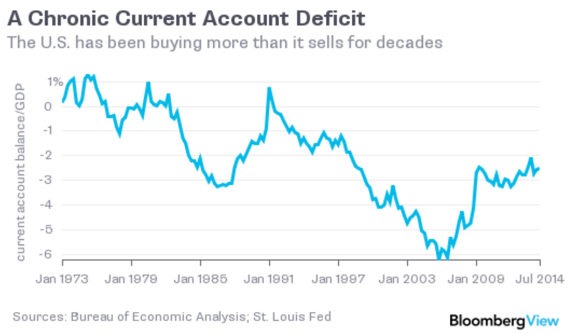
Is this evidence of American economic decline, of economic growth outside the U.S. or of nothing at all? It does seem to illustrate something or other about the strange predicament of the dollar since the collapse of Bretton Woods. As the world's main reserve currency, the dollar remains in demand even when U.S. economic performance and fiscal policy don't really merit such popularity. The result of this "exorbitant privilege" is that the dollar is valued a bit more highly than it would be otherwise, and that the U.S. Treasury is able to borrow money at lower rates than it otherwise would. But the dollar's privilege also puts it under long-term downward pressure.

I'll let Eswar S. Prasad, author of the recent book "The Dollar Trap," explain:

> The dollar’s prominence is a mixed blessing for the U.S. A strong dollar and low interest rates mean the U.S. gets cheap goods from the rest of the world and cheap financing. But

> a strong dollar hurts U.S. exports and job growth. A more fundamental problem is that this reduces U.S. fiscal discipline.

The strong dollar creates conditions that weaken the U.S. economy and encourage the U.S. to run big government deficits, and that in turn causes the dollar to fall. The now-chronic current account deficit can be construed as evidence of this ongoing weakness:



Then again, the inevitable flip side of a current account deficit is a capital account surplus. Foreigners have kept pouring money into U.S. stocks, bonds and property, thus strengthening the dollar. Then, by the mechanism described above (the strong dollar hurts exports and job growth and enables poor fiscal policy), that strengthening causes the dollar to weaken.

It is a paradox. Or maybe a conundrum. It has got to be one of the reasons why most people in currency markets don't spend too much time thinking about the long-run implications of what they're doing. Because that might make their heads explode.

1. *It came into being on currency markets then. The actual notes and coins weren't available until 2002.*

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