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The Falling Dollar and the US Economy - Which Way Now?

Monday, July 23, 2007

Not only is the US dollar sliding it has dropped by about 40 per cent against the euro in the last two years. This has given rise to a number of worries (mainly justified) and the usual fallacies about inflation, exports and imports. So how is this to be explained? The answer is supply and demand. Every layman knows that if the supply of any good increases against an unchanged demand prices will fall.

Money is no exception to this law. But , unfortunately, the economic forces that are creating so much turbulence in the foreign exchange markets are not easily explained with the use of simple supply and demand curves. Nevertheless, the ancient truth that these types of foreign exchange movements have their roots in fallacious monetary policies cannot forever be suppressed. Let us turn to the venerable Edwin Cannan for illumination. As he himself wrote:

Hence the continued rise of prices at various rates in the different countries which occasions what is called "the dislocation of the exchanges." The exchanges have been dislodged from their old rate simply because the different paper units of account, pounds, francs, marks, etc., have been issued in various degrees of excess, so that their relative purchasing power has altered. A pound exchanges for many more francs than it did before the war [WW I], because the issue of paper francs has been much more excessive than that of pounds: a pound exchanges for fewer American dollars than it did before the war because the issue of American paper dollars, though great, is limited to an amount which keeps them in their old relation to gold, while the issue of English paper pounds is not similarly limited. (*Money: Its Connexion with Rising and Falling Prices*, P. S. King & Son, Limited, 1920 pp, 78-79).



Four years later, a frustrated Cannan was to declare that

If I could have foreseen only a tenth of the ruin of neglect of that doctrine that due limitation was about to bring upon the civilized world in the next six years, I would have given up other avocations in order to give more time to the endeavour to convince unbelieving mankind of its truth. (Edwin Cannan *The Economic Journal*, Vol. 34, No. 133, March 1924, pp. 52-64).

The deleterious effects of an expanding money supply on exchange rates were noted by fifteenth century Spanish scholastics. Roundabout 1724 Richard Cantillon wrote his brilliant *Essay on the Nature of Commerce in General* (Transaction Publishers 2001). Chapter VI (*Of the increase and decrease in the quantity of hard money in a state*, pp. 66-72) gave an excellent description of how the flow of gold and silver from the New World damaged the Spanish economy. Returning to Cannan, it would pay economic commentators to carefully study *The Paper Pound of 1797-1821* (P. S. King & Son, Limited, 1919). This was a reprint of the *Bullion Report* that had been published in 1810. Cannan's introduction was a forceful and detailed account of the report and a damning indictment of European war-time and post-war monetary policies.

So how does US monetary policy stack up? Not very well, I'm afraid. I did a quick check of the monetary aggregates this evening and found that since 1990 the monetary base has increased by over 200 per cent. I also noted that during the last 10 years the currency has grown by nearly 60 per cent. These figures just might account for the massive number of dollars that are sloshing around the world. (Either that or Kim Jong-il's little forgers have been working overtime).

By now readers will have probably started to make the connection between America's trade deficit and the Fed's loose monetary policies. Unfortunately the vast majority of people have no idea of the mechanism by which foreign currencies exchange and goods flow. Let's start with China. (Everybody else does). Assume that Wal-Mart buys \$1000,000 worth of DVD players from a Chinese company. Because dollars are not legal tender in China Wal-Mart has to buy yuan. This additional demand tends to pull up the Chinese currency relative to the dollar.

It's therefore easy to imagine the pressure on the yuan when the demand for Chinese goods is in billions of US dollars. Nevertheless, the Chinese manufacturer does not see these dollars. The People's Bank of China — the equivalent of the Fed — relieves the pressure on the exchange rate by expanding the supply of yuan so as to try and maintain the current exchange rate. China's central bank now finds itself holding \$1000,000. Basically one of two things can happen. The dollars can be used to buy American exports or they can be used to buy interest-bearing US bonds. In either case the dollars, so to speak, return.

Irrespective of what some free market enthusiasts say, this is not a healthy situation. For example, the financial imbalances that some commentators are pointing to are very real. However, these commentators have missed the vital fact that these imbalances are creatures of an irresponsible monetary policy. Even worse, real imbalances are also piling up — to the detriment of China.

By running a monetary-induced deficit with China the US has probably succeeded in misdirecting a great deal of Chinese manufacturing in to serving the needs of US consumers. The consequences for the US economy are manifold. The longer this process continues the more likely it is that more and more American manufacturers will be deceived by the exchange rate into shifting production offshore. Another result is that the US economy will tend to become more and more oriented to domestic consumption.

(I should point out that I think the same thing is happening to Australia but to a much larger degree. Unfortunately, it is literally impossible to get this subject publicly debated).

Economic optimists will immediately point out that a declining dollar will reverse the process. Not quite. A depreciating dollar will tend to reduce the demand for imports, particularly from China. This in turn will cause dollar-induced changes in Chinese investments to be exposed as malinvestments. Rather than see this happen the Chinese government would probably accelerate monetary expansion, not realizing that this policy is ultimately self-defeating. Redirecting American manufacturing will also cause some pain.

So how does the economic commentariat manage to overlook these facts? Blame it on J.B. Clark and Frank Knight, the founders of the Chicago School. Knight took on board Clark's absurd belief that once capital goods came into existence their maintenance and reproduction were automatic. In other words, capital became a homogeneous permanent fund with the result that production and consumption were basically synchronous. Combine this view with the belief that money is neutral and we end up with a very explosive mixture.

Adam Smith said of free trade:

The proposition is so very manifest, that it seems ridiculous to take any pains to prove it; nor could it have been called in question, had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind. (*Wealth of Nations, Liberty Classics*, 1981, pp. 493-494).

Cannan and so many others who are long gone could have rightly said the same thing about monetary policy and exchange rates.

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