ECONOMIC VIEW

Buckle Up for the Dollar's Ride

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IS the writing on the wall for the dollar? Researchers at one big fund manager say it is, but the markets haven't read along just yet.

Since the start of March, Bridgewater Associates, a manager of more than $100 billion of institutional and hedge fund money in Westport, Conn., has been issuing warnings in its daily reports. One on March 11, titled "The Breakdown of the Dollar System," said, "As we often say, we've seen this movie many times and we know the ending."

There is indeed a volatile blend of risks surrounding the dollar. President Bush's new budget proposal would substantially expand the government's debt burden in the next decade, potentially raising doubts about the desirability of its i.o.u.'s. Some Asian central banks have declared that they will diversify their reserves away from dollar-denominated assets. If China decouples the yuan from the dollar, it will not need as many dollar-denominated assets to keep its currency from gaining value, nor will its competitors for export markets. In recent times, long-term interest rates have stayed stubbornly low, making it difficult for American companies to attract new investment from abroad.

These ingredients may just be waiting for the right catalyst. If enough people start thinking like those at Bridgewater Associates, the dollar will lose value rapidly. There's no point trading dollars today, after all, if everyone thinks that they will be worth less in the near future. Fundamental economic factors need not worsen any further; in currency crises, perception very quickly becomes reality.

Bridgewater says it believes that the dollar is already beyond the point of no return. To keep the currency at its current value, private investors will have to buy more American securities as central banks desert them, said Robert P. Prince, the firm's co-chief investment officer. Before private investors will act, they need to see a higher return from American assets, relative to assets carrying similar risks abroad.

Mr. Prince said that those higher returns had begun to arrive through lower prices for assets. If an asset comes with a fixed interest payment, say 4 percent, buying it at a lower price will

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offer a relatively higher return. But these higher returns could cause problems for the economy. Borrowers in the competitive market for credit will have to offer higher returns, too, and interest rates may rise. "The Fed doesn't want that, because too much of a rise in interest rates will choke off the economy," Mr. Prince said.

The alternative is for the assets' prices to remain the same while the dollar loses value. That way, foreigners will be able to buy assets at a discount, yielding a higher return, but without putting too much upward pressure on American interest rates. (The implicit assumption here is that the assets' future returns will not be harmed too much by today's lower dollar.)

So, instead of allowing the economy to adjust purely through higher interest rates, perhaps causing another recession, Alan Greenspan and his colleagues at the Federal Reserve will have the luxury of allowing the dollar to do some of the heavy lifting. The numbers? Bridgewater predicts a further decline in the dollar of 30 percent, especially against Asian currencies, and a rise in American long-term rates of one-half to one full percentage point.

Not everyone thinks that events will play out this way. "It's really too extreme to be talking about potential crises in the dollar," said Martin D. D. Evans, a professor of economics at Georgetown University in Washington. "Yes, we have seen a large movement in the dollar versus the euro in particular, but to say we're sort of on the edge of a precipice isn't really merited by the facts. The premise here, thinking that it's impossible for the dollar to come back, I also don't buy."

Professor Evans said the Fed's hand would be forced by the rising tide of inflation. "The Federal Reserve cares about inflation," he said, "and they're going to be very reluctant if they start seeing the inflationary effects of the decline in the dollar to just sit by and say, 'But we need low interest rates to support exports.' " He predicted that the Fed would put the clamps on credit, leading to interest rates high enough to attract foreign capital: "We are going to see quite a sharp tightening in the United States, perhaps tighter than people are expecting."

Drastic predictions for the government's fiscal position may not come true, either, even though the White House's budget would raise the debt-to-G.D.P. ratio in 2015 to 37 percent, versus 29 percent under current law. "I don't think it's big enough to warrant the attention it's gotten," Douglas J. Holtz-Eakin, director of the Congressional Budget Office, said of the nation's fiscal erosion. "A lot of the dollar's future will in fact be driven by the other determinants."

That does not mean the budget can be ignored. Mr. Holtz-Eakin said he expected that the government would eventually have to steer clear of a dip into the red. "It is unavoidable that we will rein in our spending," he said, "because we are unlikely to be able to tax enough to cover it."

Though action by the Fed and a clampdown on federal spending could spare the dollar's blushes, they would both be bad news for the economy. A cutback in federal spending will, at least in the short term, create slack in labor and product markets. And one of the surest forecasters of recession is a tightening of short-term credit by the Fed.

Congress and the White House have shown no sign that they are serious about controlling spending, but the Fed's policy-making committee may already be proving Professor Evans right. After the committee opted to raise short-term rates another quarter of a percentage point last week, its statement acknowledged that "pressures on inflation have picked up in recent months" and asserted its willingness to act forcefully if necessary.

Whichever way you cut it, we're in for a bumpy ride.

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