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OPINION

The Dollar and the Credit Crunch

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We are all too familiar with the problem of mortgage credit associated with the slump in home prices. The great unresolved puzzle in today's financial crisis is why some other private credit markets are seizing up.

The financial press is full of stories about a shortage of the U.S. Treasury bonds necessary in the multitrillion-dollar interbank market as collateral for borrowing by illiquid banks. This shortage seems even stranger in the face of a large federal fiscal deficit (\$237.5 billion in 2007) that continually increases the supply of new Treasuries.

This shortage of Treasuries, and the unexpected severity of the credit crunch, is linked to the flight from the dollar in the foreign exchanges.

The U.S. Federal Reserve has hastily cut short-term interest rates to just 2.25% in March 2008 from 5.25% in July 2007. Unsurprisingly, private capital inflows for financing the huge U.S. trade deficit have dried up. Hot money has flowed out of the U.S. into those countries (of which China is the most prominent) with currencies that are most likely to appreciate.


Foreign central banks (apart from those in Europe) are then induced to intervene, sometimes massively, to buy dollars in order to slow their currencies' appreciations. In 2007, China had the biggest overall reserve buildup of \$460 billion. Other central banks, from the Gulf oil-producing states to Russia, Brazil and some smaller Latin American and Asian countries, have also intervened to accumulate dollar reserves.

A substantial proportion of these official reserves is invested in U.S. Treasuries. The Federal Reserve's Flow of Funds data (March 2008) show that in 2007 foreign central banks accumulated about \$209 billion of U.S. Treasuries. Somewhat inconsistently, the Treasury's own data show an accumulation of \$250 billion.

Although acute in 2007 and more so going into 2008, this drain of Treasuries was also very large from 2003 to 2005. By early 2004, the federal funds rate had been cut to just 1%, which also triggered a flight from the dollar -- at that time more into yen than renminbi. This previous episode of easy money and unduly low interest rates greatly aggravated both the U.S. housing bubble and the more general overleveraging of the American financial system from 2003 to 2006.

In 2007-08, the crash in housing and the implosion of over-leveraged hedge funds, special investment vehicles and so on, has increased counterparty risk in most financial transacting. Illiquid financial institutions cannot effectively bid for funds by putting up suspect private bonds or loans as collateral. Unsurprisingly, there is a "flight to quality" that increases the private domestic demand for Treasuries. But this is happening at a time when the flight from the dollar in the foreign exchanges has greatly reduced

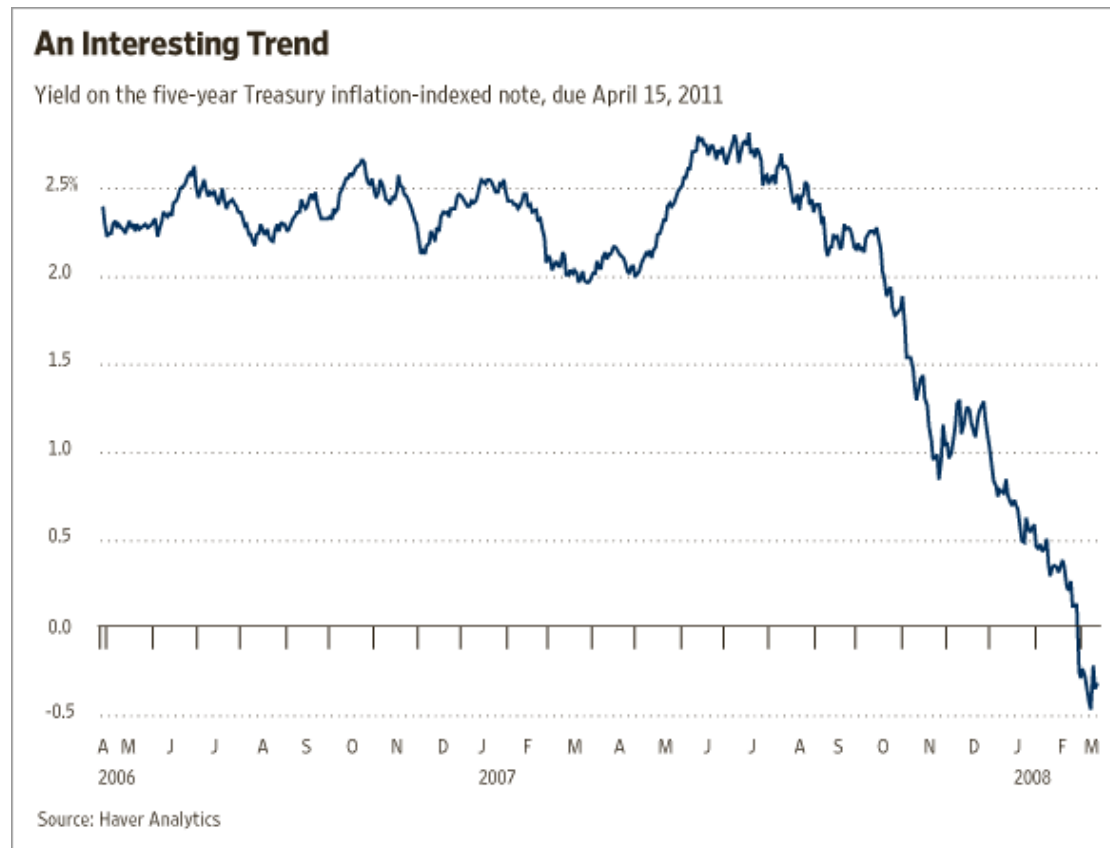
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their supply.

This increased demand coupled with a fall in supply helps explain why, in the midst of a U.S. credit squeeze with higher interest rates on private financial instruments, nominal interest rates on U.S. Treasury bonds have fallen to surprisingly low levels. Despite substantial ongoing U.S. price inflation of 4.3% in the consumer price index and 6.4% in the producer price index, Treasury yields are less than 1% on a three-month bill, 1.32% on a two-year note, and 3.5% on the benchmark 10-year bonds. There are even reports of effectively negative nominal yields on certain very short-term Treasuries. The real yield on Treasury Inflation Protected Securities has turned negative. (See chart.)



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So we have a paradox. Despite the financial turmoil in the U.S. and its government's not-so-strong fiscal position, with huge contingent liabilities for guaranteeing private and public pensions as well as bailing out failing banks, its credit

standing has strengthened. The fact that the U.S. government can market Treasury bonds at insultingly low interest rates at least provides an argument for using fiscal stimuli -- such as the \$160 billion tax rebate passed in February 2008 -- to prop up the sagging U.S. economy.

Beginning on March 27, the Fed offered to lend banks and bond dealers as much as \$200 billion of Treasuries from its own portfolio for up to 28 days, in return for a variety of collateral. The Fed was responding to complaints from dealers of a shortage of Treasuries in the interbank markets, but without recognizing that the root cause was the flight from the dollar in the foreign exchanges.

In the 1970s under the dollar standard, episodes of a weak and depreciating dollar led to monetary explosions in foreign trading partners, with world-wide inflationary consequences. Now, the inflation threat to the U.S. could be aggravated if foreign central banks intervene to prevent their currencies from appreciating too fast and overly expand their money supplies.

Stabilizing the dollar in the foreign exchanges and encouraging the return of flight capital to the U.S. will require two things. The first is to convince the U.S. Federal Reserve that continually cutting interest rates and expanding the U.S. monetary base is not the appropriate response to today's credit crunch; rather it triggers a vicious cycle.

The Fed responds to the credit crunch by cutting interest rates, which would be the seemingly correct textbook strategy if the economy were closed and the foreign exchanges could be ignored. But the economy is open, and capital flies out of the country. Because of the unique position of the U.S. at the center of the world dollar standard, the drain of Treasuries -- the prime collateral in impacted credit markets -- exacerbates the credit crunch, and monetary expansion abroad worsens world-wide inflation. The Fed then further expands in response to the tightening of U.S. credit markets.

The second component of a strong dollar policy is more direct action on exchange rates. At the very least, China bashing as a means to force dollar depreciation against the renminbi should end. The U.S. government should also cooperate with central banks in Europe, Japan, Canada and elsewhere to stabilize the sinking dollar.

The best solution to the current crisis is to stop the flight from the dollar. This would be beneficial beyond relieving the drain of Treasuries and relaxing the crunch in American credit markets. Letting the dollar depreciate without any convincing action to secure its long-term value against other major currencies undermines confidence in the dollar's long-term purchasing power. It also lets the inflation genie out of the bottle, and makes a return to 1970s-style stagflation look imminent.

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