QUEST CLUB

OCTOBER 17, 2008

THE GOOD, THE BAD, AND THE UGLY OF THE WEAK DOLLAR

BY: JOHN D. AULD

Before I address the weak dollar, I would like to review money, in general, and how the dollar became what it is today.

What is money? By definition, money is any marketable good or token, used by a society as a store of value, a medium of exchange, and a unit of account. Since the need arises naturally, societies organically create a money object when none exists. Our primary unit or money is the United States dollar. Very early societies didn't use money. They worked with a "gift" economy, and bartering or trading only took place with outsiders. Within the tribe or family goods were shared. As societies became more complex the use of money was found to facilitate and even accelerate trade, which is the primary purpose of money.

Many types of goods have been used as money (beads, shells, animals, paper, and even people). For the Mayans of Yucatan chocolate became such a precious commodity that cocoa beans were not only a source of food and drink, but the "coin of the realm." But coins made of precious metals became the early favorite for most societies. Money was not only used as a medium of exchange, but as a measure of value and a standard of deferred payment.

During the middle ages the emergence of banking brought about a significant change in how money was used. Since carrying coins was considered dangerous, traders began depositing them in strongboxes of silversmiths and goldsmiths in exchange for redeemable receipts. These receipts gradually

became regarded as equivalent to the coin itself: the first paper money. The silversmiths and goldsmiths found they could issue receipts for the coins they didn't actually hold. The creating of fiat money (that is, money not supported by coins or precious metal) became one of the earliest forms of banking. This practice spread into other areas of the world, including the United States, and became part of the basis of our banking system.

In the beginning years of our country we didn't have a national bank. That is, a bank owned and operated by the federal government. The establishment of such a bank was a very contentious issue for our early founders. Thomas Jefferson was opposed, on the grounds that it would give too much control of the economy to an elite few. Alexander Hamilton led the group supporting the establishment of a national bank, contending that it was needed in order to establish a national currency and to finance the government. In the early days currencies were issued by local banks, a system which failed to meet the needs of the country. Jefferson's anti-national bank group won early victories, but twice banks were established, only to later be abolished. In both cases the banks were charged with being corrupt and unconstitutional.

In 1792, when the Mint Act was passed, the U. S. government began printing dollars. The value of the dollar was pegged to a specific amount (in grains) of silver and/or gold. Earlier, under the Articles of Confederation, paper money was not backed by precious metals and was considered by many to be worthless.

In 1862, when the cost of the Civil War became overwhelming, paper money was issued without the backing of precious metals. The actual bills were printed with a special green ink on the back to prevent counterfeiting- thus the origin of the term “greenback.” Gold and silver coins continued to be issued and were considered more valuable than the greenbacks.

The National Banking Act of 1863 permitted nationally chartered banks to create a uniform national currency. Before that time there were more than five thousand state banks issuing their own paper currencies. Merchants and bankers relied on bank-note directories to determine which were acceptable and what their value was. In addition, companies were paying employees in “script”, redeemable only at the company store, and merchants, even a few churches, were issuing their own currencies, mostly to make up for the shortage of small change. The federal government eliminated most of these by taxing them out of existence, and then by making the private production of money illegal. A Fort Wayne banker named Hugh McCullouch went to Washington to lobby against the National Banking Act, became convinced it was a good idea, and ended up overseeing its implementation as our country’s first Comptroller of the Currency.

In 1900 the dollar was tied solely to gold, and in 1933, when all gold coins were “called in” by the government, the value of gold was fixed at $35 an ounce. This standard lasted until 1968, when a series of peg prices to gold were attempted.

Finally, in 1975 the dollar was allowed to float freely on the currency markets, backed only by the “full faith” of the U. S. government and not supported by a precious metal.

An interesting and unique feature of the dollar is that it has been issued in more than ten forms, including: Silver Certificate, National Bank Note, Gold Certificate, Compound Interest Treasury Note, Demand Note, and Federal Reserve Note. Since the 1970’s the Federal Reserve Note has been the only one in circulation. If you were to check the dollars in your wallets and purses, chances are very great that you would only find Federal Reserve Notes. If you were to find an older form, such as a Gold Certificate, it would probably have more value as a collector’s item.

In 1907 the United States suffered what became known as the “Bankers’ Panic.” It was a financial crisis with the stock market falling almost fifty percent from the previous year’s highs, and the closings of many banks and businesses. The U. S. Secretary of the Treasury pumped $35 million into the banking system to avert a panic, but the panic wasn’t fully quelled until J. P. Morgan organized group of bankers to redirect money between banks, establish expanded international lines of credit, and purchase the stocks of healthy corporations. The 1907 panic was the fourth panic in thirty-four years. The following year congress passed the Aldrich-Vreeland Act, which established the National Monetary Commission to

study the panic and propose legislation to regulate banking and currency reform, and to avoid future panics.

Senator Nelson Aldrich of Rhode Island, chairman of the National Monetary Commission, and his group, studied the European banking system for almost two years and then brought together a few prominent financiers to discuss the establishment of a new central banking system. That meeting was the impetus for the creation of the Federal Reserve Bank. Any discussion of the U. S. dollar has to include a discussion of the Federal Reserve Bank because of the crucial role it plays in our monetary system.

In 1913 congress passed the Federal Reserve Act, establishing the national banking system which exists today. The Federal Reserve sets short-term interest rates and controls member banks through a set of rules, and further by setting the discount rate (the rate at which banks can borrow from the Fed, as it is known). The Fed also acts as the agent through which the government borrows, by issuing and marketing U. S. Treasury bonds and notes. And, while the U. S. Mint actually prints the dollars, the Fed controls how much money is in circulation. One of the duties of the Fed is to keep our currency “elastic.” Elastic currency means currency that can, by the actions of the central monetary authority (the Fed), expand or contract in an amount warranted by economic conditions. This is accomplished by buying and selling U. S. Treasury Securities.

There are twelve different Federal Reserve Banks located throughout the country, all of which are owned by their "member" banks. The member banks are required to buy stock in an amount equal to three percent of their capital. All nationally chartered banks (not the same as a national bank) are required to be members of the Federal Reserve Bank. That is, they have a stock ownership in the bank and are subject to its rules and regulations. They are paid a six percent dividend, set by law, but cannot sell, trade, or transfer their stock. State chartered banks, which apply for membership, and qualify, can also become members of the Fed. While only about forty percent of the banks in the U. S. are members of the Fed, membership does include all large nationally chartered banks and represents a very high percentage of total bank assets.

The member banks that own the Federal Reserve Banks don't really control or run them. Nationally, the Federal Reserve System is managed by a seven-member Board of Governors who are appointed by the President of the United States and confirmed by the Senate. The banks do, however, elect the boards of directors of the twelve Federal Reserve Banks.

The Federal Open Market Committee, the group responsible for regulating the nation's money supply and setting targets for short-term interest rates, consists of twelve members. A majority of seven of these voting members are the members of the National Board of Governors, with the other five coming from the

twelve Federal Reserve Banks. This means that the Board of Governors controls all the Fed's major decisions.

The "Frequently asked Questions" section of the Federal Reserve Bank webpage gave this explanation about Fed ownership:

As the nation's central bank, the Federal Reserve derives its authority from the U. S. Congress. It is considered an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive or legislative branch of government, it does not receive funding appropriated by Congress, and the terms of the members of the Board of Governors span multiple presidential and congressional terms. However, the Federal Reserve is subject to oversight by Congress, which periodically reviews its activities and can alter its responsibilities by statute. Also, the Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government. Therefore, the Federal Reserve can be more accurately described as "independent within the government."

The current Chairman of the Federal Reserve, a position also appointed by the President and confirmed by the Senate, is Ben Bernanke. Mr. Bernanke took over the chairmanship from Alan Greenspan, who had held that position for almost twenty years under four presidents. Mr. Greenspan recently voiced his disapproval of the decisions by the Fed to "bail out" Bear Stearns (a very large

investment banking company) and the two largest shareholder-owned, government-sponsored enterprises, Fannie Mae and Freddie Mac (also the two largest mortgage issuers in the United States). He objected mostly to the manner in which this was done, which potentially protected shareholder interests at the expense of U. S. taxpayers. His concerns may have been misplaced as, it appears, the equity holders of Fannie Mae and Freddie Mac will be eliminated with the issuance of new stock.

Prior to World War II the British Pound Sterling came the closest to being the accepted international currency. Britain’s influence was global (the sun never set on the British Empire), and its economy was strong. Neither its empire nor its economy survived the war intact. On the other hand, the U. S. economy, in spite of the recent depression, emerged from the war with a very strong economy, becoming the world’s leading exporter of goods.

In 1944, in anticipation of the end of World War II, a meeting was held in Bretton Woods, New Hampshire, the purpose of which was to set up a system of rules, institutions, and procedures to regulate the international monetary system. Seven hundred-thirty delegates from forty-four allied nations met for three weeks. The Bretton Woods meeting resulted in the establishment of what later became the World Bank and the International Monetary Fund. The primary result of the new system was to require each country to maintain a fixed range of exchange rate for its currency – in terms of gold. This system worked well for the United

States, as it had the largest gold reserves of any nation (80% of the world's reserves), in effect giving it the strongest currency.

The system collapsed in 1971 when President Richard Nixon "closed the gold window" by making the dollar inconvertible directly into gold. The decision to do this was apparently made without consulting members of the international monetary system or even his own state department. This was soon referred to as the "Nixon shock." The strain on our gold reserves had become too great, considering the decline in U. S. oil production, the emerging strength of the European and Japanese economies, and our spiraling national debt brought on by the Vietnam War.

The U. S. was the world's leading producer of oil until 1971, its peak production year. After 1971 oil production leadership shifted to the Persian Gulf. In 1975 the U. S. dollar was given a huge boost when, first the Saudis, and the all of OPEC, agreed to export their oil for U. S. dollars exclusively-thus the term "petrodollar." A petrodollar is a U. S. dollar earned by a foreign nation from the sale of its own oil. This created an external artificial demand for the dollar. It meant that if Japan, for example, wanted to buy OPEC oil it had to pay with U. S. dollars. Oil became the commodity that supported the U. S. dollar. This circumstance of oil for gold has been referred to, by some, as Bretton Woods II. One additional advantage of this system is that the U. S. doesn't have to

maintain a reserve in other or foreign currencies. No other currency buys the commodity that all nations depend on.

The U. S. dollar continues to be the world's reserve currency. Central banks in many countries peg their currency to the dollar - for the sake of exchange rate stability. The dollar is still involved in ninety-percent of all foreign exchange transactions. This makes the dollar sound like the most desired and most important currency in the world, and it is. But it is weakening. Six years ago a Euro cost less than a dollar. Today it is closer to $1.50. The Canadian dollar (or Loonie, as it is called) was around seventy cents. Today it costs close to a dollar. So, while the dollar is still the standard for the world, it is losing value against foreign currencies. The definition of a weak dollar is one that has fallen in value against foreign currencies. By that definition the dollar is weak. In fact, the dollar has lost over thirty-percent in value against other major currencies since 2002.

Who determines what a dollar is worth? This is partly determined by the policies of the Fed and other central banks, and is also a reflection of foreign confidence in our economy. But foreign exchange traders (called FX traders) set the day-to-day price of the dollar and other currencies by buying and selling them. The FX trader group consists of major banks, multinational corporations, and wealthy individuals throughout the world. FX traders exchange about $3.2 trillion every day. This is close to ten times the combined trading value of all the stock

markets in the world. This trading goes on twenty-four hours a day, seven days a week.

What caused the dollar to become weak? The basic causes are considered to be our large trade deficits, our large budget deficits, and the Federal Reserve's low-interest rate policy. During every year since 1975 the U. S. has spent more on imports than it has received from exports. Our trade deficit is currently averaging almost $60 billion per month or $700 billion per year. Last year our budget deficit was $162 billion and our national debt was $9 trillion. More than $2 trillion of that was owed to foreign investors.

These aren't easy problems to correct. The weak dollar has actually helped our trade deficit from being even worse than it is. Low interest rates have helped boost our economy and kept the mortgage crisis from becoming a catastrophe. Although critics of the Fed's low interest rate policies say these low rates have brought us to another potential inflation crisis, and the low rates contributed to the credit crisis in the first place. It is one giant balancing, or juggling act.

The Federal Reserve Bank recently announced that it would nearly quadruple the dollars it provides to foreign central banks. This temporary measure was done to help these central banks provide funds to their customer banks, which have become reluctant to loan to each other, in order to keep funds flowing to their business borrowers. A few days later the Fed Chairman and Treasury Secretary

addressed Congress, asking for a $700 billion package to shore up the entire U.S. financial system.

Mark Farrington, head of currency at Principal Global Investors in London said the government "is now obligated to print as much money as necessary to meet their obligations, and we know they're going to be quite large. The equivalent of a share price for the U.S. government is the U.S. dollar, so you need to re-price the American share price." The clear implication is that the dollar will become worth less in relation to other currencies as a result of these actions.

The dollar did not drop substantially in value upon the announcement of the planned bailout primarily because the U.S. Treasury debt is still considered the world's safest investment and funds move to safety in times of uncertainty.

What is good about the weak dollar? Actually, several things:

A weak dollar makes the cost of the U. S. manufactured goods less expensive, and imports more expensive, allowing our manufacturing companies to be more competitive. Contrary to popular belief, we still produce lots of goods for export. Think of companies like Boeing and Caterpillar. In recent months net exports have been the only source of economic growth in the U. S.

As mentioned, by improving our sales, it improves our trade deficit. We have a huge trade deficit. Imagine how big it could be with a strong dollar.

These sales also stimulate employment and production. Our workers buy goods, and, in turn, help stimulate our economy.

A weak dollar attracts tourists. High-end hotels and stores are benefiting and have found sales to foreigners up some fifteen percent in the first few months of this year.

More foreign students can afford to attend our universities, not only increasing enrollment, but helping our cultural exchange.

Our real estate market is currently suffering. A weak dollar attracts foreign investment in capital markets and real estate.

What is bad about the weak dollar? Lots.

From a personal point of view, foreign travel is far more expensive. Even foreign goods, like French wine, cost more.

Oil costs, which for us translates into gasoline costs, increase. Economists estimate forty percent of our increased gasoline costs is directly attributable to the weak dollar.

A weak currency is considered a direct cause of inflation. Holding interest rates low to bolster a weak dollar, and a weak economy, can drive up prices, creating inflation. After the Fed dropped rates to protect the dollar, and ease the mortgage crisis, inflation reached a seventeen-year high of five point six percent this July.

Another effect of these low interest rates is to lower the rate of return for investors, making it difficult to achieve a rate of return sufficient to protect individual retirement funds without taking undue risks.

A weak dollar makes American companies vulnerable to foreign company takeovers – ultimately further weakening our manufacturing base.

A weak dollar has encouraged the purchase of U. S. real estate by foreigners. For example, the Chrysler building in New York City was recently purchased by the Abu Dhabi Investment Council, the investment arm of that government. This was also listed as a good effect of the weak dollar. The question is: do we care that landmark buildings in our major cities are owned by foreign governments?

The reduced spending power caused by the weak dollar amounts to a cut in income for the average American. Workers may be receiving increases in their wages, but those increases aren't keeping up with the lost value of the weak dollar. Another way to say this: It lowers our standard of living.

A weak dollar is historically not good for the stock market. Since 1967 the dollar has had four up cycles and five down cycles. The average return for the S & P 500 has been dramatically higher during the up cycles.

What is ugly about the weak dollar?

As the dollar weakens demand for United States bonds weakens, ultimately raising rates and costing us more to finance our deficits. In addition, by paying back our debt with dollars which are worth less we are damaging our credit. Some economists have suggested that by permitting our dollar to weaken, and repaying with cheaper and cheaper dollars, we are "quietly repudiating our debt." We are becoming a "deadbeat" nation. And, as I learned in my years of banking, you don't loan money to deadbeats. With almost one-half our current deficits being financed by foreign governments this would not be a good time to have our credit reputation questioned. According to the December 2007 issue of the Economist: "The dollar's decline already amounts to the biggest default in history, having already wiped far more off the value of foreigners' assets than any emerging market has ever done."

A weak dollar encourages both American and international investors to invest in non-U.S. markets.

The decline in the dollar value has created a transfer of trillions of dollars of wealth from the United States to the rest of the world. This isn't good for all concerned. It is good for those foreigners whose assets have increased in value and bad for the citizens of the United States whose asset values have substantially declined in value.

The continued depreciation of the dollar, and the corresponding decline in the value of assets, could reduce spending and curtail demand. This could be aggravated by a liquidity crisis as lending institutions turn cautious, ultimately leading to a recession.

The health of the dollar is seen, by the world, as a reflection of the health of our country. A weak dollar cheapens our image and lessens our world standing.

For over four decades the U. S. dollar has been the premier medium of exchange for the world. No other currency has come close to challenging it. That is, until recently, when the EURO became the official currency of the European Union. Thirteen countries comprise what is known as the Eurozone, a region where the EURO serves as the national currency for all the separate nations. The EURO

became official in 1999, but didn't become fully implemented until 2002. Since that time it has gained considerable strength against the dollar.

The Eurozone represents over three-hundred-twenty-million people with a gross domestic product slightly greater than that of the United States. When you include the European countries that peg their currency to the EURO you have about five-hundred million people and a currency with a present total value of over eight-hundred billion dollars vs. the some six-hundred billion U.S. dollars in circulation.

There has been talk recently of the OPEC countries selling their oil for a variety of currencies instead of only for dollars, or, perhaps, switching from the dollar to the EURO, since that currency has been stronger and more stable in recent years. But this would not be a quick and easy transition. There are estimates that the process of making the full transition could take as long as eight years, and the process has not yet started. Also, the EURO is still relatively new and untested, while the dollar does have a long history. It would be very difficult to estimate the result of such a move, but it would certainly not be a good one for the dollar, and continued weakness will surely prompt more speculation about such a change.

Finally, economist Carl Delfeld points out that: "Economic history indicates that no country has ever achieved greatness, nor maintained it, by debasing its (own) currency."

BIBLIOGRAPHY

Aversa, Jeannine**.** *Greenspan Wants Bailout Guidelines.* Journal Gazette: 9-5-08

Coe, Sophie D. and Michael D. Coe. *The True History of Chocolate.* London: Thames & Hudson, Ltd.: 1996.

Hetzel, *The Monetary Policy of the Federal Reserve.* Cambridge University Press: 2008.

Hill, Adriene. *U.S. Multinationals Get Boost From Weak Dollar.* NPR: 8-5-08.

Hosli, Madeline O. *The Euro: A Concise Introduction to European Monetary Integration.* Boulder, Colo. Rienner Publishers: 2005.

Hurt, Harry. *Dollar Doldrums.* Readers Digest: 9-2-08.

Huslin, Anita. *Foreigners, U.S. Hotels Cash in on Weak Dollar.* Journal Gazette: 6-29-08.

Mann, Bill. *A Weak Dollar is Bad? Guess Again.* Boston Globe: 1-28-08.

Nathan, J. Citino. *From Arab Nationalism to OPEC: Eisenhower, King Saud, and Making the U.S. – Saudi Relations.* Bloomington, IN. Indiana University Press: 2002.

O'Driscoll, Gerald P., Jr. *Washington is Quietly Repudiating its Debts.* Wall Street Journal: 8-22-08.

Penner, Ethan. *How Low Interest Rates Contributed to the Credit Crisis.* Wall Street Journal: 8-15-08.

Phillips, Kevin. *Bad Money.* New York, New York: Penguin Press: 2008

Reddy, Sadeep and Slater, Joanna. *Bernanke Bolsters Weak Dollar.* Wall Street Journal: 6-4-08.

Rosenbush, Steve. *The Pros and Cons of a Weak Dollar.* Business Week: 11-12-04

Rugaber, Christopher. *Fed Tries to Help Foreign Banks.* Journal Gazette: 9-19-08

Salisbury, Ian. *Global Players Must Watch the Dollar.* Wall Street Journal: 9-4-08.

Setser, Brad. *The Perils of a Weak Dollar.* Boston Globe: 2-16-08.

Slater, Joanna. *Cost of Bailout to Pressure Dollar,* Wall Street Journal: 9-22-08

Tran, Mark. *Why is the U.S. Dollar Weak?* http://www.guardian.co.uk.

Wessel, David. *Greenspan Sees Bottom in Housing, Criticizes Bailout.* Wall Street Journal: 8-14-08.

Zelizer, Vivian A. *The Social Meaning of Money.* New York: Basic Books, 1994.