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Dollar Dilemma

November 16, 2009

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The dollar's recent weakness has prompted yet another bout of concern that it will lose its position as the world's reserve currency. Though surely such a radical outcome is distant, there are, nonetheless, reasons to worry over the dollar's longer-term value. Both the flood of liquidity poured into markets by the Federal Reserve and the huge federal budget deficits speak to deteriorating national finances and strong, possibly inflationary pressure, both of which would tend to depress the dollar. Of course, currency is always a relative game, and since many other countries also face similar and equally severe problems, the dollar may not suffer as much as some think. Even so, circumstances surrounding the greenback are precarious enough to consider currency diversification in any investment strategy.

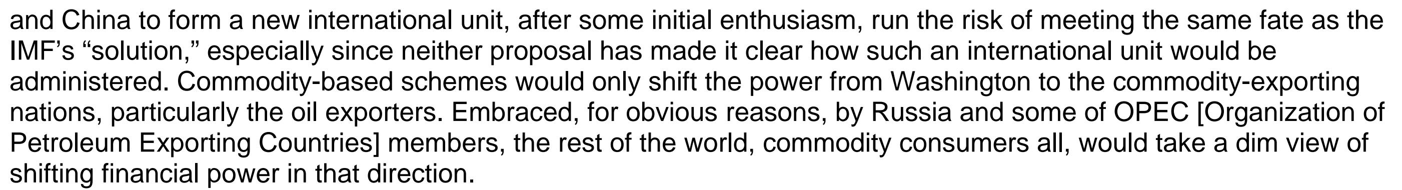
The greenback's recent slide is only partly a result of these fundamentals. Mostly, it reflects a straightforward adjustment to the improving financial environment. The dollar had risen late in 2008 and early in 2009 largely because the financial crisis drove so many into U.S. Treasury securities. Now that the worst financial fears have begun to dissipate, this process has worked in reverse, and the dollar, accordingly, has taken a round-trip against the yen, the euro, and most other currencies. But if in this immediate adjustment, the greenback is not likely to fall much beyond its old lows, dangers widen over the longer-term horizon, especially if Washington is unable to adjust its monetary and fiscal policies.

On the monetary front, the Federal Reserve needs to remove the excess liquidity it has put into the system during the past year to relieve the strains of the financial crisis. Fed chairman Ben Bernanke has acknowledged this need. Indeed, there already are preliminary signs of progress. Fed programs such as the Term Asset Lending Facility (TALF) have begun to shrink with the healing in financial markets. But, ultimately, once the recovery gains momentum, the policy correction will require a rise in short-term interest rates. In all probability, the Fed will wait until the employment situation begins to improve, probably later in 2010. Moving in that time frame should be sufficient to forestall the inflation and contain any drop in the dollar. Without such action, however, fears associated with such an excess of dollar liquidity will put significant downward pressure on the greenback's foreign exchange value, especially if, at the same time, other central banks behave in a more responsible way.

As far as the federal budget is concerned, there is no way in the short run for the White House to turn around the huge deficits that so threaten the economy and the dollar's stability. Policymakers can, nonetheless, relieve the strain on exchange markets by outlining a credible long-term plan for a more prudent fiscal policy. That would help stabilize the dollar. Without it, the dollar will come under renewed pressure.

If Washington can make the monetary and fiscal adjustments outlined here, the dollar should stabilize, and, subsequently, recent talks of replacing it as the world's reserve currency will dissipate. If not, the dollar will lose foreign exchange value, especially against the currencies of the world's fast-growing emerging economies. Talk about replacing the dollar will continue, but even in a worst-case outcome, action in this regard will take a very long time.

The problem the world has with replacing the dollar is the absence of a viable alternative. Europe depends too heavily on exports to withstand the rise in the euro's value that would certainly attend its elevation to reserve currency status. Neither do purpose-built international currencies offer much promise. For years, the International Monetary Fund (IMF) has, for example, offered what are called Special Drawing Rights[1] to central banks, and from time to time those units have attracted attention as a substitute for the dollar. But the idea has never gained momentum, perhaps because market participants are no happier about shifting the central position to the IMF as they are about leaving it in the dollar. Thus, in the 1970s, the dollar fell a precipitous 50%-plus against Japan's yen and Germany's deutschemark—yet still held its place as the world's reserve currency. More recently, proposals by the United Nations



and China to form a new international unit, after some initial enthusiasm, run the risk of meeting the same fate as the IMF's "solution," especially since neither proposal has made it clear how such an international unit would be administered. Commodity-based schemes would only shift the power from Washington to the commodity-exporting nations, particularly the oil exporters. Embraced, for obvious reasons, by Russia and some of OPEC [Organization of Petroleum Exporting Countries] members, the rest of the world, commodity consumers all, would take a dim view of shifting financial power in that direction.

Some day, certainly, the dollar may lose its special role, but not just because of the potential for a downward adjustment now. Still, even if it retains its place, it can lose significant value, as before, leaving investors with every reason to consider protecting their portfolios with adequate international diversification.

[1]The Special Drawing Right (SDR) is an international reserve asset created by the IMF in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies—the U.S. dollar, the yen, the euro, and pound sterling—and SDRs can be exchanged for freely usable currencies. Source: International Monetary Fund.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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