February 24, 2005

OP-ED COLUMNIST

Honey, I Shrunk the Dollar

By THOMAS L. FRIEDMAN

I have just one question about President Bush's trip to Europe: Did he and Laura go shopping?

If they did, I would love to have been a fly on the wall when Laura must have said to George: "George, do you remember how much these Belgian chocolates cost when we were here four years ago? This box of mints was $10. Now it's $15? What happened to the dollar, George? Why is the euro worth so much more now, honey? Didn't Rummy say Europe was old? If we didn't have Air Force One, we never could have afforded this trip on your salary!"

The dollar is falling! The dollar is falling! But the Bush team has basically told the world that unless the markets make the falling dollar into a full-blown New York Stock Exchange crisis and trade war, it is not going to raise taxes, cut spending or reduce oil consumption in ways that could really shrink our budget and trade deficits and reverse the dollar's slide.

This administration is content to let the dollar fall and bet that the global markets will glide the greenback lower in an "orderly" manner.

Right. Ever talk to someone who trades currencies? "Orderly" is not always in the playbook. I make no predictions, but this could start to get very "disorderly." As a former Clinton Commerce Department official, David Rothkopf, notes, despite all the talk about Social Security, many Americans are not really depending on it alone for their retirement. What many Americans are counting on is having their homes retain and increase their value. And what's been fueling the home-building boom and bubble has been low interest rates for a long time. If you see a continuing slide of the dollar - some analysts believe it needs to fall another 20 percent before it stabilizes - you could see a substantial, and painful, rise in interest rates.

"Given the number of people who have refinanced their homes with floating-rate mortgages, the falling dollar is a kind of sword of Damocles, getting closer and closer to their heads," Mr. Rothkopf said. "And with any kind of sudden market disruption - caused by anything from a terror attack to signs that a big country has gotten queasy about buying dollars - the bubble could burst in a very unpleasant way."

Why is that sword getting closer? Because global markets are realizing that we have two major vulnerabilities that this administration doesn't want to address: We are importing too much oil, so the dollar's strength is being sapped as oil prices continue to rise. And we are importing too much capital, because we are saving too little and spending too much, as both a society and a government.

"When people ask what we are doing about these twin vulnerabilities, they have a hard time coming up with an answer," noted Robert Hormats, the vice chairman of Goldman Sachs International. "There is no energy policy and no real effort to reduce our voracious demand of foreign capital. The U.S. pulled in 80 percent of total world savings last year [largely to finance our consumption]." That's a big reason why some "43 percent of all U.S. Treasury bills, notes and bonds are now held by foreigners," Mr. Hormats said.
And the foreign holders of all those bonds are listening to our debate. They are listening to a country that is refusing to raise taxes, and an administration talking about borrowing an additional $2 trillion so Americans can invest some of their Social Security money in stocks. If that happened, it would almost certainly weaken the dollar, further depreciating the U.S. Treasury bonds held by all those foreigners.

On Monday, the Bank of Korea said it planned to diversify more of its reserves into nondollar assets, after years of holding too many low-yielding and depreciating U.S. government securities. The fear that this could become a trend sparked a major sell-off in U.S. equity markets on Tuesday. To calm the markets, the Koreans said the next day that they had no intention of selling their dollars.

Oh, good. Now I'm relieved.

"These countries don't have to dump dollars - they just have to reduce their purchases of them for the dollar to be severely affected," Mr. Hormats noted. "Korea is the fourth-largest holder of dollar reserves. ... You don't want others to see them diversifying and say, 'We'd better do that, too, so that we're not the last ones out.' Remember, the October 1987 stock market crash began with a currency crisis."

When a country lives on borrowed time, borrowed money and borrowed energy, it is just begging the markets to discipline it in their own way at their own time. As I said, usually the markets do it in an orderly way - except when they don't.