Testimony

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"Implications of a Weaker Dollar for Oil Prices and the U.S. Economy"
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Implications of a Weaker Dollar for Oil Prices and the U.S. Economy

Chairman Frank, Ranking Member Bachus and members of the Committee, thank you for the opportunity to discuss the implications of a weaker dollar for oil prices and the domestic economy.

A weaker U.S. dollar[1] helps to spike oil prices and otherwise generally fuels domestic inflation, reducing the purchasing power of consumers' paychecks and the real value of their assets. The underlying factors that have led to recent turmoil in the currency markets remain in play. While significant further weakness in the dollar would place additional upside pressure on oil prices and domestic inflation, it also could encourage oil producers to denominate oil prices in a currency or currencies other than the U.S. dollar. Such would exacerbate U.S. inflationary pressures. Separately, further weakness in the dollar could threaten domestic financial-market liquidity, complicating the systemic challenges already being addressed by the Federal Reserve.

On the plus side for the economy, a weaker dollar tends to help narrow the trade deficit. Yet, the positive effects are seen primarily in commodity-like goods. Where quality and features are important to the goods and services traded, the impact is quite muted.

From the standpoint of consumer inflation, a number of factors influence prices, including the value of the dollar. A weaker dollar means that those living with dollar-denominated incomes and assets are losing purchasing power and real value against the non-dollar denominated world. Over the long-term, that lost global purchasing power tends to be reflected in domestic inflation and a parallel loss in domestic purchasing power. For example, since March 1985, the dollar has lost 50% of its purchasing power against the major Western currencies, while the dollar has lost 51% of its domestic purchasing power to inflation.

An historically high negative correlation between movements in the dollar and oil prices suggests that dollar weakness adds upside pressure to oil prices. With oil denominated in dollars, dollar weakness provides an effective discount to non-dollar-based economies, due to the relative strength of the local currency. While dollar oil prices had nearly doubled for the year ended June 30th, oil prices were up only 70% in terms of the yen and euro.

In response, market forces tend to balance the effective discounts with upside pressure on oil prices in dollars. Additionally, it is in the direct interest of oil producers to see upside pressure on dollar oil prices as an offset to global purchasing power being lost in weakening dollar-denominated revenues.

[1] All dollar references are to the U.S. dollar unless otherwise specified.

As to the domestic financial markets, where the U.S. trade deficit has pumped excess dollars into the global markets, a significant dollar overhang has developed, particularly with foreign central banks. The investment of these holdings in the United States has kept the domestic credit and equity markets relatively flush with liquidity. Perennial weakness in the U.S. currency, however, discourages such investment, and intensified dollar selling is a risk in the months ahead. Such selling could trigger dumping of the dollar and dollar-denominated assets. The same could result from efforts to mitigate the impact of higher oil prices with an offsetting decline in the dollar. Unless otherwise compensated for by the Federal Reserve, such action would drain liquidity from and correspondingly roil the U.S. financial markets.

The relative value of a nation's currency is a measure not only of its trade position, but also of global capital flows that mirror how the rest of the world views that nation's economic strength, financial-system integrity and political stability. While the U.S. dollar's exchange-rate value has experienced high volatility over time, it generally has trended sharply lower during the last four decades, having hit historic lows in recent months against key currencies such as the Japanese yen and Swiss franc.

The current circumstance results from extended periods of deliberate debasement or neglect of the U.S. currency by various administrations and Federal Reserve chairmen. Contrary to popular conventional wisdom, the dollar does matter, and so does the budget deficit. The dollar issues are coming to a head. The deficit issues are related but still are smoldering in the background.

Underlying fundamentals that drive the relative value of the U.S. dollar, against the currencies of its major trading partners, could not be much more negative. The key factors, or surrogates for global market concerns, include the relative U.S. conditions on trade balance, economic activity, inflation, fiscal discipline, interest rates and political/systemic stability. Only interest rates and related monetary policies are quickly addressable at present. Changes there could run counter to the Federal Reserve's needs in its current efforts to promote systemic financial stability, and could be somewhat counterproductive in what I contend currently is a recessionary environment.

Neglecting U.S. dollar weakness, or providing nothing more than unsupported jawboning of a "strong dollar" policy, begets further selling pressure on the dollar, promising further upside pressure on oil prices, further depreciation of U.S. consumers' purchasing power, and increased risk of a torrent of dollar dumping and resulting turmoil in the U.S. financial markets.

Thank you.

Expanded Detail

Dollar Weakness Feeds Inflation

As of June 2008, the dollar had lost 50% of its value since March 1985, against the major Western currencies.[2] In the same period, the dollar lost 51% of its domestic purchasing power due to inflation.[3] A

[2] The Federal Reserve's Major Currencies Trade-Weighted Dollar Index hit a near-term monthly-average peak in March 1985 of 143.91, versus 71.42 in June 2008.

[3] Bureau of Labor Statistics' CPI-U (not seasonally adjusted) stood at 106.4 in March 1985, 218.8 in June 2008.

decline in the exchange-rate value of the U.S. dollar directly reflects a loss of global purchasing power for those receiving their income or holding their assets denominated in dollars.

Prices of imported products (including oil) tend to rise, adding to domestic inflation pressures. The reasons for rising dollar oil prices resulting from dollar weakness are discussed below. While a variety of factors impact the popularly followed U.S. consumer inflation numbers, over time, the loss of global purchasing power due to a weak domestic currency eventually tends to manifest itself in a parallel loss of domestic purchasing power.

Oil Prices Impacted by the Dollar

Oil prices are driven by a variety of supply and demand issues, including significant cartel-controlled production. With global oil priced in terms of dollars, significant changes in the value of the dollar also have flow-through impact on the price of oil.

Consider, for example, conditions as they stood at June 30, 2008, with the price of oil at $140.00 per barrel, up by 98% from the year before. The dollar, however, had declined in value over the same period by 14% versus both the euro and the Japanese yen, with the effect of the price of oil being up by just 70% in terms of both the euro and the yen.[4] Market forces tend to balance the differential with some further upside pressure on dollar-denominated oil prices.

Separately, from the standpoint of oil producers, who find that their dollar-denominated revenues are losing their purchasing power, higher dollar-denominated oil prices are a desired offset.

The current oil price problem in many ways is a dollar problem -- tied to the weakness of the U.S. currency. Over the last 10 years, there has been a negative correlation of 83% between monthly average dollar value and oil prices, meaning that oil prices have tended to move in the opposite direction of the dollar (i.e., a weak dollar means strong oil prices).[5]

Having oil priced in U.S. dollars is a positive for the greenback, as such increases demand for holdings of the U.S. currency. At some point, however, continued dollar depreciation might force oil producers to abandon oil pricing based in dollars. The broad effect of that would be intensified dollar selling pressures and an inflation spike in the United States, with the energy-inflation impact much mitigated in the non-dollar world.

High Oil Prices Risk Triggering Dollar Dumping

High oil prices raise the potential of some foreign holders of U.S. dollars selling the greenback in order to lower their effective petroleum costs.

Overhanging the markets for a number of years has been the question as to when the major holders of excess U.S. dollars in the global financial system might look to liquidate those holdings. An opportunity for that dumping is at hand. Most central banks recognize that their unwanted dollar hoards likely are going to generate long-term losses, but the strong oil market has opened up an opportunity to mitigate

[4] Respective June 30, 2008 and 2007 values: West Texas Intermediate spot $140.00 per barrel and $70.69 per barrel (Wall Street Journal); euro = $1.5748 and $1.3520 and dollar = ¥106.17 and ¥123.39 (Federal Reserve Board).
[5] The Federal Reserve's Major Currencies Trade-Weighted Dollar Index versus West Texas Intermediate spot prices.

some of those losses. For the rest of the world, dollar dumping now could reduce inflation risks outside the United States.

With oil prices off their recent peak -- shy of $150 per barrel -- but still well over $100 per barrel, serious inflation consequences are in store for those economies that have been propping the greenback against their own domestic currencies, either by not selling unwanted dollar holdings or by intervening in the markets to maintain the dollar's relative market value. From a perspective outside the United States, an offset to oil-price-based inflation risk is available in dollar depreciation, which reduces the cost of oil in the currency of the oil-purchasing country. The effects of a declining dollar, however, still do tend to boost dollar-based oil prices further, but not fully, in something of a self-feeding cycle, as discussed earlier.

Weak-Dollar Risks for U.S. Financial Markets

The value of the U.S. dollar should be of significant concern to the Administration and to the Federal Reserve for reasons beyond the implications for inflation. If selling of the greenback intensifies sharply, the effects on the domestic financial system and markets could be severely negative. The influx of foreign capital enjoyed by the U.S. markets in recent years has kept the domestic markets flush with liquidity, funding roughly 80% of Treasury debt issuance as well as a significant portion of new corporate capital needs.

A reversal of those flows would drain liquidity from the system. Such would have the potential of crashing the various U.S. markets, if the Fed did not move otherwise to re-liquefy the system. The Fed and the U.S. Treasury have to have a serious interest in major holders of the U.S. dollar continuing to hold their dollars and dollar-denominated assets. Continued weakness in the dollar and a further spike in oil prices, again, run the risk of triggering a general exit from the dollar and dollar-denominated assets, spiking U.S. interest rates and potentially savaging the U.S. financial markets.

Dollar Fundamentals

In terms of underlying fundamentals that drive, or act as surrogates for concerns that drive relative currency values, the U.S. dollar's portfolio could not be much worse. Against major trading partners, consider the United States' relative positions:

- Trade Balance (Negative): Despite recently reported narrowing of the monthly trade deficit, the U.S. trade shortfall remains unprecedented in its relative global magnitude.
- Economic Activity (Negative): U.S. business conditions are deteriorating, with the economy clearly in a recession in all but formal declaration of same.
- Inflation (Negative): U.S. inflation has risen sharply, with the CPI-U up 5.0% year-to-year as of June; broad money growth is highest since 1971; double-digit inflation is possible by early 2009.
- Fiscal Discipline (Negative): The already expanding U.S. federal budget deficit likely will be worse than expected, thanks to the developing recession.
- Interest Rates (Negative): U.S. interest rates are low, with Federal Reserve policy perceived to be on hold per current market expectations.
- Political/Systemic Stability (Negative): The President's approval rating (currently low) is a fair indicator of currency trends; the banking crisis is a negative.

Options for Strengthening the Dollar

Jawboning and central bank intervention (covert or overt) in support of the dollar have been seen irregularly, but neither action has lasting impact. Of the above fundamentals, only interest rates and monetary policy effects on inflation could be addressed quickly. Yet, raising interest rates or constricting money growth might be counterproductive to the Federal Reserve's efforts in stabilizing the financial system and somewhat counterproductive in the current recession.

Changes in the trade, economic and fiscal factors would require major policy shifts that generally would be long-term in nature before broad impact would be seen. The issues of political and systemic stability tend to flow from the other factors.

Neglecting U.S. dollar weakness, or providing nothing more than unsupported jawboning of a "strong dollar" policy, begets further selling pressure on the greenback, promising further depreciation of U.S. consumers' purchasing power, and offering increased risk of a torrent of dollar dumping and resulting turmoil in the U.S. financial markets.

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