Opinion **Larry Summers' blog**

Why Treasury secretaries should stick with the strong dollar mantra

LAWRENCE SUMMERS

Lawrence Summers JANUARY 25, 2018

Yesterday in Davos, Secretary Steven Mnuchin left the impression that he might be reversing 25 years of US Treasury strong dollar policy by asserting that, "obviously a weaker dollar is good for us as it relates to trade and opportunities".

The dollar then had its biggest one-day decline in nearly a year and bond yields rose.

Commerce secretary Wilbur Ross later joined the fray claiming that the US strong dollar policy was unchanged but this did not affect markets. What is wrong with this picture?

Style first. Previous Treasury secretaries have had little to say about the dollar. What they have said has been carefully scripted and orientated to long-term soundness. They have insisted on being their administration's sole spokesperson on foreign exchange issue.

Secretary Mnuchin spoke without a script, began with near-term commercial considerations, and was apparently contradicted by the commerce secretary. None of this can be reassuring to those looking to judge the competence and credibility of Donald Trump's administration. This all may matter very little in the short run. But credibility is a crucial asset for any Treasury secretary given that financial panics or crises can come suddenly and the secretary's words can come to be needed for reassurance.

If such a moment comes, a secretary will regret previous false claims, highly political forecasts or unsound financial assertions. Beyond style there are good economic reasons why the past seven Treasury secretaries stayed with the strong dollar mantra.

First, the level of the dollar determines America's terms of trade. Yes, a weaker dollar means cheaper US exports. But it also means higher-priced imports and, therefore, less purchasing power for American incomes. It is much better to strengthen our fundamentals than to make ourselves poorer by putting our goods on sale as we push our currency down.

That is why during my time at the Treasury, I frequently remarked that "no nation can devalue its way to prosperity".

Second, a weakening dollar is likely to mean higher US interest rates. If the dollar is weaker, the US is exporting more. If US prices are higher because of higher import prices, there is more pressure on the Federal Reserve to raise interest rates, especially with unemployment in the 4 per cent range.

Moreover, if global investors expect the dollar to fall in value, they will demand a higher interest return to induce them to hold dollar assets. Higher rates mean less investment, lower stock prices and more risk of financial instability.

Third, when policymakers appear like they might be endorsing a falling dollar after a period of sharp dollar decline, which we have seen, there is some risk of avalanche effects. If a falling dollar means weaker asset prices and weaker asset prices lead to the selling of dollar assets a vicious cycle can result. There is also the possibility of a currency war if other countries seek to weaken their currencies to remain competitive.

It is widely believed that sparring between the United States and Germany over currency values was a significant contributing factor to the 1987 stock market crash.

What should secretary Mnuchin do now, having made a very problematic statement? I know from painful experience that when one says too much about markets there is the risk of making a bad situation worse by seeking to clarify and explain.

But in his shoes, at my next public appearance, I would say something like: “An economic truism about trade is not a policy pronouncement. I believe, like my predecessors, that a strong dollar is in the national interest. That is all I have to say on the subject.”

Copyright The Financial Times Limited 2018. All rights reserved.

Show comments

Read next

fastFT US Dollar

Treasury yields, dollar rally on rising US wage growth

10-year yield hits highest level since January 2014

America's benchmark government bond yield rallied to its highest level since early 2014 on Friday, while the dollar rose, after the latest jobs data pointed to an acceleration in wage growth.

The 10-year yield jumped as high as 2.843 per cent after the report, from 2.79 per cent before the release at 8:30am in Washington (1:30pm GMT). Bond yields move in the opposite direction of prices.

Read more