

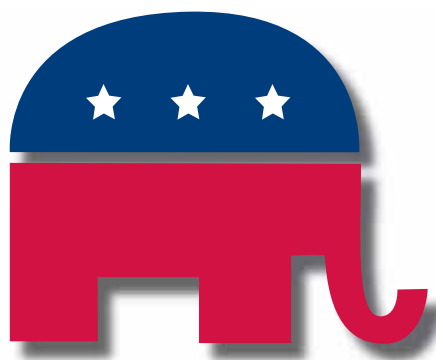
The Next *President*

Former Treasury Secretary Paul O'Neill remarked early in his tenure that he would march a brass band through Yankee Stadium if there was change in support for the "strong dollar" policy. My advice to the next president is to keep the tuba players busy with State dinners and south lawn barbecues and leave in place a policy that's worked well for the past decade. That's not to say it's without imperfection, but to jettison the strong dollar now could trip up the swaying greenback, send gyrating shock waves through fragile global markets, and signal a U.S. retreat from global financial leadership.

Instead of digressing into doomsday dollar scenarios, it's worth backing up a moment and asking a threshold question: just what does the slogan "strong dollar" mean, anyway? Obviously, there's certain degree of designed ambiguity regarding its meaning, and woe to those who dare to offer even a glimpse of explanatory thinking behind the sound bite. That said, I regard the strong dollar mantra as a pledge that United States will not use the currency as tool to gain competitive advantage in a beggar-thy-neighbor manner. The dollar is simply a derivative of other factors—a reflection of relative cyclical and structural fundamentals and policy—and not a direct target of policy. The policy is also a pledge to protect the value of Treasury-issued U.S. debt, which is the modern gold standard for all other debt instruments.

The key, therefore, is to pursue sound policies that give rise to a strong currency. First and foremost is to maintain a near-rabid support for an open economy and the free flow of goods, services, and capital. A misguided

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I. A Republican Perspective

BY TIMOTHY D. ADAMS

THE INTERNATIONAL
ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY

888 16th Street, N.W., Suite 740

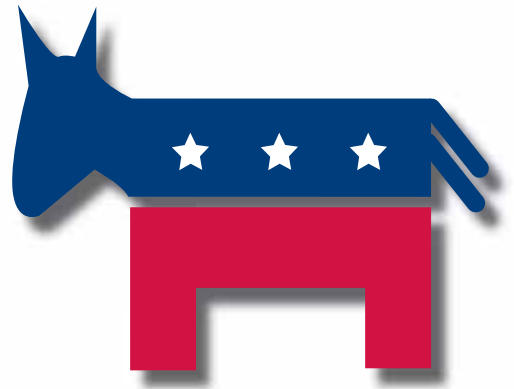
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and the *Dollar*

II. A Democratic View



BY JEFFREY E. GARTEN

We are nearing the point where the decline of the American currency will cause havoc in the international monetary system as other countries search for a substitute for the greenback as a reliable indicator of value. It has been many years since the Federal Reserve faced such agonizing decisions between growth and inflation as it faces today—and those decisions are made vastly more difficult by concerns that lower rates will start a foreign stampede to sell the greenback, necessitating a precipitous raise in rates to keep that from happening. The next president needs to recommit to a strong dollar policy, despite the attractions of letting it slide.

In December 1992, President-elect Bill Clinton held a town-hall type summit meeting in Little Rock, Arkansas,

at which I was asked to talk about the dollar. A week or so before, Treasury Secretary-designate Lloyd Bentsen, a highly regarded former chairman of the Senate Finance Committee, had publicly expressed his preference for a weaker dollar to help America compete with Japan and Germany. I was therefore in an uncomfortable position of deciding whether or not to challenge the triumphant new team in front of the global media. But I swallowed hard and bluntly delivered the following message.

An economically advanced superpower like ours must have a strong currency. It is essential to the maintenance of America's predominant role in the world, reflected in the dollar's use as the world's key currency for

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I. Republican Perspective, *cont.*

lurch to protectionism in an effort to soothe the middle-class angst over globalization may offer a temporary anesthetic to voters, but will prove damaging in the longer term. The same is true of possible responses to the current housing correction, with a large portion of the ever-proliferating set of prescriptions running counter to our greatest strengths, such as sanctity of contracts, cutting-edge innovation, and access to credit and capital.

The next President also needs to focus on sound fiscal policy, keeping tax rates at growth-generating levels while courageously attacking the monster of entitlement spending, which will painfully gobble up ever-larger chunks of the Federal budget. An independent, inflation-focused central bank is also critical, and any effort to install a new, decidedly dovish chairman at the Federal Reserve would undermine the attractiveness of dollar-denominated assets and therefore the dollar itself. Finally, the next President should encourage the productive capacity of the economy, emphasizing capital formation and a world-class system of education.

Of course, this assumes that the next President wants a strong dollar policy. It may prove a close call. Some will argue that continuing the policy will disadvantage the United States because other countries actually engage in what we pledge to avoid, targeting the exchange rates to achieve competitive advantage. These charges are not without merit as in fact some do, and are worthy of our sober engagement. But rather than jettison our values in what will be a fruitless and possibly dangerous game of competitive

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currency manipulation, the better path is to embrace a fair and functioning system of universal rules and ensure that those rules are enforced—objectively, equally, and visibly. Enter the International Monetary Fund, which recognized that business as usual was doomed to failure and, along with G7 leadership,

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and work to ensure a fair, universally accepted, multilateral solution.

In sum, the strong dollar policy, and the implied pledge behind it, has given confidence to both foreign and domestic investors that capital is protected from the policy risk of devaluation. It doesn’t mean that value of the dollar will remain static. The business cycle alone will make for a pulse-quicken ride. But the policy does reflect U.S. leadership and responsible treatment of our currency’s reserve role in the global economy by avoiding the disruptive, destabilizing, and ultimately destructive beggar-thy-neighbor policies witnessed in the last century. Maybe if the next President puts his or her signature on the greenback, the strong dollar pledge won’t soon fall victim to the ironic melody of Gershwin’s “Someone to Watch Over Me” echoing off the bleachers at Yankee stadium. ♦

II. Democratic View, *cont.*

trade, investment, and central bank reserves. A strong dollar is essential to enhancing productivity and forcing us to turn out ever-more-sophisticated products and services. That is preferable to trying to compete with other countries on the basis of price, where our high wages would become a debilitating disadvantage.

On the monetary side, a powerful greenback would also be insurance against inflation, as it would increase imports and foster domestic competition. A strong dollar would give us more flexibility when it came to monetary policy, as we would not have to worry that lowering interest rates would cause foreign investors to panic. Besides, no major country in history became stronger or even maintained its position in the world while its currency steadily lost value. A strong dollar is essential to U.S. purchasing power and to Washington’s ability to maintain its extensive security commitments at home and abroad.

Since the Little Rock summit four presidential terms ago, the United States has experienced large swings in fiscal position from deficits to surpluses and back to deficits; its economy has become more tightly interwoven with the economies of other countries; oil prices have more than tripled; the euro has been created and assumed a major role in international finance; and we have assumed new and costly military burdens in the Middle East and for homeland security that we never had before. But none of these developments have changed my views about the U.S. currency.

In fact, the goal of a strong dollar is even more important now. In an era marked by new threats of terrorism, national power rests less on raw military capability than on economic vibrancy at home and the ability to deploy economic resources abroad. Moreover, the growing competition from the China and the other large emerging markets makes America's moving up the value-added chain the *sine qua non* for a good future for U.S. companies and U.S. workers. A falling dollar already has pushed up the prices of oil and other commodities that are invoiced in dollars at a time when U.S. petroleum imports are growing and the general price level is rising at a disturbing rate. And, as noted, the Fed's aggressive lowering of interest rates may have to be reversed to prevent a stampede out of the dollar.

True, the difficulties of reversing the dollar's downward trajectory should not be underestimated. The greenback is down over the last six years by more than 20 percent against a basket of six leading currencies and likely to head south for a while longer. The global financial markets have been growing at a phenomenal pace—the volume of currency trading alone is estimated to be over \$3 trillion per day, double that of two years ago—with complex instruments that are beyond human comprehension. But none of this obviates the need for a Herculean effort to revive a strong dollar, through creation of conditions necessary for markets to regain their faith.

The next President should understand that the dollar is not something to be left only to monetary theorists and economic technicians. He or she must take a direct interest in its future. The new leader must also realize that the notion that the value of currencies is set in a truly free market is a fiction, since governments can and do manipulate the value of currencies with interest rate policies and their own printing presses. Pretending otherwise means abdicating responsibility for the nation's security and welfare.

I would advise the next President to be ready on Inauguration Day with a medium-range goal that before the end of the first term, the United States would have gradually reasserted its global leadership, both economic and diplomatic. The U.S. aspiration would not be to act like a

Weak Dollar Man

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hegemon, but as *primus inter pares*—a country that recognizes its awesome power, but uses it smartly, consistently, and cooperatively, and marshals the respect and demonstrates the clout to persuade others to join its efforts. Achieving this aim would require a new style of international engagement from what has been pursued of late, and a revitalization of America's ability to be seen as having a strong interest in global rules, institutions, and alliances—as opposed to being seen as just one of the self-interested mercantilist players, as it is today.

Only in that context could a President aspire to reverse the downward path of the dollar. Here then is what he or she should do on that critical front:

First, a big test of the next President's policy toward the dollar is what is said publicly about it.

The mantra that the United States believes in a strong dollar is no longer credible—if that is *all* that is stated. The reality is that the only way to raise the value of the dollar is to strengthen underlying economic policy. A statement that would be accurate and credible given that reality is, “We believe that a strong dollar is in the interests of America and the world. We know that the currency will reflect the strength of underlying economic policies. It is the intention of this administration to establish those policies and our conviction that the dollar will strengthen as the American economy does.”

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Paul O'Neill



John Snow



Henry Paulson

The Next Treasury Secretary

The next President should be sure to have the right people in place. Recent history has shown that the key position of Treasury Secretary must be held by someone who has lived and breathed markets, someone with extensive ties to Wall Street and its counterparts abroad. President Bush tried two industrialists, **Paul O'Neill** and **John Snow**, who, for all their other talents and experiences, should not have headed up the Treasury. His final appointment, **Henry Paulson**, the former Goldman Sachs chief, was the only one who hit the mark.

If Senator **John McCain** (R-AZ) becomes president, he should retain Paulson. If Senator **Barack Obama** (D-IL) or Senator **Hillary Clinton** (D-NY) wins, both too should think about keeping Paulson, remote as this may seem at first blush. No one is more experienced and qualified, and a less experienced banker could take a year or more to learn the ropes.

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Toward the end of a stronger dollar based on a stronger U.S. economy, a host of policy changes will be necessary. The budget deficits must be put on a path that leads ultimately to surpluses. Fiscal prudence as well as fairness demand that the tax code be made more progressive, with an end to the Bush tax cuts for wealthy Americans and the establishment of a greater negative income tax on the lower end. New revenue-generating programs should be established including an escalating gasoline tax at the pump, with rebates for lower-income citizens, and an auction-based cap-and-trade system for carbon emissions. In addition, our entitlements programs must be put on a firmer footing, and radical cutbacks should be instituted in a host of government programs. The incentives to increase saving must be enhanced everywhere possible, since lack of savings is the prime contributor to our current account deficits.

Second, the current anti-trade attitudes prevalent in both political parties and the public at large need to be turned around. So, too, the political complaints that are

arising over direct investment in the United States by sovereign wealth funds. Both trade and foreign direct investment are critical to the U.S. economy, and Washington must also set the example for other countries in terms of support for an open world economy. Much of the negativity about global engagement on the part of Americans comes from well-founded insecurity about wages, health benefits, and retirement. That could be overcome if we had two things: one, better policies to help workers who face economic change, including re-training, portable pensions, guaranteed health insurance, and more extensive wage insurance; and two, integration of these policies into one seamless safety net—not several, each with their own holes and bureaucratic complexities.

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If Senator John McCain (R-AZ) becomes president, he should retain Paulson. If Senator Barack Obama (D-IL) or Senator Hillary Clinton (D-NY) wins, both too should think about keeping Paulson, remote as this may seem at first blush. No one is more experienced and qualified, and a less experienced banker could take a year or more to learn the ropes. Admittedly, Paulson has not been identified with any great achievements during his brief time in office, but he has deep ties to China, and he has drawn important attention to the competitive position of America's financial services industry. He has been handicapped by having joined a failing administration late in the game. For a Democratic President, in particular, Paulson would provide the bipartisanship needed to pass a host of critical legislation, and he would give markets more confidence that some of the Democratic candidates' mistaken populism—such as the pledge to renegotiate NAFTA—will be reined in.

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Another crucial appointment is the Chairman of the Federal Reserve. Ben Bernanke is a distinguished economist, but the returns are not yet in as to whether he will have the mettle to constrain inflation while he focuses on preventing a recession. The next President-elect should immediately know who the alternative to Bernanke would be—whether there is someone who is a tough-minded inflation fighter and who understands the dangers of not confronting asset-based booms before they bust—in the event the current Fed chairman turns out not to have met those needed criteria a year from now.

Finally, the next President and his or her team should be quietly laying plans with key countries for a new global monetary pact. This might not be possible for a few years, and it would depend on America's getting its act together first. It would require truly extensive consultations with

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finance ministries and central banks around the world. Such a pact would map out how massive global economic imbalances can be reduced by complementary domestic policies; how major currencies should be better aligned over the long term, including the valuation and role of the Chinese yuan; and when and how periodic coordinated intervention by key central banks could contribute to greater currency stability. The ultimate goal would be for the United States to show it is not cavalier about the international financial system generally and the dollar in particular, as now seems to be the case, and that it can lead the way towards a world of more stable currencies, backed by lesser global imbalances and a stronger dollar.

This is what I would say to the next President-elect about the dollar. ◆