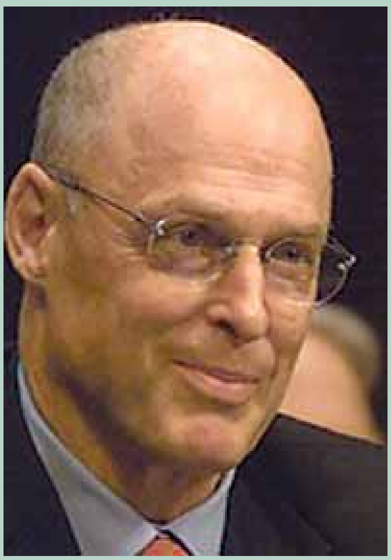
Paulson's *Hypocrisy*

Why U.S. policy should promote the delinking of oil currencies and the dollar.

BY KENNETH ROGOFF



The U.S. Treasury's **Hank Paulson:** *Time to get aboard the IMF train?*

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Does it make sense for U.S. Treasury Secretary Hank Paulson to be touring the Middle East supporting the region's hard dollar exchange-rate pegs, while the Bush administration simultaneously blasts Asian countries for not letting their currencies appreciate faster against the dollar? Unfortunately, this blatant inconsistency stems from the United States' continuing economic and financial vulnerability rather than reflecting any compelling economic logic. Instead of promoting dollar pegs, as Paulson is, the United States should be supporting the International Monetary Fund's behind-the-scenes efforts to promote delinking of oil currencies and the dollar.

Perhaps the Bush administration worries that if oil countries abandoned the dollar standard, today's dollar weakness would turn into a rout. But the United States should be far more worried about promoting faster adjustment of its still-gaping trade deficit, which in many ways lies at the root of the recent subprime mortgage crisis. The administration's

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multi-pronged effort to postpone pain to U.S. consumers, including super-easy monetary and fiscal policy, only risks a greater crisis in the not-too-distant future. It is not at all hard to imagine the whole strategy boomeranging in early 2009, soon after the next U.S. president takes office.

Of course, a strengthening of the oil currencies (including not only the Gulf States, but also other Middle East countries and Russia) would not turn around the U.S. trade balance overnight. But oil countries do account for a large share of the world's trade surpluses, and a weaker dollar would help promote U.S. exports to some degree, even in the short run.

More importantly, it is imperative for U.S. policies to be consistent across regions. How can the U.S. Treasury, on the one hand, periodically flirt with labeling China a "currency manipulator" and, on the other hand, condone a similar strategy in oil-exporting countries?

Of course, one can imagine other reasons for U.S. supplication to the oil states. Perhaps the administration worries that it cannot simultaneously beg for lower dollar oil prices and help promote a weaker dollar. But contrary to popular opinion, the two actually have little to do with each other. Oil prices are set in a world market, and depend mainly on the quantities demanded and supplied by different regions, not the currency of payment. It is not at all clear that the dollar price of oil would evolve any differently if the euro, rather than the dollar, were the reference currency.

Secretary Paulson has emphasized that the United States is "open for business" from sovereign wealth funds. One can hope that his confidence is justified. There is no cause for the United States to place any significant new restrictions on sovereign investments in the United States beyond those that it already has on trade. Besides, the United States needs these investments to help re-capitalize its badly weakened financial system. However, even if we can agree on keeping the United States open to sovereign wealth fund investments, that is no reason for promoting exchange-rate policies that exacerbate the very trade imbalances that are driving the whole sovereign wealth fund phenomenon in the first place.

Then again, perhaps the Bush administration is worried that if the oil currencies strengthen too much against the dollar, it will start becoming too expensive for the United States to scale up its military operations in the Middle East. This, too, is wrong-headed. If a cheaper dollar leads to an invasion of U.S. exports to the Middle East and rising living standards in the region, all parties will be far better served.

What about the interests of the oil countries themselves? Are they right to fear potentially catastrophic results from abandoning the dollar?

As with China, these concerns are overblown. Even with the prevalence of dollar indexation across the region, exchange-rate appreciation would still help promote cheaper imports and higher living standards. Moreover, as public confidence in the de-linked oil currencies increases over time, dollar indexation of private contracts will diminish, and currency movements will have a greater impact on overall prices.

More immediately, inflation across the oil states is soaring today, with CPI inflation in the Middle East averaging more than 6 percent after years of relative stability. If this inflation is allowed to continue and deepen, it is likely to have effects easily as pernicious as the exchange-rate appreciation the region's leaders are striving so hard to avoid.

Perhaps the most important positive effect of exchange-rate appreciation would be to help promote the development of domestically oriented industries such as health care, education, and banking, thereby alleviating some of the region's mass underemployment.

To be sure, there are important differences between the oil exporters and the Asian economies. With world energy prices at record highs, it makes sense for oil economies to run surpluses, thereby saving for when oil supplies eventually peter out. But flexible exchange rates are still the right way for the region to develop a more balanced economic and financial base. As for the United States, it makes little sense to support dollar currency pegs in any large emerging market, at least until its trade balance normalizes. This is no time for oil currency hypocrisy. ◆