

Stop the Music on the Dance of the Dollar  
**Steve Hanke** | November 25, 2010

US Federal Reserve Chairman Ben S. Bernanke continues to claim that the Fed's monetary policies had virtually nothing to do with setting off the panic of 2008, and the financial press and public have bought into the Fed's denials of culpability.

This is par for the course. To understand why the Fed's fantastic claims are rarely subjected to the indignity of empirical verification, we have to look no further than the late Nobel Prize winner Milton Friedman.

In a 1975 book of essays in honor of Friedman, professor Gordon Tullock wrote that "a very large part of the information available on most government issues originates within the government."

He said Friedman "has pointed out that one of the basic reasons for the good press the Federal Reserve Board has had for many years has been that the Federal Reserve Board is the source of 98 percent of all writing on the Federal Reserve Board."

Friedman's assertion has subsequently been supported by professor Larry White's research.

In 2002, he found that 74 percent of the articles on monetary policy published by US economists in US-edited journals appeared in Fed-sponsored publications, or were authored (or co-authored) by Fed staff economists.

Not all economists have been willing to turn a blind eye to the Fed's role in triggering the panic of 2008, however.

Another Nobel Prize winner, Robert Mundell, concluded that, during the second half of 2008, US monetary policy was ultra-tight and that this forced Lehman Brothers and others to go to the wall.

Mundell observes that after July 2008, the dollar soared against the euro while commodity prices collapsed.

According to him, both signaled that the Fed's monetary policy was too tight.

Contrary to the Fed's claims, the dance of the dollar and related movements in commodity prices indicate whether monetary policy is too tight or too loose.

The dance of the dollar counts — and it counts a lot. With few exceptions, when the dollar weakens against the euro, commodity prices soar, and when the dollar soars against the euro, commodity prices plunge.

Every commodity trader knows the importance of the dance of the dollar. Indeed,

commodity traders know that, when the value of the dollar falls, the nominal dollar prices of internationally traded commodities — like gold, rice, corn and oil — must increase because more dollars are required to purchase the same quantity of any commodity.

To examine the linkage between the greenback and commodity prices, a what-if thought experiment known as a counterfactual is well suited.

Counterfactuals are often employed to examine alternatives to actual history: What would have happened if, contrary to fact, some present conditions were changed?

The use of counterfactuals has a rich, if not controversial, history. Perhaps the most famous counterfactual was employed by professor Robert Fogel of the University of Chicago.

In “Railroads and American Economic Growth,” Fogel calculated what the transportation system of the United States in 1890 would have looked like without railroads.

His calculations created a great controversy, but they were robust and helped him win the 1993 Nobel Prize in economics.

Consider a series of counterfactual calculations during the five phases of the dance of the dollar since December 2001.

In Phase I, lasting through July 2008, the dollar was becoming weaker, contributing to a boom in commodity prices.

By computing what the prices of various commodities would have been on July 11, 2008 — if the dollar-euro exchange rate had remained the same as it was in December 2001 — we can determine (on a counterfactual basis) what the exchange-rate (weak dollar) contribution to the total change in various commodity prices was in the period under study.

For example, rough rice prices increased by 358 percent and the weak dollar contributed 57 percent to the price increase of rough rice.

Because the counterfactual price in July 2008 shows an increase from December 2001, we note that real factors (supply and demand fundamentals) also contributed to the price increase in the period under study.

Lean hogs are at the other end of the spectrum. If the dollar-euro exchange rate would have remained at its December 2001 level, the price of lean hogs would have declined from 56 cents per pound to 40 cents per pound during the December 2001 to July 2008 period.

In fact, the price of lean hogs was 71 cents per pound in July 2008.

Accordingly, the exchange-rate contribution to the change in the price of lean hogs in the period under study was 212 percent.

Because the counterfactual price of lean hogs in July 2008 (40 cents per pound) shows a decrease from the original price, we conclude that real factors were working to depress the price of lean hogs.

By embracing inflation targeting — aiming monetary policy to hit an annual inflation rate of zero to two percent — the Fed has ignored the dance of the dollar and related commodity prices.

This resulted in one of the most unstable periods in US monetary history and the panic of 2008. It is time for the Fed to put a halt to the dance of the dollar.

This will require the Fed to dump inflation targeting and to start paying attention to the value of the dollar and commodity prices — like gold.

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