Comment sent to WSJ Forum "The euro decades and its lessons, in Editorial Page"

Dear Sir,

Time and again you keep saying that the Federal Reserve flooded the market with dollars in the 2000´s and that there would lie the most important reason for its depreciation. If I may reprint, in your last editorial article you state the following:

"Like most currencies, the euro declined during the strong-dollar era of the late-1990s, only to soar against the greenback as the U.S. Federal Reserve made its historic mistake of flooding the world with dollars earlier this decade. It declined mid-decade as the Fed belatedly tightened, only to soar again in late 2007 and early 2008 as the Bernanke Fed gunned the money supply once more. After an even briefer decline, the euro has climbed sharply again since Mr. Bernanke cut rates virtually to zero last month and signaled his new policy would be "quantitative easing" -- i.e., printing as much money as it takes to revive the U.S. economy. "

It turns out you are basically wrong. Oh yes, wrong.

Let us go step by step.

Between November 1998 - on the eve of the implementation of the Euro - and November 2008,US monetary aggregates such as the most liquid and meaningful M1 and the lesser one M2 annually grew by 3,35% and 6,2%, respectively, in nominal terms. So much for the flooding dollars image so frequently referred to.

During that same period, real US GDP approximately grew 2,6% annually and prices by a corresponding 2,4% per year. Where is the excess of money here, when a neutral monetary policy would be required to satisfy additional monetary needs that are approximately born out of real growth in activity and that of expected inflation?

If anything, monetary policies were unnecessarily restrictive, particularly during the last three years, before the "quantitative easing" was expressly - and, if I am allowed to say, rightly - adopted by the Federal Reserve as of last September, to unlock financial credit markets that were working under almost surreal conditions. The sole consideration of Federal Reserve interest rate decisions lead and have led to erroneous interpretations. A more complete one would involve looking at the monetary results, and not just at one of the factors that affect them.

In terms of exchange rates considerations, instead of using references to the nominal dollar euro parity evolution, a more meaningful figure would be found in a price adjusted broad dollar index, so as to get to a global net picture for the US dollar undistorted by inflationary phenomena. Here we have an interesting exchange rate evolution, when looking at a 25 year time frame since 1973. The December 2008 real exchange rate is 27% below its 1985 highest peak, 17% below its 2002 second highest peak but only 4% below its 25 year average 1973 - 2008. There is a pattern here that reflects a fall in the relative value of the US against the other economies, which is something that should be expected, given the relative improvement of the other nations´free market policies that started to have meaningful effects during the 1990´s. It makes no sense to try to get to historic highs, given the others´better policy trajectories. Under equilibrium terms, the US$ will depreciate in real terms against the other currencies, particularly those of developing nations, which are just catching up with their economic leading partners. This is what has been behind the stronger world economic growth we have had lately, mirrored in exchange rates, and that will return after this short term financial recess.

In summary, there was no flooding of dollars in the 2000´s and the US$ real currency depreciation responds to relatively more important economic improvements from less developed nations. Mr. Bernanke is doing the right thing, particularly with a much needed quantitative easing that could be undone at short notice when financial markets start working again and the growth machine accelerates. What will not help to the long term value of the US, as reflected in the real exchange rate, is for example a trillion US$ fiscal package with no efficiency conditions attached resembling more like a massive pork barrel project. There there is work to do. Until now, the signaling has been poor.

Best regards,

Manuel Cruzat Valdes
Santiago, Chile
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