December 4, 2006 The financial press reported last week that the value of the U.S. dollar plummeted to a 14-year low against the British pound, and weakened against the Euro and Yen. Many financial analysts predict continued rough times for the dollar in 2007, given reduced expectations for economic growth at home and less enthusiasm among foreign central banks for holding U.S. debt. This decline in the value of the dollar is simple to explain. The dollar loses value as the direct result of the Federal Reserve and U.S. Treasury increasing the money supply. Inflation, as the late Milton Friedman explained, is always a monetary phenomenon. The federal government consistently wants to spend more than it can tax and borrow, so Congress turns to the Fed for help in covering the difference. The result is more dollars, both real and electronic-- which means the value of every existing dollar goes down. Federal Reserve Chairman Ben Bernanke faces two basic ongoing choices: raise interest rates to prop up the dollar, but risk pushing the economy into a recession; or lower interest rates to stimulate the economy, but risk further declines in the dollar. This unfortunate dilemma is inherent with a fiat currency, however. Of course Mr. Bernanke inherited this tightrope act from his predecessor Alan Greenspan. The Federal Reserve did two things to artificially expand the economy during the Greenspan era. First, it relentlessly lowered interest rates whenever growth slowed. Interest rates should be set by the free market, with the availability of savings determining the cost of borrowing money. In a healthy market economy, more savings equals lower interest rates. When savings rates are low, capital dries up and the cost of borrowing increases. However, when the Fed sets interest rates artificially low, the cost of borrowing becomes cheap. Individuals incur greater amounts of debt, while businesses overextend themselves and grow without real gains in productivity. The bubble bursts quickly once the credit dries up and the bills cannot be paid. Second, the Fed steadily increased the monetary supply throughout the 1990s by printing money. Recent Fed numbers show double-digit annual increases in the M2 money supply. These new dollars may make Americans feel richer, but the net result of monetary inflation has to be the devaluation of savings and purchasing power. The precipitous drop in the dollar shows how investors around the globe are very concerned about American deficits and debt. When government policies in a fiat system are the sole measure of a currency's worth, the currency markets act as a reliable barometer of how those policies are viewed around the world. Politicians often manage to fool voters and the media, but they rarely fool the financial markets over time. When investors lack faith in the U.S. dollar, they really lack faith in the economic policies of the U.S. government.