WORLD NEWS - CENTRAL BANKS: Fed sanguine as long as orderly descent does not turn into chaos

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The weak dollar - which last week sank to its lowest level since the era of floating exchange rates began a quarter of a century ago - carries with it both benefits and potential risks for the US economy.

Most commentators emphasise the benign consequences for the US, while noting that it could have adverse effects on its trading partners, in particular in Europe.

This is essentially a current account perspective. A falling dollar - plus slower growth in the US than the rest of the world - boosts net exports and should help offset the effects of the US housing recession on overall growth.

David Heuther, chief economist at the National Association of Manufacturers, says: "Exports remain strong and are holding the economy above water."

This may overstate the case but virtually all economists are expecting a positive contribution to growth from exports. Equity investors also appear bullish, buying into large cap export stocks.

Larry Meyer, chairman of Macroeconomic Advisors, estimates net exports should contribute roughly a quarter point to gross domestic product in 2008 and 2009, up from a tenth of a point this year.

"It gives a little cushion," Mr Meyer says.

This cushion has not appeared by accident. Federal Reserve policymakers expected that cutting rates would weaken the dollar and boost net exports - it is one of the channels through which they hoped to stimulate the economy.

A softer dollar of course also puts upward pressure on inflation, via the cost of US imports. But in recent years the "pass-through" of exchange rates to prices has been muted.

Yet while a weak dollar is both helpful in the short term in terms of propping up demand and desirable in the long run to help moderate global economic imbalances, the risk is that the dollar slide starts to run out of -control.

This is essentially a capital account perspective. The US has to continue to fund a large current account deficit, making it vulnerable to any loss of confidence in US assets.

Raghu Rajan, a professor at Chicago University, says the world could pay a price for failing to facilitate global rebalancing in happier times. The dollar's decline is now taking place in a difficult -environment.

Growth remains strong outside the US but foreign investors are uncertain about US economic fundamentals and, suddenly, less confident of their ability to value and trade classes of dollar-denominated assets - including asset-backed securities and collateralised debt obligations.

Moreover, the tensions within the global dollar bloc are intensifying - with the US needing to ease policy to stave off the risk of recession at a time when the big oil producers, China and

other emerging markets whose currencies are either formally or informally pegged to the dollar need to tighten policy to guard against inflation.

All these factors heighten the risk that the current orderly decline in the dollar could turn disorderly.

Indeed some economists speculate that the decline in the dollar could already, in part, reflect diminished demand for US assets, alongside the expected impact of lower US rates.

The Fed will not be troubled by even a significant steady decline in the dollar, provided this is orderly. However, Eswar Prasad, a professor at Cornell, says the more persistent the dollar decline is, the more likely it will start to feed through into inflation.

Moreover, if the dollar ever went into free-fall, many economists believe the central bank could be forced to abandon its efforts to support growth.

"The Fed would have to raise rates like Britain and Sweden did in 1992," says Jeff Frankel, a professor at Harvard.

Put another way, there are plausible scenarios in which the so-called Fed "put" - the market's assumption that the Fed will rescue the economy from any misfortune - would be taken off the table.

There are two warning signs that would indicate the dollar decline was turning ugly.

First, exaggerated volatility in the dollar itself. Second, evidence that the downward movement in the dollar was being accompanied by upward pressure on US risk premiums and falling prices of US financial assets.

So far these indicators are reassuring: risk premiums have moderated in the past fortnight as the dollar has fallen. But it is too soon to sound the all-clear.

Fed policymakers, meanwhile, remain hopeful that their formal policy objectives - functioning markets, low and stable inflation and sustainable growth - are consistent with the demands of foreign investors.

Ken Rogoff, a professor at Harvard, says: "If the Fed can do a great job of engineering the economy away from deep recession that is a big contribution to avoiding a dollar collapse."

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