Different Dollar Indices Produce Different Results

Whenever someone tells you it is not about the money, guess what? It is about the money. Whenever the Federal Reserve tells you the dollar is the Treasury's concern and they are happy to stick to their knitting regarding their official dual mandate of price stability and full employment and maybe, just maybe, financial market stability, guess what? They are concerned about the dollar as well.

One of the problems with something called "the dollar" is it is devilishly hard to define. As a rule of thumb, we tend to focus on the euro as it is the most-traded financially, and maybe some venerable major currency indices such as the ICE dollar index with its 57.6% euro weight. However, there are only six currencies in this index and their weights have been held constant since 1973.

Various dollar indices have been developed, such as the Bloomberg correlation-weighted and spot dollar indices that attempt to measure importance in financial flows and changes in trade weights or the Dow Jones-FXCM dollar index, an equal-weighted basket of only four currencies. None of these indices are intrinsically better or worse than the others as no objective standard of what is better or worse exists. If you are looking for an index that supports an ecosystem of financial products and is followed by others, you might as well stick with the ICE dollar index and call it a day.

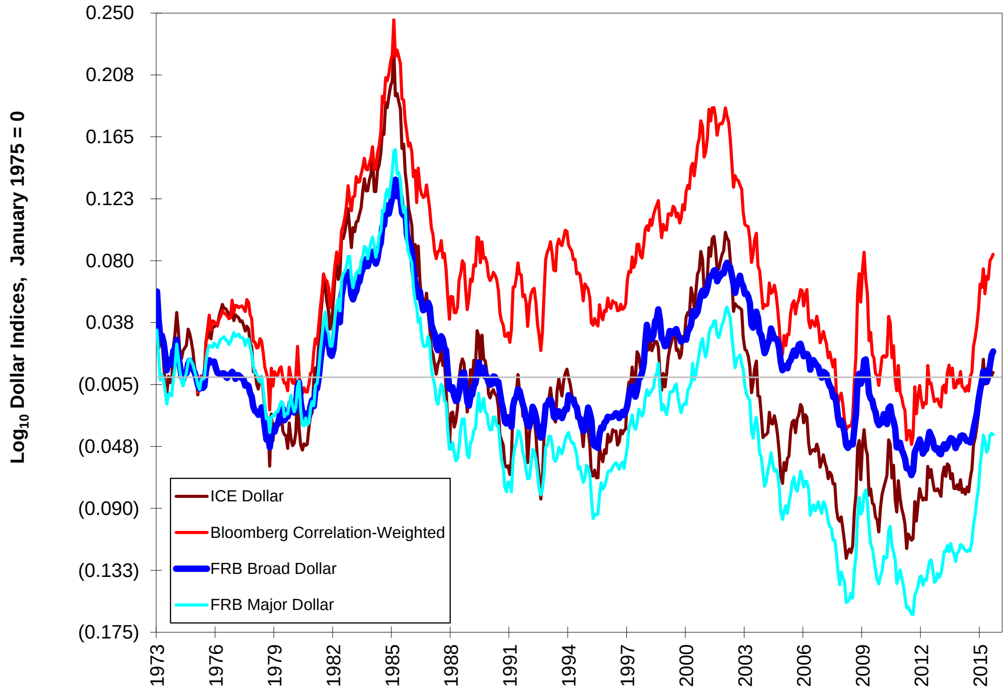
Four Decades Of Comparison

Let's compare the ICE dollar index, the Bloomberg correlation-weighted dollar with its shifting weights across ten major currencies and the Federal Reserve's trade-weighted indices for both major currencies and a broad basket of currencies. The Federal Reserve indices are not produced on a real-time basis and do not support any tradeable products.

All four of these measures bottomed on a monthly basis in July 2011, a time when the U.S. was toying with default risk in Congress. The correlation-weighted dollar has rebounded most strongly since then, by 35.06%; this has been followed by the trade-weighted major currency, ICE and broad trade-weighted indices at 32.80%, 30.38% and 21.61%, respectively.

For all of the justifiable concern over the effect of a stronger USD on emerging market currencies, the strongest gains have been in the indices based on major currencies. The stronger gains for the correlation-weighted index are attributable to the commodity-linked major currencies such as the Australian and Canadian dollars.

The Dollar: Different Measures Producing Divergent Results



The long-term picture has the correlation-weighted dollar, a construct unrelated to trade flows, outperforming its peers since January 1975 with the Federal Reserve's trade-weighted index of major currencies bringing up the rear. The ICE dollar index lies in the middle of these two. As these indices' constituents have a great deal of overlap, we should view these divergences with concern. After all, how can any self-respecting central bank (or ministry of finance) with central-planning impulses design policies for the future if it cannot agree on where "the dollar" is at present?