

Whoa, Dollar!

Falling greenback reveals a global imbalance.

SINCE 2002, the dollar has fallen against the euro, yen and other currencies. The decline has worsened in recent months, prompting economists, financial managers and the Federal Reserve to issue warnings about the dangers of a plummeting dollar. The popular view blames the “twin deficits” of foreign trade and federal spending for eroding the dollar’s value. But history offers scant evidence that deficit spending affects exchange rates. In the late 1970s, the U.S. had modest deficits and a depreciating dollar—and in the 1980s, large deficits and a strong dollar. Clearly, other factors are involved, including the balance of trade and monetary policy.

Global enablers

A more insightful argument is that global economic imbalance has weakened the dollar. The U.S. economy has been expanding much faster than the economies of its major Asian and European trading partners. Consequently, Americans are consuming more and foreigners are consuming less. The exporting nations of the world have depended on strong U.S. demand to keep their economies growing—and have loaned surplus capital needed to finance America’s growing trade deficit. This arrangement has provided mutual benefits. Net exporters have supported the dollar to keep their currencies competitive. Their lending and investment capital has kept U.S. interest rates low while enabling the federal government to cut taxes, prolong the economic rebound and fight a war. Also, the U.S. financial markets have offered foreign capital a stable environment and higher expected return.

The weak dollar fix

According to conventional wisdom, the dollar will continue dropping until foreigners are compelled to buy cheaper U.S. goods, relocate business and send more capital to our shores. On the other side of the equation, American demand for imports will fall as foreign goods and services become more expensive relative to domestic alternatives. A gradual dollar decline results in an orderly reversal of the trade trend. As foreign markets demand more dollars to buy our products, the greenback gains value in the currency markets. This is a classical “weak dollar fix”. But this conventional model may not work. Here’s why:

- **Foreign exporters don’t want a competitive dollar.** A weakening dollar would stunt growth in Asia and Europe by opening their markets to more competitive U.S. goods. China is perhaps most vulnerable, which is why it maintains a fixed exchange rate with the dollar. This ensures that the yuan will not rise and Chinese goods will stay competitive in the U.S. market. The smaller Asian economies also compete with China for exports. They will support the dollar to prevent their currencies from rising against the yuan.

- **Trading partners may not boost demand for U.S. exports.** The Euro-zone has averaged a recessionary 1% annual growth in recent years, while the U.S. economy has averaged 3.5%. And if the Bush Administration and Congress implement more pro-growth policies in 2005, the performance gap might widen. To stimulate demand in their economies, Europe and Japan must cut social spending, reduce taxes and excessive regulation, reform their pension system and implement expansionary monetary policy. These fiscal and structural reforms will not come easily.

- **Cross-border trade is more complex now.** About 20% of U.S. import activity involves foreign trade among companies that purchase components and services from overseas partners or subsidiaries. Since corporate strategy drives this activity, a falling dollar may not alter commerce as expected. Also, if foreign companies find the American market more lucrative and stable relative to other

economic regions, they may choose to give up profits rather than lose U.S. market share. So, as the dollar falls, they may cut prices to counteract the effect of their rising currency.

- **The U.S. economy has moved on.** Lowering the dollar won't bring back low-margin industries or low-wage factory jobs to our shores. The economy has retooled for higher-margin industries and higher-paying knowledge and design work. As the "intellectual property economy" advances, U.S. wealth is built on exporting profitable designs— such as advanced medical technology, new wireless networks, advanced drugs, digital content and iPods—and importing finished goods. Rising corporate earnings, higher salaries and a climbing stock market balance this out as dollars flow back into the financial markets. A strong dollar benefits this economic model. ■