The Disappearing Dollar
By Andrew Brod
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The dollar is getting weaker. When compared to other currencies such as the euro and the British pound, it's lost about a quarter of its value over the last two years. In spite of a few minor surges this month, analysts expect the dollar to continue its slide throughout the remainder of 2005. What are the implications of the weakening dollar? Should we care?

Before we proceed, let's get our terms straight. Saying a currency is strong means that it's expensive in terms of other countries' currencies. When the dollar strengthens, it takes more euros and pounds to buy one dollar. When the dollar weakens, it takes more dollars to buy a euro or a pound.

A strong dollar tends to favor imports and Americans who travel abroad, because products priced in foreign currencies are relatively cheap. If a lunch in Mexico costs 24 pesos and a dollar can be exchanged for 10 pesos, then the dollar cost of that lunch is $2.40. But if the dollar strengthens so that the exchange rate rises to 12 pesos to the dollar, then that lunch will cost only $2.00. Unfortunately, exchange rate increases like this are often accompanied by inflation in the other country, pushing the dollar price of our Mexican lunch back toward $2.40.

In contrast, a weak dollar tends to favor exports and foreign tourists who come to the U.S., because then products priced in dollars are relatively cheap. And therefore, a country's relationship with its own currency can be complicated. A strong currency is psychologically important to some and can be an indicator of a strong national economy. A weak currency is preferred by those who want to promote exports.

But as is often the case in economics, things aren't that simple. Exchange rates are prices, and prices provide important information about what's really going on in a market or an economy. They are both causes *and* effects. So one might think that a weak dollar would be ideal if we want foreign investors to purchase U.S. government securities and thereby finance our ever-expanding federal budget deficit. But a big part of the risk of holding such securities is currency risk, i.e. risk related to the upward and downward swings in exchange rates, and hence a strong and stable dollar has been the real inducement to those foreign lenders.

For this and other reasons, the U.S. has traditionally pursued a "strong dollar" policy. However, in recent years it's probably more accurate to say that the U.S. *says* it favors a strong dollar but doesn't seem to mind its steady decline. The Bush administration appears to like the idea of using a weak dollar to spur exports. And it most assuredly wants the dollar to fall against the Chinese currency, the renminbi, whose artificially low value is one of our primary scapegoats for our huge trade deficit with China.

Our overall trade deficit, the excess of all imports over exports, is closely related to these dollar issues. The U.S. has consistently run a trade deficit in recent decades, and for years some analysts have issued dire warnings of how horrible this is for the American economy. So far nothing horrible has happened.

This is because a trade deficit by itself isn't necessarily a problem. As long as foreigners are willing to take our dollars, we can continue to import more than we export. Fortunately, foreigners have historically loved holding dollars. The dollar's strength is a reflection of that. The Federal Reserve estimates that between 55 and 70 percent of all outstanding dollars circulate entirely outside of the U.S. And that's okay, because each dollar abroad that never returns to our shores is like a loan that never has to be repaid.

There's nothing new about the U.S. running a trade deficit, but what's new is how large that deficit has grown. It's grown not just in dollar terms, but as a percentage of Gross Domestic Product. Back in the 1980s, when pundits wrote op-ed column after op-ed column on the pros and cons of the unprecedented trade deficit, it never got bigger than 3 percent of GDP. Those pundits wouldn't recognize it now. The U.S. trade deficit crossed the 4 percent threshold in 2002 and the latest figures from the government indicate that it could approach 6 percent of GDP for 2004.

Writing in 2001, a scholar at the pro-free-trade Cato Institute pooh-poohed the notion that trade deficits would lead foreign investors to refuse to hold dollars, thereby driving down the value of the dollar. He claimed, "the problem with that scenario is that it ignores the fact that trade deficits are linked to a strong, not a weak, dollar." Well, it's not so strong anymore.

Even if the burgeoning trade deficit isn't causing the dollar to fall, it certainly isn't helping. As the trade deficit grows, it puts downward pressure on the dollar because more and more dollars have to be held abroad. In the past, there seemed to be no limit to the willingness of foreign investors to hold dollars, and hence the downward pressure on the dollar was virtually nil. But things seem to be changing.

A recent article in the Financial Times reported that central banks around the world are beginning to replace dollars with euros in their reserves. Seventy percent of those banks reported increasing their holdings of euros due to concerns about the value of the dollar. Most of them felt that the euro is now as attractive as the dollar as a reserve currency.

An interesting article by Daniel Gross in the on-line magazine Slate cites a report that the dollar is falling out of favor among international drug dealers and smugglers. We might think of these folks as low-lifes, but they're like the canary in the coal mine when it comes to international demand for the dollar. Dollars still dominate cash transactions around the world, but the percentage is dropping. Meanwhile, the relatively new euro has gone from nothing to a significant player in these black-market deals.

And right when the euro is emerging as a powerful currency, there are concerns in international markets that the once unthinkable might be thinkable: that the U.S. is overextending itself to such a degree that its securities may not be as iron-clad and risk-free as they once were.

If, for whatever reasons, the dollar becomes one of two important currencies in the world instead of the clear top dog, there could be some serious implications for the U.S. economy. And if, while this historic transition is happening, we succeed in convincing China and other Asian countries to stop suppressing their currencies by propping up the dollar, the effects could be even more serious. We could be left hanging with two huge deficits, the trade deficit and the government budget deficit. There's nothing wrong with being a borrower when the terms are favorable, and that's what the U.S. has done for decades. But it stinks to be a borrower when the terms are unfavorable.

If foreigners become less willing to lend to us, we'll have to start financing our own borrowing, and that will lead to higher interest rates. If the dollar gets much weaker, we'll have to import less and pay more for what we do import, and that will lead to higher inflation rates. The party, in a sense, will be over.

This won't necessarily be an economic disaster, because the American economy is incredibly resilient and flexible. But the economy won't adjust instantaneously, and the near-term pain could be significant. What should we do? On a personal level, if you're still thinking about refinancing that home, you might want to do it soon. On a policy level, it might be nice for our Congress and president to realize that this isn't the best time to run huge budget deficits, or to commit to borrowing even larger sums in order to create private accounts for Social Security. I'm confident that homeowners will make the right decisions for themselves. I'm less confident about Congress and the president.