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The Dollar is Falling! The Dollar is Falling!

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Like Chicken Little, we often jump to overly pessimistic conclusions, particularly with regard to economic issues. The depreciation of the dollar over the past three years, and the rhetoric associated with it, is a case in point.

Since early 2002, the dollar has depreciated 32% against the euro, 21% against the yen, and about 26% against a broad index of major currencies. Yet even in the face of such daunting statistics, the sky is not currently falling. In fact, the most remarkable thing about the dollar's slide since 2002 is how benign its effects have been. Over the 12 quarters since the dollar's slide began, U.S. real output has grown at an average annual rate of 3.5%, which is slightly better than our long-term trend.

Even if this were a case of the sky falling, it might be comforting to know that it fell even worse than this once before in our lifetime, and we survived. During the three years from early 1985 to the spring of 1988, the dollar fell 49% against the German deutschmark (a predecessor to the euro), 50% against the yen, and 37% against the major currency index. During that period, real gross domestic product in the U.S. grew at an average annual rate of almost 4%.

Most Americans seem to have a rough understanding of why the dollar is falling. We import more than we export. By historical standards, a lot more. Our current account deficit (roughly equivalent to our trade deficit) is currently somewhere between

5% and 6% of GDP, larger than at any time since World War II. We borrow from the rest of the world to satisfy our desire to consume more than we produce domestically, and thus, we supply dollars to the rest of the world. From this perspective, the falling exchange rate is a consequence of our trade imbalance.

In theory, however, the falling dollar should eventually help turn our trade deficit back toward balance. As the dollar falls, our exports become more affordable to foreigners and foreign imports become more expensive for us. Though this logic is impeccable, our trade deficit has been very stubborn. After 12 quarters of dollar depreciation, it is actually larger today (as a percentage of total output) than it was when the current depreciation began early in 2002! This observation suggests something about what economists refer to as “necessary and sufficient conditions”: a falling currency is a necessary condition for closing a trade deficit, but is probably not sufficient to get the job done on its own.

So what other changes could help turn our trading position toward balance, and if other changes don't occur how low could the dollar go? There seems to be some consensus among economists on the first of these questions. If Americans would save more, both in the private and public sectors, there would be less demand for foreign goods. This is why the federal budget deficit often is mentioned in the same breath as the trade deficit. Our federal government contributes to our poor level of saving. Interestingly, our current account (as a percent of GDP) actually had started to turn back toward balance in early 2001 when the federal budget was in surplus. When the federal budget veered into deficit in 2002, our trade balance resumed its downward path.

During the 1985 – 1988 dollar depreciation, the current account was similarly stubborn and did not start moving toward balance until the winter of 1987-1988 – about three years after the depreciation began. But it's important to remember that the dollar actually fell by more during that period than it has fallen so far this time and that our trade deficit in relative terms was actually smaller. Applying the same magnitude fall to this current episode – remember, the dollar fell 49% against the deutschmark back then – the dollar would have to fall another 17% against the euro to accomplish a fall equal in magnitude to the 1980s.

That would put the dollar-euro exchange rate, which currently stands at \$1.30, at about \$1.72. Of course, forecasting exchange rates is tricky business, some would say a fool's game. All that seems certain is that as long as our national saving rate is low and our trade deficit grows, the pressure would seem to be on the dollar to fall further. So far, that fall has been fairly innocuous; the sky has not fallen.

Nevertheless, historical precedent would seem to indicate that after three years of a depreciating currency, we are likely to see a further fall until there is some sign that our trade position is turning toward balance. My own guess is that if that turn doesn't occur by the middle of this year, then the Chicken Littles of the economic world might turn out to be right after all.