Don’t Let the Dollar Take the Fall

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S the dollar continues to sink against the euro, the yen and other currencies, the conventional wisdom is that there is little choice but to allow it to continue to fall.

America’s trade imbalance can be corrected, the current reasoning goes, with a much cheaper dollar — perhaps 30 percent cheaper than it is today. The idea — supported by Treasury Secretary John Snow and Alan Greenspan, the Federal Reserve chairman — is that this would raise the price of imports for Americans, who would then buy less from abroad. A cheaper dollar would also supposedly allow us to sell more to the world by making our exports less expensive.

Here is what’s wrong with this analysis.

A falling dollar is unlikely to cut imports as much as hoped. It is more likely instead to act as a consumption tax. About one-quarter of the United States import bill arises from oil purchases, which are priced in dollars. A rapidly depreciating dollar thus means lower earnings for OPEC producers. In response, the cartel might well raise prices. Goods from Asia, especially China, account for at least another 25 percent of our import bill. Because these computers, machine tools, TV’s and toys are essential to our work and lifestyle, chances are that we will still buy them, even at higher prices.

No will a cheaper dollar encourage domestic production that can replace imports, as some argue. Auto parts, for instance, are increasingly produced in Mexico and other developing nations. These plants, part of a highly specialized global supply line, are not likely to be replaced by suppliers in the United States just because of temporary currency movements.

American exports, meanwhile, will not be spurred as much as most forecasters hope. Because currencies’ values are relative to one another, the lower the dollar gets, the higher the euro and yen rise. As the currencies of Europe and Japan strengthen, the exports of these nations will become more expensive. That could easily translate into slower growth in America.

A perilous, and futile, approach to fixing the trade gap.

percent of their disposable income, practically the lowest level in 45 years. Since we have so little savings to finance capital investment, we borrow from savings pools abroad. Our government, too, needs foreign creditors to invest in Treasury securities, to finance its escalating budget deficits.

Another trade issue not addressed by dollar devaluation: the need to sharpen our global competitiveness. In an advanced economy like ours, price should be less of a selling point than the quality and sophistication of a product. This isn’t going to happen unless we improve the fundamentals underlying competitiveness — our education system and labor-force skills. A devalued dollar also does not lower health-care costs — costs so high that they encourage American employers to move operations to countries where governments often pick up the insurance tab.

Traders churning $2 trillion daily in currency markets know that if the United States relies on a cheap dollar alone to correct its trade imbalance it will push the currency down fast and for a long time — because the benefits will never quite match the predicted expectations.

This is a one-way bet for speculators. Already, rumors are rampant that several central banks with significant dollar holdings may diversify into other currencies. Hedge funds and other speculators may be moving in. If momentum to sell dollars gathers steam, it could lead to a dollar plunge, a global financial crisis and deep worldwide recession.

The dollar may well be overvalued now. But rather than just talking the currency down, Washington should try to pursue a formal agreement with Europe, Japan and China that addresses not only currency realignments but also the domestic policy changes needed to back them up.

A model for this is the so-called Plaza Accord negotiated by the Reagan administration with Germany and Japan in 1985. Then, as now, the United States was running large trade deficits and wanted to devalue the dollar. But rather than talking down the currency or letting it fall on its own, President Reagan’s team got key trading partners to share the burden of adjusting policies to correct the imbalance. It worked. America’s trade gap slowly narrowed, and foreign lenders did not demand significantly higher interest rates on Treasuries. If Washington negotiated a similar accord today, countries like China and Japan could slow the dollar’s slide by revaluing their currencies. The pact could also involve policy commitments to support the currency realignments.

For example, rather than just assert that economic growth will reduce our budget deficits, the Bush administration might postpone or trim permanent tax cuts. It could also agree to partly privatize Social Security only after creating a plan to finance the $1 trillion to $2 trillion in transition costs without deepening the deficit. It could announce measures to improve our export performance — starting, perhaps, with more support for certain research and development programs and a plan to lower health-care premiums for employers by offering reinsurance for catastrophic illness costs.

For their part, European nations could pledge to accelerate deregulation to further open their economies and become bigger importers. And key countries could agree to intervene in currency markets to keep the dollar’s decline gradual and orderly.

A great power does not debase its currency — a currency around which most global commerce revolves. It does not take its hand off the tiller, as if the market bears all responsibility for global financial stability. To fix the problems that underlie huge trade imbalances, it uses statesmanship — at home and abroad.