Beware the Weak Dollar

S O FAR, SERIOUS CURRENCY TURMOIL HASN'T been a part of the subprime-induced credit crunch. Nevertheless, the monetary system could be more fragile than it appears. In fact, the way Washington has handled the U.S. dollar these past several years could be part of a future problem.

President George W. Bush has seen a steadily weakening dollar as an answer to its ever-widening current account deficit. After all, the dollar has depreciated about 25 percent against a basket of currencies since 2002 without a peep from Washington. The United States has been pushing relentlessly for China and other Asian countries to revalue their currencies, thereby trying to make the greenback relatively weaker. And we've seen no sign that the United States is ready to broker a more orderly rebalancing of key currencies among major countries.

Indeed, the Bush administration has been relying entirely on a depreciating dollar to increase exports and restrain imports. It has done little to rein in federal spending and tax cuts in order to constrain consumption. It has not encouraged domestic savings in order to reduce the need for massive inflows of foreign funds. It has devoted scant attention to enhancing American competitiveness by addressing such problems as soaring health-care burdens on industry.

It would be one thing if this lopsided policy were working, but the current account has continued to increase from its record-breaking $850 billion last year. The bellwether Chinese global trade surplus is rising, too.

One of Washington's fundamental assumptions about a declining dollar is wrong. As the figures show, just because a cheaper greenback might make imports more expensive, it doesn't mean Americans will significantly cut back on their purchases of foreign goods. Reason: the nation has become hooked on imports, not just for finished products that are no longer made in the United States, such as many machine tools, but also on parts essential for the finished goods themselves, such as the electronic components for computers. Thus, a weak dollar leads not to less imports, but to higher prices and inflation.

In addition, the dollar cannot sink far enough to do what Bush needs without creating a panic. For example, while a softer greenback has benefited exporters, almost no conceivable dollar depreciation would be enough to significantly narrow the trade gap, simply because the value of imports is twice that of exports.

Moreover, other key currencies are unlikely to appreciate as much as U.S. officials hope. Although the yen has recently strengthened in the panicky market, that's not likely to continue because financial liberalization is freeing Japanese investors to move billions of yen overseas in the coming years. A similar outpouring can be expected from China.

So the administration's weak-dollar policy is setting a trap. Most immediately, it complicates the Federal Reserve's deliberations on whether to lower interest rates in response to the credit crunch. The reason: lower rates could make the dollar unattractive enough to cause a dangerously precipitous decline.

Already, by signaling that it wants a much weaker dollar, the administration is increasing the possibility that foreign creditors—seeing the dollar value of their U.S. investments decline—will gradually move into euros or even local currencies. Two factors make this ever more likely. There are more investment opportunities abroad, where growth outpaces that in the United States. And countries in Asia and the Persian Gulf have been establishing government-owned funds to invest foreign-exchange surpluses for higher returns than they are now receiving from U.S. Treasuries.

Because the United States needs to borrow more than $2 billion each day from abroad to finance its imports and service its $3 trillion foreign debt, a dollar that plummets too fast would necessitate a rise in U.S. interest rates to attract foreign funds. We could have the worst of all worlds—inflation, high interest rates and recession. Finally, a weakening dollar could lead to more acquisitions by the cash-rich countries—China and the Gulf states—that arouse a political backlash in America. That could ignite more protectionist pressures, and send Wall Street reeling.

A currency crisis could be highly damaging to global economic growth because it would affect trade, investment and interest rates more immediately than the credit squeeze. But with 18 months left, the administration is unlikely to reverse course and deal both with the weak domestic underpinnings of the currency and the important international negotiations that are needed to reach a global currency accord. Bush will be handing his successors a big problem unless he is forced to act because it blows up in his face before then.

GARTEN is the Juan Tripe Professor of International Trade and Finance at the Yale School of Management.

Read more Garten columns in the archives at extra.Newsweek.com...