Is The U.S. Dollar Set to Plummet in Value?

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30 April 2007

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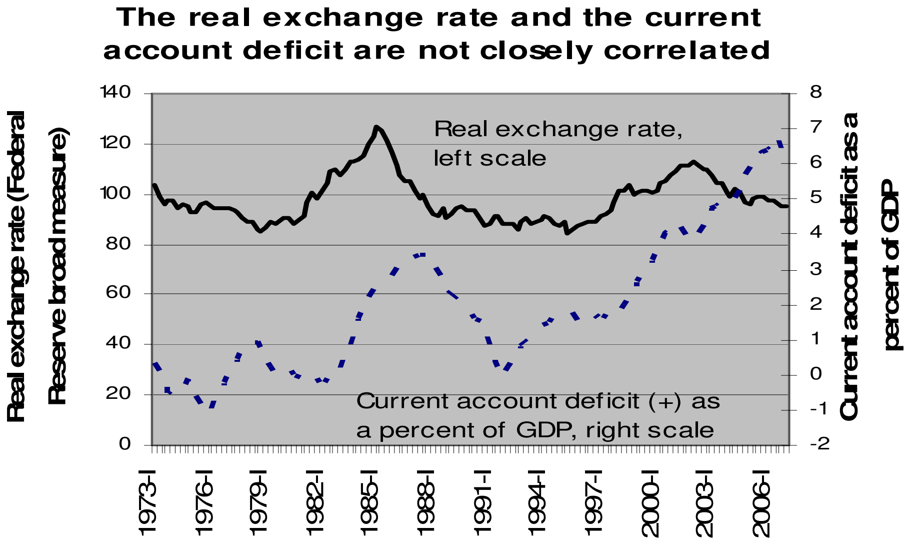
Many analysts believe that the U.S. dollar is set to fall sharply because of the large U.S. current account deficit. The March 2007 *ResearchBuzz* included an article on the Chinese renmimbi and whether it is undervalued. Looking at a single foreign country or its currency, even one as important to the United States as China and its renminbi, is not a useful way to analyze the value of a domestic currency or the source of the country's current account. The international transactions of a nation involve many currencies and countries, and the value of a currency is determined by all of these. If there is a concern that a currency is overvalued the only way to assess this is by using a broad measure of the exchange value of the currency against a comprehensive basket of currencies with which it trades. And if a country has a large deficit in its current account, it is the overall value of the currency that might be at risk. So the large U.S. current account deficit with the rest of the world is, according to some analysts, a risk to the overall value of the dollar. In their view, the dollar is at risk of a major decline. For many observers, it is the current account itself that is the cause of concern because of their belief that it has contributed to the loss of U.S. businesses and jobs and that it has built up a large debt burden for future generations. The implications for the currency are important because these analysts suspect that a currency overvaluation is the source of the problem and that the remedy will be a painful fall in the value of the dollar.

The U.S. trade deficit and the dollar

The U.S. current account deficit, the excess of imports of goods and services or unilateral transfers abroad, has climbed steadily and inexorably to record territory since 1991, except for slight improvements in 1995 and 2001. In 1991, the current account balance was a small surplus of $2.9 billion, the first surplus since 1981 and the last. Since then the deficit climbed, reaching a preliminary $856.7 billion, or 6.5 percent of GDP in 2006, a U.S. record.

Some analysts warn of the high risk of a financial crisis because of the size of the current account deficit. In their view, the financing of the deficit requires that foreigners lend to the United States (its citizens, firms, financial institutions or governments) and that the growing indebtedness of the United States will eventually bring the nation's credit worthiness into question. As a result, lenders will reduce lending or even reverse it, putting upward pressure on U.S. interest rates and downward pressure on the value of the dollar and other U.S. asset prices, including stocks. These asset price changes could also lead to a liquidity crisis as credit dries up from abroad and also domestically. Few countries are able to run current account deficits as large, as a percent of GDP, as the United States currently does without eventually encountering a financial crisis. The Asian financial crisis of 1997-98 began and was worst in countries with larger current account deficits than the United States has had. On the other hand, the United States is a much bigger, more diverse and resilient economy than others and could withstand major asset price changes and shifts in investment flows without a crisis. In addition, most of these countries precipitated a crisis by fundamentally altering their economic policies because of concern with the size of their current account deficits and the market adjustments that had begun to reverse them. Whether it was the deficits that were the problem causing the currency declines or it was the policy reaction to them remains an unsettled issue.

Will a fall in the value of the dollar reduce the current account deficit?



Sources: Board of Governors of the Federal Reserve System and U.S. Bureau of Economic Analysis

Moreover, the simple story of excessive borrowing abroad misses the point of why the United States has a large current account deficit to begin with. By definition, a current account deficit is matched by a net inflow of investment from abroad, either direct lending, or net acquisition of other assets, including direct investment in U.S. firms or portfolio investment in stocks, bonds or other financial assets. For those fearing a crisis, the picture is one of U.S. borrowers, hat in hand, begging to have a continuing stream of credit to maintain a continuing stream of excessive consumer spending. Others argue that it is the capital flows, the excessive capital inflows from abroad, that cause the current account deficit. Essentially, foreigners and domestic residents have found the United States to be a superior location for investment in terms of comparative returns and risk. Until a shortage of investment abroad makes returns there more attractive, it is unlikely that the U.S. current account will dissipate. And when returns become more attractive abroad, the current account will disappear without major disruption, according to this view.

The chart shows the Federal Reserve broad real exchange rate for the dollar and the current account deficit as a percent of GDP, using the most recent four quarters for each. The real exchange value of the dollar is constructed using the U.S. consumer price index (CPI) divided by the weighted average CPI for the countries in the broad index.

In any event, analysts who focus on the crisis view insist that the value of the dollar has to fall to eliminate the current account deficit. It can do so gradually, or in a crisis it can collapse to the appropriate lower value or even overshoot temporarily. Martin Neal Bailey and Robert Lawrence recently provided a balanced or even optimistic view of the required decline in the value of the dollar. They find that a 20 percent fall in a broad measure of the value of the dollar would be sufficient, with other steps, to restore balance in trade, although not in the current account balance.

The conventional wisdom based on most studies is that a much larger and historically unprecedented decline would be necessary to eliminate the current account deficit. The largest sustained decline in the index Bailey and Lawrence refer to was in 1985-88 when it fell by 35.7 percent. While the current account balance improved, it was not eliminated until some years later. Actually the value of the dollar has been falling for five years. The same measure of the real exchange rate that Bailey and Lawrence use has fallen almost as much as they suggest is necessary already (see the chart). From February 2002 until February 2007, the Fed's broad measure of the real exchange rate for the U.S. dollar fell 16.1 percent. Nonetheless the current account deficit has worsened from 3.8 percent in the year ending in the first quarter of 2002 to 6.5 percent, according to preliminary data, in 2006. Of course there are many other factors influencing the current account balance and there are lags in the impact of exchange rates on trade, but the recent experience is not encouraging. The chart does not support the idea that the dollar is relatively high in value either. Most recently, the index is about three percent below its average value for the period shown.

The more important limitation on the ability of a dollar depreciation to affect the U.S. current account balance is the source of the imbalance. Current account imbalances for a country are reflected in imbalances in the financial account. Thus if a country imports more goods and services than it exports, it has a matching financing flow from the rest of the world to pay for its excess of imports. The central issue is which causes which? Does a country run a deficit in its current account because it is able to borrow excessively abroad to pay for the excess imports, or does it run a current account imbalance because the rest of the world is trying to acquire more assets in the United States than U.S. residents seek to acquire abroad? The conventional U.S. imbalance story emphasizes the former: the United States borrows abroad to finance its excessive imports. But the other possibility is that foreigners want to acquire U.S. assets, flooding the country with foreign currency that is used to buy imports of goods and services that are more attractive than foreign assets. The difference in these two extreme conceptual scenarios is that the dollar falls in the former case, when foreigners must be induced to hold dollar assets, and rises in the second case, when the foreigners are trying to induce U.S. residents to acquire their assets, goods or services in return of U.S. assets. The strength of the dollar over the period of the climbing current account deficit, despite the decline since 2002, suggests that it not excessive U.S. consumption that is driving the current account deficit, but the excessive demand of foreigners for U.S. assets that has powered the current account deficit to historic levels.

The principal solution to current account imbalances will come from market adjustments unless policymakers here or abroad intervene to force an adjustment. Capital inflows to the United States will eventually slow or decline as rates of return abroad become more attractive relative to those in the United States. The corresponding excess of imports of goods and services will adjust in tandem. Policies that make the United States a less attractive market for investment or make foreign countries more attractive can reinforce that adjustment. Whether this will involve movements in the exchange rate for the dollar will depend on the extent of its current overvaluation and on the effects of policy actions on the value of the dollar in the short to medium term.

References and Recommended Readings:

Bailey, Martin Neal, and Robert Z. Lawrence, "Can America Still Compete or Does It Need a New Paradigm?" Peter G. Peterson for the International Institute for International Economics Policy Brief No. 4-9, December 2006.

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