

Economic Review

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Musings & Amusings: Imported Humor

Q: How do you know there's going to be a *double-dip* recession?

A: Greek exports of taramosalata and tzatziki have plunged.

Q: What's the capital of Greece?

A: About €3.

Q: Why can't Greece leave the euro and use its own currency?

A: Because they can't afford the printing costs.

My Spring Vacation. My son, Nick Jr., and I recently returned from a tour of the D-Day invasion sites in Normandy, France. Nick was a platoon leader with the 82nd Airborne Division, so it was very special to see where his unit fought so bravely more than 70 years ago. We stayed in a beautiful old farmhouse just a few yards from where a U.S. transport plane loaded with paratroopers crashed in the early hours of D-Day.

Ever the economist, I was amazed at what we could purchase at the recent exchange rate of 1.10 dollars to the euro. A couple of sandwiches and a shared Coke at the Ste. Lazare train station in Paris cost 14 euros, which is about \$15.40. This was much less than the \$19.30 I would have had to pay last year at this time when the euro was 1.38.

We had paid the air fare in dollars, but most other expenses were in euros: cabs, meals, that wonderful 2-day tour of the battlefields, and our final night in a nice Paris hotel. The exchange rate savings more than paid for that fancy hotel and dinner in a bistro around the corner.

The dollar is *strong* when it buys a lot more euros (or pounds, rubles, etc). Back in 2008, the exchange rate climbed above 1.55 dollars per euro. Then, the dollar was very *weak* and the *euro* was very *strong*, which is the same thing. In August of 2001, I rented a seaside villa in Tuscany at a time when each newly introduced euro cost a mere \$0.85. The dollar wasn't just strong – it was on steroids!

One of my favorite Woody Allen lines is from *To Rome With Love*, when he says to his wife, "I'm an intelligent guy. I've got a 165, 170 IQ." And she replies, "Well, only if you calculate it by euros."

Why is the dollar so strong? Although many forces influence exchange rates, the current value stems from several major developments. There is much uncertainty over whether Greece will abandon the euro and no

consensus as to what this might mean for the rest of Europe. Then there's the anxiety being caused by Russian President Vladimir Putin, whom I like to call "Vlad the Invader." (This, of course, is a reference to Vlad the Impaler, who supposedly was the real Dracula and was not a very nice person.)

In addition, Europe has lagged behind the United States in recovering from the recession. The situation has become so troubling that the European Central Bank (ECB) has very recently implemented its own Quantitative Easing program, just as the U.S. Federal Reserve has begun tapering its bond purchases. ECB purchases have driven interest rates even lower than the United States.

All this induces foreigners to buy U.S. securities. However, in order to do so, they first have to purchase dollars, thereby bidding up the exchange rate.

There's no doubt that U.S. travelers are benefiting from the strong currency when they go to Europe. So are importers. However, the flip side of this coin is that the *strong* dollar *weakens* the U.S. in several ways. Exporters now find themselves under greater financial pressure overseas. If they don't raise their prices, they will have smaller profit margins. If they do, they'll lose market share. At the same time, Europeans have an easier – and more profitable – time selling products here.

Actually, the dollar has been rising against most major currencies. One index that weights these currencies by importance of their trade with the U.S. has climbed 20-percent in the past year. As a result, many U.S.-based companies with foreign operations have been reporting softer sales and earnings because of the so-called translation or conversion effects. A million euros in profits earned abroad currently translates into about \$1,100,000. Last year, those same euro earnings would have converted to \$1,380,000.

Of course, companies can hedge much of their currency exposure. But this costs money. I recently hedged against rising home heating oil prices by pre-paying next winter's fuel in return for a fixed price. I had to tie up the funds ahead of time. And I'm out of luck if prices fall because I still have to pay the fixed price. "Downside protection" is available, but it is expensive.

What happens to exchange rates next is anyone's guess. I recently came across an article in the widely respected monthly, *The Atlantic*, about an experiment in which laboratory rodents were bred to become foreign exchange traders – honest! They did a pretty good job at predicting trends, but I think I smell a rat!

Sometime later this year, the Federal Reserve is quite likely to start raising short-term interest rates, which have been close to zero since 2008. This would tend to pull the dollar exchange rate up further. Other countries could start raising their interest rates, but this would hurt their economies. Besides, they like the strong dollar!

On the other hand, signs of renewed economic growth in Europe and a smooth resolution of the Greek situation would strengthen the euro (and, therefore, weaken the dollar).

The Region: a Yankee Dollar? I used to enjoy asking my Yale economics students to think about the following: Suppose that during the worst of New England's deep recession of the early 1990s, the region was to split off its monetary policy from the rest of the United States. It would have a new currency, the Yankee Dollar (Y\$), and monetary policy would be conducted by the New England Central Bank (NECB).

During that decline, jobs fell 10 percent overall over a three year period. At the national level, there was a mild recession that lasted about a year in which only 1.5 percent of jobs were lost. Will McEachern, who was then a Professor of Economics at the University of Connecticut, was the first to use the term "Great Recession." He was referring to the New England downturn of the early 1990s.

What happened was a classic boom-bust business cycle. Practically everything overheated, especially real estate. Housing and office space eventually crumbled, dragging down a number of the region's banks. At the same time, there were cutbacks in the types of defense spending important to New England. And there was a shift towards PCs and away from the mainframe computers and office equipment produced in the northeast.

Since the states were required to try to balance their budgets, they aggravated the recession by raising taxes and cutting spending. And there wasn't much that the

federal government could or would do to help. There were no special loans or grants or tax cuts to provide a regional stimulus program. Some federal money did come into the region when the FDIC paid off the depositors of failed banks and the states borrowed from the federal government in order to keep paying unemployment benefits. Finally, there was nothing the Federal Reserve was able to do to alleviate a regional economic problem.

Suppose that somehow New England is able to withdraw from the U.S. "monetary union." Naturally, there would be a huge argument over what images will appear on the currency. My students decided to put a lobster on the \$20 bill and a clam on the \$1 bill. (The association of clams with money stems from the fact that Native Americans fashioned *wampum* from mollusk shells. This bit of trivia will cost you 10 clams...)

Then what happens? The immediate reaction in currency markets would be for the new Y\$ to trade at a big discount to the US\$, say, two Y\$ for each US\$. Immediately, vacation trips to New England become very cheap! Goods and services produced here would become more competitive outside the region.

But that may be the end of the good news, at least for the short term. Anything imported from other states or abroad suddenly becomes twice as expensive! Gasoline nearly doubles in price and so do automobiles and most food items. As a result, the standard of living for New Englanders drops sharply: they have to pay a lot more for almost everything.

Furthermore, New England businesses and individuals that had obtained loans from outside the region would suddenly find the burden of their repayments had doubled because they now had to pay two Y\$ for every US\$ they owed. Needless to say, there would be numerous bankruptcies and many unpaid loans.

All this would further hurt the region's already beleaguered banks. Depositors from the region would have tried to get their money out before the switch to the Y\$ to preserve the value of their deposits – a run on the banks.

And the malaise would probably spread quickly outside the region as bills and loans went unpaid, shareowners took big losses, and uncertainty grew.

Of course, this never happened nor could it ever happen here. It was just a thought experiment that the students and I really enjoyed. However, it is very much what might happen if Greece exits the Euro currency zone.