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Dollar dilemma.

Yes, that's a real five pound Scottish note with Jack Nicklaus on the back. Maybe we should replace Andrew Jackson on our \$20 bill with contemporary heroes like Terry Francona whom more people would recognize. Incidentally, all Scottish notes are issued by three private banks. This is the way it was in the U.S. during various parts of our history. Scottish notes have to be backed pound for pound by Bank of England notes.

The U.S. dollar has been declining recently against many currencies, including the Scottish pound. When asked whether this is good or bad for the U.S. economy, my usual answer is "Yes" because the consequences are a mixture of positives and negatives, depending on what happens and how fast it unfolds.

Some background.

If you've traveled outside the U.S., you have first-hand exchange rate experience. In most of western Europe, you'll need euros, which will cost you about \$1.45 each. The table shows other important foreign exchange conversions. By custom, the pound and euro are quoted as how many dollars it takes to buy one of these. Most other currencies, are stated in terms of units per U.S. dollar.

I spent a wonderful month in Italy during the summer of 2001, when the newly emerging euro only cost about 85 cents! My morning cappuccino was then priced at about two euros, which amounted to only \$1.70 at those cheap exchange



rates. Today, even if the price were still 2 euros, it would set me back about \$2.90 or almost 70% more. Hence, the dollar has "weakened" in its ability to buy things overseas. It has also "fallen" and "depreciated." Of course, the opposite is to "strengthen," "rise" or "appreciate."

Indexes that weight major currencies by their volume of trade with the U.S. summarize changes in the dollar. A Federal Reserve index shows that the dollar has declined 10% over the past year and a total of 12% since 2006. After peaking in 2001, it has dropped more than 30%.

Who decided this should happen? Historically, the U.S. has participated in several exchange rate systems. The gold standard ruled until it came apart in the 1930s. Many economists now believe that it helped make the Depression deeper and longer. Toward the end of World War II, the U.S. and other nations agreed at Bretton Woods to a system of fixed exchange rates that persisted albeit with lots of adjustments until the early 1970s. The conference took place at New Hampshire's historic Mount Washington hotel where the guest rooms have plaques indicating who stayed there during that historic meeting. I once spent a

night in the room that had been occupied by the representative from Bolivia.

Fixed rates came under increasing pressure and were abandoned in 1973 when the U.S. let the dollar "float." Global currency markets now decide minute by minute what the dollar, and all other floating currencies, are worth.

Europeans tried to keep relatively fixed values among their currencies because of the large amount of inter-country trade. Starting in 1999, a dozen or so nations gave up their individual currencies to form the European Monetary Union (EMU). The euro moves freely against the dollar and most other major currencies.

Japan's yen and Canada's dollar (called the "loonie" because of the picture of the loon on the currency) also move in response to market forces. So does the pound sterling, since the U.K. has opted to not join the EMU. (The Scottish pound moves in lockstep.)

The most notable non-participant in the flexible exchange rates is China. The Chinese are able to control the value of their currency, much to the annoyance of many Americans who think they keep it too low in order to stimulate their already cheap exports.

What determines exchange rates?

Years ago, most economists subscribed to the Purchasing Power Parity (PPP) view that prices of internationally traded goods would equalize across countries. If you bought a book in New York for \$10, it should sell for 5 pounds in London when the pound costs \$2. Of course, this is a huge simplification because of tariffs, shipping costs and capital flows.

A more modern view goes beyond relative prices and inflation rates to take into account the impact of cross country flows of capital. In a simple example, a country's currency would weaken if a soft economy caused its interest rates to decline relative to other nations. Lower U.S. interest rates would make it less attractive for foreigners to buy bonds here. Since they would need fewer dollars to buy those bonds, the demand for dollars would fall and the exchange rate would weaken.

Capital can flow for other reasons. Suppose there's financial or political unrest in a part of the world. Funds would leave those countries, drag down their currencies, and seek safer havens whose currencies then appreciate. This is exactly what happened in the late 1990s when nations like Korea and Thailand got into serious financial straits and money poured into the much safer U.S. markets.

The U.S. runs a trade deficit of roughly \$800 billion annually (more accurately, the current account—but don't worry about this distinction). Every bit of this has to be financed by foreigners who buy our Treasury notes, corporate stocks, bonds and even fixed assets such as land and buildings. When China buys U.S. bonds, it is helping to finance the U.S. trade deficit and lending us the money to continue buying Chinese goods. But this capital flow also keeps the dollar strong

Exchange Rates (11/9/07)

	foreign currency/\$	\$/foreign currency
Canada (dollar)	0.94	
EMU (euro)		1.47
Japan (yen)	110.67	
UK (pound)		2.09

relative to the Chinese yuan, helping to keep Chinese goods cheap.

Impact of a falling dollar.

Obviously, a weaker dollar hurts those hoping to vacation overseas, but it also makes our export industries stronger. U.S. firms can sell their goods elsewhere more competitively and earn better profit margins. Foreign firms have a tougher time selling in America. Furthermore, U.S. companies with overseas operations benefit from a falling dollar when they bring the earnings home. Suppose my imaginary U.S. restaurant chain, "Fettuccini and Forecasts" has branches in Italy that earned a million euros in 2001 and in 2007. In dollars, they generated \$850,000 in 2001 but nearly \$1,500,000 in 2007. Not bad!

What can go wrong?

This is best answered by looking back to the late 1980s. After hitting record highs in 1985, the dollar plunged 40% against the index of major currencies. During 1987, there were worries about further declines. For a foreign investor, the lower dollar makes U.S. assets cheaper and, therefore, more attractive. However, it pays to wait before you buy until you think the dollar has bottomed. This hesitation keeps capital from flowing into the U.S. and can push interest rates up here. These concerns pushed the yield on the 10-year Treasury note from

7.2 % in March 1987 to 10.2% by October. As noted in our last newsletter, this was the real cause of the October 1987 stock market debacle when the Dow Jones fell a total of 30%.

The dollar is weakening today but in what seems like an orderly fashion. It is likely to fall further. What might precipitate another plunge? Remember, we have to continue to raise huge amounts of new money from foreigners to finance our trade deficit. Suppose they get concerned about a trade war, e.g., the U.S. threatens to put tariffs on Chinese imports unless they re-value the yuan. Suppose China retaliates by cutting back on what it lends us.

What can the Fed do? Not much, other than try to limit the damage and pick up the pieces. A currency-induced spike in interest rates would do further harm to the already weakened housing market. However, if the Fed were to cut interest rates during one of these crises it might exacerbate the dollar decline by making U.S. investments even less attractive to foreigners. Sure, the major central banks of the world could intervene by buying dollars in the global markets. However, history suggests this wouldn't do very much because the amounts they would be capable of buying are dwarfed by the amounts that private speculators and investors would be putting into play.

Hence, the dollar exchange rate is one of the major risks faced by the U.S. economy. I think the most likely outcome is that we won't replay the late 1980s. One reason is that the U.S. capital markets are the safest and most liquid in the world. Another is that China and other nations know that suddenly cutting back on buying our debt would harm their economies as exports of goods to the U.S. fell. Keep your fingers crossed.



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