The Dollar Will Fall *Further*

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Unless Europe and others take steps to stimulate domestic demand.

BY MARTIN FELDSTEIN

When the euro's value reached an all-time high of $1.52, Jean-Claude Trichet, the president of the European Central Bank, told the press that he was concerned about its rapid appreciation and wanted to "underline" the United States Treasury's official policy of supporting a strong dollar. Several European finance ministers subsequently echoed a similar theme.

In reality, of course, the United States does not have a dollar policy—other than letting the market determine its value. The U.S. government does not intervene in the foreign exchange market to support the dollar, and the Federal Reserve's monetary policy certainly is not directed toward such a goal. Nor is the Fed specifically aiming to lower the dollar's value. Although cutting the federal funds interest rate from 5.25 percent in the summer of 2007 to 3 percent now contributes to dollar depreciation, this has been aimed at stimulating a weakening economy.

Nevertheless, all U.S. Treasury secretaries, going back at least to Robert Rubin in the Clinton administration, have repeated the mantra that "a strong dollar is good for America" whenever they were asked about the dollar's value. But, while this seems more responsive than "no comment," it says little about the course of current and future U.S. government action.

Indeed, the Treasury's only explicit currency goal now is to press the Chinese to raise the value of the renminbi, thereby reducing the dollar's global trade-weighted average. The pressure on China is, however, entirely consistent with the broader U.S. policy of encouraging countries to allow the financial market to determine their currencies' exchange rate.

There is, of course, truth to the statement that a strong dollar benefits the American public, since it allows Americans to buy foreign products at a lower cost in dollars. But, while the declining dollar does reduce Americans' purchasing power, the magnitude of this effect is not large, because imports account

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for only about 15 percent of U.S. gross domestic product. A 20 percent dollar depreciation would therefore reduce Americans' purchasing power by only 3 percent. At the same time, the lower dollar makes American products more competitive in global markets, leading to increased exports and reduced imports.

The dollar has declined during the past two years against not only the euro but also against most other currencies, including the Japanese yen and the renminbi. On a real trade-weighted basis, the dollar is down about 13 percent relative to its value in March 2006.

This improved competitiveness of American goods and services is needed to shrink the massive U.S. trade deficit. Even with the dollar's decline and the resulting 25 percent rise in U.S. exports over the past two years, the United States still had an annualized trade deficit at the end of the fourth quarter of 2007 of about $700 billion (5 percent of GDP). Because U.S. imports are nearly twice as large as U.S. exports, it takes a 20 percent increase in exports to balance a 10 percent increase in imports. That means that the dollar must fall substantially further to shrink the trade deficit to a sustainable level.

Investors around the world to want to reduce their dollar holdings for three major reasons. First, interest rates are higher on euro and British bonds than on similar U.S. securities, making investments in those currencies more rewarding than investments in dollars.

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Second, since the United States has a large trade deficit that can only be cured by a more competitive dollar (while the eurozone countries collectively have a trade surplus), investors expect a trend decline in the dollar. That predictable dollar decline makes the relative return on holding dollar bonds even lower than the interest rate differential alone implies.

Finally, investors are adding nearly a trillion dollars worth of net dollar securities to their positions every year, thus increasing the risk of continued dollar accumulation. With a lower total yield and increased portfolio risk, it is not surprising that investors worldwide want to sell dollars.

Although individual foreign investors can sell the dollar securities that they own, they can only sell them to other foreign investors. As long as the United States has a current account deficit, the stock of foreign-owned claims on the U.S. economy must rise. But when foreign investors don't want to continue to hold dollar securities, their attempts to sell them will push down their value until the combination of reduced exposure and reduced fear of further dollar decline makes them willing to hold the outstanding stock of dollar securities.

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Instead of simply wishing that the dollar would stop falling, European governments need to take steps to stimulate domestic demand to replace the loss of sales and jobs that will otherwise accompany the more competitive dollar. This is not an easy task, because the European Central Bank must remain vigilant about rising inflation, and because many EU countries maintain large fiscal deficits.

While the European Central Bank has limited room for maneuver, regulatory changes and revenue-neutral shifts in the tax structure (for example, a temporary investment tax credit financed by a temporary increase in the corporate tax rate) could provide the stimulus needed to offset declining net exports. It is therefore important that EU governments turn their attention to this challenge. ◆