

Suite 502

1150 Seventeenth Street, N.W., Washington, D.C. 20036

Telephone: (202) 777-3000 Facsimile: (202) 777-3010

## ECONOMIC NEWS UPDATE

IRWIN M. STELZER

03 December 2006

“Yankee, stay home” is what the world’s currency markets are trying to tell us, as the dollar sinks to a level where it takes \$2 to buy one British pound, and over \$1.30 to buy a euro. And if you’re thinking about a major purchase of a made-somewhere-other-than-the-US product, think again. The flip side of that bad news is that America’s exporters are cheering, while countries that have been counting on the US to be the world’s consumer of last resort are no longer so sure that they want us to cut our trade deficit. And Europeans with their newly powerful pounds and euros are finding that shopping here is so cheap that they can fly over, do their Christmas shopping in New York, and more than cover the cost of their airplane tickets.

The world has long urged America to get its trade deficit under control. Now might be the time. And the rest of the world is already wishing for the good old days of American profligacy. Economists are generally agreed that if the US is to bring its trade deficit down from over 6.5% of GDP to a sustainable 2%, the dollar will have to fall by about 40%. That means that

Britain’s exporters -- America is their biggest market -- would find themselves trying to persuade Americans that the Jaguar that has been selling for, say, \$80,000 is still a good buy at \$133,000, and that a bottle of 18-year-old Macallan’s Scotch whisky that now retails in America for about \$140 is worth sipping even at a price of \$230. German exporters would also find life unpleasant. The \$100,000 Mercedes would cost \$166,000. Italy might find that American tourists willing to pay, say, \$200 for a hotel room in Venice, would decide that \$320 is so stiff that a vacation in Las Vegas, with its faux canals, will have to do. And the French, vocal critics of the US trade deficit, are now calling for “collective vigilance” to stem the fall of the dollar, which is making it difficult for their winegrowers to peddle their wares in America.

Their pain, of course, is also ours. The days when the world sent us the output of their factories and we sent it a few pictures of our presidents may be no more. Still, since we are less dependent on imports than many countries are on their exports to us, our pain would be minor relative to theirs,

which in some cases would be excruciating.

Few believe the dollar will hit such export-killing, import-spurring levels. At least not all of a sudden. To make a more realistic guess at the direction of the greenback, consider what has enabled it to stay so high for so long in spite of America's huge trade deficit.

First was the relative robustness of the American economy. While Europe wallowed in the consequences of its unreformed labor and product markets, America barreled ahead. Now the situation is reversed. The recent decline of the housing market, weaker sales of durable goods, and a downtick in consumer confidence forced the White House to lower its forecast for 2007. Meanwhile, the German economy is showing flickering signs of life, and the UK continues to move ahead. So the direction of the divergence that enabled the dollar to remain relatively strong might, only might, be shifting. If the EU grows more rapidly than the US, investors will be attracted away from dollar-dominated assets and towards investments in Asia, Euroland and Britain.

That trend is accelerated by investors' expectations concerning interest rates. The dollar was long buoyed by the Federal Reserve Board's upward ratcheting of interest rates, while Europe's central bankers by and large held the line. Now the situation might be reversed. A significant number of investors are ignoring Fed chairman Ben Bernanke's continuing concerns about inflation, and are expecting the weakening US economy to force the Fed to lower interest rates in the spring, while the strength in Europe will force the European Central bank to follow the

Bank of England and raise rates before this year is out. Such a reversal increases the relative attractiveness of non-dollar assets, and weakens the dollar.

Then there is China. China has supported its job-creating export industries by buying dollars and dollar-denominated IOUs in order to keep the yuan undervalued. Treasury secretary Henry Paulson and Bernanke will lead a delegation of cabinet members to China later this month to urge the Chinese to allow their currency to appreciate. The Chinese will listen with greater attention than in the past, as they want to give Paulson some weapons with which to cool the protectionist sentiment they increasingly fear now that the Democrats control the congress. If America gets what it has been wishing for, China will weaken the dollar by slowing its purchases of the US currency, and allowing its own currency to rise. Given the huge gap in labor costs between our countries, that might not do much to stem the flow of imports from China, but it might stem the flow of rhetoric from Chuck Schumer, who still favors imposing a massive tariff on imports from China.

Finally, there is oil. Part of the dollar's strength in the face of the US trade deficit stemmed from the willingness of the Middle East's oil producers to mark the dollars flowing to them from American motorists "return to sender". No longer. Arab oil producers, worried about the safety of their investments in a hostile United States, have turned to domestic infrastructure projects, and to Europe and China as outlets for their increasing riches.

So the dollar seems headed down, in the long run. Perhaps, and only perhaps. And it is more likely to drift

down than it is to plunge. If the Fed's fear of inflation, reiterated last week by Bernanke, prevents it from lowering interest rates, one of the causes of the recent decline will be removed. If China decides to protect the value of its \$1,000 billion in foreign reserves by continuing to shore up the dollar, and to continue to subsidize its exports industries to prevent mass unemployment, another cause of a possible plunge will be gone. And the dollar might merely glide down rather than crash if the economy resumes its trend rate of growth, while Europe slows down. Both are likely, as rising incomes and profits shore up the US economy, and the large tax increases in store for German consumers in the New Year drag Europe down. Remember: we consider it bad news if our economy slows to a 2.5% growth rate; in Europe, that rate of growth is considered breakneck, and is a cause for celebration.

So if you think the dollar is due to collapse, back your guess with a modest bet if you like. But don't bet the family farm on it.



## **THE SUNDAY TIMES**

A version of this Update appeared in  
The Sunday Times (London)