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Joan Claybrook, President

BACKGROUND MEMO:
Going Down with the Dollar:
Possible Scenarios and Implications of Currency Adjustments

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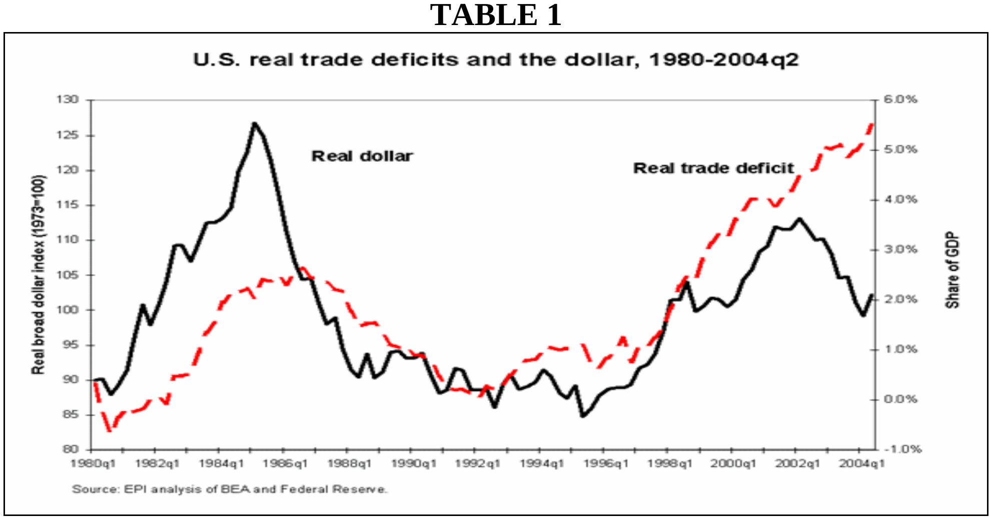
Wall Street and Beltway pundits have been busy warning investors about the dangers that the falling dollar will pose to their investments abroad. But what does the falling dollar mean for U.S. workers' wages and jobs, the stability of the U.S. economy, the prices of goods here, and economies abroad? This memo provides information useful to trade and globalization activists as well as for those who may become activated after understanding what is at stake.

THE VALUE OF THE DOLLAR AFFECTS TRADE

The terms of the trade and investment agreements with which the United States complies – such as the North American Free Trade Agreement (NAFTA) and World Trade Organization (WTO) – greatly influence where and how goods and services are produced and where and how they are consumed. However, in tandem with these commercial agreements, the value of currencies greatly influences trade flows. Over the past two decades, the U.S. trade balance had closely followed the U.S. dollar, as shown in Table 1. In other words, the more expensive the dollar gets as measured in other currencies, the less likely other countries are to import our expensive goods; the cheaper the dollar gets, the more likely they are to import our goods. The reverse is also true: U.S. corporations and citizens make their decisions to import from other countries based on the strength or weakness of the dollar, with the flow of such imports made much easier by the terms of recent trade pacts.

TABLE 1



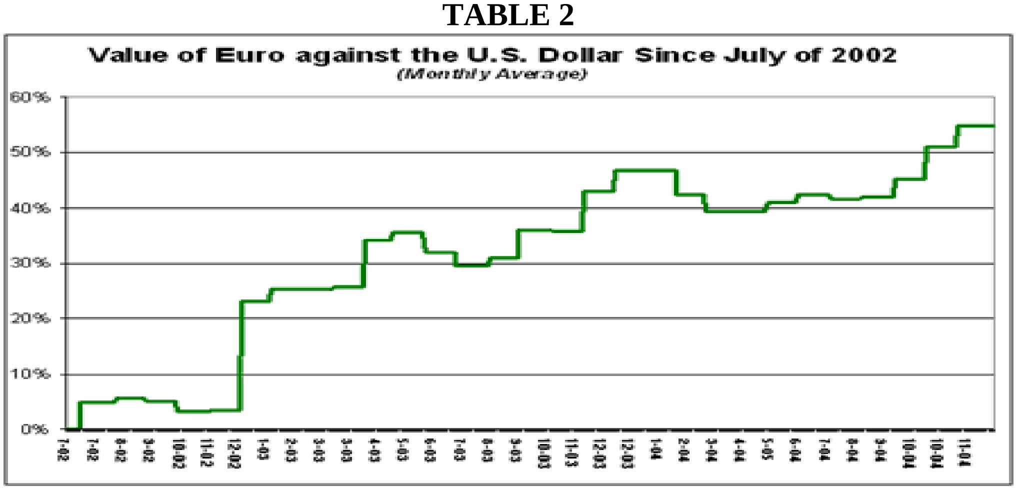
Source: Robert E. Scott, "August Trade Picture," Economic Policy Institute, Aug. 13, 2004.

The combination of a "strong dollar" and recent trade agreements that eliminate barriers to imports and promote investment in production abroad have resulted in a growth in the amount of goods and services that the United States imported by an equivalent of $860 billion in today's dollars over the 1990's. This was due in part to the Clinton administration's pursuit of a "strong dollar" policy, which meant that companies found it cheaper to buy from and produce abroad rather than in the United States. This flood of imports, also facilitated by the policies of NAFTA and the WTO, led to a 1,434 percent nominal increase in the U.S. trade deficit from $39.1 billion in 1992 to a projected $600 billion in 2004, or over 5 percent of U.S. national income in that year – a post-war high. A similar level of deficit for 2004 is expected for the current account, which includes trade in goods and services as well as worker remittances, official aid, and return on investments abroad.

Much like an individual who consumes beyond their means, the difference in what the United States consumes and what it produces has to be financed by borrowing, taking the U.S. financial deficit – what the United States owes the rest of the world minus what the rest of the world owes the United States – to a whopping $3 trillion, or 30 percent of U.S. national income. In the case of the U.S. trade deficit, it is largely financed by Asian central banks, which are doing the lending by holding large dollar reserves and dollar-denominated assets like U.S. Treasury bonds. This serves to keep the dollar's value high against the Asian currencies, allowing those economies to grow on the basis of selling into the U.S. market, while essentially creating a dollar bubble similar to the stock market bubble that grew and then burst over the last decade. Overall, foreigners' willingness to hold U.S. debt and dollars are limited by their belief that they will be paid back, which they gauge by the perceived sustainability of U.S. government and national borrowing. At the same time, China has a real interest in maintaining the dollar bubble, because it allows the country to sell more to the United States (and maintain stability among the vast population of workers who have moved from the countryside to the cities to work in factories making goods for export).

Asian central banks' intervention in currency markets means that their currencies are pegged to the dollar – much like Argentina's peso was through the 1990's. The implication is that, if the currencies were un-pegged, the value of the dollar would automatically fall against the Chinese renminbi (RMB) and other Asian currencies. The dollar has already fallen against the euro, which is an un-pegged currency. As shown in Table 2, the rate of change in the rise of the euro against the dollar has been accelerating rapidly in the last two and half years, leading to much protest from European exporters.[1]

TABLE 2



Source: Scott Lilly, "What's Behind the Sagging Dollar?" Center for American Progress, Dec. 22, 2004.

Currency pegs are problematic for a number of reasons, but primarily because they block an automatic "painless" adjustment to an external imbalance through the exchange rate. In the absence of exchange rate movements, the United States' only adjustment option is to force our savings rate upward until we are again consuming within our means. Practically speaking, this could mean substantial cuts in government programs or families' spending patterns.

This is of course a simplification of the factors affecting exchange rates movements. Other macroeconomic factors are also important, such as the return on investments in the United States versus that of other countries (which is affected by the interest rate set by the central banks of each country), and the amount that a given change in the value of the dollar affects the cost of U.S. imports and therefore U.S. prices overall (called the "pass-through" effect, which is affected by the share of imports in U.S. consumption).

HISTORICAL PRECEDENTS FOR FORCING CURRENCY ADJUSTMENTS

In the mid 1980's, the world economy confronted a similar problem: the dollar was high, and U.S. manufacturing was being displaced by cheap imports from U.S. trading partners. In the absence of import magnets like WTO and NAFTA, the trade deficit in this period was 3 percent of national income at its highest peak – much less than today's peak but substantial nonetheless. After trying to ignore the problem during its first term, the Reagan administration bowed to pressure from U.S. industry and in 1985 convened the Plaza Accords, named after the hotel in New York where the meetings between the finance ministers of the United States, Japan, Germany, France and the United Kingdom were held. Through diplomacy, Treasury secretary James Baker was able to negotiate a rise in the value of the other countries' currencies against the dollar, in what was held as a major international breakthrough.

In contrast, in 2004, the Bush administration has been unable or unwilling to convince certain U.S. trading partners – namely China – to sell their dollars and allow the currency to depreciate.[2] In fact, the administration has gone so far as to defend China's decisions,[3] and continues to call for a "strong dollar" policy as recently as December.[4]

THE ROAD AHEAD: The U.S. Dollar Will Fall in 2005, but How?

Nearly all analysts predict that something will happen in the coming year that will allow the value of the dollar to fall, but they differ over the means and the speed by which this will happen. A rapid fall could have dire implications for the U.S. and world economy, while a more gradual fall could allow countries and economic sectors time to adjust. Each of these scenarios presents distinct challenges and opportunities to global justice activists. But first, let's examine the argument that the status quo can and should be maintained.

Scenario #1: More of the Same, or Bretton Woods II

The most prominent voices for the maintenance of the current high dollar, high U.S. trade deficit regime are a team of economists affiliated with Germany's Deutsche Bank.[5] The essence of their argument is that it is in the Asian, U.S. and world interest to maintain a global economy where Asian governments save a lot and export a lot, and the United States spends a lot and imports a lot. They suggest that we are in new global financial system of informal fixed exchange rates, similar to the formal "Bretton Woods" system of fixed exchanged rates that existed prior to 1971. While acknowledging that this system has its costs – namely that Asia might not consume as it might like to otherwise, and Asian central bank's holding of low value dollar assets offers little return and high risk – these economists say that high levels of Asian exports and the resultant high rates of economic growth in Asia make it all worthwhile. In fact, they suggest that Latin America and Europe might want to get on the bandwagon and buy up dollars in order to export on the cheap to the U.S. market.

The problem with this argument is that it advocates a status quo that is politically and economically unstable and unsustainable. While the United States currently enjoys low interest rates and high levels of consumption, the country simply cannot allow a high dollar to continue to destroy what is left of its manufacturing base. At the same time, European countries will not want a dollar that is cheap relative to the euro to continue to destroy their manufacturing base. And the longer Asian countries wait to get out of dollars, the riskier it becomes for them.[6]

As long as the status quo is maintained and thus the U.S. trade deficit continues to grow, global justice activists will be able to point to the ongoing destruction of U.S. manufacturing industry and the potential for financial crisis in Asia as examples of the downside of corporate globalization.

Scenario #2: IF Gentle Drift Downwards in the Dollar's Value, THEN Sober Reflective Analysis

University of California economist J. Bradford DeLong has outlined a soft-landing scenario, whereby:

> "(1) The dollar falls, (2) as a result net exports rise, (3) export and importing-competing industries hire workers, (4) unemployment falls, (5) wages start rising and bring rising inflation with them, (6) the Federal Reserve raises interest rates to stop any inflationary spiral, (7) the economy cools off as higher interest rates reduce construction and investment spending and raise unemployment back to its natural rate."[7]

As noted elsewhere, a scenario with less rapidity and volatility also gives manufacturers and importers the opportunity to adjust their expectations accordingly, thereby minimizing the number of factory orders that have to be cancelled or the number of workers that have to be laid off from economic uncertainty surrounding a dollar decline.[8] For the sake of the world, a soft landing is clearly an optimal outcome.

But there are real reasons to doubt that this could happen. The dollar has been falling for two years, but still the United States is importing more and exporting relatively less. Even as the dollar has fallen against the euro, this is having a limited impact on getting U.S. consumers to switch away from buying imported goods to buying domestic ones. The consumer prices of all imported manufactured durable goods, excluding cars, has actually fallen 0.1 percent over the last year, meaning that it is still cheaper for U.S. consumers to buy these items from abroad.[9] Also, a great deal of the U.S. manufacturing base has been eroded over the last twenty years, and what still exists is largely dependent on trade for raw materials. Entrepreneurs would have to sink a lot of money and capital into their plants if they wanted to revitalize U.S. manufacturing. This means that they would need to know that the dollar will stay low *for years* before they make investment in expanding their manufacturing capacity, something that cannot be guaranteed. Furthermore, it does not seem that either the U.S. or the Chinese governments are budging from their status quo policies of a "strong" U.S. dollar and a pegged Chinese currency, making a negotiated soft landing even more unlikely.

In this scenario of a more gradual dollar decline, the fall on U.S. standards of living will not be as grotesquely noticeable as in a more rapid decline scenario. But the same story we have told for years about the long term effects that trade and bad economic policies have had on our communities will still ring true. We can continue to emphasize the impact of twenty-five years of trade and corporate policies on creating a global "race to the bottom" in labor and environmental standards, a phenomenon which has led to rising inequality and stagnation of the median real wage in the United States. This, combined with losses from the stock market bubble of the late 1990's, has led U.S. citizens to have one of the highest rates of household debt among developed countries, projected to be over 150 percent of household income by 2009.[10] All indications are that the second Bush administration, like previous administrations, will continue to pursue these kinds of policies that are good for Wall Street at the expense of the average citizen. So even if the United States is spared the sudden and dramatic economic devastation described below, global justice activists will still have a role in explaining how harmful trade agreements brought the country to the brink of a dollar collapse, and continue to do little for the average worker and consumer.

Scenario #3: IF Hard and Fast Dollar Fall, THEN Scream Bloody Murder

Analysts at Morgan Stanley, the global financial company, have been among the voices warning of the dangers of a rapid fall in the dollar.[11] Among the possible dangers are a generalized crash on Wall Street, wherein investors rapidly flee any and all dollar denominated assets, thereby putting in peril the entire U.S. and global financial sector. Investor and consumer confidence would also be destroyed, making a recovery next to impossible.

Under this scenario, the cost of imports would skyrocket overnight, meaning that many goods would simply become unavailable in the U.S. market, and retailers would rapidly mark up prices in an attempt to salvage some profits. Since the United States is projected to become a net food importer in 2005 for the first time since 1959, under this scenario food shortages are also a real possibility.[12]

Such a crash would have devastating consequences for working people, who would see their real wages rapidly decline as prices shot up, without the benefit of new jobs in exporting industries. If investors start fearing a sharp increase in inflation, the Federal Reserve would quickly raise interest rates, which could have the effect of popping the housing bubble in the United States. This could lead to further losses for homeowners, who benefited from the creation of almost $4 trillion in illusory paper wealth since the mid 1990s, as housing prices soared 35 percent above the rate of inflation.[13]

The political consequences of such a sequence of events could be catastrophic, as every country is left to fend for itself and face massive internal dislocation. European import-competing industries and the workers they employ would be left destitute overnight. Asian countries that had kept large amounts of dollar reserves would see the value of those reserves destroyed, and their economic model of growing through exporting to the U.S. market severely compromised.

At this point, trade activists would have engraved invitations from the White House to help design sound economic alternatives, as it would be a painful vindication of the critiques that this movement has made for years! While Morgan Stanley only gives this nightmare scenario a one-in-ten chance of happening, it is notable that the dangers to a highly globalized economy are being cited by a firm that has benefited greatly from the current state of affairs.

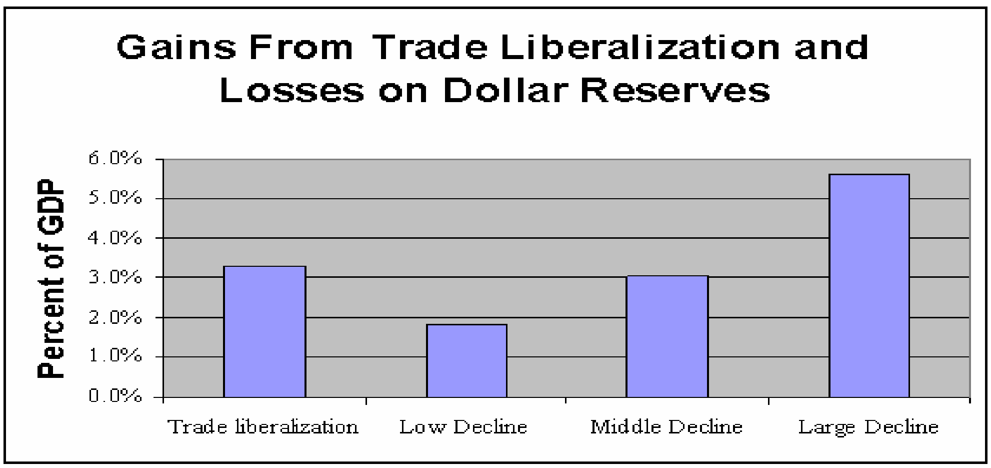
MOVING FORWARD

Activists can help avert such a scenario by raising the alarm today. In particular, we can show how commercial agreements like the proposed Central America Free Trade Agreement (CAFTA), an expansion of NAFTA to six additional countries, would only make an unstable situation worse. One reason this is true is that these agreements diminish the ability of governments to use economic policy mechanisms to shield their citizens from currency volatility. Under CAFTA's terms, Central American countries are explicitly forbidden from using capital and currency controls as barriers to trade in services. These policies helped to shield countries, such as Malaysia, from much of the financial crises that shook the globe during the 1990s which severely damaged countries such as Indonesia and Brazil.[14] This is but one example of how trade rules can interact with currency movements to compromise government's ability to pursue policies that are in the public interest.

Whether the dollar falls gradually or more rapidly, the fact that the United States' international economic policies have gotten us in this bind strengthens the arguments of CAFTA's opponents. In particular, the falling dollar means that the U.S. import market will shrink substantially in the coming years so that Central American exporters will have fewer opportunities to sell to U.S. consumers than at present. The non-partisan Center for Economic and Policy Research (CEPR) has estimated this shrinkage to be on the order of $90 to $375 billion over the next decade, meaning that the compromises that Central America's CAFTA negotiators are making in the areas of intellectual property rights, services and procurement are literally being made in vain. More so than in the past, selling to the United States will become an increasingly competitive endeavor, pitting low-wage, high productivity countries like China against relatively high-wage, low productivity countries from Central America, with China claiming the majority of the slices of this shrinking U.S. import market pie.[15]

The fall in the dollar will have implications beyond our hemisphere as well. Even China and other Asian countries will suffer, as the value of their foreign currency reserves plummet. Notably, the losses from holding U.S. dollar reserves will exceed the gains that the World Bank – a major globalization advocate – projects would result from complete world trade liberalization, as shown in Table 3.[16]

TABLE 3



Source: Mark Weisbrot, Dean Baker and David Rosnick, "Going Down with the Dollar: The Cost to Developing Countries of a Declining Dollar," Center for Economic and Policy Research Briefing Paper, Sept. 20, 2004, at 5.

It is becoming clear to more and more people that the current trade and globalization model is benefiting fewer and fewer people. When even Wall Street firms are calling for a radical change in U.S. trade policies, and even CAFTA – one of the world's most comprehensive and intrusive commercial agreements – cannot guarantee additional import and export opportunities, it is clear that "free trade" is not delivering on its own promises. Trade activists should seize the moment to build even wider coalitions to defeat the imposition of CAFTA.

For more economic analysis on the dollar, trade and more, please visit the following websites:

Economic Policy Institute
(*Resource on the impact of trade on U.S. working families)*
http://www.epinet.org

Center for Economic and Policy Research
(*Resource on the impact of globalization on developing countries)*
http://www.cepr.net

General Glut's Globalization Weblog
(*Daily analysis of trade and economic data)*
http://globlog.blogspot.com

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[1] Mark Landler and Simon Romero, "Diverging Fortunes, Tied to the Dollar," *The New York Times,* Dec. 11, 2004.
[2] Eduardo Porter, "Whoops! It's 1985 All Over Again," *The New York Times*, Dec. 19, 2004.
[3] U.S. Treasury Department, "Report to Congress on International Economic and Exchange Rate Issues," Report to Congress, Dec. 3, 2004.
[4] Edmund Andrews, "Growing Global Unease Over Ballooning Deficits," *The New York Times*, Dec. 24, 2004.
[5] *See* Michael P. Dooley, David Folkerts-Landau, and Peter Garber, "An Essay on the Revived Bretton Woods System," National Bureau of Economic Research Working Paper No. 9971, Sep. 2003.
[6] This is because the borrowing that the U.S. economy would need to finance its current account deficit would grow over time, meaning that Asian central banks would have to accumulate more and more dollars to maintain the status quo. As the risk increases, there is also an increased incentive for one of the Asian banks to sell their dollars, in an attempt to save themselves at the expense of the other banks still holding the dollars. This is extremely unstable. For a more extended analysis of these arguments, *see* Nouriel Roubini, "BW2: Are We Back to a new stable Bretton Woods regime of global fixed exchange rates?" *Nouriel Roubini's Global Economics Blog*, Oct. 8, 2004.
[7] J. Bradford DeLong, "The Soft Landing Scenario," *Brad DeLong's Semi-Daily Journal: A Weblog,* Dec. 23, 2004.
[8] Christian E. Weller, "The Dollar's Decline in Perspective," Center for American Progress Column, Nov. 23, 2004.
[9] Eduardo Porter, "Leave No Truffle Behind?" *The New York Times,* Dec. 23, 2004.
[10] Dean Baker, "Dangerous Trends: The Growth of Debt in the U.S. Economy," Center for Economic and Policy Research Data Brief, Sept. 7, 2004.
[11] *See* Stephen Roach, "What if the Dollar Crashes?" Morgan Stanley Global Economic Forum Latest Views, May 31, 2002.
[12] Griff Witte and Nell Henderson, "U.S. Food Imports Increase, May Match Exports this year," *The Washington Post*, Nov. 25, 2004.
[13] Dean Baker, "Too Much Bubbly at the Fed?: The New York Federal Reserve Board's Analysis of the Run-up in Home Prices," Center for Economic and Policy Research Briefing Paper, June 12, 2004.
[14] Myriam Vander Stichele, "Financial Services in GATS: EC Requests and Offer Endanger Financial Stability," Center for Research on Multinational Corporations Briefing Paper, March 2003.
[15] Dean Baker and Mark Weisbrot, "Fools' Gold: Projections of the U.S. Import Market," Center for Economic and Policy Research Briefing Paper, Jan. 8, 2004, at 6.
[16] Mark Weisbrot, Dean Baker and David Rosnick, "Going Down with the Dollar: The Cost to Developing Countries of a Declining Dollar," Center for Economic and Policy Research Briefing Paper, Sept. 20, 2004.