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A Falling Dollar Will Mean a Faster U.S. Recovery

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Despite the eurozone's financial crisis, the dollar has fallen 15% against the euro during the past 12 months and more than 10% in inflation-adjusted terms against all currencies. Looking ahead, fundamental market forces are likely to drive the dollar down further over at least the next few years relative to a broad basket of other currencies.

If that happens, it will strengthen the U.S. economy. A falling dollar may be the only major economic change that can accelerate the anemic pace of recovery and prevent a new downturn in U.S. economic activity.

The declining dollar has been the key driver of American exports, particularly now that slower growth in Europe and Asia is reducing their demand for imports. Although exports are only 10% of U.S. gross domestic product (GDP), the rise in exports during the past four quarters contributed more than 50% of GDP growth during that period.

While a lower dollar means higher import costs and therefore increased pressure on domestic inflation, even the 30% cumulative decline of the dollar over the past 10 years has not prevented the Federal Reserve from keeping average annual inflation at less than 3%. That experience shows that the U.S. can have both a strong currency at home and a more competitive dollar abroad.

Four strong market forces will put downward pressure on the dollar during coming years. The primary driver will be selling by sovereign wealth funds and other international holders of large dollar balances that believe their portfolios should be diversified to reduce their risks.

Korea, Taiwan and the oil-producing states each accumulated hundreds of billions of dollars over the past decade as a result of their large trade surpluses. While they initially viewed these funds as traditional foreign exchange reserves to be invested in highly liquid U.S. Treasury bills, they gradually realized that these large funds should be treated as investment assets and diversified accordingly.

Euro bonds are the main alternative asset into which they have been shifting their funds. While that shift was temporarily suspended last spring when the crisis began in the European peripheral countries, investors soon realized that the problems of those countries should be reflected in interest spreads rather than in the value of the euro. So they started buying euro bonds again, allowing the euro to recover and remain strong. The indication that China has been investing three-fourths of its incremental foreign exchange in euros this year is indicative of this continued portfolio rebalancing. And even with the recent chaos in Europe, the euro has held its value.

The interest rate difference between short-term dollar securities and similar euro securities is the second reason to expect the euro to keep rising relative to the dollar. The European Central Bank has set a higher short-term interest rate than the Fed's near-zero federal-funds rate. The ECB will increase it further to prevent the rising prices of imported food and energy from triggering a wage-price spiral in Europe's highly unionized economy.

In the U.S., where only 7% of private workers are unionized, there is now little danger of an inflationary wage-price spiral. The Fed can therefore counter the current economic weakness by promising to keep short rates at a near-zero level for an extended period of time.

The widening interest spread makes German euro bonds more attractive than dollar bonds and reinforces investors' desire to diversify away from the dollar. Interest rates are even more attractive in other European countries like Norway and Sweden.

The third force leading to the likely decline of the dollar is the enormous U.S. trade deficit, nearly $500 billion over the past 12 months. Even if foreign portfolios were not already overweight dollars, foreign investors would be reluctant to keep financing such large current-account deficits. And if they don't want to buy that many dollars, the value of the dollar will fall, shrinking that deficit by boosting the current $1.3 trillion of U.S. exports and by inducing American consumers and businesses to substitute U.S.-made products for similar goods imported from Europe and elsewhere. The higher relative prices of imported products will also induce American households to shift consumption from goods made in low-wage countries to services produced in the U.S.

The final reason for a weaker dollar is the likely decline in China's current-account surplus and therefore in China's demand for U.S. bonds. In its recent five-year plan, the Chinese government promised that household incomes and consumer spending will rise more rapidly than GDP. If that happens, China's enormous saving rate will decline from the current level of more than 40% of GDP.

A declining saving rate restricts China's ability to make additional investments in dollar bonds and other foreign currencies. And if China wants to continue to invest in foreign assets like oil and overseas businesses, it will have to sell dollar bonds and other assets from its portfolio.

In short, there are powerful forces that will cause the dollar to decline over the next several years. The declining dollar can strengthen the pace of our recovery but only if the reduced foreign demand for dollar bonds doesn't trigger very large increases in U.S. interest rates. That prospect should now add greater urgency to the task of reducing the projected growth of our budget deficits.

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