On Campus

The Buck Stops — Where?

Should you worry about the dollar’s decline? Columbia economists say Yes. And No.

By
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When Emily Lo ’06CC arrived in Paris in January, she experienced more than culture shock. “The impact of the exchange rate really hit me,” says Lo, an architecture major studying at Reid Hall, Columbia’s academic center there. “I’m more money conscious here and sometimes even miserly. I’ll have to find a paying internship this summer to compensate for my depleting bank account.”

Over the past four years, the dollar has slid more than 30 percent in value against the euro, which became the standard circulating currency of 12 European countries in 2002. In October 2000, almost two years after it was introduced as legal tender for financial transactions, the euro hit its lowest value against the dollar. At that time, a dollar was equivalent to 1.21 euros. Now, it’s worth little more than 0.75 of a euro.

To put it in perspective, let’s say a bottle of Vichy costs one euro. Whereas five years ago it would have cost Lo the equivalent of $.83, this spring it costs her about $1.29. This trend means much more than pricier French water. The dollar has been the dominant reserve currency in the world for nearly 60 years, and foreign central banks traditionally store dollars, trusting in the size and strength of the U.S. economy. These banks finance as much as three fifths of America’s current account deficit, which added up to $666 billion in 2004. But the United States’ growing debt and trade imbalance threaten the stability of the dollar. Asian banks are already diversifying their holdings to other currencies. These factors raise the question of whether the dollar can retain its position and stability as the world currency. Experts at Columbia disagree sharply on the implications of the declining dollar.

Dollar Doubts

Economist Joseph Stiglitz is particularly worried. “All around the world, there is a lack of confidence in U.S. economic management,” says Stiglitz, University Professor, 2001 Nobel laureate, and former chair of the Council of Economic Advisers under President Bill Clinton. “You have an administration which has mismanaged the economy and has lost all credibility. And that inevitably raises the question: Do you want to keep your money in the U.S. dollar?”

But other Columbia economists and experts think the slide isn’t as alarming or irrevocable. “I would expect to see at some point a return to a stronger dollar,” says Glenn Hubbard, dean of the business school and chairman of George W. Bush’s Council of Economic Advisers from 2001 to 2003. Hubbard’s outlook is in line with some economists’ belief in the fundamental strength of the U.S. economy. Hubbard points to factors such as U.S. monetary policy and the country’s strengths relative to Europe in areas including productivity and low inflation.

The dollar hit its low point, $1.36, against the six-year-old euro, in December. By May, it had strengthened to $1.29. The dollar’s fall is not unprecedented. It faltered in the 1990s but its recovery was aided in part because there was no euro or alternative currency to threaten its preeminence. Ilian Mihov, visiting associate professor of economics, suggests putting the euro in historical perspective by using, as a stand-in, the pre-1999 behavior of the German deutsche mark. That’s appropriate, he says, because the eurozone’s European Central Bank conducts its monetary policy in the anti-inflationary tradition of the Bundesbank, Germany’s central bank (and the equivalent to the U.S. Federal Reserve).

Using the deutsche mark as a proxy for the euro prior to 1999, Mihov calculates that in 1995 the dollar was trading at the equivalent of $1.42 per euro. “You will see that, in fact, the current value of the dollar is not bizarre,” Mihov says. In 1996 the euro was about $1.30 throughout the year, and in 1998 it was about $1.01.

Maxed Out

At the root of the dollar's weakness is the current account balance, essentially a broad measure of a country's current economic transactions with the rest of the world. For more than 20 years, the U.S. has been running a current account deficit, of which trade deficit is the most significant part. That is, the U.S. has been importing more goods than it has been exporting, buying more than it's been selling. And just like a family that has to borrow money from outside the household if it spends more than it earns, the U.S. has had to borrow from overseas to fund the current account deficit. The country's trade deficit is about 5.5 percent of the gross domestic product.

A growing current account deficit in the U.S. translates into a weaker dollar. It's a supply and demand issue, Mihov explains. Companies importing goods to the U.S. spend dollars to buy the foreign currencies necessary to purchase the goods. Meanwhile, companies exporting goods from the U.S. receive foreign currencies as payment, which they then use to buy dollars. Since the total value of imports is higher than that of exports, more dollars are being sold by importers than are being purchased by exporters. That supply-demand imbalance drives the dollar down, unless it's eased by capital inflows into the U.S. — for example, overseas central banks, such as China's and Japan's, buying up dollars.

The Chinese yuan further complicates matters. While the dollar has fallen in value relative to the euro, its value against the yuan has remained constant, thanks to the Chinese government's system of fixed exchange rates. With the growth in China's economy, most U.S. economists would characterize the value of the dollar as unnaturally strong compared to the yuan. This means U.S. companies are buying even more products from China, increasing the U.S. trade deficit and resulting in a call by President Bush for China to revalue the yuan. Lowering the value of the yuan would raise the price of Chinese goods in the U.S. That move, some U.S. politicians hope, would cut Chinese imports and narrow the U.S. trade deficit.

Central bankers around the world add yet another dimension in the dollar market. As in the cases of China, Japan, and South Korea, they may be motivated to buy dollars to help keep their own currency relatively weak, thus aiding their exports to the United States. More generally, countries hold dollars as part of foreign exchange reserves. (Just as countries hold oil reserves as insurance in an energy crisis, they hold foreign exchange reserves to protect their own currency in a monetary crisis; if its value is in danger of plummeting, they can buy it up and support the price.) There are already signs that the dollar is losing popularity among central banks

worldwide. In January, for example, the London-based Central Banking Publications reported that over the past two years more than two thirds of central banks responding to a survey had increased their holdings of euros, mainly at the expense of the dollar. Asian banks are already shifting out of dollars in favor of other currencies, and even rumors of sell-offs cause jumpiness in the foreign exchange market.

Finally, the U.S.'s current account deficit is tied into both the public and private sectors. A federal budget deficit, currently about 4.5 percent of GDP, adds to the current account deficit. The dollar's slide, says Stiglitz, stems chiefly from the Bush administration's plans to make first-term tax cuts permanent and privatize social security while spending more on things like the military. The problem is not just the actual worsening of the deficit in the future, says Stiglitz, but the more immediate international reaction to that prospect.

"One reason people want to hold the dollar is because of what they can sell it for tomorrow," says Stiglitz. "But if they think the U.S. is borrowing and borrowing and borrowing, no one will want to buy the dollar. So the dollar is weak today in part because the market is expected to be weak in the future."

Social Solution

Hubbard, on the other hand, looks at Bush's plans for social security and sees not burgeoning deficits but a possible benefit. As entitlement programs are reformed, says Hubbard, "I do expect we will see private savings rise in the United States."

"Savings, both public and private, are key to closing the current account deficit, says Hugh Patrick, professor emeritus of international business at the business school. "By borrowing from the world," says Patrick, "we're able to invest more than we would have otherwise and also to consume more than we would have otherwise." But, he says, the current situation isn't sustainable in the long run. So the U.S. must address the low savings rate — the "negative savings rate" of the government's deficit, as well as the very low savings rate among individuals. "The problem is how you adjust those over the long term," says Patrick. "And that's not easy economically or politically."

Stiglitz isn't optimistic that the dollar will regain its strength under current conditions. "Probably the most likely scenario is a continuing weakening of the dollar," he says. "As the dollar gets weaker, more and more political pressure gets put on European and Asian central banks to ask, 'Why are we keeping so much in the dollar?' They won't pull it all out, but they will buy fewer dollars in the future, which will put more downward pressure on the currency."

Imagine, says Stiglitz, you're a foreigner investing in U.S. stocks, bonds, or treasury bills. "If you think the stock market's going to go up by 5 percent, but you think the dollar is going to go down by 15 percent over the next year, you're going to be 10 percent poorer keeping your money in the U.S. stock market. So if you think that way, you will pull your money out of the stock market and move it to Europe or Asia. That means there is a risk that the stock market will get weaker and that the bond market will get weaker.

"A weaker stock market and bond market will affect investment and economic confidence in the United States," says Stiglitz. "So there is a scenario in which these adverse effects are far larger than the positive impact of increased tourism and exports."

Other economists, however, see the decline as part of a self-correcting cycle. The dollar's depreciation, says Mihov, will eventually make U.S. exports more attractive internationally, and those higher exports will generate higher income. But it's crucial, he says, to examine what will become of that higher income. "If this extra income goes into saving more, then the current account deficit will close. If instead it goes into buying more DVD players produced in China or cars produced in Germany, then the current account deficit will not close. At some point the current account deficit will persist and the dollar will depreciate further, and then it will be too expensive to buy cars produced in Germany. What about China? The increase in demand for Chinese goods in the U.S. will eventually lead to price increases in China, and this will lead to a decline in the U.S. deficit." Mihov thinks it's likely the dollar will return to the range of between $.95 to $1.10 per euro within the next three years.

Economics professor Richard Clarida, who was assistant secretary of the treasury for economic policy from 2002 to 2003, also paints a picture of a euro aiming for some equilibrium. "The euro began life at an exchange rate of $1.18," Clarida says. "I always thought, and wrote at the time, that the euro was undervalued below $1.00,

so a lot of the move against the dollar has been to offset a previous overshoot."

But Robert Mundell, an economics professor who won the 1999 Nobel Prize in Economics for his work in exchange rates and currencies, suggests that fluctuations aren't the means of reaching economic stability, but rather are the cause of instability. The shifts taking place in exchange markets are both destructive and unnecessary, says Mundell. "I would like to see a monetary union of the United States, Europe, and Japan which would eliminate the major problem that we have of huge swings in exchange rates. And then the creation of a global currency which would relieve the pressure on the dollar as the sole or main abode of international reserve." Ideally, he says, the arrangement would be like the Bretton Woods agreement of 1944, under which there was a fixed exchange rate that stabilized rates through the early 1970s.

Even if there's no major reform, according to Mundell there is a 40 to 50 percent chance that major countries will start to realize that vacillation in the exchange rate is "counterproductive, not only for their own economies but for the rest of the world." The euro's downs and ups are "absurd," he says. "There's no inflation in Europe, in the United States, or in Japan, so there's no need for changes in exchange rates."

Mundell and Patrick both say that though the weak dollar may be worrisome for the U.S., it's even more so for Europe and elsewhere. "The euro has appreciated a lot relative to the dollar, and it's the only currency that really has, unlike most Asian currencies," says Patrick. "That means European exports are more expensive. Therefore they're less competitive, which means their home industries are getting hit by this."

Throughout the world, he says, growth is driven "to some substantial part" by other countries' ability to carry on a trade surplus with the U.S. — to sell more than they buy. Many countries, such as Japan and Korea, rely on running a trade surplus in order to stimulate their own economy.

"If that trade surplus with the United States declines, in the absence of some policy adjustment in those countries, there will be a tendency for growth to slow down," Patrick says. "So the big global problem is that if the dollar continues to weaken, other countries are going to have to pursue more active domestic policies of stimulus to generate the demand at home that formerly had been fed by their

exports to the United States.”

Despite their conflicting views, economists agree that the more crucial issue behind the dollar’s dip is the cause. Emily Lo may have a tough time paying for dinner in Paris, but the underlying factors matter more. Fretting about the dollar “is like worrying about the price of something in the grocery store,” says Hubbard. “What you should be worried about are the supply and demand factors underneath it.”

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