Executive Summary
Backgrounder
Published by The Heritage Foundation

No. 1855
May 31, 2005

The Brutal Price of a Dollar

Tim Kane, Ph.D.

Conventional wisdom about international trade deficits, China, and the dollar is confused. Headlines bemoan "dollar jitters," pointing to the troubling 30 percent decline of the greenback against the euro in recent years. Yet conventional wisdom also seems to believe that China is manipulating its currency and should allow it to appreciate and further weaken the dollar. This kind of confusion is dangerous: It supports the faction of trade isolationists in America while averting attention from America's real problem of runaway congressional spending.

The dollar's recent swings against the euro indicate neither a dangerous erosion of U.S. power nor an opportunity for industrial rebirth. By the same token, forcing China off its peg is no panacea. While the dollar is worth less against the euro than ever before, we should remember that the euro is an infant currency that has been in circulation only since January 1, 2002. As for the U.S. current account deficit of roughly 6 percent of gross domestic product (GDP), it is worth remembering that many countries with trade surpluses are less productive and are growing more slowly than the United States.

The record-high $61 billion monthly trade deficit is a sign of strength, not weakness. It reflects a balance of heavy foreign investment in the high-tech, high-productivity American growth engine. As Treasury Secretary John Snow has pointed out, America is growing much faster than other advanced nations. Nations with trade surpluses like Japan and Germany are economically stagnant and actually suffer much worse budget shortfalls than the U.S. suffers.

None of the suggested links between the federal budget, trade deficit, and dollar exchange rate withstands scrutiny. The basic measures of economic vitality are GDP growth and employment, and America's continuing strength, according to these measures, is due largely to its superior institutions and freer markets. But all observers agree that the U.S. Congress has a very real challenge with fiscal spending, and global investors are bound to lose confidence in the mighty American growth engine unless the problem is fixed.

If Congress is dominated by weak leaders who cannot say no to spending, cannot acknowledge the entitlement crises, and cannot stop nudging up taxes, then investors are right to start questioning America's commitment to economic freedom. While big government is rhetorically out of fashion in America, actions speak louder than words. That concern hurts the dollar.

—Tim Kane, Ph.D., is Bradley Research Fellow in Labor Policy in the Center for Data Analysis at The Heritage Foundation.

This paper, in its entirety, can be found at:
www.heritage.org/research/tradeandforeignaid/bg1855.cfm

Produced by the Center for Data Analysis

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation

Backgrounder

No. 1855
May 31, 2005

Published by The Heritage Foundation

The Brutal Price of a Dollar

Tim Kane, Ph.D.

Unsustainable.

That word characterizes the consensus of commentators on the U.S. trade deficit, which surged to a record monthly high of $61 billion in February.[1] Even though the trade deficit contracted to $55 billion in March, the U.S. set a record annual trade deficit in 2004—a record that it is far outpacing this year.

Media reports describe a "deteriorating trade situation" and link it to stories that "the greenback is getting weaker."[2] Even *The Economist*, which is reliably free-market, has been sounding glum, with numerous stories dissecting the twin trade and budget deficits along with the decline of the dollar. Now the Department of the Treasury has joined the chorus, warning in a May 17 report to Congress that "Current Chinese policies are highly distortionary."[3]

This is all wrong: Many economists and the weight of history suggest that the trade deficit, a symptom of investment capital inflows, is a sign of national economic strength. All of the angst over the dollar—its recent decline against the euro and calls for a devaluation against the yuan—is unnecessary and even dangerous.

Worrying About the Dollar

True, the foreign exchange markets have been showing signs of what *The Washington Post* calls "dollar jitters," especially in February when South Korea's central bank hinted that it might buy fewer dollar reserves in the future. The market was quick to dump and run.

Talking Points

- The record-high $61 billion monthly trade deficit is a sign of strength, not weakness. It reflects a balance of heavy foreign investment in the high-tech, high-productivity American growth engine.
- The dollar exchange rate with the euro has little relationship with trade flows. The undervaluation of the euro during the dot-com years seems to have been the anomaly.
- None of the suggested links between the federal budget, trade deficit, and dollar exchange rate withstands scrutiny. The interest rate leads the exchange rate, and it is a useful rule of thumb to think of these two variables as the two prices of money.
- Investment follows growth, not the reverse. The policy implications for Congress are profound: faster growth above all else. Investors prefer balanced budgets, but they put their money into nations with reality-based entitlement spending, low taxes on capital, healthy entrepreneurship, transparency, and strong property rights.

This paper, in its entirety, can be found at:
www.heritage.org/research/tradeandforeignaid/bg1855.cfm

Produced by the Center for Data Analysis

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

It is also true that the dollar has fallen from its heights of 2000, when a single dollar traded for 1.15 euros. Today, one dollar trades for 0.8 euros, a decline that one French official has called "brutal" even as many analysts suggest that the dollar still remains overvalued. For example, Warren Buffet and Bill Gates have declared that they are "short the dollar"[4]—a gamble that, it should be noted, has lost them millions. Some pundits cheer the dollar's decline as an overdue stimulant to American manufacturing exports, while others fret that it represents economic decline.

Congress is worried. It is worried about trade (or current account) deficits, miniscule national savings, budget deficits, and a possible collapse of the dollar, as if all of these factors were tightly interwoven. They are not. A few interpretations of how they are functionally related are mistaken, and the proposed solutions are downright naïve.

For example, Senators Hillary Clinton (D–NY) and Byron Dorgan (D–ND) recently proposed a law that would cap the trade deficit at 5 percent of gross domestic product (GDP). While this may sound reasonable, it betrays an ignorance of the economic forces of nature. Senators might equivalently propose bills to cap the number of calories per home-cooked meal, cap the number of *F*s in high school math classes, or cap the force of gravity.

Policymakers need to be very careful about distinguishing what they *can* control from what they *cannot* control, and what they *should not* try to control. If Members of Congress continue to move toward trade protectionism, they will invite a global recession and possibly a Chinese meltdown.

The dollar's recent swings against the euro indicate neither a dangerous erosion of U.S. power nor an opportunity for industrial rebirth. By the same token, forcing China off its peg is no panacea. While the dollar is worth less against the euro than ever before, we should remember that the euro is an infant currency that has been in circulation only since January 1, 2002. As for the U.S. current account deficit of roughly 6 percent of GDP, it is worth remembering that many countries with trade surpluses are less productive and are growing slower than the United States.

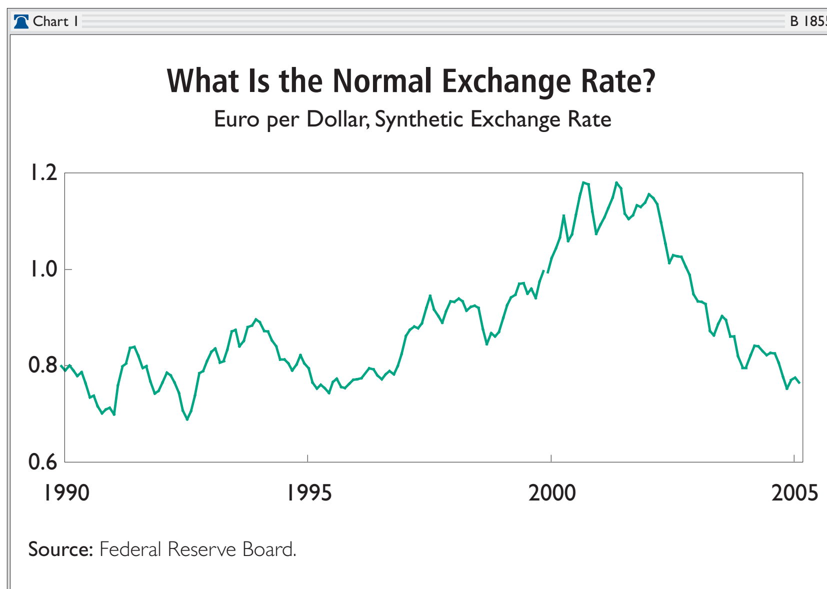
Policymakers need to remember that these "trade deficit" alarm bells have sounded many times before. They also need to keep some basic facts in mind:

- **The record-high $61 billion monthly trade deficit is a sign of strength, not weakness.** It reflects a balance of heavy foreign investment in the high-tech, high-productivity American growth engine. As Treasury Secretary John Snow has pointed out, America is growing much faster than other advanced nations. Nations with trade surpluses like Japan and Germany are economically stagnant and actually suffer much worse budget shortfalls than the U.S. suffers.
- **There is no doomsday today.** None of the suggested links between the federal budget, trade deficit, and dollar exchange rate withstand scrutiny. The basic measures of economic vitality are GDP growth and employment, and America's continuing strength, according to these measures, is due largely to its superior institutions and freer markets.
- **Exchange rates are unrelated to economic fundamentals.** Academic research has not found clear linkages between the exchange rate of the U.S. dollar and real economic variables. Speculators and emotional momentum appear to dominate exchange markets.
- **The euro is a new currency** that has been in circulation for only four years and has had a

1. News release, "U.S. International Trade in Goods and Services, February 2005," U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis, April 12, 2005, at *bea.gov/bea/newsrel/tradnewsrelease.htm* (April 21, 2005).
2. Nelson D. Schwartz, "The Dollar in the Dumps," *Fortune*, December 13, 2004.
3. U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," May 2005, at *www.treas.gov/press/releases/reports/js2448_report.pdf* (May 21, 2005).
4. Ted C. Fishman, "Betting on China," *USA Today*, February 17, 2005, p. A11, at *www.usatoday.com/news/opinion/2005-02-16-china_x.htm* (May 21, 2005).

fixed internal value only since January 1999. Recent concerns about the dollar's relative decline should take a longer view: Comparing the dollar against a synthetic euro dating back to 1980 shows that the today's exchange rate is normal and actually stronger than in 1980 or 1990. As for China, those calling for a flexible yuan should admit that they are calling for a weaker dollar.

- **Investment follows growth, not the reverse.** Studies show that good institutions lead to economic growth, and hence to higher investment. The policy implications for Congress are profound: faster growth above all else. Yes, investors prefer balanced budgets, but they put their money into nations with reality-based entitlement spending, low taxes on capital, healthy entrepreneurship, transparency, and strong property rights.



The Price of Money

Everything has a price, the saying goes—everything from $1.3 billion Boeing 787 Dreamliners to 99-cent iTunes. In a free-market system, prices represent value, as determined by the equilibrium of supply and demand. Yet what about the value of money itself? Does the dollar have a price?

Actually, we might say that a dollar has hundreds of prices—the exchange value of a dollar bill can be expressed in terms of nondurable goods (wheat or cigarettes); metals (gold or uranium); or other currencies (the yen or the peso). A useful rule of thumb is to think that a dollar has two prices—the prices to which Congress and Wall Street pay the most attention—and that both prices represent supply and demand in peculiar markets.

- *The first price* of a dollar is the interest rate. One can buy a dollar today with a promise to pay the price of even more dollars in the future. This price is a mixture of patience and risk, the market of supply and demand for credit.
- *The second price* of a dollar is the exchange rate. One can buy one dollar in exchange for another currency. This price is instantaneous, representing supply and demand of many national currencies at the current time.

Alan Greenspan famously quipped, "There may be more forecasting of exchange rates, with less success, than almost any other economic variable."[5] Indeed, economists agree that no variable has proven effective at predicting exchange rates in the real world, despite what various theories suggest. As Federal Reserve economist Greg Hopper wrote in 1997, "What is not so well known outside academia is that exchange rates don't seem to be affected by economic fundamentals in the short run."[6]

Economists will tell you that the ultimate price of a dollar is nothing more than its value in terms of

5. Alan Greenspan, testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 16, 2002, at *www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm* (May 21, 2005).
6. Gregory P. Hopper, "What Determines the Exchange Rate: Economic Factors or Market Sentiment?" Federal Reserve Bank of Philadelphia *Business Review*, September/October 1997, at *www.phil.frb.org/files/br/brso97gh.pdf* (May 21, 2005).

actual goods and services, whether those are purchased in the present, in the future, or in a foreign economy. However, the market for dollars includes—and in some ways is dominated by—speculators, who are not focused on real goods and services.

Currency traders try to stay just ahead of the expectations of the market but can create self-fulfilling prophecies of exchange rate movements. They have routinely abandoned a currency when there was a widespread loss of confidence in the underlying economy. In short, market sentiment matters, even if sentiment is impossible to know—much less quantify—beforehand.

When will the dollar stabilize? In a sense, the dollar will never stabilize, at least not as long as it is part of a truly flexible exchange rate system. However, exchange rates are not as volatile as headlines suggest. The yen–dollar exchange rate was fixed at 360 yen to the dollar until 1971, when it began a rapid readjustment. It has varied between 100 and 120 for over a decade with a few exceptions.

In the big picture, the rising value of the euro is not the brutal experience some imagine. (See Chart 1.) The euro was introduced as a new common currency in 1999, so an "all-time low" counts only if time began seven years ago. Comparing the dollar against a synthetic euro dating back to 1980 shows that the current exchange rate is in the mid-range norm and that the dot-com boom years were the outliers for dollar exchange rate valuation.

Flawed Doomsday Logic

Those who worry over the dollar's fluctuations are revealing a lack of faith in the ability of free markets to find balance. Markets are unstable and dynamic by definition, which is not a disease in need of a policy cure or control. Rather, the great lesson of the 20th century is that attempting to control uncontrolled markets for goods or capital never succeeds in creating stability and always destroys prosperity.

In the mind of the control-oriented advocate: (1) Undertaxation causes budget deficits, which are a problem; (2) budget deficits cause trade deficits; and (3) trade deficits cause dollar depreciations. If only we could control those links, the thinking goes, we could achieve stability. Yet each link is weak.

First, the primary cause of budget deficits is too much spending, not undertaxation. Sadly, government spending is a bipartisan addiction. Although there is scant academic support for the crude Keynesianism of policymakers and pundits who believe government spending is essential to a healthy, growing economy, the politics are overwhelming. On the other hand, respected economists of all stripes agree that low taxes provide real fiscal benefits for long-term growth. The result has been deficit spending at record levels.

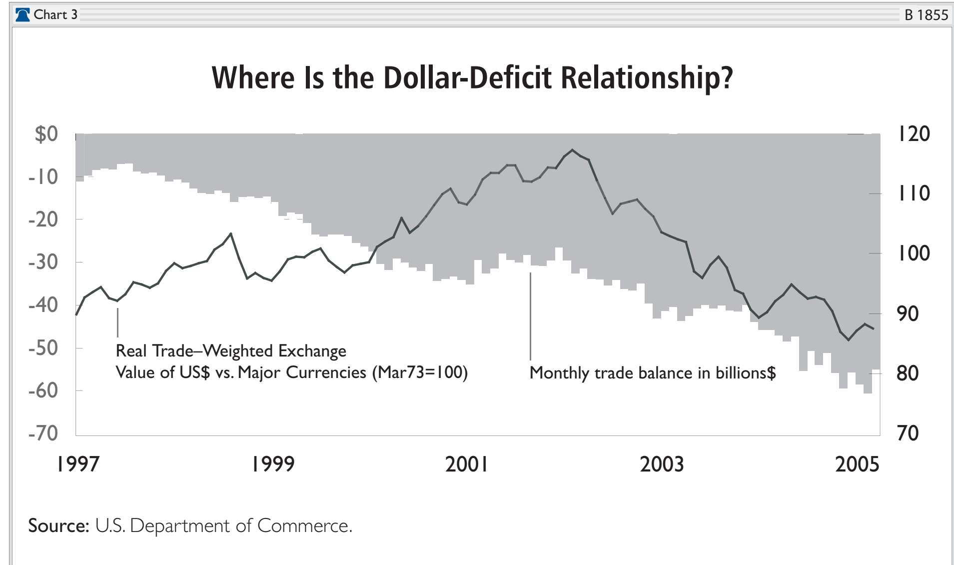
Budget deficits are indeed a net negative for the economy, but not for reasons commonly assumed. Budget deficits do not correlate with higher interest rates. However, budget deficits do represent deferred taxation tomorrow in favor of spending today. Quite aside from trade policy, it would be helpful for Congress to get spending under control as an intergenerational moral issue.

Second, budget deficits simply do not cause trade deficits. One wonders what lessons of history support such thinking. The notion that balanced budgets and trade surpluses walk hand in hand with economic growth is refuted by Japan's experience since 1990. Despite its infamously mercantilist strategy—pushing exports and limiting imports—Japan's trade surpluses over the years have not been matched by budget surpluses. Instead, Japan's budget has been in the red year after year, and its national debt now totals 169 percent of GDP.[7] By contrast, U.S. national debt is just 65 percent of GDP.

Twin deficits, "joined at the hip and blamed for all the world's economic woes,"[8] were a rallying cry for the Bill Clinton candidacy in 1992, according to his own Secretary of Labor Robert Reich, but they proved to be economic fiction in the U.S. in 1998 and 1999, when the federal budget was in surplus with no impact on the balance of trade.

7. Sebastian Moffet, "Japan Risks Recession with Tax Increases," *The Wall Street Journal*, January 19, 2005, p. A2.

8. Floyd Norris, "This Deficit Is Soaring Again," *The New York Times*, February 15, 1998, Section 3, p. 1.

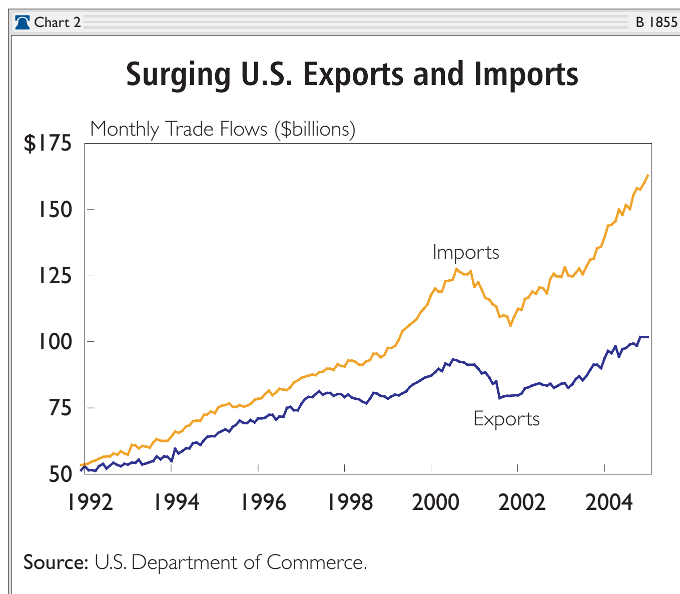


Source: U.S. Department of Commerce.

Still, the existence of persistent trade deficits with particular countries leads some to believe that America is playing the fool. This was the argument put forth when Japan was an ascendant economic superpower in the 1980s, and the rise of China has revived the argument. Many believe that Asian mercantilism is still a powerful challenge, but China is no Japan. China has a net trade balance globally, not a surplus, so the mercantilist case again rings hollow.

Furthermore, unlike Japan, China is extremely poor, and its financial system is fragile. That is one reason why China's leaders chose stability by pegging the currency since 1994 at 8.28 yuan per dollar. If the yuan begins to float and causes a currency collapse that ripples through Asia, nobody wins. China's poor will suffer, and an autocracy in economic recession is likely to be more belligerent than ever.

Turning back to America's trade figures, the real problem is that there *is* no real problem. The American current account deficit looks like a canyon as it surpasses 6 percent of GDP only until placed in the context of total exports and total imports. (See Chart 2) The real lesson of Chart 2 is that America is going global, not that it is sinking into debt. The trade deficit will likely persist as long as the U.S. technology-driven growth surge outpaces that of other advanced nations.



Source: U.S. Department of Commerce.

The larger lesson is that the dollar has no obvious relationship with the trade deficit. The exchange rate rose and fell from 1990 to 2005 on a trade-weighted basis, while the trade balance simply fell and fell further. By calling for the yuan to float, some voices are actually calling for the dollar to fall further, but there is scant evidence this will bring balance to the trade accounts.

In sum, the public bias against imports is wrongheaded. Trade is the foundation of economics, and an "excess" of imports from Tokyo to a small American town is not fundamentally different from an excess of imports from Detroit. Free people engage in mutually beneficial trade, and it is wrong to "fix" that freedom.

Yes, Americans buy Ferrari, Prada, and Glenfiddich, but the surge in imports is not just a story of conspicuous consumption. For decades now, a relative flood of computer technology imports has given Americans, especially American children, a technological head start on the rest of the world.

As for the third link, the notion that the exchange value of the dollar is related to the cur-

rent account does not seem to exist in empirical data. The logical breakdown between deficits and dollar prices is that trade alone does not drive the global flow of monies. Investment is the other half of the equation, and one should think of it as the dominant half. In a recent speech, Federal Reserve Governor Ben Bernanke made this same case, characterizing the U.S. trade balance as "the tail of the dog."[9]

The rule is this: Capital flows balance out trade flows. It is a mistake to interpret weak export demand as weak dollar demand. As Brian Wesbury puts it, "The dollar system is a closed system."[10] Every dollar supposedly lost in the externally negative trade imbalance is really just counterbalancing the excess of dollars in the externally positive investment flows.

Demand for dollars comes from those who wish to use dollars to buy American goods and from those who want to invest in American stocks and bonds. What *New York Times* columnist Thomas Friedman calls the "electronic herd" of global investors pushes billions of dollars into and out of the most promising nations, and that herd drives exchange rates, not trade in goods and services. Case in point: Comments about investments—not trade—by the South Korean central banker Park Seung are what shook exchange markets.

What Congress Should Do

The question Congress should ask is: What attracts the electronic herd of global investors? The answers are the same ones that any investor would seek: security, a culture of innovation, free trade, and a record of solid growth. These are the areas on which Congress should focus.

For many years, because Congress has successfully advanced these pro-growth institutions, America has enjoyed massive inward investment flows. Real technology innovations offer unequaled equity returns, and U.S. government securities serve as the global standard for reliability in a dangerous world. The point is that growth causes investment, not the other way around. Indeed, this observation has been a key revelation among academics. According to William Easterly, "[T]he conventional wisdom that investment in buildings and machinery is the key to long-run development is another panacea that has not met expectations."[11] Cross-country studies show that nations need to "get the institutions right"—strong property rights, low taxes, and minimal regulation—if they intend to grow and subsequently attract capital.

The flow of investments into the U.S. has pushed up dollar exchange rates in the past, but exchange rates themselves are a secondary effect, and they should be a secondary concern for policymakers. The right question to ask is: How can Congress help the economy grow?

Congress can start by passing DR–CAFTA[12] and empowering the President to negotiate more free trade agreements. If Congress makes America the best business environment in the world, the dollar will take care of itself.

America continues to be the fastest growing advanced country, which would not be the case if trade deficits were actually harmful. Germany and France, still sorting out their slow-growth socialist hangover, are still plagued with unproductive labor regulations and uncompetitive tax policy. According to a recent global survey by *The Economist*:

9. Ben Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit," remarks at the Homer Jones Lecture, St. Louis, Missouri, April 14, 2005, at *www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm* (May 21, 2005).

10. Brian Wesbury, "Don't Blame a Weak Dollar on the Trade Deficit," GKST Inc. *Monday Morning Outlook*, November 15, 2004.

11. William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (Cambridge, Mass.: MIT Press, 2001), p. 48. Easterly provides a masterful summary of capital fundamentalism, noting that even Nobel Laureate Robert Solow's workhorse model of economic growth shows that capital investment has severely diminishing returns and that growth is driven by technology above all else. Technology, we now know, means everything except the input factors, including institutions, culture, and scientific technology.

12. DR–CAFTA is a free trade agreement with the Dominican Republic, Costa Rica, Guatemala, Honduras, El Salvador, and Nicaragua.

> The [International Monetary Fund's] economists expect Japan's GDP growth to be a mere 0.8% in 2005. The outlook for the euro zone's big economies is similarly bleak, with unemployment high and domestic demand low. Like most other economists, the IMF's number crunchers have scaled back their euro-zone growth projections to a mere 1.6% for this year.[13]

In contrast, U.S. growth over the past year was 4.4 percent, and future forecasts are equally optimistic. This kind of contrast is a powerful signal to global investors to stay away from Europe and to continue investing in the United States.

The lesson for American policymakers is profound. The policy focus should be on faster growth above all else. Yes, investors prefer balanced budgets, but they also prefer nations with reality-based entitlement spending over runaway demographics. They prefer low taxes on capital. They prefer risk-taking, entrepreneurship, transparency, and strong property rights.

The Real Danger to the Dollar

The value of a dollar has little to fear from lower taxes or high imports. Likewise, the dollar is unlikely to collapse due to foreign meddling, especially since mercantilist foreign countries prefer stronger dollars.

The only real danger to the value of a dollar is American politics. Overly stimulative monetary policy by the Federal Reserve might create an inflationary headache and distort prices, but only misguided fiscal and trade policy by Congress can permanently poison free markets.

If Congress is dominated by weak leaders who cannot say no to spending, cannot acknowledge the entitlement crises, and cannot stop nudging up taxes, then investors are right to start questioning America's commitment to economic freedom. It is well and good to be for a strong dollar, which is a public good, but the epidemic of government spending on special interests is putting great strain on America's fiscal credibility. In other words, the trade deficit is infinitely sustainable, but the spending-fueled budget deficit is not.

While big government is rhetorically out of fashion in America, actions speak louder than words. That concern hurts the dollar.

—Tim Kane, Ph.D., is Bradley Research Fellow in Labor Policy in the Center for Data Analysis at The Heritage Foundation.

13. "A Call to Action" *The Economist*, April 14, 2005.