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# How far will the dollar fall?

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How far will the dollar fall, and should we care? We should be concerned, but if the administration, the Federal Reserve and the Congress act responsibly, the dollar should be near its bottom and begin to rise against most foreign currencies.

The dollar has fallen sharply, about 30 percent, against the euro during this past year. At the moment, one has to pay about $1.24 for each euro, while three years ago one only had to pay about 80 cents for a euro, but at the beginning of 1999 the euro cost about $1.15. The dollar has also fallen in recent months against the British pound, the Japanese yen and many other currencies, but as much as it fell against the euro.

These wide swings in currency values increase instability in the world economy by impeding international trade and investment because of rising uncertainty. Some applaud the dollar's fall because they believe it makes U.S. exports less expensive and that higher demand will cut the trade deficit.

The downside of a low-value dollar is that it makes all the imports we consume more expensive, including raw material and parts used by U.S. businesses, and makes it costlier for U.S. dollar holders to travel or invest outside the U.S. A continued drop in the dollar's value could destabilize the international economy, leading to a worldwide recession.

Some argue our large trade deficit (or current account deficit) is responsible for the fall in the dollar's value. They have it backward. It is the flow of foreign investment dollars (the capital account) into the U.S. economy that drives the trade deficit. The U.S. economy's higher return on capital than Europe or Japan for the last 20 years caused private foreign investors to buy U.S. stocks and bonds and other assets. In addition, foreign governments, particularly of China, Japan and other Asian states, have steadily increased their purchases of U.S. dollars as reserve backing for their own currencies.

The world now is actually on a two-currency standard -- the dollar and the euro. China in effect has fixed its currency to the dollar for the last two decades, and the Japanese central bank only allows the yen to fluctuate within a limited range against the dollar. In the fall 2003 issue of the International Economy, monetary economist Criton Zoakos noted: "Europe, Japan, China and the Asia-Pacific region are all export-driven economies whose growth depends on U.S. markets. The U.S. economy depends for its growth on internal, entrepreneurial high-tech ferment."

So long as the U.S. continues to offer a higher return on capital than its foreign competitors, both foreign banks' and private investors' demand for dollars grow, and the current account deficit can be sustained.

The whole world has a vested interest in exchange-rate stability. The export-driven economies of Asia and Europe cannot afford for the dollar to fall too much, both because their markets will dry up and the value of their dollar assets in their own currencies will decline. It appears the dollar rose too high against the euro two years ago and now has fallen too low.

The current drop in the dollar's value owed primarily to a decline in private foreign investment, and not to a decline in foreign central bank demand for dollars. The decline in private foreign demand for dollars was partially fueled by a belief the dollar had become too expensive -- a normal market response.

However, the U.S. government made a series of mistakes that have discouraged foreign investors. America now is viewed as unfriendly to foreign investors. Certain provisions of the Patriot Act and the Sarbanes-Oxley Act produce excessive and costly paperwork and unnecessary privacy intrusions. The president's tax bill reduced the tax on capital for U.S. taxpayers, but kept very high withholding rates on dividends for foreign investors, making them pay relatively more for helping our economy.

The Treasury Department also has not withdrawn the proposed, destructive foreign interest-reporting requirement, opposed by nearly all economists, even the administration's.

To grow, the world economy needs reasonable currency stability. That will return when the U.S. government reaffirms belief in a strong dollar and stops driving away foreign investors by making it very costly and difficult for them to invest.

If our leaders fail to understand the problem is not "the trade deficit" but destructive taxation and regulation, they will be personally responsible for the unnecessary suffering of millions of the worlds' people. The U.S. needs foreign investment to sustain its economic growth, and foreign governments and private investors need a safe and stable haven, with reasonable rates of return, for their savings.

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