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Dollar vs. the euro

By Richard W. Rahn
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Do you think the U.S. dollar will continue to fall against the euro? First-quarter economic growth in the U.S. was just revised down to only 0.6 percent while the euro area grew 3.1 percent, and the U.S. dollar reached an all-time low against the euro in April. (In July 2001, it only took 84 U.S. cents to buy one euro; last week it took $1.34 to buy that same euro.)

Those who have been pessimistic about the U.S. economy (some from the time Ronald Reagan was elected) crow they are right, given the first-quarter number. But, before counting out the U.S., it would be wise to look at the data. Changes in economic growth rates most often are due to changes in tax, regulatory, trade, government spending and central bank policies, much like a runner's speed will decrease if he gains weight and increase if he slims down.

In the 1950s and 1960s, Europe was lean and hungry and ran quickly to rebuild its war-ravaged economies. By the 1970s, it had begun to put on the fat of higher taxes, government spending and regulation. As a result, its growth rates fell and for the last quarter-century, Europe has grown more slowly than the U.S.

But then, not to be outdone, the Washington political establishment did some really dumb things over the last few years, which have taken away much of the benefit of the Bush tax cuts. The administration and Congress caused government spending to soar, which drained productive resources from the private sector and put them into the low- or nonproductive government sector; allowed the U.S. to have the world's highest corporate tax rate; and engaged in destructive financial regulation (e.g., Sarbanes-Oxley, requiring stock-options to be expensed, etc.), which has driven major pieces of the financial industry to London and elsewhere.

Meanwhile, some Europeans have begun to learn there are political and economic benefits from freeing up an economy (as the British learned from Margaret Thatcher). The two biggest euro economies, Germany and France, are actually beginning to flirt with pro-growth policies with the elections of market friendly leaders -- Angela Merkel two years ago in Germany, and now Nicolas Sarkozy in France. After several years of stagnation, Germany and France have now economic growth above 2 percent -- not great, but a big improvement.

More impressive is the pickup in the growth rate of the world economy, as more and more countries, such as China and India, move away from socialism towards free markets and secure property rights (see chart).

Growth Rates (Percentage average annual GDP change)				
	1983-1992	1993-2002	2003-2006	2007 forecast
US	**3.4**	**3.2**	**3.3**	**2.1**
Euro Area	**2.7**	**1.9**	**1.7**	**2.4**
World	**3.5**	**3.2**	**4.9**	**5+**

Most of the world's currencies are directly or indirectly tied to the euro or the dollar. The British pound and the Japanese yen are the only other significant free standing currencies. Like anything else, the value of one currency versus another is a function of supply and demand.

The central banks largely determine the supply of a currency, but demand is a function of a number factors, such as the expected rate of inflation, the real interest rate, strength of the underlying economies that support the currency, and the faith people have in the issuing government's soundness and stability.

Several of the best economic forecasters, such as Brian Wesbury and David Malpass, argue the U.S. has only experienced a temporary slowdown and the economy is likely to grow more rapidly than the consensus forecast. If they are correct, as I expect, the Fed will engage in a more restrictive monetary policy to curb inflation, which should result in higher real interest rates, making the dollar more attractive.

Over the long run, the U.S. economy should continue to outperform the EU for the following reasons:

- The demographic situation in the U.S. is much more favorable -- that is, worker-retiree ratio will continue to be much better than the EU's because of higher population growth rates in the U.S.

- The average tax rate on labor will remain much lower in the U.S. -- about 60 percent of that in the EU. Though the Europeans will try to lower labor tax rates, the demands of their social welfare programs limit tax-cutting discretion.

- The Europeans will slowly increase labor market flexibility, by necessity, but they are unlikely to ever have labor markets as free the U.S. enjoys because of the political resistance (remember the French riots).

Both the EU and U.S. overregulate, but the Europeans tend to be even more prone to the disease than the Americans and are unlikely ever to be as open to entrepreneurship as the U.S.

Finally, on a purchasing power parity basis, the euro and the British pound are clearly overvalued versus the dollar as any American who has recently traveled in Europe can attest. And at some point, even currency traders will notice a Big Mac is a Big Mac and ought not to cost a whole lot more in Europe.

Richard W. Rahn is chairman of the Institute for Global Economic Growth.

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