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## Dollar-Euro Madness

By Richard W. Rahn

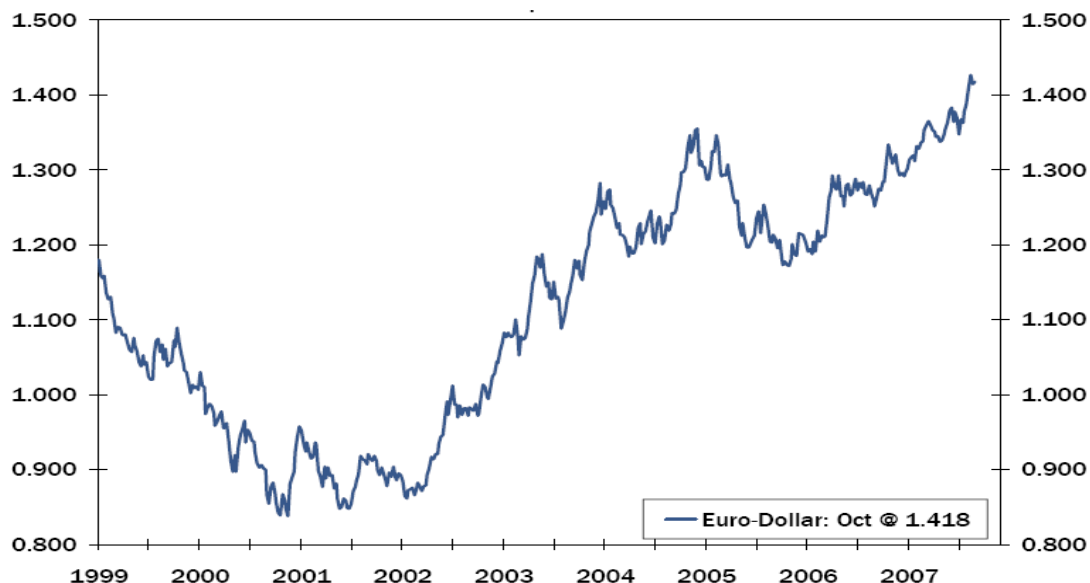
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Do you care about the fall of dollar against the euro? This article explains why you should care and what might be done about it.

In 2001, a Spanish family living in Barcelona and an American family living in Orlando had very similar homes of equal value. That year, they each bought a BMW 5 series car and paid the same price. Now six years later, each family has experienced a 30 percent appreciation in home value, and the automobiles are only worth one-third of the amount paid for them. Yet the Spanish family's home and car are now worth 40 percent more than the American family's home and car. The Spanish family appears to have gotten a lot richer than the American family, all due to the rise in the euro against the dollar.

As you can see in the accompanying chart, the dollar and the euro have widely fluctuated against each other for the last decade, the euro falling roughly 40 percent against the dollar from 1999 to 2001 and then rising roughly 60 percent since.

**Euro-Dollar Exchange Rate**  
(U.S. dollars per euro)



If the above mentioned Spaniards decide to sell their home in Spain and move to or travel to Florida, they can now buy a much nicer home for the same money; while if the Floridians decide to move to or travel to Spain, they will have to pay more or downsize. Note: neither the Spaniards nor the Americans did anything to change their relative wealth circumstances; they were solely at the mercy of government policymakers and currency speculators like George Soros.

These rapid and extreme currency value shifts wreak havoc with manufacturers in all the affected countries. If you were a European automobile manufacturer and had to decide in the year 2000 where to build a new assembly plant to serve the American market, you might well have concluded to build it in Europe because of the low value of the euro at that time. But now in 2007 many of your relative costs may be a third higher than anticipated. These exchange rate movements swamp tariff and other tax concerns, and often cause manufacturers and those in the tourist industry to lose money.

The exchange rate movement implies that the whole physical stock of Europe (land, buildings, machines, art, etc.) is suddenly worth 40 percent more in dollar terms than it was six years ago — and this of course is nonsense, given there has been no drastic difference in the performance of the relative economies in the last six years. The problem comes from the fact that currencies, like commodities, are priced at the margin — that is, how much it costs to obtain one additional unit, not the average cost of the entire stock. If every item in Europe had been put up for sale for dollars, in total it could not sell for 40 percent more today than in 2001, unless the supply of dollars had grown 40 percent faster than the supply of euros, which it has not.

Many economic commentators argue that the dollar has fallen relative to the euro largely because of the U.S. trade deficit, and must fall further to rectify it, even though the United States has been running a trade deficit for years. In fact, it has been the desire of foreign governments, companies and individuals to buy dollar assets, such as U.S. government bonds, which has caused the trade deficit. For them to obtain dollars to invest in the U.S., they must sell us goods and services.

A non-American who believes the dollar will continue to fall is likely to curtail purchases of U.S. financial assets, but at some point the products and real assets of the U.S. (real estate and operating businesses) will look so cheap to Europeans that they will trade their euros for dollars to buy these cheap products, hotels, manufacturing plants and homes, and the dollar will begin to rise. When the dollar begins to rise, it is likely to cause the belief that not only real assets are undervalued but also financial assets, and the pendulum will swing in the opposite direction.

Agricultural futures markets, which enable price hedging, were initially established well more than a century ago to mitigate wide and destructive price swings in corn, wheat, etc. There was little need to have futures contracts with expiration dates more than a year in the future, given that both farmers and processors of agricultural products could protect themselves from price fluctuations over the growing season.

Part of the solution of destructive currency price swings is to develop currency futures markets with expiration dates much longer in the future, perhaps even 10 years, than the current widely traded contracts, which are mostly a year or less. This would enable those in the manufacturing, tourist and other severely impacted industries to protect themselves from exchange rate swings, outside their control.

In addition, very long-term currency contracts would provide government economic policymakers with cues about what they were doing correctly or incorrectly.

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