A Field Guide to the Falling Dollar

By DANIEL ALTMAN

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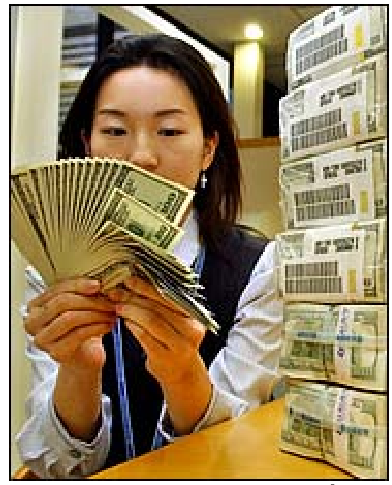
JUST what will the plummeting value of the dollar mean for the American economy? The answer is not quite as simple as "less imports, more exports." Depending on how investors behave, the dollar's downward drift could cast anything from a benign breeze to a hurricane.

If the dollar loses value slowly, giving businesses and investors plenty of time to adjust their spending and portfolios, the main effect may be to make the American economy more competitive. That would be a happy conclusion.



Lee Jin-man/Associated Press

A bank clerk in South Korea counts American currency. Analysts say it takes time for foreign demand to adjust to dollar weakness.

But if the dollar takes an abrupt dive, the consequences may be dire. Companies and consumers alike may find themselves stripped of purchasing power and ground down by sky-high interest rates.

The repercussions of a long-term decline in the dollar could be far-reaching. A permanent change in the relative prices of goods and services produced in the United States and abroad could hamper some important and long-running economic trends, like the growing productivity of the American work force.

"On balance, it's going to be good for people invested in the manufacturing sector of the United States if this thing is permanent," said Samuel S. Kortum, a professor of economics at the University of Minnesota. "It sounds very mixed and potentially even sort of bad if you think about it for the whole economy."

Right now, the short-term effects of the dollar's fall are pressing enough. Imports are becoming more expensive for Americans, and exports from the United States are becoming less expensive for foreigners. For some businesses, these changes have already become very real.

At the Cadillac division of General Motors, which sells American-built cars in Europe, margins have improved as a result of the dollar's drop.

At Volkswagen dealerships in the United States, which must import all their automobiles, sales fell by a total of 18 percent in the first 11 months of the year, compared with the same period in 2003. Overall sales of European brands have dropped by only 6 percent. These kinds of rewards and penalties are likely to multiply as time passes, said Maurice Obstfeld, a professor of economics at the University of California at Berkeley. "It takes time to reallocate resources to export industries so they can produce more," he said. "It also takes time for foreign demand to adjust, and switch to new sources of supply."

Long-term contracts can contribute to these delays, said Harvey D. Bronstein, a senior international economist at the Small Business Administration. "You have to build relationships and a trust level with purchasers in other countries. This takes much longer than the daily or monthly fluctuations in currency values."

To this point, the dollar's depreciation has not narrowed the nation's trade gap. Exports have been increasing steadily for five consecutive quarters, according to figures adjusted for changes in prices and seasonal variations by the Bureau of Economic Analysis, but imports have risen even faster. Both of these trends would be consistent with a gradual comeback in economic activity after prolonged weakness - and have perhaps little to do with the exchange rate. So, will the sliding dollar ever eliminate the trade deficit?

Not necessarily, Professor Obstfeld said. Americans can keep buying more imports as long as foreigners are willing to accept dollars - and the financial assets they can buy in return.

"The dollar's fall is a necessary but not sufficient condition for closing the trade gap," he said. "We also need an adjustment in the global saving and investment patterns. Saving by the private sector and by the government has to rise, or investment has to fall. No one wants to see investment fall in the United States, so we're looking at some sort of adjustment in saving. But it's not clear how the dollar's fall by itself will bring that about."

Shrinking the trade gap may require higher long-term interest rates, which could encourage Americans to save more and rely less on foreign financing. Several factors in the markets and the economy are already auguring for higher rates for bonds, home mortgages and other loans. The Federal Reserve Board has been raising short-term rates since June and is expected to continue at its next meeting, on Dec. 14.

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If bond traders believe that short-term rates will keep rising, long-term rates will almost certainly tick upward as well. The potential for bigger budget deficits in Washington - and bigger federal borrowing - could also help push to rates higher.

Finally, foreign lenders may start to demand higher interest rates from American borrowers, because payments in dollars are now worth less in the lenders' home currencies.

Indeed, the mystery to some economists is why long-term rates haven't risen already. "I really find it puzzling," Professor Kortum said.

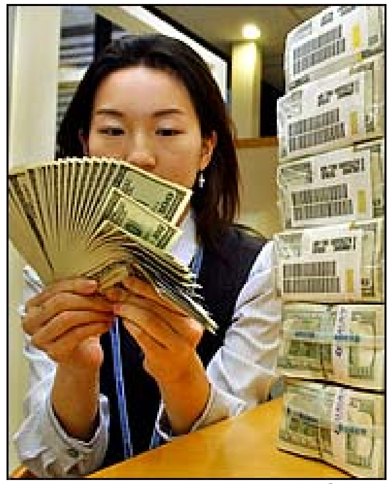
A partial explanation, said David A. Wyss, chief economist of Standard & Poor's, is the enormous appetite of foreign central banks for American bonds. He said the banks bought $260 billion worth of Treasury securities in the 12 months through September, more than two thirds of the government's total borrowing during that period.

By keeping Treasury yields low, the foreign central banks are taking pressure off interest rates. But they have also prevented, or at least postponed, further decreases in the dollar's value.

"I think the dollar is going lower," Mr. Wyss said. "The problem is that you have the central banks fighting very hard against the market." The banks were less interested in protecting the value of their dollar-denominated reserves, he said, than they were in protecting their countries' exporters, who have a harder time selling to the United States when the dollar weakens.

Those exporters may not be the only foreign businesses hurt by dips in the dollar. According to Professor Kortum, American companies will use fewer imported intermediate goods - that is, goods that are used to produce other goods and services - as they become more expensive in dollar terms. Instead, the companies may use more American workers.

"From the point of view of their production, they're finding now that U.S. labor is cheap relative to imported intermediate goods,"



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he said. "It would lead to more employment, more labor-intensive production to some degree."

Though this may sound like good news, it stands in opposition to a long-running and in many ways beneficial economic trend. For decades, workers have had increasing amounts of useful stuff like computers, machines and software at their disposal -- making production more capital-intensive rather than more labor-intensive. When workers have more capital to use, they tend to be more productive - and to earn higher wages.

The depreciation of the dollar may also blunt the ability of foreign competition to transform industries in the United States, Professor Kortum said. "Firms that would have been put out of business by imports are going to stay in business," he said, and companies that did not export before may enter foreign markets.

FOR the short term, much will depend on the speed of the currency shift, the economist said.

"The best outcome would be a rise in U.S. saving coupled with a gradual decline in the dollar to a sustainable level," Professor Obstfeld said. "There's no doubt that the dollar will need to decline more, and the economy will be able to adjust much more smoothly if the adjustment is a gradual one."

That outcome, though, is far from certain. If investors lost confidence in the business climate in the United States, or in the federal government's ability to pay its debts, the dollar could plunge sharply and interest rates could rocket.

In that case, investors would demand a higher return to match what they perceived as higher risks of lending money or buying equity in the United States. But if the flow of investment also slackened, the demand for dollars to buy American securities would dry up. That could be the start of a vicious cycle, forcing a further slide in the dollar and leading investors to demand an even higher return.

A similar situation occurred two decades ago. "The danger is if the decline in the dollar gets too severe, that could really drive U.S. bond yields up like it did in the early 80's," Mr. Wyss said. "Then you could be looking at 15, 20 percent mortgage rates again. That could cause a recession despite the fact that the trade gap is closing."

Investors' attitudes could change abruptly, Professor Obstfeld said, especially if they focused on how one piece of news might change the economic outlook. "Certainly, the fiscal measures that are being tossed around in Washington are not particularly helpful," he said, referring to the multitrillion-dollar liability that could result from adding private accounts to the current Social Security system. "It's clear that it's a big fiscal shift that could have an impact on the markets."

That could bring back unpleasant memories of the 1980's, when the "twin deficits" in trade and the federal budget damaged the country's economic competitiveness. A weaker dollar wasn't enough to close the gaps then, and it may not be enough now, either.

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