

What is the Dollar's Sustainable Value?

By Martin Feldstein

How much further will the dollar fall? Or has it already fallen so far that it will now start to move back to a higher level?

For travelers to the United States from Europe or Asia, US prices are dramatically lower than at home. A hotel room or dinner in New York seems a bargain when compared to prices in London, Paris, or Tokyo. And shoppers from abroad are loading up on a wide range of products before heading home.

But, despite this very tangible evidence, it would be wrong to conclude that US goods are now so cheap at the existing exchange rate that the dollar must rise from its current level. Although the goods and services that travelers buy may cost less in the US than abroad, the overall price of American products is still too high to erase the enormous trade imbalance between the US and the rest of the world.

To be sure, the falling dollar over the past few years has made American products more competitive and has caused the real value of US exports to rise sharply – by more than 25% over the past three years. But the trade deficit in 2007 nevertheless remained at more than \$700 billion, or 5% of GDP.

The large trade deficit and equally large current account deficit (which includes net investment income) implies that foreign investors must add \$700 billion of US securities to their portfolios. It is their unwillingness to do so at the existing exchange rate that causes the dollar to fall relative to other currencies. In falling, the dollar lowers the value of the dollar securities in foreign portfolios when valued in euros or other home currencies, shrinking the share of dollars in investors' portfolios. The weaker dollar also reduces the risk of future dollar decline, because it means that the dollar has to fall less in the future to shift the trade balance to a sustainable level.

But what is that sustainable level of the trade balance and of the dollar? While experts try to work this out in terms of portfolio balances, a more fundamental starting point is the fact that a US trade deficit means that Americans receive more goods and services from the rest of the world than they send back – \$700 billion more last year. The difference was financed by transferring stocks and bonds worth \$700 billion. The interest and dividends on those securities will be paid by sending more “pieces of paper”. And when those securities mature, they will be refinanced with new stocks and bonds.

It is unthinkable that the global economic system will continue indefinitely to allow the US to import more goods and services than it exports. At some point, the US will need to start repaying the enormous amount that it has received from the rest of the world. To do so, the US will need a trade surplus.

So the key determinant of the dollar's long-term value is that it must decline enough to shift the US trade balance from today's deficit to a surplus. That won't happen anytime soon, but it is the

direction in which the trade balance must continue to move. And that means further depreciation of the dollar.

An important factor in this process will be the future price of oil and the extent of US dependence on oil imports. In each of the past four years, the US imported 3.6 billion barrels of oil. At the current price of more than \$140 a barrel, that implies an import cost of more than \$500 billion. The higher the cost of oil, the lower the dollar has to be to achieve any given reduction in the size of the trade deficit. So a rising oil price as measured in euros or yen implies a greater dollar fall, and therefore an even higher oil price when stated in dollars.

There is one further important consideration in thinking about the future value of the dollar: relative inflation rates in the US and abroad. The US trade deficit depends on the real value of the dollar – that is, the value of the dollar adjusted for differences in price levels in the US and abroad. If the US experiences higher inflation than our trading partners, the dollar's nominal value must fall even further just to maintain the same real value.

The inflation differential between the dollar and the euro is now relatively small – only about one percentage point a year – but is greater relative to the yen and lower relative to the renminbi and other high-inflation currencies. Over the longer run, however, inflation differentials could be a more significant force in determining the dollar's path.

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