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In Whole or in Part?
The Value of the U.S. Dollar

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In 2001, when George W. Bush became president of the United States, the dollar bought about 30% more on the international markets than it did in 2007. That's measured against an inflation-adjusted index of major foreign currencies. Weighted against the countries which with the United States conducts most of its trade, the dollar still lost about 20% of its purchasing power. Because that is an average across many countries, for specific countries the loss can be smaller or greater. For example, in 2001, for one U.S. dollar you would have received C$1.55, but in 2007 you got only C$1.07, about a 45% loss in purchasing power.

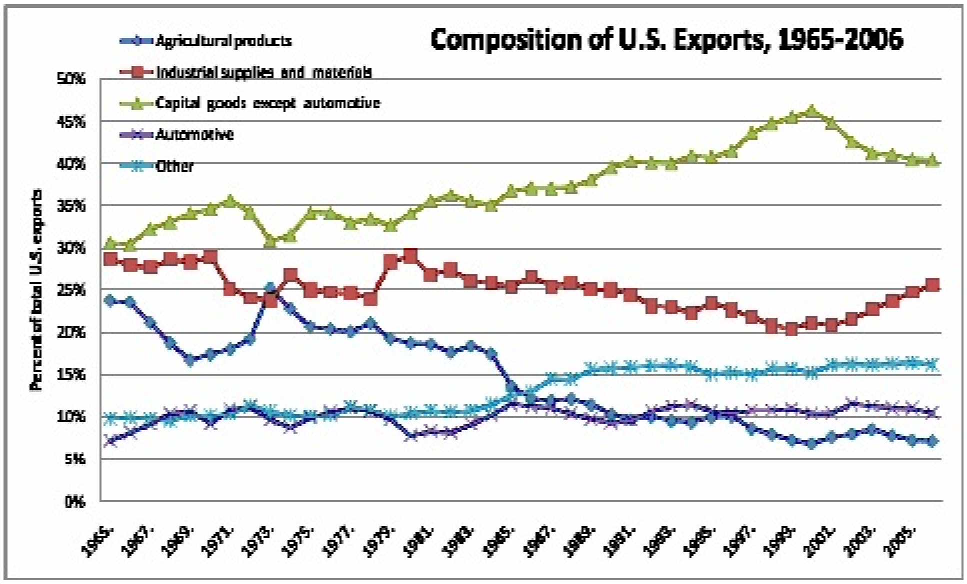
Say a much-cherished Canadian winter family vacation in 2001 cost you C$5,000. At the time, that would have translated into US$3,226. The same C$5,000 vacation in 2007 would have cost US$4,673 — effectively, a 45% price increase. Understandably, fewer U.S. Americans will vacation in Canada. But by the same token, more Canadians will vacation in the United States because what the U.S. dollar has lost, the Canadian dollar has gained.

Loss of purchasing power suggests that citizens of the United States not only vacation less often in Canada but that they generally should want to buy less from its northern neighbor. Imports from Canada should shrink. Similarly, Canadians should buy more from their southern friends, and exports should increase. Fewer imports and more exports should lead to a reduced trade deficit, or even to a trade surplus for the United States.

The last time the U.S. dollar rapidly lost international purchasing power was in the 1985-1988 time period. And with a 2 to 3 year delay, the U.S. trade deficit (with all trading nations) indeed fell from US$152 billion in 1987 to a low of US$31 billion in 1991. But this time around, things are different. The U.S. trade deficit stood at exactly a billion dollars a day in 2001 (US$365 on the year) and, in 2006, was US$759 billion, or about two billion a day (final numbers for 2007 have not been released yet).

Granted these numbers have to be adjusted for inflation but in this case that's a nicety. After all, the direction is wrong. Instead of a falling trade deficit, as in the mid to late 1980s, the trade deficit keeps rising. Moreover, when earnings and other transfers are included in this picture — what Americans earn on foreign investment, and what foreigners earn on their U.S. investments — the picture gets even worse.

So, what, if anything, is wrong? One reason has to do with the increase in world energy prices on account of rapidly increasing Indian and Chinese energy demand combined with the onset of the Afghan and Iraq wars. More demand and supply disruptions increase the



price. Thus, fuel and power producer prices in the United States increased by nearly 69% from 2001 to 2007. In contrast, industrial producer prices as a whole increased by only 29% (which includes the fuel and power component). Indeed, petroleum imports to the United States tripled in dollar-terms between 2001 and 2007 and, in percentage terms, went from 9% of all U.S. imports in 2001 to 16.2% in 2007.

But even if petroleum prices had not been changed at all, the trade deficit would still have been rising — despite the falling value of the dollar.

So perhaps part of the answer lies not so much on the import side but on the export side. A falling dollar means that the United States ought to be exporting more. And it has. But not as much as one might have thought it should. During the mid to late 1980s dollar rout, exports rose by 80% (1985-1990). But from 2001 to 2006, exports rose by only half that, 42%. It appears that despite the falling value of the dollar, foreigners aren't buying. When one examines the composition of U.S. exports, one notes that exports of agricultural, automotive, and "other" exports have held steady as a percent of overall exports since 2001, but that capital goods exports have drastically declined, and that exports of industrial supplies and materials have equally drastically increased (by about 5 percentage points each). That is, whereas industrial supplies and materials reacted to the fall in the dollar value as expected (an increase from about 20% to 25% of all U.S. exports), capital goods exports fell from about 45% to 40% of all U.S. exports (see Figure above).

Foreigners, in other words, are buying capital goods elsewhere. Despite the low value of the dollar, American-made products, capital goods in particular, do not appear sufficiently competitive. Instead, the U.S. is now in the parts-supply business. That's overstating things a bit, to be sure, but it should get policymakers thinking.

Note: All numbers are taken from the *Economic Report of the President 2008* (released February 2008).

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