The *Risk* of Dollar Devaluation

By David Hale

Why Team Bush can't devalue its way to a stronger economy.

The U.S. Treasury scored a minor coup for its exchange rate policy recently. Cuba announced that it will revalue its currency against the dollar by 8 percent. The Treasury did not claim credit for the Cuban decision but it could point to Cuba's decision as a justification for other developing countries to let their currencies appreciate against the dollar.

The Treasury began to encourage dollar depreciation when the Bush Administration became concerned about the loss of three million manufacturing jobs. The Administration wanted to demonstrate that it was promoting manufacturing competitiveness and employment with a soft-dollar policy. Political advisor Karl Rove was very focused on holding the electoral votes of swing industrial states such as Ohio through a mixture of explicit protection—in particular steel tariffs—and dollar depreciation.

The Rove strategy appears to have worked. The president held the electoral votes of Ohio by a slender margin while enhancing his margin in West Virginia and losing Pennsylvania by a very narrow vote. What the Republicans have so far failed to appreciate is how they won elsewhere in the country. The decisive factor which drove the president's reelection was house prices. George Bush has presided over more housing inflation than any president in the twentieth century. During his first four years as president, real house prices rose by 36 percent and produced a $5 trillion capital gain for the American people. The previous record was a 25 percent real house price gain during the second term of Ronald Reagan. The poorest house price record was the term of the first President Bush, when real house prices were flat.

House prices have continued to increase since the election while there are increasing signs of a speculative frenzy in the market. House prices have increased by more than 30 percent in many regional markets during the past

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year. Realtors report that investors now account for about 23 percent of all home purchases, or a level double what it was five years ago. In Miami, the number is 66 percent. There has been a sharp increase in both variable-rate loans and mortgages without any principal payments for several years. According to the Joint Center for Housing Studies, mortgage payments now consume nearly 20 percent of personal income while one in three households are devoting a third of their income to mortgage payments. The ratio of rents to house prices has risen to a level one-third higher than what prevailed during the mid-1990s. There are now 427,000 real estate agents in California while there were only 680,000 homes sold in the state last year.

It is important for the Republicans to recognize their dependence upon property values because a policy of excessive dollar depreciation could jeopardize the American housing boom by driving up mortgage borrowing costs. The economic risk to housing is very simple. The American current account deficit is now approaching $800 billion and is equal to 50 percent of the value of U.S. manufacturing output. If the dollar falls by enough to reduce the current account deficit by 25 percent, the country's capacity utilization rate will rise from 79 percent to 86 percent. If the deficit falls in half, the utilization rate will increase to 93 percent. The Federal Reserve would regard a utilization rate of 86 percent as dangerously inflationary. It would respond by hiking its official lending rate from 3 percent to 6–7 percent. In such a scenario, mortgage rates would also rise sharply and puncture the great American housing boom.

The Republicans have to recognize that they cannot devalue themselves into a strong economy without running the risk of higher inflation, sharply higher interest rates, and falling house prices. What they should try to achieve is steady growth with a stable dollar, which would increase the current account deficit to $1 trillion by 2008. Such a deficit may seem frightening, but the reality is the East Asian central banks would finance it. Japan provided $400 billion of funding for the U.S. deficit in 2003–04 while China provided over $200 billion. As neither country wants its currency to rise against the dollar, they could easily expand their foreign exchange reserves by another trillion dollars in order to fund the U.S. deficit. In 2008, Japan could have foreign exchange reserves of $2 trillion while China could have $1.5 trillion compared to $850 billion and $640 billion today.

The Bush Administration should cease talking the dollar down and criticizing the Asian central banks for promoting currency stability in their region. The White House should also be careful not to appoint a replacement for Alan Greenspan as Federal Reserve chairman who would promote dollar depreciation to reduce the current account deficit. The Administration should instead recognize that it needs an expanding current account deficit to sustain domestic consumption and the house price boom, which helped to reelect the president in 2004. In fact, it would not be an exaggeration to suggest that the current account deficit could be the major swing variable in determining the 2008 election. If the current account deficit falls to $300-400 billion, interest rates will rise sharply and help Hillary Clinton to win the election. If the current account deficit expands to $1 trillion, there will be much less pressure to tighten monetary policy and the Republicans will have an excellent chance of retaining the White House. ◆

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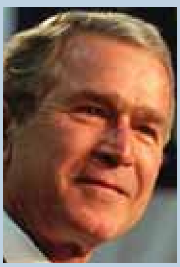

George W. Bush

Ronald Reagan

George H. W. Bush