

# Protectionism and the Falling Dollar

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Reactions to the dollar's relentless decline have been mixed. Some think of the dollar as an instrument of government policy and believe that a cheapened dollar protects the U.S. from foreign competition. Others assert that movements in the dollar are a natural result of market forces. My work places me among a third group of observers who see the dollar's decline as unnatural and dangerous.

The value of the dollar measures market confidence that the government will preserve the purchasing power of its debt -- hardly a question that should be left unanswered or delegated to markets to guess.

A fall in the dollar is the first in a familiar sequence of closely connected and undesirable events. The steps in this process (not necessarily always occurring in exactly the same order) include substantial rises in the prices of gold and other commodities, increasing inflation, a bear market in bonds, capital outflow from the U.S. economy, financial uncertainty, a decline in the investment performance of equities, Fed rate hikes and flattening economic growth.

In today's world, currency movements are directed in large part by protectionist sentiment. Granted, protectionism is no longer so much a matter of tariffs or quotas for specific industries. Usually it's a unified effort to cheapen the dollar relative to foreign currencies so that (it's hoped) U.S. exporters will gain a price advantage -- or overcome a price disadvantage.

Belief in this theory lives on despite its preposterous implications. If we could make the dollar completely worthless, the logic goes, domestic producers would wipe their foreign competitors off the map, and the U.S. economy would take over the world! The fallacy is that international prices are set by competition and habitually compensate for currency changes. As many countries have found out, the end result of allowing the value of a currency to depreciate is hyperinflation and economic collapse -- as in Weimar Germany in the 1920s and in Zimbabwe today.

Nevertheless, too many people believe that what's good for exporters must be good for the whole economy. The fact that exports underperform when the economy grows best, and outperform when the economy grows least, does not sway them. And as long as the U.S. Treasury and Congress continue to telegraph their desire for a cheaper dollar, markets will allow the dollar to depreciate.

The touchstone for protectionism in the U.S. is the trade deficit. Historically when the deficit has widened, the foreign-currency value of the dollar has declined; when the deficit has narrowed the dollar has risen. Congressional intolerance for the deficit has been growing throughout this decade, and this year it appears to be spinning out of control.

Protectionists are focused on China because of the sheer size of the bilateral deficit with the Chinese. They export to us five times as much as we export to them. Nothing like such a ratio has been seen since the mid-1980s, when Japanese exports to the U.S. exceeded its imports from

the U.S. by a factor of three, and "Japan-bashing" was in vogue in Washington. To their credit, the Chinese have consistently declined to cooperate with the U.S. desire to try to shift the terms of trade against them by depreciating the dollar 30% or so relative to the yuan. As a result, pressure on the dollar to decline has been diverted to other currency markets where resistance has not been so strong, and that may explain the current dollar decline. But now European central bankers are beginning to complain.

It's hard to argue that the overall economy is suffering so much that it needs protection. A sustained slowdown has long been feared, but is yet to appear. Consumer spending is growing despite the housing market's troubles, and the unemployment rate remains historically low. So what is all the fuss about? It's probably the same old political problem that results from all economic progress. Some parts of the country are hurt by globalization even as the economy as a whole is boosted.

Perhaps politicians are also in awe of China's growth. They may still be shell-shocked by the speed with which our bilateral trade deficit widened after the Chinese economy began to be reintegrated with the free world more than a decade ago. For whatever reason, the Bush administration (led, as tradition decrees, by the Treasury) and the Congress (with New York Sen. Charles Schumer at the fore) are aggressively pursuing a dollar-cheapening policy, with China principally in their gun-sights. Most presidential candidates, including the Democratic front-runners, have signed on. The markets, responding to all of these political voices, are pricing the dollar lower and lower.

It's a myth that deficits are created by currency misalignments. They are driven by the business cycle. In the late stages of a U.S. business-cycle expansion, as now, exports traditionally outgrow imports and the trade deficit narrows as a result. When that occurs, the dollar's foreign-exchange performance tends to improve with a delay of about a year. Symmetrically, after U.S. imports grow faster than exports, the dollar's foreign-exchange performance tends to deteriorate.

Although you don't hear it from the press, U.S. exports have now been outgrowing imports for two years. A multi-year decline in the exports-to-imports ratio bottomed in 2005 at 0.65. Final data for the second quarter of 2007 show a ratio of about 0.69 -- back to where it was five years ago. From mid-2006 to mid-2007, exports grew 10% while imports grew 4%. Our bilateral exports-to-imports ratio with respect to China has also been rising. That stabilized back in 1999 and is slowly increasing. The trouble is that politicians look at trade "gaps" rather than ratios, and the trade imbalance between the U.S. and China is so huge that exports have to outgrow imports for quite a long time before the deficit narrows.

It's ironic that, because economic vitality keeps imports growing, it also fuels protectionist sentiment. The fervor with which politicians are still intent on cheapening the dollar can be traced back to the economy's strength. Protectionism is a political and intellectual virus that attacks the soundness of a currency even in the midst of economic health -- unless it is checked. But there is no one on duty in Washington who is willing to perform that role.

So it's too soon for trade-deficit mania to calm down quite yet. The economy is still sucking in imports. Conditions for a sustained rise in the dollar have been created only quite recently, but

they are there now. It should be only a matter of time before protectionist politicians turn to more urgent matters, and the traditional cyclical upturn in the dollar reappears.

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