Why U.S. Should Root For Dollar to Weaken More
By MARK WHITEHOUSE

Last year, the U.S. dollar did what economists had long predicted it would have to do: It fell in value against other currencies. And many believe that if Americans know what is good for them, they should be hoping for more of the same this year.

A weaker dollar creates plenty of hardships. Not only do European vacations get more expensive for Americans, so do Chinese-made television sets and other imported goods. For foreigners, a weaker dollar means their investments in the U.S. lose value. But in the eyes of economists, the more the dollar weakens, the more it helps alleviate one of the great worries of our time: The gaping U.S. current-account deficit.

The current account, which includes trade flows and other international payments, measures exactly how much Americans' spending is outpacing their income -- and how much they are borrowing from abroad to fill the gap. The U.S. is estimated to have rung up a deficit of about $900 billion in its current account last year. That is equivalent to nearly 7% of the U.S. economy -- a level that, if sustained, would cause the nation's foreign debts to pile up to dangerous levels.

A weaker dollar would help narrow the deficit by making U.S. exports more attractive to foreign buyers while making it costlier for Americans to buy products from abroad.

The fate of the dollar and the current account, which has worried economists for years, was a hot topic at this past weekend's annual meeting of the American Economic Association. A panel of prominent economists -- including Nobel Prize winner Robert Mundell of Columbia University, Harvard's Martin Feldstein and Kenneth Rogoff, Michael Mussa of the Peterson Institute for International Economics and Ronald McKinnon of Stanford -- held forth on the subject to a packed ballroom in Chicago.

"We clearly need a more competitive dollar," said Mr. Feldstein, who also heads the National Bureau of Economic Research. "The dollar is still very high -- too high to be sustained."

A tougher question is how far and how fast the dollar needs to fall. Some economists fear a sudden plunge will roil international markets and trigger a U.S. recession. Others believe a slower and more manageable adjustment is under way. They guess it could take a decline of 8% to 25% over as many as 10 years to get the U.S. current-account deficit down to a more sustainable level of 3% of gross domestic product.
In the past several years, the dollar's movements have played into the hands of those who believe the dollar's adjustment will be slow and not too painful. After gradually weakening from its 2002 peak, the dollar strengthened in 2005, even as the U.S. current-account deficit set records. In 2006, the U.S. currency weakened again, as evidence of improving economic growth in Europe prompted investors to put more money into euros. Friday, the dollar's value against a basket of U.S. trading partners' currencies was down 2% from a year earlier and 17% from its February 2002 high.

Jim O'Neill, chief economist at Goldman Sachs in London, applauded the currency's renewed slide. "I think it's good," he said. "It's all part of the growing evidence that the likelihood for international imbalances improving themselves has risen quite significantly."

A weaker dollar by itself won't be enough to resolve global imbalances. Many economists agree that Americans also will need to save more, either by spending less or by cutting the federal budget deficit. As of November, U.S. consumers' spending exceeded their disposable income by 1%. The nation's budget deficit is running at about 3% of GDP.

Stronger growth abroad could play a role in shrinking the current-account deficit by increasing U.S. exports, though some believe the benefits would be limited. In recent history, increases or declines in foreign consumption have had only about half the effect on U.S. exports as changes in U.S. consumption have had on U.S. imports, says Catherine Mann, an economics professor at Brandeis University in Massachusetts.

Beyond that, much depends on exactly which currencies the dollar weakens against. Economists view Asian currencies as most crucial because trade deficits with Asian countries account for more than half of the U.S. current-account gap. So far, the dollar's biggest retreat has been against the euro. Friday, a euro bought $1.30, up 7% from a year earlier. In the same period, the dollar weakened 3% against the tightly controlled Chinese yuan and has strengthened about 4% against the yen.

"You'd need the Asian currencies to do more of the adjusting," says Mr. Mussa, senior fellow at the Peterson Institute for International Economics in Washington.

With all the caveats taken into account, economists' estimates vary widely on how much the dollar would have to weaken to bring the current-account deficit into line. Mr. O'Neill is among the most optimistic. He thinks a 25% drop in the dollar's trade-weighted value from its February 2002 peak, combined with consumer spending slowing in the U.S. and accelerating abroad, would be enough to do the trick. With the dollar down 17% from its peak, that leaves only eight percentage points to go.

Mr. O'Neill's view depends in part on the idea that the U.S. has yet to fully benefit from the dollar's previous weakening, because changes in exchange rates tend to affect trade flows with a lag of as much as two years. Indeed, in inflation-adjusted terms, the U.S. current-account deficit has been stable as a percentage of GDP since late 2004.
Mr. Rogoff, a specialist in international economics at Harvard, sees a darker picture. He believes the dollar must fall at least another 20% from now and worries that the longer it takes, the greater the chances that some unforeseen shock -- such as a terrorist act or a housing-industry collapse -- will trigger a crash. "So far we've just seen a small ripple in the dollar and not the big tsunami that could hit someday," he says. "That's still a significant risk."

As a result, many economists view any move toward a weaker dollar as a step in the right direction. Says John Huizinga, a professor of economics at the University of Chicago Graduate School of Business: "Any depreciation that's in a normal, observable range is good, because it leaves less depreciation to happen and lessens the likelihood of one of these crises."