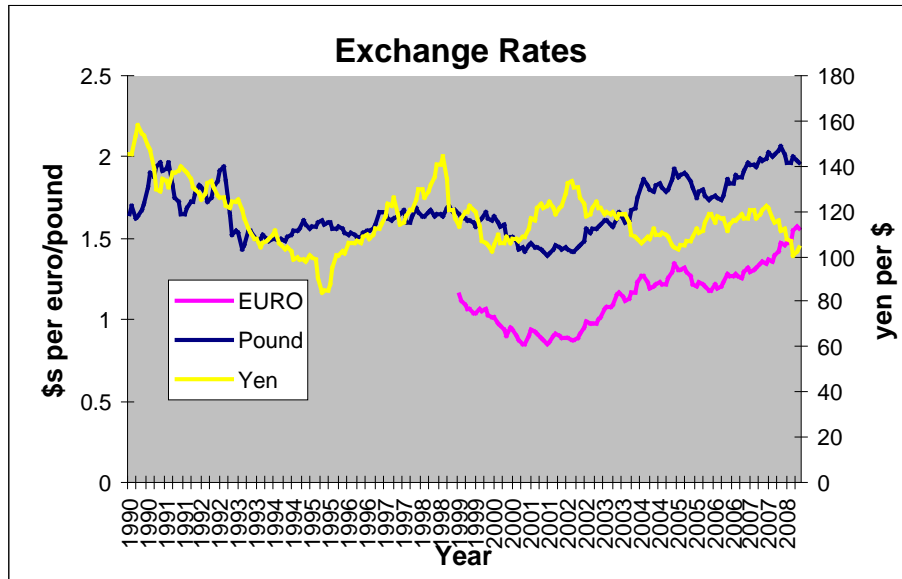


Exchange Rates: June 2008

By Tino Sonora PhD

Zagreb, Croatia – As I am currently in Croatia I spend a lot of time thinking about the exchange rate. Over the past seven years, the dollar has depreciated about 60% to the euro, 33% to the pound, and 44% to a basket of our 12 largest trading partners. Of course this has implications for many economic variables. See figure below for euro, yen and UK pound exchange rates, all show a depreciation of the dollar since 2001.



Though seemingly somewhat simple, exchange rates contain a lot of information. A currency's value reflects peoples willingness to hold that currency, hold assets denominated in that currency, or trade with that country. Changes in these preferences impact the value of that currency relative valid substitutes – other currencies.

Loss of faith in a given currency has precipitated many global financial crises: the European currency crisis in the early 1990s, the Mexican peso crisis a couple of years later, and the Asian crisis and Argentinean currency crises soon thereafter.

Let's discuss the trends in causality, twboth how the exchange rate effects us but also how our behavior impacts the exchange rate. As you might suspect, the combination of these effects becomes a loop – back and forth.

Recession

I know the “R” word is still not official – usually we don't know we were in a recession until we are out of it – but it's probably safe to say we are in one. Over the past 8 – 10 years the health of the economy has increasingly fallen on the shoulders of the humble

household consumer – household consumption now accounts for about 70% of total GDPO rising from about 65% or so in all previous years.

This was, of course, fueled by over spending by households, stoked by rising home prices and historically low interest rates. However, for the past three years, household personal income has fallen behind its trend, and is currently about 2% below trend. Simple analysis shows that a fall in personal income below trend of 10% causes the dollar to depreciate about 1%.

Trade-Deficit

Many economists and policy makers believe that the large trade deficit is also responsible for the falling dollar. With a rising trade deficit the demand for foreign currency (say, the euro or Chinese yuan) relative to the dollar rises pushing the value of the dollar down a 10% increase in the deficit yields about an unconditional 3% depreciation of the dollar.

This is not helped by the relatively low interest rates in the US and the slumping stock markets as American producers fail to reach analyst's expectations and rising costs, e.g. the price of oil. This makes US paper assets less attractive to foreign and domestic investors and they ship their money elsewhere, again more downward pressure on the dollar.

To combat inflation the European Central Bank (ECB) has maintained a relatively high interest rate for its member banks while the FED has chosen to lower rates to combat an impending recession.

Risk

Next, we have risk. The US being involved in a couple of years in the Middle East makes holders of dollars a little nervous. Couple that with the decline in the housing market, rising household debt, and rising government deficits (increases the probability of default) and you have a rising risk premium.

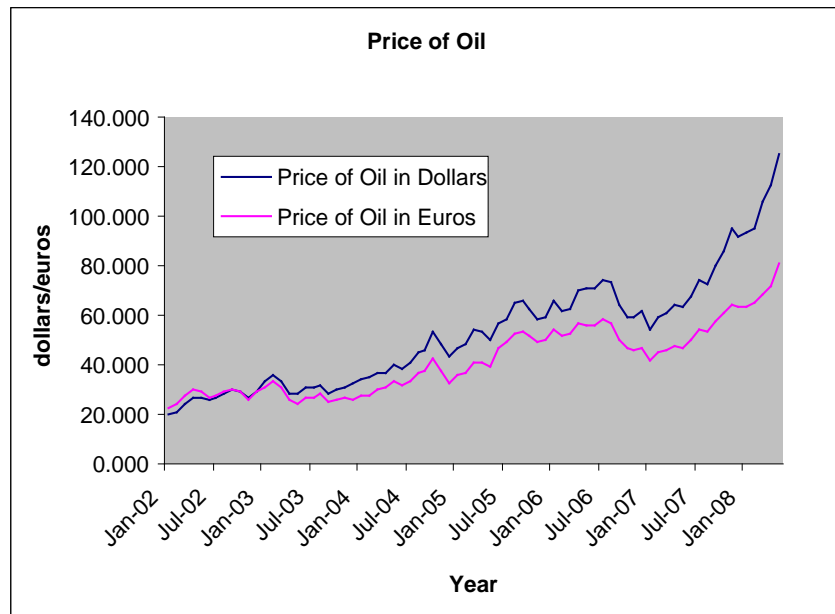
Inflation

One of the great concerns of any central bank is inflation. Many of the largest central banks have chosen to concentrate much of their efforts on keeping inflation low and predictable – including the US Federal Reserve. Unfortunately, a falling dollar impacts our inflation rates as the prices of imported intermediate and final goods rise if we use dollars to buy them. Clearly this helps to drive inflation, and the Fed should be concerned about this. Unfortunately, the lower interest rates, which helps stimulate the economy driving inflation, a dangerous game.

Oil Prices

One of the largest sources of the rise in oil prices is the decline in the dollar. Oil is traded in dollars, and there is a premium associated with a falling dollar – if oil exporters can't buy as many goods per barrel of oil produced, they have to compensate with higher dollar prices.

Of course this happens US demand, but for Europeans, the price of oil has risen but not nearly as dramatically as in the US. Therefore, for them, and all countries which fix their currency to the euro, the rise hasn't dampened demand too much, see the figure below.



It remains to be seen if the depreciation of the dollar is short lived, given that the dollar is the world's "reserve currency" or if other currencies, such as the the euro, will maintain their current strength, my guess is that the dollar will probably not regain the same level of prominence it has enjoyed since the end of World War II.