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The Devaluation of the United States Dollar: Causes and Consequences

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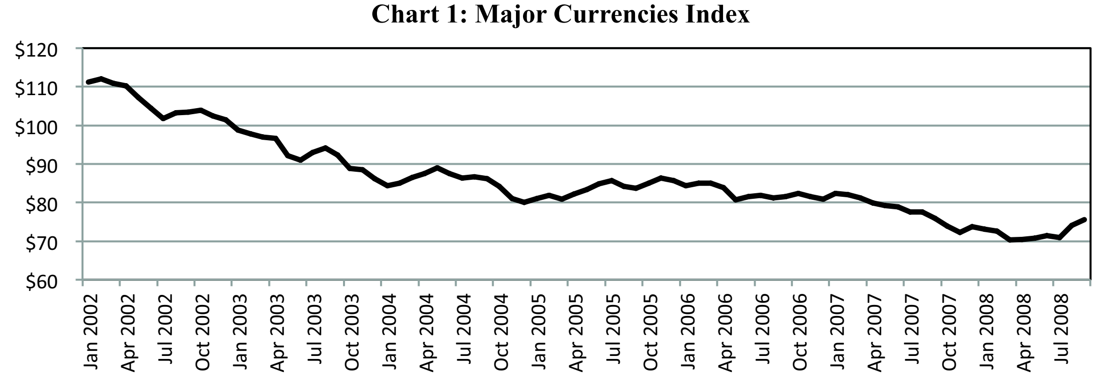
This paper identifies many of the challenges that the U.S. dollar faced between 2002 and 2008, and also the consequences Americans are facing because of the dollar's free fall in value. Implications of the United State's current activities, both in- and outside of its borders, are examined in order to determine the causes of the decline of the U.S. dollar. In addition, a potential remedy is presented and includes the formation of a coalition with other countries to begin allowing all currencies to float freely in the exchanges, thereby letting the market dictate currency prices. Of course, the likelihood of this is small. Another remedy that is within the power of the U. S., but also unlikely to take place, is to reduce government spending as well as the ever-increasing deficits. If drastic actions such as these are not instituted, further declines in the dollar's value will take place, and the ramifications will be severe.

The beginning of the Twenty First Century has seen a tumble of the United States currency that, if it continues, threatens to knock the dollar out of its position as the primary currency of the world. From a high in 2002 to the recent low in the summer of 2008, the U.S. dollar has taken a dramatic dive, one that may continue for the foreseeable future if the causes accredited with its decline are not rectified. The decline of the U.S. dollar is already affecting the prosperity of millions of Americans. The rapid rise in oil prices that has taken place in 2008 is probably the most notable effect of the currency decline. In addition to losing its title as the bloodline of global commerce and security of the world, the American dream is at stake, and action must be taken to strengthen the value of the U.S. dollar.

This paper shows the causes that have besieged the U.S. dollar between 2002 and 2008, and also the consequences Americans are facing because of such a free fall. The implications of the current activities both in- and outside of the United States must be examined in order to determine the causes of the decline of the U.S. dollar. Remedies must be instituted or else further declines in its value will take place, and the ramifications will be severe. Drastic action must be taken to strengthen the U.S. Dollar.

This paper is divided into three main sections. The paper will first describe the causes that have led to, and continue to foster, the deterioration of the U.S. currency in the world markets. This includes America's appetite for imported goods, the federal government's fiscal policies, the emergence of the European Union and China, and the general globalization of the world market. Next, the paper will describe the consequences that have come about because of the sharp drop of the U.S. Dollar and its low value in comparison to other currencies of the world. The consequences consist of high import prices, including commodities, diversification of currency because of current globalization and perceived risk of the dollar, and an increase in exports by U.S. manufacturers. The paper will then conclude with suggested, and common-sense, remedies which will combat the decline of the U.S. Dollar and help it reaffirm its title as the dominant currency of the world.

Chart 1: Major Currencies Index



Federal Reserve Statistical Release

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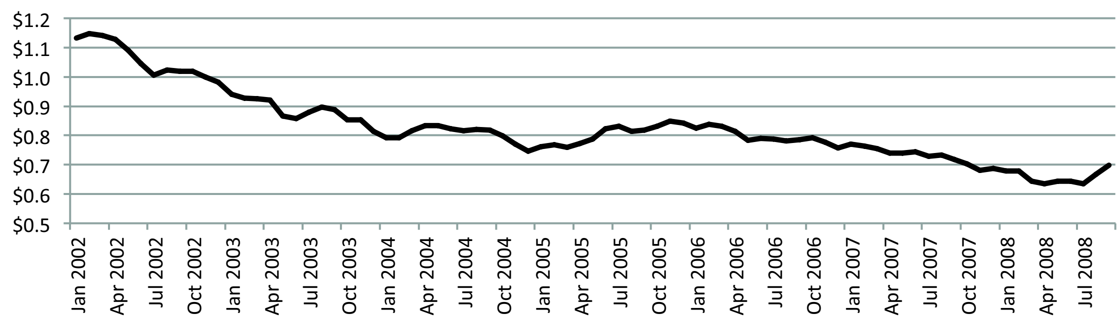
Brief History

According to the Federal Reserve Statistical Release, during the current decade, the U.S. dollar has seen one of the most severe and drastic devaluations in its history. In six short years its weighted average value in the world market, represented by the major currencies index, has declined from an average high of $112 in February 2002 to a low of $70 in July 2008 as shown in Chart 1 above. One U.S. dollar is now worth 38% less than it was in 2002 when looking at the broad spectrum of major world currencies that make up the Major Currencies Index (MCI). The MCI is issued by the Federal Reserve Statistical Release, and includes Canada, Japan, and many of the countries in the Euro area such as the United Kingdom, Switzerland, Australia, and Sweden, with the addition of other major currencies in developed countries. When looking at the currency exchange rate between the U.S. dollar and the European Union (the Euro), the decline is staggering (Chart 2). As seen from Chart 2 below, the dollar hit a high in 2002, where one dollar was worth over 1.1 Euros. Since then, the dollar has been on a steep decline, shedding over 45% of its value, to the low reached in July 2008 of less than 0.6 Euros. Only recently has the dollar rebounded against world currencies, not due to a change in the fundamentals described below, but due to a change in the global market. Investors are flocking to the U.S. because, currently, they deem us to be one of the best of the worst in the current financial crisis. After the current financial crisis has passed though, there is nothing to keep the dollar from continuing its downward trend against the world's major currencies as demand for the dollar dissipates.

Chart 2: Value of 1 USD to Euro



Federal Reserve Statistical Release

CAUSES OF THE DEPRECIATION OF THE U.S. DOLLAR

The U.S. Trade Deficit

There are many factors that can be attributed to the relentless devaluation of the U.S. dollar, but the one that is having a profound effect is the trade deficit that continues to plague the U.S. economy. In the current decade the value of the trade-weighted dollar has continued to fall as "the United States has continued to rack up historically unprecedented trade deficits" (Rogoff 2008). As Chart 3 depicts, the deficit has more than doubled since the early 2000's, even as the value of exports has been increasing (Foreign Trade Statistics). The U.S. trade deficit is currently running between 5 and 6 percent of Gross Domestic Product (GDP). With the American consumer's addiction to cheap goods and services and their current ability to spend as they please through endless amounts of debt, the imbalance between the trade deficit and GDP will only get worse. This imbalance has the effect of pouring massive amounts of U.S. dollars into the world, which in turn, pushes down the value of the dollar. Since the products or services exported by the U.S. are not equivalent to the net goods and services imported, countries are left holding dollars which they may either use to rack up currency reserves or to purchase U.S. Debt. Countries, such as those in the Persian Gulf, are finding themselves with huge stockpiles of U.S. dollars due to oil sales. These countries must either stockpile endless reserves of dollars or invest them back into the U.S. through trade, debt, or equity purchases. With large quantities of the dollar being injected into the world market because of trade discrepancies, investors from foreign countries are demanding increased returns on their investments. They do this by either requiring higher interest rates or through additional purchasing power with their native currency. With the federal government artificially keeping interest rates low (discussed later), investors are left to push down the value of the dollar. This pushing down of the value of the dollar increases their purchasing power when investing in the U.S. or purchasing

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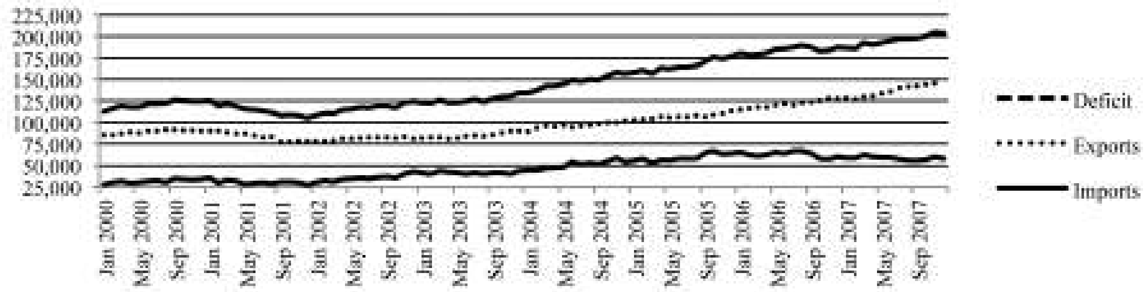
goods from the U.S. An insufficient inflow of dollars back into the U.S. leads to a further depreciation of the dollar. This depreciation gives foreigners an incentive to purchase goods or services, invest in government or corporate debt, or take equity stakes in U.S. corporations. The dollar will continue this process until its value is low enough to attract needed buyers or investors who are willing to purchase dollars. This will generate inflows of dollars back into the U.S. economy (Mouhammed 2008).

Chart 3: U.S. Imports & Exports (in Millions)



Tying the deficit and government debt with the need for the global community to embrace the dollar, Ronald McKinnon (2008) writes:

> "The sustainability of the huge U.S. current account deficit depends on the continuance of the dollar as the world standard. If the United States as center country maintains a stable price level, countries with trade surpluses are loathe letting their currencies appreciate against the dollar for fear of losing mercantile competitiveness in the short run while risking deflation in the long run. If private inflows are insufficient to fund the U.S. current account, then foreign central banks step in to buy dollar assets to prevent their currencies from appreciating. Thus, the deficit could continue indefinitely with no well-defined upper bound on America's net international indebtedness."

As McKinnon points out, the dollars' reliance on foreign capital pouring into the U.S. to fund its account deficit is helping the dollar value in the short run, but in the long run, it is setting the dollar up for a huge downward correction. Once countries lose faith in the dollar, they may be less willing to invest their funds in the U.S. economy. This point has been proven in the first part of 2008 when most believed that the financial crisis was contained only to the U.S. During this period alone, the dollar fell almost 15% against major currencies. Foreign Investors around the world were dumping dollars for fear of a significant correction due to the financial crisis. They were also hedging their dollar holdings against commodities that generally move in the opposite direction of the dollar. This is a contributing factor to the commodities bubble that grew at the beginning of 2008 and one of the main reasons the American public was paying over four dollars per gallon for gasoline at that time.

Low Interest Rates

The Federal Governments' deliberate intervention to keep interest rates low in addition to injecting funds into the money supply in the U.S. is also compounding the problem of the devaluation of the dollar. At a time when interest rates should be rising, because foreign investors are in need of additional returns due to of the decline in the value of the dollar, the federal government is keeping rates at artificially low levels. With interest rates low, the rate of return required by foreign investors is not being satisfied. Foreign investors then look to other markets such as the European Union, where interest rates are much higher, and as a result, demand for their currency goes up while the U.S. dollar goes down. This imbalance is causing foreign investors to either flock to European countries for superior returns or drive down the dollar to get additional value out of their native currency.

Financial Globalization

Financial globalization is also a key ingredient that continues to promote the devaluation of the dollar. Many economists argue that the dollar is destined to lose its value and its position as a key currency in the world economy (Danailova-Trainor 2007). They believe that the U.S. cannot continue to maintain the demand needed by the rest of the world to keep new foreign investment pouring into the U.S. Economists argue that the reliance on the U.S.

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for their own well being is being eroded, because of the emergence of other markets such as the European Union and China. They also believe that as a result of the foreign investment in the U.S., any perceived threat on the U.S. economy, and thus depreciation of the U.S. dollar, is compounded because foreign investors are likely to quickly withdraw their money. Allen Greenspan, former Federal Reserve Chairman, argues that, "foreign accumulation of U.S. assets will slow as dollar-denominated assets occupy a larger share of the world's store of value. As investors refuse to buy U.S. assets, interest rates will rise or the dollar will depreciate" (Danailova-Trainor 2007). This scenario may already be playing out. Because of the high trade deficit and the U.S. budget deficit, the global market is being saturated with U.S. dollars. Foreign investors are feeling pressure to diversify their positions. New global markets, such as China and Europe, have given the dollar a real rival for the first time in over a century, and thus foreign investors have an alternative to the dollar (Bergstein 2008).

The China Syndrome

The emergence of China as the number one exporter of manufactured goods in the world has also contributed to the decreased value of the U.S. dollar. During the short period of the eight years between 2000 and 2008, China has surpassed the United States as the number one exporter of the world. China has turned into a manufacturing "juggernaut," taking a huge global market share away from the U.S. and leaving the U.S. manufacturing base in ruins. The "Made in China" mark on goods has replaced the "Made in America" mark and can be found almost everywhere that consumers spend their money. This transfer to China has fundamentally changed the way dollars are handled in the world. Before China, U.S. dollars were needed and demanded because the United States was the primary exporter of the world. Dollars kept flowing back into the U.S. by the purchase of goods and services by the consumers in foreign countries. This inflow has now slowed. China has now become the primary exporter in the world, and the U.S. has turned into a huge importer of goods and services from China, only second to Europe (Preeg 2008). This has significantly reduced the inflow of trade dollars back into the U.S. economy. This has also enabled China to accumulate vast amounts of U.S. debt, and China is now number two, behind Japan, as the largest holder of U.S. Treasury securities.

The China effect has also been compounded by China by not letting their currency, the yuan, float freely against the U.S. dollar. Letting the yuan float would make Chinese products and services more expensive to the U.S. and to other foreign consumers (Moody 2006). Although letting the yuan float freely in the currency markets would further pull down the U.S. dollar in the short run, it would also enable the U.S. to gain back some of its competitive edge by being able to compete with China on the price of exported and domestically produced goods. With the yuan able to appreciate in relation to the U.S. dollar, the prices for Chinese products and services would increase and the prices for U.S. goods would decrease. This would cause exports to gain significant strength in the U.S., bringing dollars flowing back into the U.S. economy. Although China has recently let their currency appreciate against the dollar by a small increment, the yuan still has a considerable amount to appreciate to put the yuan and dollar in a correct relative position that matches their respective imports and exports (Bergstein 2008).

The Emergence of the European Union

Another significant factor that is contributing to the decline of the dollar is the emergence of the European Union. The integration of countries in Europe has created an economy that is now bigger than that of the U.S., and it has given the world an alternative currency than that of the U.S. dollar. The European Union has also taken demand away from the U.S. in the form of foreign investments and exports, and it has overtaken the U.S. in currency holdings of the world. Up until now, the Euro has provided greater returns than the U.S. dollar when higher interest rates and currency appreciation is factored in. In an article by Fred Bergstein (2008), he warns that:

> "…we should expect a steady and sizable portfolio diversification from dollars into euro's as private investors, central banks, and sovereign wealth funds seek to align the currency composition of their assets with the new structure of the world economy and global finance. One result will be steady upward pressure on the euro and downward pressure on the dollar..."

The move to euro's from dollars has already started and is a continuing cause for the decline in the value of the U.S. dollar. In 2006, the "global foreign exchange reserves totaled $4.35 trillion, of which 66.3% were held in U.S. dollars; but, as recently as 2002, the U.S. dollar accounted for over 70% of total foreign exchange reserves. The euro's increasing stature has provided foreign central banks [investors] with an alternative, and the diversification trend is likely to continue" (Moody 2006).

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The U.S. Economy

Recent perceived instability in the U.S. economy is also contributing to the depreciation of the dollar. The U.S. dollar has historically been viewed as a "safe" currency in that the risk of default or wild swings in its economy are low, and returns are almost guaranteed. Recently however, the housing crisis, along with huge trade and budget deficits, have soured the confidence that foreign investors have in the U.S. economy. In the past, investors were willing to sacrifice some of their returns by investing in the U.S. because of its reliability and security. Recently though, with confidence eroded investors are demanding higher returns by means of higher interest rates or more purchasing power of their native currency.

CONSEQUENCES OF THE DEVALUATION OF THE U.S. DOLLAR

The Dumping of U.S. Dollars

Many consequences arise because of the impact of the depreciation of the U.S. dollar. Each has the potential to deliver a severe shock to the economy of the United States and the world. One such shock would be the dumping of U.S. dollars by foreign investors. The imbalance of dollars pouring out of the U.S. with dollars pouring back in, whether through debt issues or exports, is only minor in comparison to what could happen if foreigners jettisoned their dollar holdings. Ronald McKinnon (2008) adds to his previous remarks regarding this imbalance:

> "…, this uneasy equilibrium could be upset if the Federal Reserve loses monetary control by some 'accidental' domestic event, say, pumping too much liquidity into the economy to avoid a cyclical downturn-as might be the case with current subprime mortgage crisis. Alternatively, if U.S. protectionists succeed with bashing China or Japan to force the dollar down, then foreign holders of liquid dollar assets would again become nervous. There could be a tipping point where investors in Asia or the Persian Gulf so fear the loss of the dollar's international purchasing power that they jettison their dollar holdings-despite the short-run pain of letting their own currencies appreciate. Such deep and general dollar devaluation would then cause massive inflation in the United States itself."

As Ronald McKinnon (2008) suggests, there could be a tipping point where foreign investors feel the dollar is destined to continue to depreciate, and rather than continuing to take loses, they may decide to dump their dollar holdings to invest in more secure and stable currencies. Also, "having accumulated such vast quantities, foreigners may, at some point, lose their appetite-particularly for U.S. government debt" (Moody 2006). Without a purchasing base for debt of the U.S., the pipeline of dollars flowing back into the U.S. economy would be cut off, and the funds needed to run the government would not be available.

Currency Diversification

The euro has already surpassed the dollar as the primary reserve currency in the world. The drop in value and the uncertainty in risk has stifled the dollar's ability to provide the returns required by potential investors. Investors have been forced to diversify their holdings among other currencies of the world. As discussed earlier, foreigners have been willing to finance the U.S. trade imbalance by acquiring and accumulating large quantities of U.S. government debt, and stockpiling vast quantities of U.S. reserves; however, with strong rivals to the dollar, such as the euro and the yuan, the dollar now has competition, and investors have an alternative for investment. Foreign investors can, and are, diversifying their holdings among various currencies. As investors further diversify their holdings, the demand for dollars will further depreciate, and the cycle will keep replicating itself, thus putting the dollar in a steep, downward spiral (Bergstein 2008).

The Rise in Commodities

One of the most visible signs of the depreciation of the dollar, and the consequence it is having on the U.S. consumer, is the rapid rise in the prices of commodities that has taken place during the past few years. When the exchange rate for the dollar falls, commodities, such as oil which is traded in dollars, rise. The sellers of commodities in foreign countries refuse to let their revenues decline because the value to the dollar has gone down, so they demand more dollars. The recent rise in commodity prices has been fed by fear that the U.S. dollar will continue to drop, and investors will take huge losses. Investors started to hedge their positions by purchasing commodities, thus fueling the bubble that recently burst. Even though commodity values have recently come back down to a manageable level, the upward trend continues, and higher prices are still likely in the near future as long as the dollar continues its decline (Mouhammed 2008).

Increased Import Prices

Cheap imports of goods and services, which U.S. consumers have come to expect, are also being hurt by the devaluation of the U.S. dollar. With the dollar losing its value to currencies all across the world, dollars paid for goods and services must be increased so that revenues will not be sacrificed once they have been converted to the importer's native currency. This is especially true for goods and services coming out of Europe. U.S. consumers will eventually see prices rise in the U.S. for foreign goods.

Inflation

Inflation will also increase. The downward spiral of the dollar is increasing the cost of foreign exports entering the U.S. and contributing to the overall inflation of the U.S. economy. As seen in Chart 4 below, compiled by Timothy McMahon (2008), inflation has been on a six year upward trend, since 2002 when the dollar peaked. At the same time, the U.S. dollar has been on a six year downward trend. This shows a correlation between the decline in the value of the U.S. dollar and the rise of inflation in the U.S. economy. Foreign investors are requiring higher and higher prices in terms of dollars for the goods and services they export to the U.S. This pushes up the costs of goods and services entering the U.S., which leads to a rise in inflation. Amid the depreciation of the dollar, inflation will continue. Consumers have already started to curtail their spending which is leading to a slowdown of the U.S. economy.

Chart 4: Annual Inflation Rate

Timothy McMahon (2008)

Cheap U.S. Goods

With the help of the weak U.S. dollar, U.S.-made products have become more competitive in the world arena, leading to a short term increase in U.S. exports. In Addition, U.S. goods and services are essentially on sale to the rest of the world. This effect can be seen on Chart 3, presented earlier in this paper, where the account deficit has taken a breather from its rapid increase and has leveled off for 2007. But the increased exports by the U.S. and the strengthening of foreign currencies, in contrast to the U.S. dollar, are also hurting foreign countries who rely heavily on their exports as a significant portion of their GDP. Such countries as Germany, Japan and South Korea are finding their completive edge evaporate as the U.S. dollar declines and their goods and services are becoming more expensive to their crucial customers in the U.S. (Roubini 2008). This increases the possibility of potential dispute between the United States and some European countries. Seeing their currencies appreciating against the dollar, along with their higher rates of interest, many of the countries' economies will be affected. This will lead to a contraction of export industries, causing their unemployment to rise, and their GDP to fall. In this regard, Mouhammed (2008) offers the example that, "Airbus received a $40 billion contract from the U.S. Air Force in order to grease its economic wheels [of European countries] at the expense of the American workers."

Conclusions

With the prosperity of the U.S. at stake, action must be taken to strengthen the U.S. dollar and reverse the direction it has taken over the past six years. Action must be implemented to combat the depreciation of the dollar. One such action would be to restore the trade balance in the world by letting all currencies float freely in the exchanges, thereby letting the market dictate the price of currencies. Although this would hurt the U.S. dollar in the short run, in the long run the U.S. would gain back some of its competitive edge and be better able to compete in the global market place. Exports, in addition to the flow of dollars back into the U.S., would increase. This action would require a willingness by other countries, such as China, not to artificially manipulate their currencies.

Secondly, the U.S. government must reduce its spending and get rid of the budget deficits it has been plagued with. By reducing excess government spending, the need to increase the money supply in the U.S. would be reduced. This would cause interest rates to rise and lead to a strengthening of the dollar. This would also correct the imbalance of interest rates by allowing them to rise to a realistic level that will prevent significant inflation and increase the return on capital needed by foreign investors. To do this, the U.S. government would need to be willing to curb spending and refrain from capping interest rates at very low levels.

Implications for Future Research

Implications for further research include presenting the global needs of the U.S. as a world consumer of goods and services. Additional research could also be devoted to the implications to foreign countries which refuse to give "credit" to the U.S. Further research could also be done concerning the belief that the dollar has recently been over-valued, and its recent downward trend is simply a correction to a more realistic value in comparison to other currencies of the world.

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