FIFTH THIRD BANK

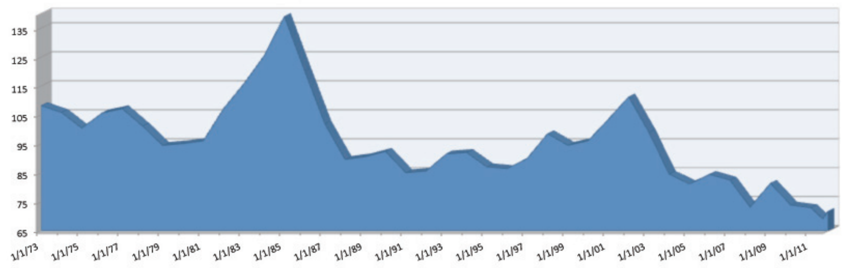
INTERNATIONAL INSIGHTS

The Buck Stops Where?

The Impact of a Declining Greenback Is No Longer Black and White

A weakening dollar traditionally resulted in lower priced American exports that stimulated sales abroad. It also caused the price of foreign goods and services to rise, reducing U.S. demand and effectively lowering the trade deficit. These past realities, although still applicable, no longer play out as they did years ago.

Federal Reserve's Nominal Major Currencies Dollar Index



Source: Federal Reserve data

Black and White Assumptions Have Become Grey

In March 1973, the value of the U.S. dollar against other currencies, measured by Federal Reserve's major currencies index, was set at 100. Since then, it reached a high of 143.91 in March 1985 and has fallen to an all-time low of 69.07 in August 2011. What is the impact?

U.S. producers increasingly rely on imported raw materials, machinery and parts, supplies and other intermediate inputs used in the manufacturing process of their products. Categorized as capital goods and industrial supplies, in 2010 they represented 52 percent of U.S. imports. When the value of the dollar weakens, these imports become more expensive. When these same producers' finished products are exported, the advantages of a weak dollar can be neutralized by the higher cost of inputs.

Many other factors play a role in turning what was a simple currency assumption upside down. These include the availability of domestic and foreign substitutes, opportunity costs of finding new suppliers, and especially, the decline in the pass-through rate.

Thus, if a currency falls by 10 percent and the cost of imports rise by 10 percent, the pass-through rate would be 100 percent. In turn, the weaker currency would theoretically reduce import demand and improve the trade balance. But today, many types of imports, especially consumer goods, typically have not become more expensive as the value of the dollar has come down. Why? In many cases, foreign exporters to the United States reduce their profit margins in order to maintain U.S. marketshare.

From the mid-1970s through the 1990s, the pass-through rate was as high as 50 percent, according to The Wall Street Journal. This meant that a 10 percent drop in the value of the dollar would boost import prices by 5 percent. The Board of Governors of the Federal Reserve indicates the pass-through rate has since declined to about 30 percent. This keeps inflation down, as well as the prices of consumer goods like clothes, which tend to be made abroad and imported in large quantities in the United States.

History is replete with examples where a declining dollar did not result in a declining trade deficit. For example, between 2002 and 2005, the U.S. dollar depreciated 23 percent against the Canadian dollar and 24 percent against the euro, says Daniel Ikenson, a Cato Institute policy analyst. However, during this period, the U.S. trade deficit with Canada and European Union members utilizing the euro rose by 58 and 39 percent, respectively.

“Of all the other major U.S. trading partners whose currencies appreciated against the dollar — Japan, the United Kingdom, Korea, Taiwan, and Brazil — only Taiwan had a trade surplus with the U.S. that declined over the period,” Ikenson continues. “And that decline was a relatively modest 8 percent. In contrast, the U.S. deficit increased by 18 percent with Japan, 22 percent with Korea, 71 percent with the United Kingdom, and 181 percent with Brazil.”

The U.S. - Chinese trade relationship provides another example where old assumptions are no longer valid. On July 21, 2005 the Chinese government announced a change in its exchange rate regime from a fixed peg at 8.28 per U.S. dollar to a managed float based on a basket of currencies. Since then, the yuan, also known as the Renminbi, appreciated by 30 percent through November 2011, according to the Federal Reserve. Yet, the U.S. trade deficit with China continues to mount.

A major complicating factor may be the amount of Chinese value-added. According to the U.S. International Trade Commission, Chinese value-added as a component of Chinese exports to the United States is between one-third and one-half of the value of the goods. As a result, one-half to two-thirds of the value of Chinese exports are of third-country origin. This not only confuses the currency issue, it is a new economic reality not accurately reflected in U.S. trade statistics.

The Dollar Has Little Competition

The declining value of the dollar, no doubt, has had serious implications for the United States. Nevertheless, it is still the currency of choice in 85 percent of global foreign exchange transactions, the Bank of International Settlements reports. And more than 60 percent of the foreign reserves of central banks and governments are in dollars, *The Wall Street Journa*l says.

As the European Union continues to struggle with severe economic difficulties, it is highly unlikely that the euro will gain in stature against the dollar any time soon. In fact, some analysts are questioning the euro’s future and asking how a union of different economies, fiscal disciplines, democracies, histories, values and languages could all use a common currency without encountering serious problems.

Some believe the Chinese yuan eventually could gain in stature to challenge the dollar for world dominance. If true, the yuan would have to gain much more influence. According to the Bank of International Settlements, in 2010 it was used in less that 1 percent of global foreign exchange transactions. Stated in The Wall Street Journal by Kenneth Rogoff of Harvard University, any transfer of reserve status from the dollar to the yuan likely would take most of this century. In the meantime, he said, the dollar will remain the world’s reserve currency.

What Does All This Mean?

It is doubtful the greenback will fall from first place, a position it’s held since usurping the British pound after World War I. Nevertheless, due to a variety of factors, today’s currency realities have new implications for American firms engaged in international trade.

Understanding the impact of these factors, as well as the knowledge that fluctuations in the value of the dollar could have very different consequences than even a few years ago, can improve the decision-making abilities of companies, while reducing risk. Importantly, there are very serious implications for policymakers, who may implement poor policies based on old assumptions.

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