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Weak Dollar Benefits Tennessee Economy

By Dr. Bento Lobo, Jeff Allara, Donna Osbourn and Adriano Santos

The dollar reflects economic conditions at home and abroad, yet it contributes to those conditions as well. Currency movements can benefit and hurt different sectors of the economy simultaneously. From 2002 to 2004, the dollar lost over 30% of its value relative to the Australian dollar, British Pound, Canadian dollar, European euro and Japanese Yen. When the dollar buys less relative to foreign currencies, U.S. imports such as oil, cost more, raising the cost of production, and giving rise to inflationary pressures.

By contrast, a major beneficiary of the weak dollar has been the state of Tennessee, where one of every 15 private-sector jobs is export-related. It is estimated that for a one percent decrease in the dollar's value, Tennessee's monthly exports increase by \$12 to \$20 million. Tennessee's large automotive and industrial machinery manufacturing sectors have increased exports sizably to countries with stronger currencies, particularly Canada, Japan and the Euro zone. State exports totaled \$16 billion in 2004, up 28% from the year 2003.

Dollar dominance

Since World War II, the dollar has been dominant, involved in an estimated 87 percent of global foreign exchange transactions, equal to about \$1.3 trillion a day. The dollar's special role in global finance has made the U.S. economy less vulnerable to changes in the value of its currency and permitted U.S. governments to borrow extravagantly at historically low interest rates. It has permitted Americans to consume at rates higher than anywhere else in the world and shielded the U.S. economy from many economic hardships such as high interest rates, plummeting asset values, inflation and recession.

Now, the status quo is threatened. The current concern with the dollar's weakness stems from the growing twin U.S. trade and budget deficits and the diminishing allure of the dollar as the world's leading reserve currency.

Stumble or tumble?

The expanding trade deficit, roughly \$650 billion in 2004, means that Americans must sell more dollars to pay for the goods they import, thereby increasing the supply of dollars in the global money market and lowering its value. At the same time, the federal budget deficit has grown to about \$400 billion or 4% of GDP, making the U.S. the world's largest debtor nation. For the most part, foreign investors and central banks have been financing this debt. The country must attract \$2 billion dollars per day in foreign capital to sustain the current trade deficit, while foreign central banks reportedly finance close to three-fifths of the U.S. budget deficit.

Current concerns center on the likelihood of a pronounced drop in the dollar and a fire sale of U.S. assets by foreign central banks and private investors which will hurt U.S. financial markets, ignite inflationary pressures, cause interest rates to rise sharply and lead the U.S. economy back into recession. The effects would be felt right down to Manufacturer's Road and Jersey Pike.

Economic policy fixes collide with local politics. Americans need to save more and consume less, primarily by reducing government dissavings, i.e. budget deficits. The Asians need to let their currencies rise in value, rely less on export-led growth and more on domestic demand. The Europeans need to lower taxes and interest rates and stimulate their economies.

However, Japan continues to languish in an economic mire. China refuses to revalue the yuan, currently pegged to the dollar, and other Asian economies fear loss of competitiveness to China due to a revaluation. France, Germany and Italy continue to be major European economic drags. And in America, the current account deficit continues to finance a consumption binge rather than an investment boom.

What's ahead?

A hard landing, however, is unlikely. Foreign investors are attracted to American assets because even today they earn a higher return in the U.S. than most places in the world. Moreover, many Asian governments have "pegged" their currency at a percentage below the value of the American dollar. To "defend" their currency peg to the dollar and prevent their currencies from rising in value, these governments buy American securities. This, in turn, promotes export-led growth. By the end of 2004, Japan, China and Korea had accumulated about \$1.7 trillion in reserves which they have used to effectively support the dollar. A sell-off of dollars could hurt the sellers more.

Nonetheless, the emergence of the euro means that the U.S. dollar now has a competitor in global currency markets. The six-year old Euro zone is an economy about the same size as the U.S., but unlike the U.S., is a net creditor. Foreign central banks cannot keep accumulating dollars indefinitely especially if those dollars keep falling in value. To paraphrase Fed Chairman Greenspan, eventually foreigners will lose their appetite for more dollar-denominated assets. The euro offers an attractive second choice.

If global demand for the dollar were to seriously wane, foreigners would be less likely to price

imports/exports in dollars, necessitating currency risk hedging strategies on the part of American companies; U.S. interest rates would have to rise to attract foreign capital; a switch from a petrodollar system to a petroeuro system could result in Americans paying a lot more for oil and its byproducts. The price of excessive consumer and government consumption would be significantly higher.

According to the Chamber of Commerce's 2004 BREV study, 21% of Chattanooga-area businesses have overseas operations, mostly in Europe and Asia. Some 17% of local businesses primarily service an international market. This exposure to foreign markets will only increase in a world with global sourcing and internet commerce. It is imperative that consumers, investors and corporate managers pay heed to currency market developments. Successful business strategies will recognize that the dollar may be America's currency, but it is the world's problem.

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