Dollar's Decline Has Little Impact On Import Prices

While Euro-Zone Nations Feel Pressure, Trade Deficit Remains Unaffected So Far

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The dollar's steady erosion continued amid rising concern in Europe and among economic-policy makers and investors. But the latest economic indicators show little adverse effect yet in the U.S.

One of the few signs that the sliding currency ultimately could prove painful was a brief pop in the price of oil, which Tuesday touched a 10-month high of $35.

What is protecting the world's biggest economy from the ill effects of a depreciating currency is the peculiar nature of the current economic cycle. Normally, a declining dollar would translate into inflation, because the cost to Americans of foreign imports rises as the dollar buys less. It would also typically narrow the trade deficit, as Americans buy fewer imports and their exports become cheaper in foreign markets. But those things haven't happened.

The world today is flush with factories and equipment built in the boom of the late 1990s and cheap labor in emerging economies. That excess capacity, and resulting competition among producers trying to keep their plants up and running, is keeping prices down. At the same time, many countries that export heavily to the U.S., notably China, have fixed their own currencies to the dollar. That keeps prices of their goods steady, no matter how the U.S. currency moves against other currencies such as the euro.

For now, it's a double-edged sword for the U.S. Because the falling dollar isn't triggering more inflation, the Federal Reserve has seen no reason to raise interest rates, which would rein in U.S. growth and Americans' appetite for imports. Speaking Tuesday in Germany, Fed Chairman Alan Greenspan said, "inflation, the typical symptom of a weak currency, appears quiescent." But for the same reason, the weaker dollar has yet to shrink the record U.S. trade deficit, which analysts say is the main reason the dollar is falling.
The euro dipped briefly Tuesday to $1.2715, but rebounded to close at $1.2766, not far from its record of $1.29 set Monday.

Since February 2002, the dollar has fallen 26% against the world's major currencies, and 14% against an index of all U.S. trading partners' currencies, including Asian countries. But in that same period, import prices, excluding volatile petroleum prices, are up only 2%. The Labor Department said Tuesday that import prices rose just 0.2% in December from November, and were up 0.1% excluding petroleum. As a result, the dollar has had little impact on underlying consumer price inflation, which is at a 40-year low.

The weak dollar hurts European exporters, whose products cost more in the American market, something even American policy makers are concerned about. Mr. Greenspan said that because of the euro's rise to record levels against the dollar, "euro-area exporters have been under considerable pressure." Speaking at the same event, Ernst Welteke, president of the German central bank, which is part of the European Central Bank, added: "The euro appreciation could put brakes on [Europe's] economic upswing."

Excess capacity has discouraged foreign producers from trying to raise prices in the U.S., even though their costs are rising in dollar terms, and they would rather see their margins shrink than surrender market share.

For instance, because of the price war in the U.S. car market, German auto makers now sell some high-end models in the U.S. for far less than they fetch in Europe, according to a study by Ferdinand Dudenhoffer, managing director of the Center for Automotive Research in Gelsenkirchen, Germany. For example, Volkswagen AG's luxury Audi A8L with a V8 engine lists for $68,500 in the U.S., a third less than its dollar-equivalent price in Europe. "We are definitely not going to make a huge profit," VW Chief Executive Bernd Pischetsrieder said at the Detroit motor show last week.

Japan's Toyota Motor Corp. has insulated itself against dollar fluctuations by building about 60% of the cars it sells in North America locally. Last week, Toyota did raise prices on some luxury Lexus sport-utility vehicles, which are still built in Japan or Canada, but by just 0.4%. It has left the base price of its LS430 Lexus sedan unchanged at $55,125.

The dollar hasn't fallen as much against many emerging-market currencies. China, a supplier of a growing share of U.S. imports, has kept its currency, the yuan, from rising against the dollar through massive purchases of dollars which it has invested in U.S. Treasury bonds. Still, some suppliers in emerging countries do face higher costs from increased raw materials, fuel and shipping. Producers of oil and other commodities have been boosting dollar-denominated prices in part because the dollar buys less world-wide than it had.
Robert Skinner, president of St. Louis, Mo.-based Kellwood Co., a marketer of branded and private label garments, such as Calvin Klein, says some of its suppliers in Asia have asked about raising their prices because of higher supply costs.

But, as with autos and many other goods, apparel is an industry with "significant global overcapacity" and suppliers realize that if they raised prices, there are many competitors in other countries that would love to have Kellwood's business instead, Mr. Skinner said. "Our retail partners are not able to charge more to their consumers, ergo we are not able to charge more to our retail partners." Kellwood hasn't raised prices in the past year, he said.

Economists say eventually the falling dollar will force import prices higher, which should stem consumers' appetite for foreign goods and narrow the trade deficit. There is a smaller, but more serious, risk that foreign investors who own U.S. stocks and bonds decide that the value of their investments, denominated in their home currencies, is falling too fast, could dump them, accelerating the dollar's fall, driving interest rates up and stock prices down and hurting the U.S. economy.

But economists say those things for now seem unlikely. Consider the effect of the dollar's decline on the trade deficit. "The overarching phenomenon in the U.S. economy is that it has gotten more competitive over the past five or 10 years," said Harvard University economist Kenneth Rogoff, former chief economist at the International Monetary Fund. The old "rule of thumb" was that 50% of a decline in the dollar would get passed through to consumers within a year. Now, he said, it is more like 30%. To quickly wipe out the U.S. trade deficit would require the dollar to fall three times as much as it already has, he said.

There are signs the dollar's decline is helping U.S. exporters. "Manufacturers are pretty upbeat about an export recovery emerging in many sectors, or most sectors, in 2004," said Jerry Jasinowski, president of the National Association of Manufacturers. But the gaping U.S. trade deficit is due primarily not to weak exports, but to imports, which surged to 14% of gross domestic product last year from 11% in 1993, while exports fluctuated between 9% and 11%. As a result, the U.S. current-account deficit -- the shortfall in goods and services trade and investment income between the U.S. and the rest of the world -- averaged $530 billion at an annual rate through the first nine months of last year, or a record 5% of GDP.

Reducing imports normally would require either that their prices rise, prompting U.S. consumers and businesses to choose locally made products over imports, or for overall spending to weaken, or both. But so far neither has happened.

A study last year co-written by New York Fed economist Linda Goldberg found that a change in the exchange rate has a far smaller impact on U.S. import prices than in other countries. Just 26% of a change in the exchange rate is passed through to import prices in the U.S. in the short run, the study found, compared with 53% in France, 59% in Germany and 88% in Japan. That helps explain why the dollar's decline has caused far more consternation abroad than in the U.S.
This is a big departure from the late 1980s when the 39% plunge in the dollar that began in 1985 was a persistent source of concern at the Fed. In late 1986, the Fed began a series of interest-rate increases, which continued until the fall of 1987, aimed at restraining inflationary pressure caused in part by the weaker dollar. Those increases, plus U.S. anger at Germany's refusal to lower interest rates and take the pressure off the dollar, helped drive up bond yields and trigger the October 1987 stock-market crash.

So far, there is no sign of a repeat. While stocks tumbled Tuesday on Mr. Greenspan's remarks before recouping some of their losses, 10-year bond yields fell to a three-month low of 4.02%. "This has been, so far, a painless devaluation," said David Hale, chief economist of Hale Advisors LLC in Chicago. Previous comparable dollar declines would have pushed bond yields and mortgage rates up by a half to a full percentage point, he said.

That could change if foreign investors turn reluctant to finance the U.S. current-account deficit or if Asian central banks stop purchasing so many bonds to keep their currencies from rising against the dollar. That would put upward pressure on bond yields, and probably hurt stocks. Many analysts have warned that the unprecedented scale of U.S. foreign borrowing is raising the risks of such a dollar crisis.

Mr. Greenspan Tuesday said that the more sophisticated international finance system can accommodate a bigger U.S. current-account deficit than before. If it continues to rise, at some point investors will become reluctant to lend any more to the U.S., and that will reverse the process, he said, but it is "unclear at what point." As long as the world economy becomes more flexible, "history suggests that current imbalances will be defused with little disruption."

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