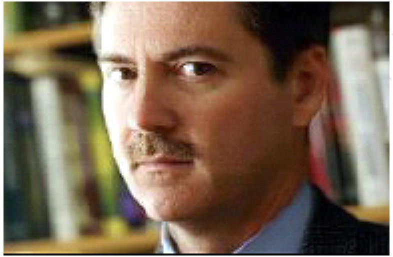
A CHAT WITH

Campbell R. Harvey on the sinking dollar

Pluses and minuses of a weak currency

The U.S. dollar dropped to another record low against the euro, Europe's main currency, last week. Since 2002, the dollar is down 18 percent against a basket of six major currencies. But many people aren't sure what a weakening dollar means for investors, businesses, consumers and the country's economic health. Is it good, bad or both?

Staff writer Frank Norton spoke with Campbell R. Harvey, an international finance expert at Duke University's Fuqua School of Business and a research associate of the National Bureau of Economic Research in Cambridge, Mass. Harvey, 46, consults on global risk management and the international cost of capital for multinational clients.



Harvey, who teaches at Duke's business school, says that a further fall in the dollar could be cause for concern.

STAFF PHOTO BY MEL NATHANSON

Q. What might intensify the fall of the dollar against major world currencies?

A. If the U.S. stumbled economically or fell into a recession or if there were some sort of domestic terrorism. It would also fall further if foreign central banks decided to increase interest rates more aggressively than the Federal Reserve, which would shift some investment away from the U.S.

Q. When should we start to worry?

A. For most of us, this is not going to cause a startling difference in what we do. But if the dollar were to fall 30 or 40 percent in relation to other currencies, there could be significant changes. If you ask most people, this is really not on their radar screen, but it is important. Once you go beyond the zone of decline that we've seen already, it could start to be a rude awakening.

Q. What is causing the dollar to fall against other major currencies?

A. It's a combination of three factors. The first is that we've been

SEE **HARVEY**, PAGE 3E

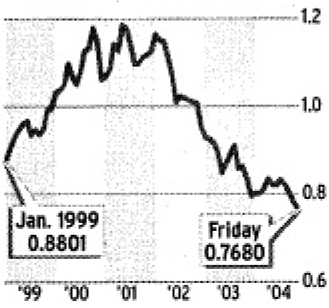
HARVEY

CONTINUED FROM PAGE 1E

DOLLAR DROPS

The U.S. dollar has fallen to record low against the euro and other major currencies.

Value of U.S. dollar in euros, by month



Source: Bloomberg News

running a massive trade deficit, meaning we're buying more goods than selling, and that creates an imbalance. If we're paying the Chinese for things in dollars and they put those dollars on the market to sell, the dollar falls.

The second factor is our low interest rates, in which investors find it less attractive to invest in the United States. That reduces demand for the U.S. currency.

The third factor has to do with global investment attractiveness. For years, the U.S. was the most attractive place for foreign investment in terms of setting up a plant, buying equipment or a company. But with the growth in other markets, particularly China, people are looking at other locations to capture growth opportunities, and that further cuts demand for (dollar-denominated assets).

Q. Why is any of this important to average consumers?

A. It is important because there are pluses and minuses. The benefit of a declining dollar is that it makes our exports more competitive on world markets, and that is likely why our policy-makers in Washington have indicated they will not be intervening to stem the decline. The fall in the dollar versus other currencies should help drive our exports, and that's good for export-oriented industries. It's not the whole story, though. When the dollar declines, our imports become more expensive. And as the cost of certain goods goes up, we could see inflationary pressures that affect consumers.

Q. Is there a net effect?

A. That's the most difficult thing to determine, and before you try, you have to consider other factors. For decades, the U.S. has had the luxury of owning the premier currency. Most important commodities in the world, like oil and gold, are quoted in dollars. And that makes the dollar not only a sort of world currency but very important one. As a result, the United States gains a bit of extra clout when it comes to world policy, both financial and political. People have had to be very careful in many cases not to mess with the country that has the premier currency. So there are other benefits outside of cheaper imports to having a strong dollar. But when the dollar declines against, say, the euro, there is the specter, that the U.S. will lose its advantage of tying its political and economic agenda to a strong currency.

Q. Do you expect the dollar to fall further?

A. In a way, you're asking for investment advice, and I don't want to be misinterpreted by readers. If that were asked in my classroom, I wouldn't answer for fear of litigation.

Q. What if this is just macroeconomic curiosity, not personal finance?

A. I expect the rate of decline to stabilize. Imports will become more expensive and exports more competitive. That should reduce the trade deficit; not immediately, though. Also, the fact that the U.S. is raising interest rates should increase demand for the dollar, as people look to invest in U.S. government bonds, and that should decrease the rate of decline.

Q. How is the fall in the dollar affecting businesses in the Triangle?

A. Whether in service or manufacturing, companies that buy U.S.-made inputs [i.e., subcomponents] to use in export products will do well. On the other hand, firms that are heavy consumers of foreign goods will take a hit, although they can try to substitute their foreign inputs with U.S. ones. This is one of the reasons that large multinational firms engage in hedging, to curb currency risk.

Q. What does this mean for consumers?

A. Foreign goods, especially luxury items, become more expensive. Again, consumers can either substitute with U.S.-made products or use up more of their disposable income to pay for imported ones. It could mean drinking California wine instead of French wine or buying a domestic car instead of a foreign car. It could also mean less travel overseas and more travel in the U.S., which again would tend to slow the decline. Foreigners may also substitute European vacations with vacations in the U.S.

On a more subtle level, the fall in the dollar means there could be inflationary pressure on prices overall. The other thing consumers are seeing is that short-term interest rates are going up. That's important because consumers are pretty leveraged and the savings rate is abnormally low. If the dollar continues the same rate of decline, rates will go up faster, and that puts consumers who are choosing — in many cases unwisely — to go with adjustable-rate debt at risk.

Q. What is holding back a stronger slide in the dollar?

A. The U.S. is still a great place to invest. It's safe, has good shareholder protection and good government; all the ingredients that make it attractive to world investors. Also, a large part of government bonds are snapped up by foreigners (buying in dollars), and that slows the decline.

FRANK NORTON