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## The Drop in the Dollar — What Does it Mean to You?

The most notable event in recent weeks was Alan Greenspan's European speech where he claimed that the U.S. trade deficit was unsustainable and would lead to further dollar depreciation, higher interest rates, or both. After his speech, stocks dropped sharply but have since recovered. What is likely to be the economic result of a continued dollar decline? And is it a good thing to see the dollar decline?

With the dollar down more than 40% against the euro since 2002, and hitting new lows since George Bush's reelection, economists are debating whether America's foreign indebtedness could lead to a collapse in the dollar and a global financial crisis. The U.S. does spend far more than it produces (about \$600 billion more), which is another way of saying that our imports are greater than our exports. Also, lacking in domestic savings, the U.S. must import foreign savings to finance the growth of its economy. Much of that excess spending has been financed by Asian governments, which bought more than \$1 trillion in U.S. Treasury bonds in the last two years, in an effort to keep the dollar strong against Asian currencies. The United States' trade partners do not like it when the dollar drops, since that raises the value of their currencies, making their imports to the U.S. more expensive.

How has the Bush administration responded to the falling dollar? Secretary of Treasury John Snow used to say that the U.S. favors a strong dollar, but he has been silent on the subject lately. It appears that he and his boss don't mind the falling dollar. Why would that be? Well, for U.S. companies that export their products, the falling dollar is not necessarily negative, since it makes their exports more competitive. And if the

dollar drops perhaps another 20%, it could actually wipe out most of our huge trade deficit.

The hope is, according to most economists, that the dollar drop remains controlled and not panicky; under those circumstances, equilibrium will probably be reached without too much trauma. In fact, some economists feel that a falling dollar is actually needed to rebalance the world economy and hence reduce economic and even political tensions between nations. Too sharp of a drop, however, might slow the export-driven economies of Europe, Canada and Japan and also cause U.S. interest rates to rise sharply. By the way, we also have to hope that foreigners continue buying U.S. government bonds.

Some U.S. investors see a falling dollar as a sign to invest more heavily overseas. That, in my opinion, works very well for foreign bonds, and that's why my clients' portfolios now contain a 7% allocation of the American Century International Bond fund. The effect on foreign stocks, however, is harder to predict. Because the stronger euro, for example, could adversely affect corporate profits and economic growth in Europe, a falling dollar may not benefit European stocks. So I've decided to remain at my usual foreign stock allocation of 20% for most clients and not raise it.

In conclusion, I'm not overly worried at this point about the dropping dollar, and my clients should feel comfortable since I'm hedging against that drop with foreign bonds. Although taking that action will ease the effect somewhat, I'm certainly keeping a close eye on the situation and will continue to revisit my strategy as the situation warrants.

