



THE FALLING DOLLAR

WHAT DOES IT MEAN FOR TENNESSEE TRADE?

by Steven G. Livingston

The steady decline of the American dollar is one of 2005's more important economic stories. After peaking in October 2002, the value of the dollar has dropped by 14 percent, and it is continuing to fall. The dollar's weakness should persist so long as America's huge current account deficit, budget deficit, and low national savings rate remain. What will be the effect of the lower dollar on Tennessee's economy and, in particular, on its international trade? Broadly, state industries that compete with overseas producers, whether in export markets or here in local markets, should gain from the lower dollar because they will be able to offer a more competitive price. Industries that need imports to produce their goods, on the other hand, will have increasing difficulties as the dollar continues to fall. However, things are not always quite this simple.

In part this is because many firms, especially those that engage in significant international trade, have long used strategies to limit their exposure to foreign exchange fluctuations. These include various currency hedging strategies, the use of long-term contracts and futures, or denominating their sales in dollars. Multinational firms, such as many in the state's automotive industry, can manage currency changes internally as they move production

Figure 1. Tennessee Trade-Weighted Dollar Index

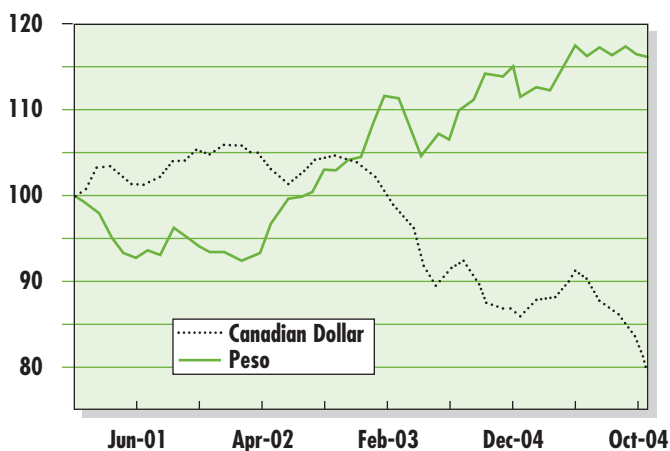


across borders but within company plants. A second complication is that the dollar's fall has varied greatly across international markets.

We have charted the path of the dollar across Tennessee's major trade partners. North America can be seen as a microcosm of the complicated effects of the dollar's fall. The dollar has plummeted against the Canadian dollar over the past two years, yet it has continued to strengthen against the Mexican peso over this same period. We can see the effect of this in the recent export surge in the state's auto parts industry. Canada has been the major alternative source of auto parts, and the fall in the dollar has made it far more difficult for Canadian companies to compete. Auto firms have shifted to American suppliers, helping Tennessee exports to Canada and lowering Canadian imports to Tennessee. But this same tailwind has not been available when it comes to trading in Mexico. The still eroding peso continues to work against Tennessee exporters, whether in the auto industry or elsewhere. Thus, for those industries where Mexico can offer an alternative to Canadian production, it may be Mexico and not the U.S. (or Tennessee) that is the primary beneficiary of the American dollar's drop in Canada. In these sectors, it would make more sense to move production or purchases from Canada directly to Mexico rather than to the U.S.

We can see that the dollar's decline varies quite a bit around the world. In South America, the dollar has been rather stable recently. The dollar's fall really has been concentrated in East Asia and especially in Europe. Even the

Figure 2. North America



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Figure 3. South America

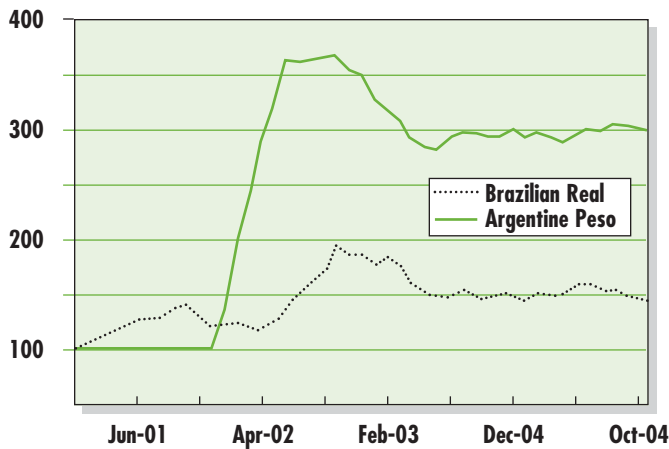
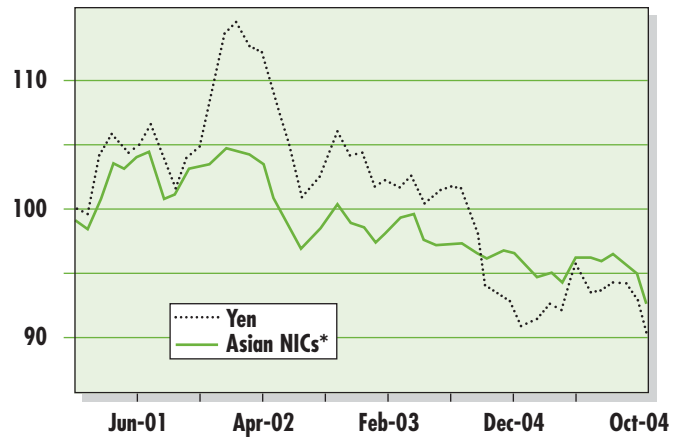


Figure 4. Asia



*Newly industrialized countries

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East Asia picture is complicated by the fact that China and Hong Kong continue to link their currencies to the dollar, and thus its fall has been primarily limited to the Japanese, Korean, and Singapore markets. This means that no relief can be expected from surging Chinese imports, at least in the near future.

The conclusion is that state exporters should be aided primarily in selling their goods in Canada, Europe, and Japan. State industries will also be helped in American markets and in other global markets when the competition is primarily from companies that are located in these three regions. In the case of Canada, this is most significantly the automotive industry, but the wood product sector will be helped, too. (Canada's largest export to Tennessee is natural gas, however, and unfortunately here we will only see an additional upward pressure on energy prices.) Vis-à-vis Europe, the chemicals sector and the state's aeronautics industry will be the major gainers. The rapid rise of the state's medical equipment industry is also being assisted by the rising prices being imposed on European competitors.

In the case of Japan, the Tennessee automotive industry will again experience by far most of the effects of the rise of the yen. The industrial machinery industry should also see some gain in competitiveness.

How large will be the effect, and when?

Every state has a different economic profile, and no two states will experience the same effect from the fall of the dollar. Tennessee, for example, tends to have a somewhat more unfavorable dollar environment than many other states. Due to the markets that it exports to, the state's weighted "foreign exchange rate" has consistently been about four percent higher than that of the nation over the past five years.

It has been estimated that a 1 percent decline in the dollar index may increase the revenues of large companies by one-quarter of 1 percent or so. While this may seem trivial, in the state of Tennessee this amounts to hundreds of millions of dollars. (And recall that the dollar has fallen 14 percent over the last two years.) Similarly, there is very little doubt that the value of the dollar affects international trade, though the estimated impact is not as large. The

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Figure 5. Europe

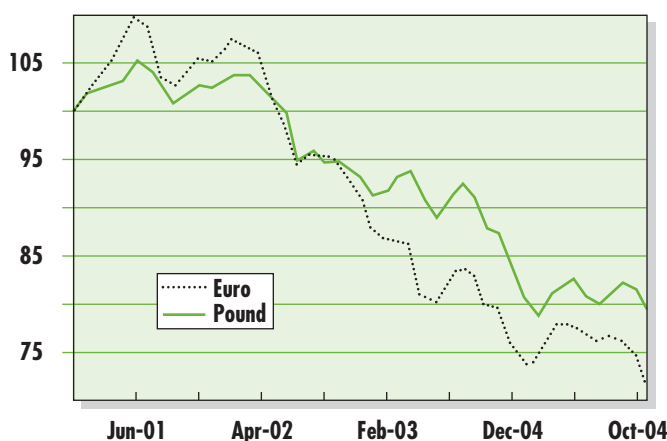
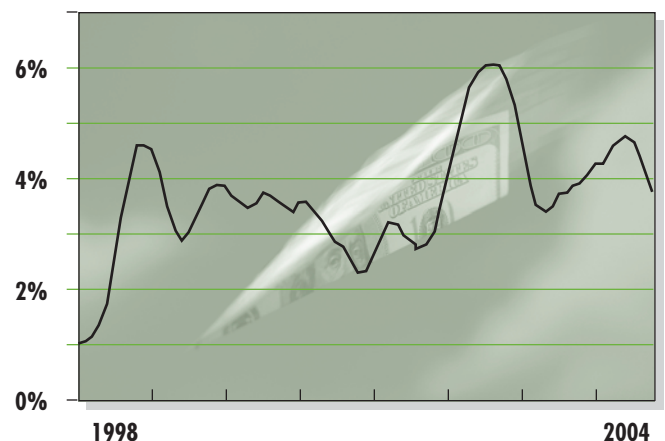


Figure 6. Tennessee's Dollar "Premium"



3rd Quarter 2004

SEVENTY-FIVE
PERCENT OF STATE
EXPORTS ARE IN
THESE SECTORS.

Tennessee's Largest Export Sectors

	Exports	Change from Last Year	Change from Last Quarter
Transportation Equipment	\$868,418,187	57.0%	3.3%
Computer and Electronic Products	\$596,371,692	23.8%	20.0%
Chemicals	\$520,521,981	31.0%	-1.0%
Nonelectrical Machinery	\$331,093,657	15.3%	-10.0%
Agriculture	\$288,651,529	12.7%	-44.0%
Miscellaneous Manufactured Goods	\$256,846,265	72.4%	-5.4%

3rd Quarter 2004

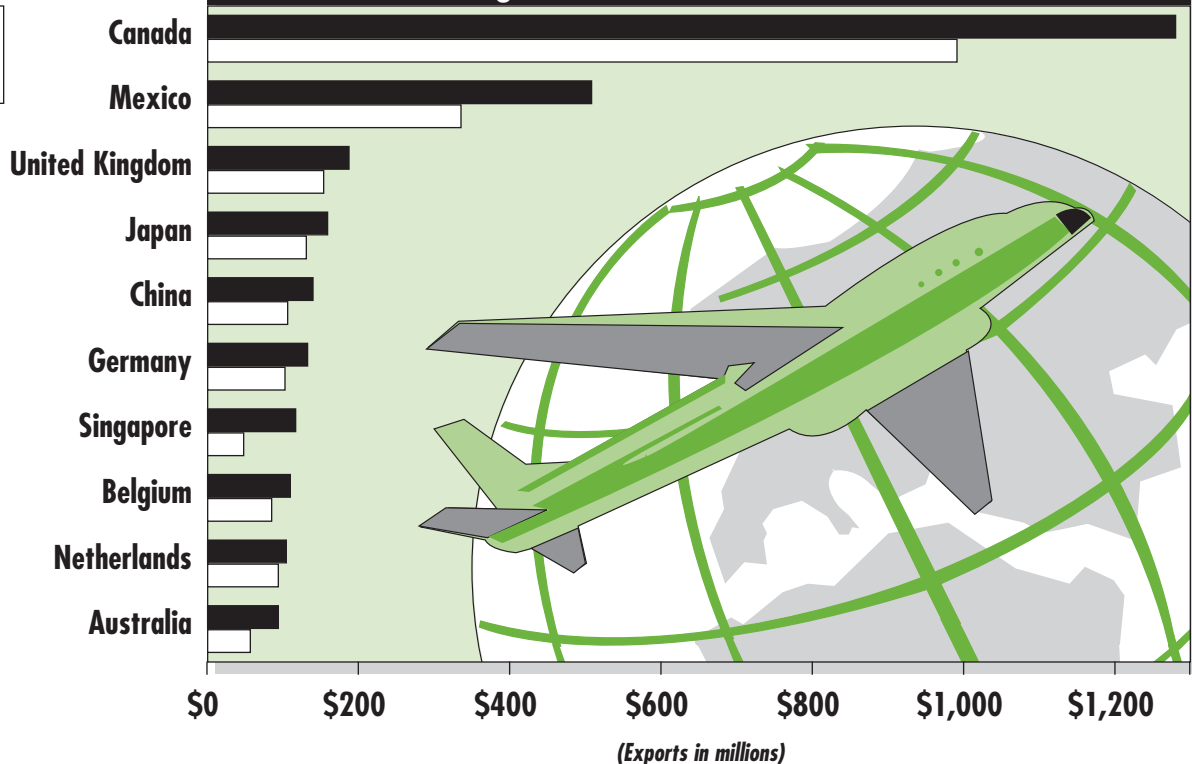
IT WAS A STRONG
QUARTER FOR
MEDICAL EXPORTS.

What's Hot and What's Not

	Value of Exports	Growth	Decline
SECTORS WITH THE GREATEST GROWTH			
Semi-Trailer Tractors	\$26,934,595	391.2%	
X-Ray Machine Panels and Parts	\$29,628,450	387.5%	
Nonwovens of Manmade Filaments < 25 G/M2	\$8,358,772	239.9%	
Medical Instruments	\$103,381,423	232.9%	
Gas Turbines > 5,000 kw	\$52,600,000	209.2%	
SECTORS WITH THE GREATEST DECLINE			
Laser Discs	\$13,591,207		-60.2%
Turbojets > 25 kn	\$11,250,000		-58.6%
Mufflers and Exhaust Pipes	\$5,585,683		-41.7%
Parts for Electrical Circuitry and Control	\$14,359,035		-41.1%
Books and Brochures	\$13,376,013		-35.8%

(Among Tennessee's top 100 exported goods)

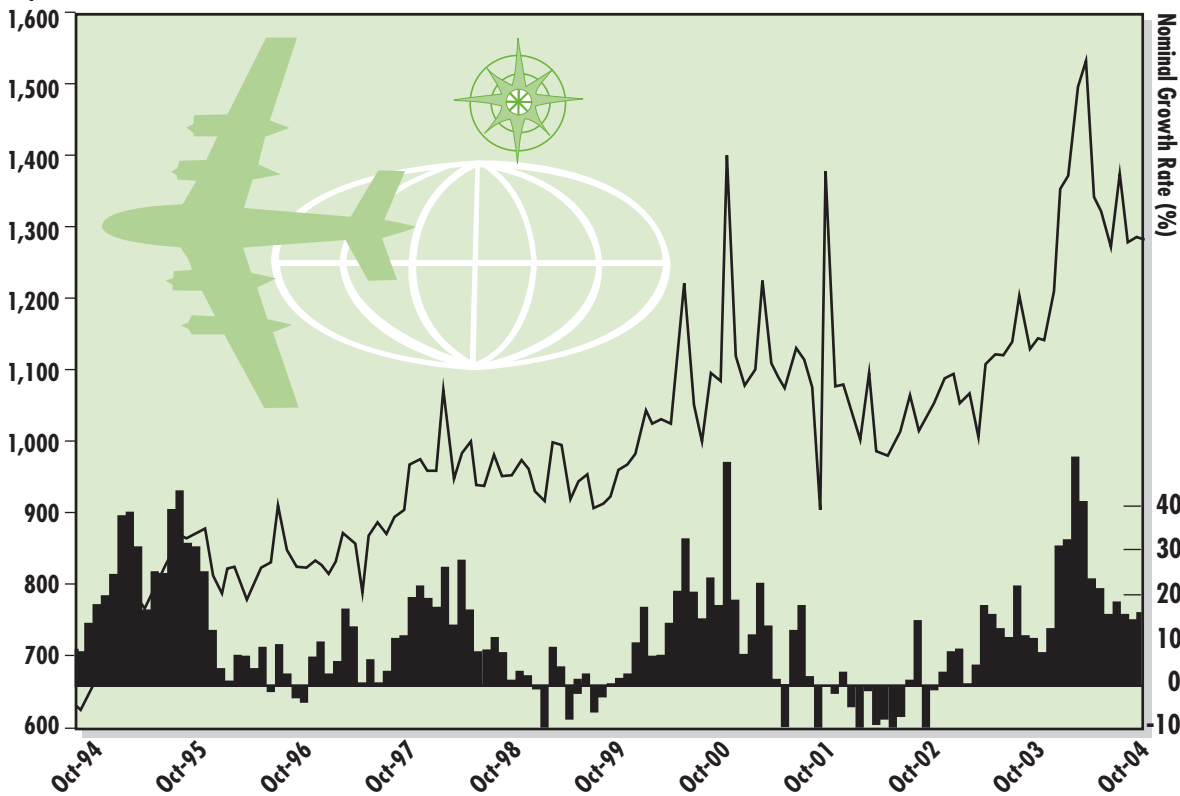
Tennessee's Leading Trade Partners



AUSTRALIA JOINS
THE TOP TEN.

Tennessee's Monthly Exports

Exports in \$ Millions



(Seasonally adjusted, expressed in year 2000 dollars)

3rd Quarter 2004

Fastest-Changing Export Destinations

	Value of Exports	Gain	Decline
COUNTRIES WITH THE GREATEST GROWTH			
Austria	\$13,029,463	240.7%	
Russia	\$14,676,826	225.8%	
Vietnam	\$7,775,560	178.3%	
Greece	\$12,157,506	147.0%	
South Africa	\$24,817,636	139.1%	
COUNTRIES WITH THE GREATEST DECLINE			
Bangladesh	\$5,166,660		-51.0%
Peru	\$4,661,151		-42.7%
Chile	\$7,716,852		-41.3%
Hungary	\$4,152,051		-36.5%
Portugal	\$3,239,256		-32.7%

(Among countries averaging more than \$2 million in sales per quarter)

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STATE EXPORTS NEARLY REACHED THE \$4 BILLION MARK ... A 28.8 PERCENT RISE FROM A YEAR EARLIER.

It was another very good quarter for Tennessee exporters. State exports nearly reached the \$4 billion mark (\$3.933 billion) for the third quarter of 2004, a 28.8 percent rise from a year earlier. Taking advantage of a weaker dollar and a rebounding world economy, exports surged across many products and to many countries. Sales to 32 of the state's top 50 markets grew by at least 25 percent.

The NAFTA market was as impressive as any. Exports to Canada increased by \$300 billion (from \$990 million to \$1.288 billion) during the third quarter. The automotive sector accounted for the lion's share of the gains. Truck and SUV exports grew from \$28.7 to \$113.1 million (293.7 percent), and car sales soared from \$1.3 to \$54.2 million. Auto parts added another \$19 million (\$18.7 to \$37.7 million). These three products accounted for more than half of the export gains in Canada. The Mexican market was just as strong, growing by 26.8 percent over the quarter (\$402 to \$510 million). This was despite the fact that car and truck exports were off significantly as state auto firms shifted some of their production and processing within the NAFTA market. Large increases in motor vehicle body parts (\$61 to \$76 million) and cotton sales (\$46 to \$81 million) more than covered these losses. Increases in exports of laptops and of electrical controls and circuitry accounted for much of the remainder of the gains in Mexico.

No doubt helped by the rising euro, state exports also gained substantially in Europe. Shipments to the European Union rose from \$563 to \$733 million for the quarter. In the euro area, medical goods were the big story. Tennessee medical instrument sales grew an astounding 413 percent (\$9 to \$48 million), becoming the largest single product exported to the E.U. And these sales do not include the exports of electrodiagnostic apparatuses and x-ray equipment that added another \$27 million to the state's European exports. Italy, where state exports nearly doubled, was one of the biggest purchasers of these goods. A more surprising product, cotton, was another big gainer as shipments rose from \$2.6 to \$24.1 million. A one-time \$10 million sale of paintings was also noteworthy. In the U.K., airplane parts (up \$5.5 million) and helicopter sales (\$5.7 million) were the backbone of the gains in that country; however, Britain was also the site of one of the biggest declines in export performance. Sales of large turbojets fell some \$16 million (to \$11.3 million), one of the single worst reversals of the quarter.

East Asia, too, remained a hot market. Exports increased by more than 20 percent to every East Asian country. Regional exports grew from \$402 to \$516 million. Chemicals, cotton, and medical instruments were again the keys. China posted a healthy 29 percent gain, and for once it wasn't all due to cotton. The number of products with quarterly sales of one million dollars or more doubled from 11 to 22. Cotton, however, remained

king among these products, with state exports of \$32.3 million. Japan continued as the largest market, buying Tennessee exports valued at \$161 million, a 22 percent increase. But South Korea took honors as the fastest growing market: Tennessee's \$82 million in exports was a 47 percent gain from a year ago.

State exporters were also successful in Southeast Asia. ASEAN (Association of Southeast Asian Nations) markets combined to purchase Tennessee goods worth about \$240 million, up 51 percent from last year. Malaysia, where exports fell \$6 million, was the sole exception. Singapore, the site of half of the region's sales, was perhaps the single best market for Tennessee goods last quarter. Its 126 percent gain was built on sales of turbojets, turbines, and aircraft parts.

At \$94.4 million, neighboring Australia joined the list of Tennessee's top 10 exporters. Big increases in lawn mower and medical instrument sales explain the growth in sales Down Under.

More modest gains were made in South America, though even there state exports were up about 10 percent (to \$138 million). The "big two" markets, Brazil and Argentina, were very strong. Argentinean sales were up by a full third (to \$27.3 million) while Brazil purchased \$71.5 million in Tennessee products, 25 percent more than last year. Auto parts, radio/TV transmission parts, and integrated circuitry accounted for half of the new exports to Brazil. But the rest of the continent was a wash with a strong showing in Venezuela offset by losses in Colombia, Chile, and Peru.



OCTOBER AND NOVEMBER NUMBERS ARE UP 16 PERCENT AGAINST THOSE OF 2003, SUGGESTING THAT THE FOURTH QUARTER IS LIKELY TO LOOK JUST AS GOOD.

Among the state's other larger markets, only Turkey and India bucked the positive trend. Sales to Turkey dropped by more than half (to \$32.5 million), and those to India fell a more moderate 12 percent (to \$37 million). In both cases, cotton was the culprit.

Yet globally cotton kept its position as the state's largest single export product. The state's \$283 million in cotton exports was not only a 13 percent increase but was nearly double the exports of the second leading product, SUVs. (However, the latter's jump from \$63 to \$148.9 million was probably the most impressive achievement of the quarter.) Medical instrument sales grew from \$31 to \$103 million, while shipments of aircraft parts were up 56 percent to also reach \$103 million. Motor vehicle parts, titanium dioxide pigments, whiskey, cars, and gas turbines were among the other products that had a very successful third quarter. A few products, notably laptops (down 14.4 percent), computer systems (-22.2 percent), and music CDs (off close to 60 percent), had their difficulties, but it was a strong quarter indeed for the large majority of the state's exporters and their goods. October and November numbers are up 16 percent against those of 2003, suggesting that the fourth quarter is likely to look just as good. ■

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accompanying chart (Figure 7) shows that for the state of Tennessee foreign exchange movements generally precede and predict similar movements in state exports. For the past several decades, a change in Tennessee's dollar index

has led a change in Tennessee's export growth numbers by anywhere from three to six months. (Recall that exports are tabulated when they are shipped, not when they are ordered.) Depending upon the exact model one uses, the impact of a 1 percent decline in the dollar is a monthly increase of between \$12 and \$20 million in Tennessee exports. This number is substantial, if not overwhelming.

The bulk of these gains will go to the state's automotive and chemical industries, the two most bound in competition with Canadian, Japanese, or European firms. The medical instrument and industrial machinery sectors should also post significant increases in sales. Sectors such as cotton and the computer and electronics industry will gain from the dollar's fall, too, but not as much because either most of their competitors are also located in the U.S. or a portion of their competition comes from Southeast Asia or those East Asian countries that have fixed their currencies against the dollar. Finally, and unfortunately, industries such as Tennessee's hard-pressed textile and apparel sectors are unlikely to see much relief as a result of a lower dollar. Their competition is mostly from Latin America and the poorer Asian countries, where the dollar remains strong.

A good many Tennesseans might bemoan the decline of the once-mighty dollar when taking their Canadian or European vacations this year. But as we can see, the impact of that decline is much more complicated when we look at the entire state economy. In particular, the modest fall of the greenback that we have seen thus far may be positive for many, though not all, of the state's major industries. ■

Figure 7.
Leading the Way? The Dollar and Tennessee Exports

