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The Op/Ed Page for Virginia's New Economy

Currency Quake

The declining value of the dollar will directly impact interest rates, property values and corporate competitiveness in Virginia. That means bad news for some, potentially good for others.

By James A. Bacon

When an earthquake rumpled the earth's curst off the coast of Sumatra last December, it took hours for the shock wave, in the form of a tsunami, to reach the shores of Thailand, India and Ceylon. If only an advance warning system had existed, thousands of lives could have been saved.

We're living through a financial tsunami right now: the collapse of the U.S. dollar in foreign exchange markets. The shock waves are radiating across the globe. They haven't reached Virginia yet, but they will. We don't need an early warning system--we all know what is happening. If we just pay attention, we can survive the cataclysm. But if we ignore the signs, we'll be caught like the bathers on Phuket beach.

The falling dollar will have several predictable consequences on governance and economics in Virginia. On the negative side, a weaker dollar will drive up the cost of imported goods, which in turn will push up inflation. Federal Reserve Board chairman Alan Greenspan has made it as clear as spring water that he will respond to the inflationary threat by hiking interest rates. Higher interest rates will make it more expensive for consumers, businesses and governments to borrow. That's Economics 101. You can take it to the bank.

Fortunately, a weaker dollar has its compensations. Because foreign products and services will cost more, U.S. companies will find it easier to under-price their competitors, both here at home and in foreign markets. The manufacturing sector, which has suffered hideously from the super-strong dollar of the past decade, should experience a welcome respite. Meanwhile, foreign corporations, benefiting from their newly muscular currencies, will find it more affordable to invest here. We can anticipate an up-tick both in the number of facility expansions and corporate takeovers in the U.S. Those investments will help offset the pain of higher interest rates. Economics 102. Like night follows day.

To commentators focused on state and local governance, that's all terribly abstract. The study of currency fluctuations is best left to the policy wonks in the Fed, the World Bank and the finance pages of the *Wall Street Journal*. You don't often hear the power brokers in Richmond discussing the exchange rate of dollars with Euros and yuan.

But perhaps we should.

The real estate bubble and tax revenues. For starters, higher interest rates will prick the real estate bubble. Under the most benign scenario, residential property values will level off. Under the pessimistic scenario, they will collapse in the very markets--we're talking Northern Virginia here--that have shown the greatest gains over the past several years.

I fully expect regional boosters to make the case for Northern Virginia exceptionalism. The blast-off in property values, they will say, is underpinned by a dynamic technology sector and record job creation. Of course, that's what Northern Virginians said in the 1980s just before the commercial real estate crash… and what they said in the 1990s before the bursting of the Internet bubble. It's undeniable that Northern Virginia has the strongest economy in the Commonwealth--by a long shot--but it's also prone to speculative excess. In my previous incarnation as editor of *Virginia Business* magazine, I called the last two big market corrections in Northern Virginia. Both times, the bubbles lasted far longer than I ever imagined. But, in the end, events proved me right.

Now I'm calling for a major correction in the Northern Virginia residential real estate market, and lesser setbacks in downstate markets. I may be wrong this time, but our political and community leaders would be fools not to recognize the possibility that a traumatic slump could occur.

Let's assume, just for purposes of argument, that I'm right. What are the ramifications? Once a bubble bursts, property values won't just return to reasonable levels. They'll plummet to unreasonable discounts as fear sets in, speculators panic and overleveraged homeowners unload their properties.

Local elected officials will face an unfamiliar problem: tumbling real estate assessments. While assessments have skyrocketed over the years, local boards and councils disguised the rising cost of government by cutting property tax rates. Assessments have been rising faster than rates have been falling, with the result that the total tax burden has steadily increased. Yet the process is opaque enough that politicians running for statewide office, from former Richmond Mayor Tim Kaine to Prince William Supervisors Chairman Sean Connaughton, have gotten away with the farcical claims that they *cut* taxes in their jurisdictions!

As property values fall, local governments will have no choice but to raise rates. I predict that there will be political hell to pay as the spending sins of the past decade--and the fraudulent claims of elected officials--are laid bare for voters to see. Many local pols will be led to the electoral slaughter. At the same time, local governments must go on. Municipal lobbyists will intensify their pressure on the state to do something to alleviate the strain on local finances. The issue of fiscal relief for local government will become a defining issue in the second half of this decade.

Collapsing real estate values also will crimp the sales tax by making it impossible for consumers to continue dipping into their home equity to pay off credit card bills. Because Northern Virginia has become such a dominant force in Virginia's economy, even state government needs to take precautions against a slowdown in sales tax revenues. It was prudent, therefore, for lawmakers this year to funnel this year's $1 billion+ surplus into measures that will strengthen state finances or go to one-time projects. Legislators need to proceed just as cautiously in future years as the currency realignment works its way through the economy.

Economic development opportunities. As faithful readers know, I have long criticized the folly of "chasing smokestacks"--devoting economic development resources to capturing an ever-shrinking pool of corporate relocation prospects. I have articulated alternate strategies based on the development and recruitment of human capital and the building of an entrepreneurial economy. In the long term, I believe strongly that those strategies still will yield the greatest returns on investment. However, the old corporate-recruitment strategy may gain some legs as a result of a weaker dollar.

It pays to be attuned to nuance here. A "weaker dollar" does not mean that the dollar declines in value equally against all currencies across the board. The Chinese government continues to peg the value of the renminbi to the dollar, with the result that the dollar remains grossly overvalued in our trade relations with China. With the Chinese economy dependent upon exports to the U.S., the Chinese central bank may prolong that policy indefinitely. If so, U.S. businesses will continue to "outsource" manufacturing capacity to China. The same logic applies to other Asian nations that, to a greater or less degree, have deliberately kept their currencies weak against the dollar to bolster exports.

But the dollar has declined precipitously against the Euro. That should present three distinct opportunities to Virginia's economic developers.

- U.S. products and services should be priced more competitively in Europe than any time in the past decade. The state should reallocate funds to the Division of International Trade. Now is the time to help Virginia companies lay the groundwork for exports--not when every other state has sniffed the same opportunity and moved to exploit it.

- A weaker dollar should provide U.S. businesses relief from European price competition. American corporations whose major competitors reside in Europe should enjoy a resurgence. It's not clear yet, however, whether this shift will lead to an increase in the number of prospects looking to set up new manufacturing operations in the U.S. Some companies may prefer to invest in boosting productivity at existing operations over building new plants. But the Virginia Economic Development Authority and its regional allies should position themselves to exploit an upturn in prospect activity should it occur.

- Foreign enterprises will find it more attractive to invest in the U.S., either to set up operations here, or to acquire U.S. companies and invest in their expansion. Now is the time that Virginia should redouble its efforts to attract this foreign investment.

Virginia economic developers need to move early to capitalize on the changing capital flows. The advantage goes to the early movers. If we wait until the trends are so obvious that everyone recognizes them, someone else will have seized the opportunities before us.

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