

RESEARCHBUZZ

Is The U.S. Dollar Set to Plummet in Value?

BY DR. JOHN A. TATOM

john.tatom@isunetworks.org

Many analysts believe that the U.S. dollar is set to fall sharply because of the large U.S. current account deficit. The March 2007 ResearchBuzz included an article on the Chinese renminbi and whether it is undervalued. Looking at a single foreign country or its currency, even one as important to the United States as China and its renminbi, is not a useful way to analysis the value of a domestic currency or the source of the country's current account. The international transactions of a nation involve many currencies and countries, and the value of a currency is determined by all of these. If there is a concern that a currency is overvalued the only way to assess this is by using a broad measure of the exchange value of the currency against a comprehensive basket of currencies with which it trades. And if a country has a large deficit in its current account, it is the overall value of the currency that might be at risk. So the large U.S. current account deficit with the rest of the world is, according to some analysts, a risk to the overall value of the dollar. In their view, the dollar is at risk of a major decline. For many observers, it is the current account itself that is the cause of concern because of their belief that it has contributed to the loss of U.S. businesses and jobs and that it has built up a large debt burden for future generations. The implications for the currency are important because these analysts suspect that a currency overvaluation is the source of the problem and that the remedy will be a pain-

ful fall in the value of the dollar.

The U.S. trade deficit and the dollar

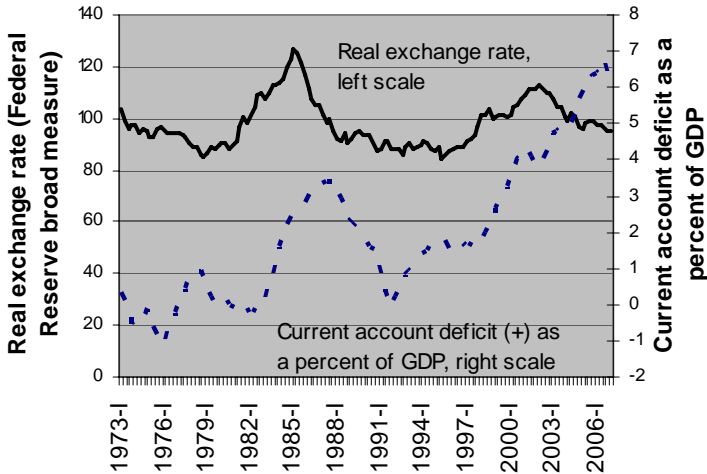
The U.S. current account deficit, the excess of imports of goods and services or unilateral transfers abroad, has climbed steadily and inexorably to record territory since 1991, except for slight improvements in 1995 and 2001. In 1991, the current account balance was a small surplus of \$2.9 billion, the first surplus since 1981 and the last. Since then the deficit climbed, reaching a preliminary \$856.7 billion, or 6.5 percent of GDP in 2006, a U.S. record.

Some analysts warn of the high risk of a financial crisis because of the size of the current account deficit. In their view, the financing of the deficit requires that foreigners lend to the United States (its citizens, firms financial institutions or governments) and that the growing indebtedness of the United States will eventually bring the nation's credit worthiness into question. As a result, lenders will reduce lending or even reverse it, putting upward pressure on U.S. interest rates and downward pressure on the value of the dollar and other U.S. asset prices, including stocks. These asset price changes could also lead to a liquidity crisis as credit dries up from abroad and also domestically. Few countries are able to run current account deficits as large, as a percent of GDP, as the United States currently does without eventually encountering a financial crisis. The Asian financial crisis of 1997-98 began and was worst in countries with larger current account deficits than the United States has had. On the other hand, the United States is a much bigger, more diverse and resilient economy than others and could withstand major asset price changes and shifts in investment flows without a crisis. In addition, most of these countries precipitated a crisis by fundamentally altering their economic policies because of concern with the size of their current

account deficits and the market adjustments that had begun to reverse them. Whether it was the deficits that were the problem causing the currency declines or it was the policy reaction to them remains an unsettled issue.

Will a fall in the value of the dollar reduce the current account deficit?

The real exchange rate and the current account deficit are not closely correlated



Sources: Board of Governors of the Federal Reserve System and U.S. Bureau of Economic Analysis

Moreover, the simple story of excessive borrowing abroad misses the point of why the United States has a large current account deficit to begin with. By definition, a current account deficit is matched by a net inflow of investment from abroad, either direct lending, or net acquisition of other assets, including direct investment in U.S. firms or portfolio investment in stocks, bonds or other financial assets. For those fearing a crisis, the picture is one of U.S. borrowers, hat in hand, begging to have a continuing stream of credit to maintain a continuing stream of excessive consumer spending. Others argue that it is the capital flows, the excessive capital inflows from abroad, that cause the current account deficit. Essentially, foreigners and domestic residents have found the United States to be a superior location for investment in terms of comparative returns and risk. Until a shortage of investment abroad makes returns there more attractive, it is unlikely that the U.S. current account will dissipate. And when returns become more at-

tractive abroad, the current account will disappear without major disruption, according to this view.

The chart shows the Federal Reserve broad real exchange rate for the dollar and the current account deficit as a percent of GDP, using the most recent four quarters for each. The real exchange value of the dollar is constructed using the U.S. consumer price index (CPI) divided by the weighted average CPI for the countries in the broad index.

In any event, analysts who focus on the crisis view insist that the value of the dollar has to fall to eliminate the current account deficit. It can do so gradually, or in a crisis it can collapse to the appropriate lower value or even overshoot temporarily. Martin Neal Bailey and Robert Lawrence recently provided a balanced or even optimistic view of the required decline in the value of the dollar. They find that a 20 percent fall in a broad measure of the value of the dollar would be sufficient, with other steps, to restore balance in trade, although not in the current account balance.

The conventional wisdom based on most studies is that a much larger and historically unprecedented decline would be necessary to eliminate the current account deficit. The largest sustained decline in the index Bailey and Lawrence refer to was in 1985-88 when it fell by 35.7 percent. While the current account balance improved, it was not eliminated until some years later. Actually the value of the dollar has been falling for five years. The same measure of the real exchange rate that Bailey and Lawrence use has fallen almost as much as they suggest is necessary already (see the chart). From February 2002 until February 2007, the Fed's broad measure of the real exchange rate for the U.S. dollar fell 16.1 percent. Nonetheless the current account deficit has worsened from 3.8 percent in the year ending in the first quarter of 2002 to 6.5 percent, according to preliminary data, in 2006. Of course there are many other factors influencing the current account balance and there are lags in the impact of exchange rates

on trade, but the recent experience is not encouraging. The chart does not support the idea that the dollar is relatively high in value either. Most recently, the index is about three percent below its average value for the period shown.

The more important limitation on the ability of a dollar depreciation to affect the U.S. current account balance is the source of the imbalance. Current account imbalances for a country are reflected in imbalances in the financial account. Thus if a country imports more goods and services than it exports, it has a matching financing flow from the rest of the world to pay for its excess of imports. The central issue is which causes which? Does a country run a deficit in its current account because it is able to borrow excessively abroad to pay for the excess imports, or does it run a current account imbalance because the rest of the world is trying to acquire more assets in the United States than U.S. residents seek to acquire abroad? The conventional U.S. imbalance story emphasizes the former: the United States borrows abroad to finance its excessive imports. But the other possibility is that foreigners want to acquire U.S. assets, flooding the country with foreign currency that is used to buy imports of goods and services that are more attractive than foreign assets. The difference in these two extreme conceptual scenarios is that the dollar falls in the former case, when foreigners must be induced to hold dollar assets, and rises in the second case, when the foreigners are trying to induce U.S. residents to acquire their assets, goods or services in return of U.S. assets. The strength of the dollar over the period of the climbing current account deficit, despite the decline since 2002, suggests that it not excessive U.S. consumption that is driving the current account deficit, but the excessive demand of foreigners for U.S. assets that has powered the current account deficit to historic levels.

The principal solution to current account imbalances will come from market adjustments unless policymakers here or abroad intervene to force an adjustment. Capital inflows to the United States will eventually slow or decline as rates of return abroad become more attractive

relative to those in the United States. The corresponding excess of imports of goods and services will adjust in tandem. Policies that make the United States a less attractive market for investment or make foreign countries more attractive can reinforce that adjustment. Whether this will involve movements in the exchange rate for the dollar will depend on the extent of its current overvaluation and on the effects of policy actions on the value of the dollar in the short to medium term.

■ Tatom is Director of Research at Networks Financial Institute.

References and Recommended Readings:

Bailey, Martin Neal, and Robert Z. Lawrence, "Can America Still Compete or Does It Need a New Paradigm?" Peter G. Peterson for the International Institute for International Economics *Policy Brief* No. 4-9, December 2006.

Tatom, John A. "Is the Chinese Renminbi Undervalued?" Networks Financial Institute *Research Buzz*, Vol. 3, Issue 3, (March 2007).

The Indiana Insurance Industry: An Engine of Employment Growth

BY MARTHA H. MCCORMICK
Martha.mccormick@isunetworks.org

In an effort to more effectively develop Indiana as home to a growing and prospering insurance market, the Insurance Industry Working Group was formed in 1998 to partner with the industry to address the financial, regulatory and workforce needs facing the insurance industry. To further that aim, Mike Chrysler, Director of Insurance Initiatives for the Indiana Economic Development Corporation (IEDC), asked Networks Financial Institute (NFI) in the Fall of 2005 to craft a project that would assist the IEDC in documenting and quantifying the Hoosier insurance workforce talent pool and emerging employment trends. NFI Graduate Fellow and Indiana State University MBA student Rebecca Shorter spearheaded this project, in response to Director Chrysler's request and NFI's commitment to help the financial services industry transform through better leadership, creative collaboration, and applied research.

In order to better understand the current and impending employment needs of the insurance industry in Indiana, NFI surveyed Hoosier insurance employers and received 61 responses. The survey examines the geographic and functional areas of insurance employment in Indiana and further explores the number of people that companies plan to hire and in what functional areas they plan to hire within the next year. Additionally, the survey documents how many new employees companies have hired in the last year and in which functional areas they were hired. Comparing survey findings with the number of employees who left companies and from what types of positions they left shows which functional areas have net gains in terms of the number of employees and which ones are experiencing

high turnover rates. Lastly, the survey examines how companies find new employees, since it is important to learn about what resources companies are using to hire new employees.

Exactly how the timeframe of the "last year" or the "next year" would have been set depending on whether the insurance employer completed the survey in the Spring or Fall of 2006. Consequently, the "last year" may refer to a timeframe from the beginning of 2005 through October of 2006 and the "next year" may extend from early 2006 through 2007. The survey also inquires about specific functional areas involved at each business location.

Context: The Insurance Industry in Indiana

State government in Indiana has established that the insurance industry is one of the priority clusters targeted for development by the IEDC¹. The IEDC intends to build on a strong base: "[w]ith our skilled workforce, top-rated educational institutions, efficient and consistent regulatory climate and competitive tax structure, Indiana offers an unparalleled environment for our insurance industry."² According to the IEDC, benefits that the Hoosier state extends to insurance operations include low taxation, a skilled workforce, and a friendly regulatory and stable judiciary environment. Indiana boasts a number of very well know insurance companies, including WellPoint. WellPoint is by far the largest insurance company in the state. Twenty five Indiana insurance companies have assets of \$200 million or more, including multiple life/health and property-casualty insurers with assets topping \$1 billion.

According to the U.S. Bureau of Labor Statistics data, there were 43,600 people working in Indiana's insurance industry in 2006. The latest figures from the Indiana Department of Insurance (IDI), however, claim that there were 60,400 employed in the Indiana insurance sector in 2004. This larger IDI number includes workers that

were not on payrolls; the insurance sector includes a large number of independent contractors. Nonetheless, this number does not include a large number of independent agents, brokers and so on, so even the IDI's numbers may be low. The insurance sector ranks as one of the largest employers in the state, just behind farm employment but outranking building construction, chemical manufacturing and food manufacturing. In fact, the insurance industry in Indiana is the highest paying nonmanufacturing sector and, overall, is the state's third best paying sector.³

Survey Objectives and Results

In 2004, Indiana counted 179 Hoosier-domiciled insurance companies and an additional 1,660 licensed to do business here. Given Indiana's position of relative strength in the insurance industry and the state's interest in bolstering and promoting insurance as a growth sector in the state economy, this study of the employment horizon in Indiana's insurance sector is intended to present a clear snapshot of what the insurance employee base is in Indiana, the range of workplace skills that insurance sector employees possess, what recent shifts might have occurred in insurance industry employment, and what the short-term anticipated hiring needs of employers is likely to be. Specific research objectives of the survey are to:

- ◆ Better understand the current and impending employment needs of the insurance industry in Indiana.
- ◆ Determine how many people the company plans to hire and in what functional areas they plan to hire within in the next year.
- ◆ Learn how many new employees the company has hired in the last year and in which functional areas they were hired.

- ◆ Assess the number of employees who left the company in the last year and from what types of positions they left.
- ◆ Determine what resources companies plan to use to hire new employees in the next year.

In the last year, companies hired on average 12.5 percent of their total workforce. On the other hand, a larger share, 18 percent, did not hire any new employees. By looking at the total number of employees in our sample and the number of employees hired, we can estimate that 6,652 new employees have been hired in 2005 in the insurance industry. Further analyzing the survey data revealed that 15 percent of the companies hired new employees in their customer service departments followed by 13 percent of the companies indicating that they made new hires in their sales departments. As the insurance companies grow, those are among the functional areas that companies need to hire more employees to support their operations. These are also the areas of high turnover in insurance. However, because of relatively high turnover and hiring, these are fields where ongoing training must be concentrated.

On average, companies lost 5.9 percent of their total workforce over the past year, although 22 percent of respondents stated they did not have any employees leave the company during the same period. Using the number of hires and departures over the same time period, we estimate the net number of job gains in the Indiana insurance industry. We estimate that 3,264 people left their current position. Using the number of new hires over the same period, this leaves a net job gain of 3,387. This suggests that insurance industry employment in Indiana grew at 5.6 percent in 2005, based on our sample.

The majority of companies indicated that

the largest job losses were customer service representative, sales and clerical positions. This is an indication of high turnover in those areas. Recall that job losses refers to employees who left voluntarily or involuntarily, without regard to whether they took another job in insurance elsewhere or whether their position was replaced by another employee. The least affected functional areas for job losses include adjuster, actuary, human resource, management information systems, and executive positions.

Further insight into new hiring can be obtained from firms' hiring plans. Many new hires result from unanticipated departures, so planned hiring is only suggestive of expansion plans. On average, employers plan to hire 10 new employees in the next year within each company. This level of planned hiring is not too different from actual hires over the past year. It represents a 2 percent drop compared to the actual number of new employees hired in 2005, but this small difference may reflect the difference in past replacement for unplanned departures. The largest planned hiring is the 15 percent of the companies that report that they are planning to hire in sales and 14 percent in customer service representatives function. Twenty one percent of the total respondents do not plan on hiring new employees within the next year. Actuarial, human resources and management information systems positions have the smallest percentage of planned new hires. However, this could be due to low turnover in those functional areas. This information shows how the insurance industry is growing and evolving in the state of Indiana.

As was the case with actual hiring that Indiana insurance companies did last year, most companies plan to add new employees in the next year to their sales, customer service representative, claims and clerical functions. More companies are planning to hire in the risk management function, but a smaller percentage of companies are planning to hire in their Information Technology departments compared to the previous year.

Within the next year, employers plan to use employee referral for the majority of their hiring needs. In addition to employee referral, employers will also use online resources such as Monster.com, newspaper ads, and career fairs. The survey indicates that 23 percent will use other resources. These resources include company Internet postings, the National Association of Colleges and Employers website, personal contacts, and other insurance related websites such as www.greatinsurancejobs.com. However, companies may use a combination of these resources to fulfill recruitment needs.

Conclusions

The survey shows that the greatest employment needs of the insurance industry in Indiana are in customer service and sales positions, followed by clerical and claims positions. From 2005 to 2006, companies hired about 13% of their labor force, but largely for replacement of departing employees. Of these employees, the majority of new hires were in sales, customer service, clerical and claims positions, with customer service representatives having the largest percentage of new hires during the year. These are the areas with the highest turnover.

During the last year, each company lost on average 5.9 percent of their total workforce. The majority of employees who left were customer service representative, clerical, claims, and sales positions with customer service representatives having the largest percentage of lost employees. It is projected that new hires in 2006-2007 will be on average 12.5 percent of existing employment. On average, Indiana insurance companies increased their workforce in 2006; the increase in 2005 was somewhat larger, but both years of increase follow several years of decline. New hires actually exceeded departures; there is a large net increase. These employees will more than likely be in customer service representative positions, but will also be in sales or "other"

not specified positions. Based on employees who departed in 2005-2006, and based on employer projected needs, the employment growth areas in the Indiana insurance sector are in the customer service representative and sales functions. It is also fair to conclude that companies will use an array of resources to find new hires, but especially employee referrals. They will also use resources including Monster.com, college fairs, and other insurance related websites, but career fairs were the least popular means.

For purposes of the IEDC's insurance initiative, this study of the present status of insurance employment in Indiana and short-term projected employment needs reveals that Indiana's insurance workforce requires an assortment of insurance industry positions, with a noted strength in the customer service function. Given a moderate level of turnover in insurance employment, the survey results indicate that the state has a large potential employee base with prior or current experience in the insurance industry, particularly in the Indianapolis metropolitan area, thus verifying the IEDC's claim to a skilled Indiana workforce. With Networks Financial Institute's emphasis on promoting growth and best practices in the financial services sector, we are pleased to present this measure of Indiana's current and future insurance employment trends and opportunities, in order to support the efforts of the IEDC's Insurance Initiative.

More details on the NFI study can be found in the NFI Report published on our website in the Research area under NFI Reports. Further information about Indiana's insurance industry may be gathered from the following sources:

Indiana Association of Insurance and Financial Advisors, Inc.

317.844.6268

<http://209.61.156.20/main-pub.cfm?usr=170000>

Indiana Department of Insurance

317.232.2385

<http://www.in.gov/idoi/>

Indiana Economic Development Corporation Insurance Initiative

317.234.2084

<http://www.in.gov/iedc/initiatives/insurance/>

Insurance Institute of Indiana

317.464.2450 www.insuranceinstitute.org

Independent Insurance Agents of Indiana, Inc.

317.824.3780

www.biggi.org

Association of Indiana Life Insurance Companies

317.684.5402

www.ailic.org

Professional Insurance Agents of Indiana, Inc.

800.555.9742

www.indianapia.com

Indiana State Association of Health Underwriters 317-844-6268

www.indyahu.org

■ McCormick is Research Coordinator at Networks Financial Institute.

References and Recommended Readings:

¹See the IEDC's website at <http://www.in.gov/iedc/initiatives/> for a list of initiatives. In addition to insurance, these include advanced manufacturing, agriculture, film, information technology, life sciences, logistics and motor sports. See <http://www.in.gov/iedc/initiatives/insurance/>.

²Covered Employment and Wage (CEW) data, as reported in "In the Spotlight: Indiana's Insurance Industry." INContext: Indiana's Workforce and Economy vol. 5, issue 6 (Nov/Dec 2004): 1.

³"In the Spotlight: Indiana's Insurance Industry." INContext: Indiana's Workforce and Economy vol. 5, issue 6 (Nov/Dec 2004): 1.