Published in Bergsten and Williamson (eds.) Dollar Overvaluation and the World Economy, Institute for International Economics: Washington DC, 2003.

THE OVER-VALUED DOLLAR AND THE U.S. SLUMP

October 2002

Abstract

The over-valued dollar poses a grave danger to the U.S. economy. A strong and durable recovery from recession requires a recovery in business fixed investment. This is being obstructed by the over-valued dollar which has undermined exports and business investment spending, and allowed imports to take market share from U.S. manufacturers. The over-valued dollar is also causing long term damage by eroding manufacturing which is a key engine of productivity growth. This augurs for lower future growth and living standards. U.S. policymakers must abandon the rhetoric of a "strong" dollar, a rhetoric which sends misleading signals to foreign exchange markets. The Federal Reserve must work with its foreign counter-part central banks to lower the value of the dollar. China's currency is under-valued and must be revalued upward, and Japan must cease using yen devaluation to try and escape its domestic recession. Longer term, there is need for a system of exchange rate management that prevents future damaging misalignments of exchange rates. Finally, trade agreements must have exchange rate provisions that guard against sudden currency movements which swamp agreed tariff reductions.

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This paper was prepared for a conference on the U.S. dollar held at the Institute of International Economics, Washington, DC, September 24, 2002. The paper is an expanded and updated version of "The Over-valued Dollar: Policy Complacency and the Deepening of America's Slump," New Economy, 8 (December 2001), 242 – 47. My thanks to Blackwell Publishing for permission to use this earlier material.

I Introduction: dangers of the dollar bubble

Over the last seven years the value of the dollar has appreciated dramatically against almost all major currencies. Since bottoming in 1995, the real value of the dollar has steadily risen against both the Federal Reserve's broad basket of currencies (which includes all major trading partners in Europe, East Asia and Latin America) and against the basket of currencies for major industrial counties.[1] Relative to the broad basket, the appreciation has been 32% as of September 2002, and relative to the major industrial currencies basket it has been 50%. This appreciation pushed the dollar to a sixteen year high in early 2002, and the dollar remains stubbornly close this peak despite the much ballyhooed recent talk of a weakening dollar. Thus, as of September, the broad basket of currencies was just 1% below the February 2002 peak.

From 1996 through to mid-2000 the U.S. economy was in the grip of a powerful economic expansion which obscured the accumulating negative effects of this appreciation. The rising dollar did help control inflation by keeping a lid on import prices, but there was already a cost in manufacturing jobs which began to decline in early 1998. Even if a strengthening dollar could once have been justified, that justification has long since ceased. Today, the U.S. economy is in the grip of an economic slump, and over-valuation of the dollar is obstructing recovery by undermining manufacturing. Robust consumption spending - financed by home price appreciation and mortgage re-financings - has helped mitigate the slump, but there is now an imminent danger that continued dollar over-valuation could trigger a deep double-dip recession. Unwinding the dollar's over-valuation should therefore be an urgent policy priority.

In the aftermath of the U.S. stock market bubble, many have wondered about resemblances between the U.S. and Japan. There can be no doubt that the U.S. is different in both the scale of its bubble and its capital market arrangements. But that said, there are clear similarities, and one similarity may be the exchange rate. Japan's asset bubble burst in 1990, yet the yen continued appreciating through to 1995, thereby deepening Japan's economic difficulties. One reason for

[1]. These exchange rate indexes are maintained by the Federal Reserve. Each country is given a weight in the index equal to its share of trade with the U.S., and the exchange rate is also adjusted to take account of differences in cross-country inflation rates.

the strong dollar is continuing robust financial inflows into the U.S driven by investor hopes that asset markets will resume an upward course. In this, the U.S. may be similar to Japan. A second reason is the strength of U.S. consumption spending, which although unsustainable, has mitigated the recession. Given simultaneous weakness in foreign economies, this has made the U.S. look relatively attractive, thereby attracting capital inflows and appreciating the dollar. This shows how asset market considerations can drive the dollar without regard to impact on economic activity and employment. This is serious policy problem. The stock market bubble has shown the destabilizing nature of asset price inflations, and the dollar's appreciation represents another instance of asset inflation, this time located in foreign currency markets. Yet, thus far policy makers have shown little inclination to engage with the question of how to guard against asset market bubbles.

II Short term damage: manufacturing and the recession

The over-valued dollar is inflicting both short and long term damage on the U.S. economy. This damage is inflicted via the impact of the over-valued dollar on exports, imports, business investment spending, and the financial position of the U.S. economy.

The trade deficit is the major damage transmission channel, and it especially impacts manufacturing since the deficit is largely accounted for by manufactured goods trade. In 2001 non-agricultural goods exports were 65% of all exports, while non-petroleum goods imports were 81% of total imports. The immediate damage comes from draining of demand for domestically manufactured goods, thereby causing manufacturing job losses. Between April 1998 and September 2002 the U.S. lost 2.2 million manufacturing jobs, of which 1.9 million were lost after July 2000. These losses can be substantially attributed to the over-valued dollar which has reduced export demand for U.S. manufactures, while simultaneously displacing domestic production through increased imports of foreign manufactures. Prior to 1998 manufacturing employment was growing, but since then the strong dollar has placed persistent downward pressure on manufacturing employment. Indeed, manufacturing lost jobs in 1999 and 2000 when the overall economy was still booming. The U.S. has some of the most efficient

manufacturing industry in the world, and for the last decade U.S. manufacturing has posted rapid productivity growth that has lowered unit labor costs. However, these efficiency gains have been swamped by the dollar's appreciation which has lowered prices of foreign competitors. The bottom line is that even U.S. industry cannot compete when confronted by a 30 percent price disadvantage imposed by currency markets.

These impacts of the over-valued dollar are documented in a recent study by the National Association of Manufacturers (2002). That study reports that U.S. exports have fallen $140 billion since August 2000, accounting for the loss of over 500,000 factory jobs. Moreover, these export related job losses are but one side of the ledger. In addition, surging imports that have grabbed market share domestic manufacturers have also caused job losses. In 2001 the deficit in goods trade was $426.7 billion, equaling approximately 25% of manufacturing GDP. Reducing this deficit by $200 billion to the level that prevailed in 1997-98 before the over-valued dollar began to bite, would add 12.5% to manufacturing GDP. This would in turn translate into approximately 2.1 million additional jobs.[2] This calculation shows how the entire job loss in manufacturing over the last four and one-half years can be attributed to the ballooning trade deficit.

Analytically, the trade deficit impact of the dollar works via the twin channels of exports and imports. This effect is clearly shown in figure 1. The solid line represents the Federal Reserve's broad trade weighted real dollar index which includes exchange rates for all the U.S.'s major trading partners, and is adjusted for cross-country differences in inflation. The broken line represents the ratio of U.S. goods imports to goods exports. When the dollar is strong, imports go up and exports go down, and the ratio therefore rises. Inspection of figure 1 shows a clear robust positive relation that is supported by the following regression:

(1) D(GM/GX) = 1.91 + 1.07D(Broad exchange rate(-1)) Adj.R2 = 0.41 DW = 2.16

[2]. Manufacturing GDP in 2000 was $1,567 billion. Reducing the goods trade deficit by $200 billion to $226 billion represents 12.8% of manufacturing GDP. Manufacturing employment in April 2002 was 16.8 million, and increasing this by 12.8% would add 2.14 million additional manufacturing jobs.

(1.10) (3.70)

where D(GM/GX) = change in goods import- goods export ratio, and D(Broad exchange rate(-1)) = change in lagged broad exchange rate. Figures in parentheses are t-statistics, and the coefficient of D(Broad exchange rate(-1)) is significant at the 1% level. The regression says that a one point increase in the broad exchange rate results in a 1.07 point increase in the import-export ratio.

Furthermore, the impact of exchange rate movements has become larger over the last two decades because the U.S. economy has become more engaged in trade. This is shown in figure 2 which shows exports and imports as a share of GDP. In 1980 exports and imports were 18.3% of GDP, but by 2001 they were 23.8% of GDP. Even more dramatic is the change in manufacturing openness, defined as manufacturing exports and imports as a share of manufacturing GDP. This is shown in figure 3.[3] In 1980 manufacturing exports and imports were 60% of manufacturing GDP, but by 2002 they had risen to 116% of manufacturing GDP. The value of manufacturing trade (exports plus imports) now exceeds the total value of manufacturing output. Manufacturing exports are 46% of manufacturing output, and manufacturing imports are 70% of manufacturing output. Given this exposure, over-valuation of the dollar whipsaws the manufacturing sector.

A second indirect damage channel is investment spending which is negatively affected for two reasons. First, by reducing exports and domestic sales, an over-valued dollar contributes to excess capacity which diminishes the need to invest. Second, by making foreign goods cheaper, an over-valued dollar lowers profitability and reduces firms' ability to finance investment. In August 2002 manufacturing capacity utilization was 74.6%, a full 6.3 percentage points below the average for the period 1967 - 2001%, and manufacturing capacity utilization in 2002 is running at its lowest level since 1983. Figure 4 shows the Federal Reserve's broad currency index and the manufacturing profit share, and it reveals a clear inverse correlation. These heuristic arguments can be supported by formal econometric analysis, and Blecker (2002)

[3]. Manufacturing exports are defined as goods exports minus agricultural exports. Manufacturing imports are defined as goods imports minus petroleum and petroleum based products.

reports that the dollar enters negatively and statistically significantly in regressions of the manufacturing profit share and the manufacturing investment rate. This links to the current recession, a hallmark of which has been the collapse in business fixed investment spending.

The policy implications are clear. The over-valued dollar has contributed significantly to the current recession, and it now risks triggering a double-dip recession. The benefits of Federal Reserve easing, mortgage re-financings, tax cuts, and increased government spending, have all been diluted to the extent that spending has bled into imports. The inventory rebuilding of the first half of 2002 also had weaker employment effects to the extent that it relied on imports. A robust sustained recovery will require renewed business investment spending, but the likelihood of this is reduced as long as the over-valued dollar undermines domestic manufacturers' competitive position, and even creates incentives to shift production off-shore.

III Long term damage: the future of manufacturing and the danger of financial stability

Not only has the over-valued dollar inflicted short run damage on the U.S. economy, it has also inflicted long run damage. In September 2002 U.S. manufacturing employment fell to 16.6 million jobs, equal to the level that prevailed in January 1962. This decline threatens the long run commercial outlook for the U.S. economy. This threat is illustrated in the aircraft industry, where Boeing has been forced to make significantly larger cuts to production schedules than has Airbus.[4] Given that airlines order on a "fleet" principle, sales lost today mean lost future sales as airlines tend to stick with their current supplier when placing new aircraft orders. In the textile industry, there were on average two mill closures a week in 2001, and there have been 240 mill closures between 1997 and September 2002.[5] Modern textile making equipment from these closures is being sold overseas in second hand markets at rock bottom prices. In this fashion, U.S. capacity is being permanently reduced while that of foreign competitors is built up.

[4] . See "Boeing's bleak outlook: It's a desert out there," The Economist, January 24, 2003, and "Airbus: Battering Boeing," The Economist, July 18, 2002.

[5] . These statistics are drawn from a report "Crisis in U.S. Textiles" posted on the website of the American Textile Manufacturers Institute (www.atmi.org). 1997 was a record year for U.S. textile industry profitability, fiber consumption, shipments, and exports. According to ATMI, "Since then the dollar's relentless rise, particularly against the currencies of major Asian exporters, has shattered the competitive structure of the industry, causing a huge import surge while collapsing major export markets."

Loss of manufacturing jobs carries a high cost. Manufacturing is widely recognized as a principal engine of productivity growth, and there is evidence of positive productivity spill-overs from manufacturing to non-manufacturing (Palley, 1999). Some of the greatest gains from new economy information technologies may come from application of these technologies to manufacturing. A shrinking manufacturing sector results in a smaller base on which to base productivity growth and on which to apply the new information technologies. Consequently, the U.S. stands to have slower future productivity growth, which will result in lower future living standards.

A second cost of lost manufacturing jobs concerns wages and income distribution (Palley, 1999). Historically, manufacturing jobs have been "good" jobs - in the sense of paying above average wages and health benefits. Moreover, these jobs have gone disproportionately to those with educational attainment of a high school diploma or less, a group still constituting 75 percent of the labor force. Manufacturing jobs have historically provided a ladder to the middle class for this large group, and there is solid empirical evidence that increasing the share of manufacturing jobs in total employment improves income distribution. Eliminating these jobs is therefore tantamount to kicking away the ladder, and the decline in manufacturing employment stands to entrench America's deteriorated income distribution.

A widespread misapprehension is that declining manufacturing employment is an inevitable feature of economic development, and a parallel is often drawn with the experience of U.S. agriculture. However, this parallel is misleading. First, the decline in agricultural employment was accompanied by the U.S. becoming agriculturally self-sufficient and a net exporter of agricultural products, whereas the decline in manufacturing is marked by increasing import dependence. Second, while it is true that the manufacturing "share" of employment tends to decline owing to manufacturing's faster productivity growth, this need not mean a falling "absolute" level of manufacturing employment. Instead, manufacturing employment can actually grow slightly over time. This is illustrated by the Canadian experience. Figure 5 shows manufacturing employment in the U.S. and Canada for the period 1990 to March 2002.

Following the recession of the early 1990s, manufacturing employment in both countries bottomed out in 1993. Thereafter, in Canada it proceeded to rise steadily from 1.8 million in 1993 to 2.3 million in 2000, making for a 28% gain over seven years. Moreover, manufacturing employment has held constant since then, being 2.3 million in March 2002.

The difference in Canadian and U.S. experiences holds a number of important lessons. First, there is no automatic tendency for manufacturing employment to fall. Canada and the U.S. have similar economic endowments, measured in terms of quality of governance, capital stock, and labor force educational attainment. Yet, Canada has significantly grown manufacturing employment, whereas the U.S. has not. Moreover, during the 1990s the U.S. even had more favorable macroeconomic conditions than Canada, since it enjoyed a stronger consumption and investment boom, and had lower interest rates. The one significant difference was the exchange rate, with the U.S. dollar showing sustained appreciation relative to the Canadian dollar.

Some have claimed that the loss of U.S. manufacturing jobs is due to the global economy's slowdown. But if this were so, there should have been a similar loss of jobs in Canadian manufacturing. However, Canadian manufacturing employment has actually risen from 2.28 million in 2000 to 2.304 million in March 2002. Nor can the U.S. recession entirely explain the loss of jobs, since Canadian manufacturing is enormously dependent on the U.S. market which absorbs 85% of Canadian exports. If the U.S. recession were decisive, Canadian manufacturing should also have been negatively impacted.

As noted earlier, the over-valued dollar and the decline of manufacturing both link intimately with the problem of the trade deficit. A declining manufacturing base threatens to entrench structurally the U.S.'s large trade deficit, which risks creating conditions conducive to financial instability. The ability to run a trade deficit requires a willingness of foreigners to finance the deficit. If that willingness diminishes, lacking a domestic manufacturing base capable of replacing imported goods, the U.S. economy could become constrained to grow more slowly with higher unemployment.

This danger is illustrated in figure 6 which shows the manufacturing trade deficit as a

percentage of manufacturing output. In 1980 the U.S. had a small surplus on manufacturing trade equal to 2.04% of manufacturing GDP, but since then this surplus has turned into a widening deficit. As of 2000, the manufacturing trade deficit was 24.56% of manufacturing GDP. The size of this deficit suggests the U.S. may now be critically short of manufacturing capacity, exposing it to a risk of stagflation triggered by financial instability.

The logic is as follows. For much of the last twenty years the U.S. has run large current account deficits that have been financed by a combination of borrowing from abroad and selling U.S. owned assets to foreigners. Having been the world's largest creditor in 1980, the U.S. has become the world's largest debtor. This changed financial circumstance is captured in table 1 which shows how persistent trade deficits have contributed to deterioration in the U.S. net international financial position, and an increase in foreign owned U.S. financial assets. Moreover, this changed circumstance is feeding back on the current account since the U.S. must now pay interest and dividends to foreigners. The balance on international income turned negative in 1998 for the first time since before World War II, and in 2001 the income account was in deficit to the tune of $19.1. These changes are captured in figure 7, and they promise to grow owing to compounding of interest on past loans and investments.

The increased size of foreign asset holdings means that even a minor rebalancing of foreign portfolios away from the U.S. could have large financial market effects. In the event that foreign investors lose their appetite for U.S. financial assets, U.S. financial markets will stand exposed to reduced demand that will lower asset prices and raise interest rates. The dollar also stands to weaken precipitously as asset holders exit U.S. markets. Higher interest rates would then choke off economic activity, while a sharp decline in the dollar would make for significant imported inflation owing to dependence on imported manufactured goods. Hence, stagflation.

The trade deficit - financial instability nexus described above can be understood through the metaphor of a bath tub. Water in the tub represents accumulated indebtedness, while water entering through the tap represents new borrowing. As long as there is room in the tub, more water (i.e. new debt) can flow in. But once the tub reaches its limit, the water immediately starts

to overflow. This metaphor captures the nature of financial crises. One minute everything appears sound, the next financial markets are in turmoil. No one knows exactly what the U.S. financial instability threshold is, but the U.S. has run large trade deficits for twenty years and the current account deficit was 4.0% of GDP in 2001. Historically, deficits of this magnitude have proved harbingers of instability. Policy prudence therefore suggests a course of smooth gradual adjustment now, rather than risking larger future disruptions.

IV Global economic problems stemming from the over-valued dollar

It is not only the domestic economy that is being hurt by the over-valued dollar. So too is the global economy. Though foreign economies do benefit from the over-valued dollar to the extent that it lowers their export prices and increases export sales to the U.S., foreign economies also bear several costs.

A first cost comes from imported inflation resulting from the fact that most commodities are priced in dollars. This is illustrated by the European experience where, following the introduction of the euro in January 1999, inflation surged owing to higher oil prices. The near-tripling of dollar denominated oil prices that took place over the period 1999 - 2001 interacted with the 35 percent fall in the value of the euro relative to the dollar, to cause higher inflation. This prompted the European Central Bank to raise interest rates, which slowed the European economy.

A second cost relates to developing country debt service. Most developing countries have significant dollar denominated foreign debts. A rise in the value of the dollar makes it more difficult to service this debt, requiring countries to export more to meet their debt service obligations. By increasing the debt service strain, the over-valued dollar creates developing country financial instability. Moreover, this comes on top of the problem of higher dollar costs of imported oil which also afflicts developing countries.

The third and most important cost pertains to the U.S. economy which is the locomotive of the global economy. If the U.S. economy is pushed back into a double-dip recession as a result of the over-valued dollar, the global economy will be profoundly and negatively impacted. A

double-dip recession can be expected to significantly reduce U.S. imports, and these losses stand to far outweigh the sales gains at the margin that foreign economies gain as a result of the over-valued dollar. In effect, the negative income feedbacks resulting from a dollar induced double-dip will dominate any positive relative price effects on foreign country exports.

V Arguments for a "strong" dollar do not wash

The arguments against an over-valued dollar are compelling, yet some continue to argue that a "strong" dollar is desirable. One argument is that the strong dollar helps keep down inflation by lowering import prices and keeping the lid on prices of domestic manufacturers. This argument had some support in the late 1990s when the U.S. was in the midst of a huge credit-driven boom, but that is no longer the case. Inflation is not an imminent economic danger, and there are reasons to believe that deflation is actually the greater danger given the highly indebted state of the U.S. economy. In these circumstances, slightly higher inflation could be a benefit to the extent that it reduces debt burdens.

A second argument is that a strong dollar is needed to finance the trade deficit. This argument has the reasoning backward. There is a need to finance the trade deficit because the dollar is hugely over-valued. Absent this over-valuation, exports would be higher and imports lower, which would diminish the trade deficit and the amount needed to finance it.

The above financing argument also links with claims that the U.S. trade deficit is the product of inadequate domestic saving rather than the over-valued dollar. However, these under-saving claims misunderstand the nature of the national income identity from which they derive. The national income identity is given by

(2) [Private saving – Private investment spending] + [Taxes – Government spending] =

[Exports – Imports]

The logic of this identity can be understood through the logic of credit markets which require that for every lender there be a borrower. The trade deficit represents foreign lending to the U.S., and by implication there must be either a private sector borrower (private saving < private investment) and/or a public sector borrower (taxes < government spending). A higher valued

dollar drives up the trade deficit, thereby inducing additional foreign borrowing, the counterpart of which must by definition be a domestic saving shortfall.

VI Exchange rate intervention works

Having made the case that an over-valued dollar is economically damaging, it is time to turn to the problem of what is to be done. Some argue that foreign exchange market flows are simply too large, and that effective intervention is no longer feasible in a world of globally integrated financial markets. In making this claim, intervention opponents point to the many instances where massive intervention has failed to sustain exchange rates. Most recently, there is the case of Turkey in 2002. Other recent cases include Brazil in 1999, Russia in 1998, and the East Asian economies in 1997. A classic instance concerning developed economies is the United Kingdom in 1992. In each of these instances market forces proved too powerful, and central banks ultimately had to accept lower exchange rates.

Missing in the discussion of dollar intervention is the fact that there is a significant difference between intervention designed to lower the value of a currency and intervention designed to support a currency's value. Turkey, Brazil, Russia, East Asia, and the U.K. were all instances where national central banks were pitted against market participants in an attempt to defend exchange rates. The resources available to these banks were restricted to limited holdings of foreign reserves, and given the huge leverage possessed by market participants, they were inevitably defeated. However, intervention by a strong currency bank is a different matter since it is selling its own currency, of which it has unlimited supplies.

Evidence for the success of intervention is provided by the Plaza Exchange Rate Accord of September 1985 when the G-7 finance ministers agreed to bring down the value of the dollar, and there followed a smooth depreciation that lasted eighteen months. On a more systematic level, research by Frankel and Dominguez (1993) report evidence that exchange rate intervention was successful in the 1980s. Their conclusions are re-affirmed in a recent state-of-the-art survey of the literature on exchange rate intervention by Sarno and Taylor (2001), and in a recent intervention event study by Fatum and Hutchison (2001). Ito (2002) also provides implicit

support for the effectiveness of intervention by reporting how the Bank of Japan made systematic profits on its interventions during the 1990s. Currency markets appear to be significantly driven by psychology, momentum trading, and herd behavior, which explains why econometric models do so poorly predicting the exchange rate. That said, this also explains why robust coordinated central bank market interventions accompanied by coordinated central bank "open-mouth operations" can change market psychology and the direction in which the herd is moving.

If successful exchange rate intervention is feasible, that still leaves the question of when intervention is warranted. When it comes to exchange rate settings, policy makers can be guided by real exchange rate measures that track the real value of currencies and take account of difference in country inflation rates. A theoretical framework for analyzing this issue is provided by Williamson (1985) through his concept of "fundamental equilibrium exchange rates." In arriving at decisions, the policy process should also ensure that those who are economically impacted are consulted. In this connection, it is noteworthy that the National Association of Manufacturers, the AFL-CIO, and the American Farm Bureau Federation are all currently calling for a weaker dollar.

Economic policy making involves judgments. Adjusting interest rates is the dual of adjusting asset prices. Central banks willingly engage in interest rate management because they recognize the pervasive effect of interest rates on economic activity. The same holds for the exchange rate. Just as interest rate policy is set on the basis of sensibly informed judgments about the economy, so too exchange rate policy should be conducted in similar fashion.

VII China and Japan: two special policy concerns

The value of the dollar needs to be brought down against the broad index of currencies. However, the Japanese yen and the Chinese renimbi represent two currencies which are especially problematic. In the case of yen, the Japanese government has repeatedly engaged in strategic interventions to gain competitive trade advantage. In the case of the renimbi, China has run persistent large trade surpluses yet capital controls prevent the renimbi from appreciating. In both cases, these policies have resulted in large accumulations of foreign reserves that have

blocked the yen and renimbi fro appreciating. The scale of accumulations is shown in table 2.

With regard to the yen, Japanese government policy appears driven by the hope that yen weakness will sufficiently stimulate exports so as to pull the economy out of recession. However, the reality is that Japan is a relatively closed economy, with exports constituting just 11 percent of GDP, while a significant portion of imports are non-substitutable primary products. This means that yen depreciation cannot solve Japan's domestic economic problems because the base on which depreciation operates is too small. Instead, it risks exporting Japan's problems to the U.S. and other East Asian trading rivals. This risks triggering financial instability and a cycle of competitive devaluation in the East Asia region. The clear policy implication is that Japan must abandon its attempt to depreciate its way out of recession.

With regard to the renimbi, the problem is that China is using an artificially under-valued currency to spur export-led growth. According to IMF Direction of Trade Statistics Yearbook (2000), China had a trade surplus with the U.S of $68.7 billion in 1999, and a surplus with the European Union of $28.7 billion.[6] It is also a massive recipient of foreign direct investment (FDI), being the dominant destination in the developing world. In a free market, China's exchange rate should appreciate under these conditions. However, China has pursued an aggressive interventionist and mercantilist exchange rate strategy that has prevented its currency from appreciating. The result has been continuing trade surpluses that threaten global deflation. Jobs are being lost in the U.S. manufacturing sector, and China is also effectively sucking all the demand out of the global economy, leaving nothing for other developing countries. In this fashion, the developing economies are being pushed into permanent stagnation. Once again the policy implication is clear. As a member of the international economic community, China must abandon its mercantilist exchange rate policy and allow its currency to appreciate as market forces dictate.

VIII Policy recommendations

[6]. These are the latest available numbers.

The recognition that currency markets can damage economic activity points to broader issues of international economic governance The existing international policy framework treats trade and finance as separate independent arenas, yet it is clear that trade outcomes are profoundly impacted by currency markets. Milton Friedman's (1953) old defense that exchange rates are determined by market fundamentals, and that market speculators will inevitably pull exchange rates back to levels warranted by these fundamentals, is now discredited. The empirical literature on purchasing power parity conclusively proves this.[7] Instead, exchange rates appear to behave like asset market prices, and exchange rate bubbles driven by speculative expectations can persist for long periods. Today's dollar problem shows that exchange rate misalignment is not just a problem for developing countries.

Recommendation 1. An immediate policy recommendation is for the U.S. Treasury to explicitly revoke its earlier "strong dollar" rhetoric. Such rhetoric has likely contributed to the dollar's appreciation by creating market expectations that the Treasury stands ready to intervene in the event of dollar weakness. When linked with the willingness of many foreign governments to accept weaker currencies to gain international competitive advantage, the Treasury's rhetoric has likely fostered perceptions of a "one way" bet that places persistent upward pressure on the dollar. Revoking this rhetoric will help erase such perceptions.

Recommendation 2. Japan must abandon its attempt to depreciate its way out of recession. This is a policy that will not work for Japan, yet risks exporting Japan's problems. China must abandon its mercantilist exchange rate policy and allow its currency to appreciate as market forces dictate.

Recommendation 3. The European Central Bank must be enjoined to lower interest rates and adopt a more pro-growth monetary policy stance. There is clear evidence that the European economy is slowing dramatically, and this has had a dampening effect on investor demand for euro denominated assets.[8] By raising growth, an interest rate reduction stands to appreciate the

[7] . Obstfeld (2001) provides a survey of the empirical literature on PPP.
[8] .The IMF's World Economic Outlook, September 2002, reports (p.27) of Europe that "(T)here are signs of core inflation starting to come down, and, as discussed above, the recovery has appeared increasingly hesitant."

Euro by making European assets more attractive.

Recommendation 4. Leaders of the G-8 should initiate a second Plaza Accord. They should publicly acknowledge that the dollar needs to be brought down smoothly from current levels, and that their central banks will act to do so through coordinated market intervention. An appropriate benchmark would be 100 -110 yen per dollar and 1.10 – 1.20 dollars per euro.

Recommendation 5. In addition to these changes in country policies, there are deeper structural failings in foreign exchange markets that point to a need for permanent coordinated exchange rate policies. Acting together, with the onus of intervention falling predominantly on central banks of stronger currencies, the international community should establish procedures to prevent future damaging currency misalignments. American workers suffered from the dollar bubble of the mid-1980s, and they are suffering again from today's dollar bubble. Exchange rates are too important and potentially disruptive to be left to unfettered speculation, and the community of central banks should establish procedures for monitoring and correcting exchange rate excesses.

Recommendation 6. There is a need to reconsider existing arrangements of unfettered capital mobility. The goal should not be to prevent capital mobility, but rather to give central banks the ability to slow inflows when they deem necessary. One possibility is application of speed bumps in the form of temporary non-remunerated reserve requirements on capital inflows. These have been used to good effect in Chile.

Recommendation 7. The fact that exchanges rates can become significantly distorted points to the need for exchange rate considerations to be addressed in trade agreements. In serial fashion across countries, exchange rate depreciations have destroyed U.S. manufacturing jobs and capital investments without regard to underlying productive efficiency. Such depreciations swamp the benefit of tariff reductions achieved through trade negotiations, and amount to an "exchange rate subsidy" for U.S. competitors. Trade policy must explicitly address this problem and can no longer be pursued as if trade and exchange rates are unrelated.

In the global trade - exchange rate game U.S. policy makers have persistently abdicated

their responsibilities, leaving U.S. manufacturers unprotected against the exchange rate manipulations of rival governments. Some of the U.S.'s major manufacturing trading partners, such as Japan and Korea, manipulate their currencies to give their exports a competitive edge. This has been documented by Calvo and Reinhart (2000) who term developing countries' practice of managing their currencies, "fear of floating." Though governments nominally commit to a floating exchange rate regime, they actually engage in systematic intervention to prevent appreciations.

The old Bretton Woods system of fixed exchange rates guarded against this type of unfair practice, but that system suffered from the need for large disruptive periodic exchange rate adjustments, and it could not withstand the powers of speculation created by liberalization of capital flows. The system that has replaced Bretton Woods encourages unfair exchange rate gaming, and it also allows exchange rates to be set by capital flows irrespective of trade deficits. There is no going back to the Bretton Woods arrangements. However, placing exchange rate provisions in trade agreements, having coordinated G-7 exchange rate policy centered on strong currency central banks leading interventions, and making small modifications to the rules governing capital flows so as to allow central banks to slow inflows, would go a long way to making the international financial system work more fairly and productively. Implementing such an agenda will require policy makers escape the existing efficient financial markets ideology that has them abdicating their powers of responsible governance. In the meantime, this ideology promotes a policy of dollar complacency that is deepening America's economic slump.

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Percent of GDP	**1990**	**1995**	**2000**	**2002(1)**
Trade balance, goods	-1.9%	-2.4%	-4.6%	-4.1%
Current account balance	-1.4	-1.4	-4.2	-4.3
Net U.S. international financial position	-2.8	-4.6	-16.0	-22.6
Foreign financial asset holdings in U.S.	33.1	44.2	62.5	65.1

Table 1 Selected U.S. trade and international financial wealth statistics. Source: Blecker (2002).

Country	**1990**	**1995**	**2001**
Japan	78	183	395
P.R. China	30	76	216
Hong Kong	24	55	111

Table 2 Total reserves excluding gold. (end-of-period, in billions of U.S. dollars). Source: Blecker (2002).

Figure 1 Real broad dollar index and Import/Export ratio, 1980 - 2001.

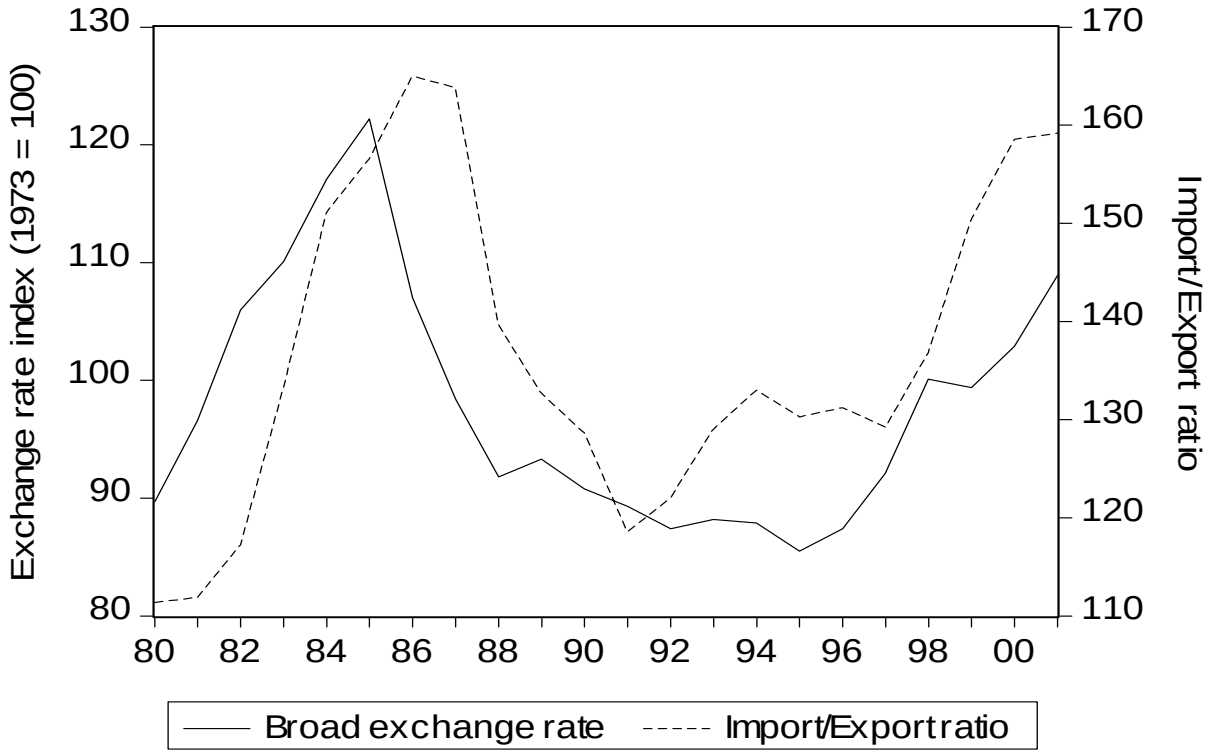

Figure 2 Exports plus imports as a percent of GDP, 1980 - 2001.

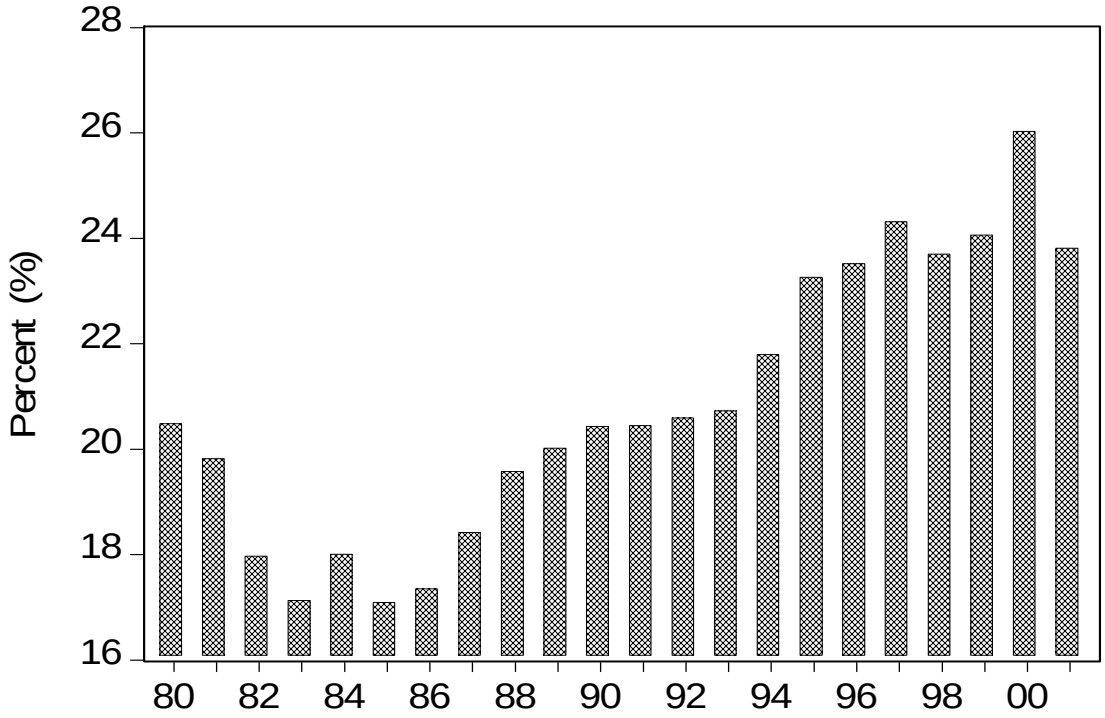

Figure 3 Manufacturing exports plus imports as a percent of manufacturing GDP, 1980 - 2000.

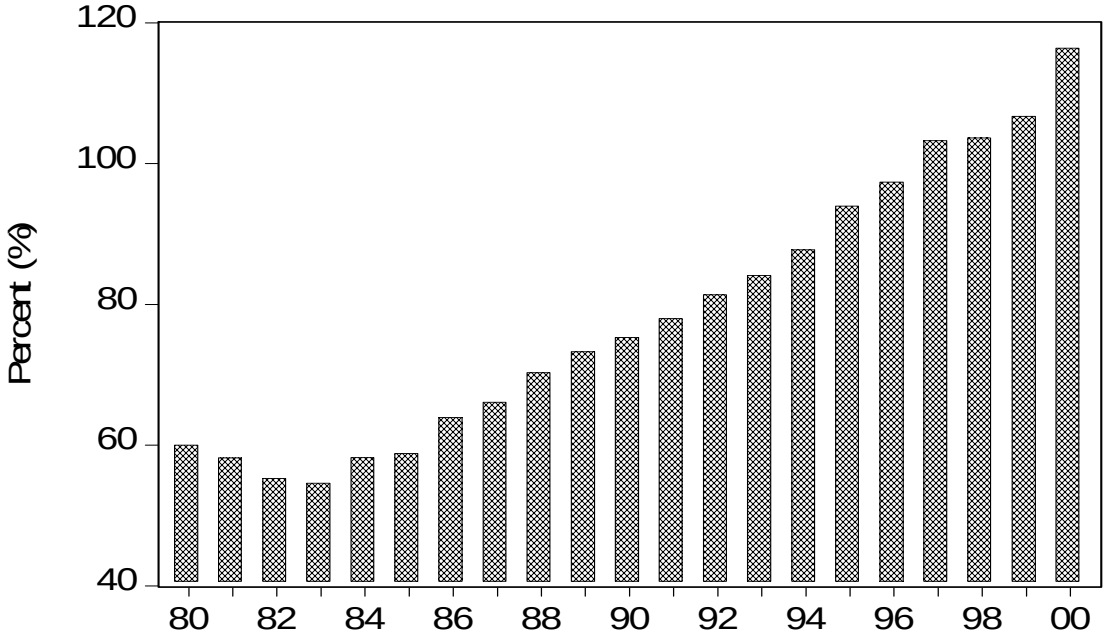

Figure 4 Real broad dollar index and manufacturing profit share.

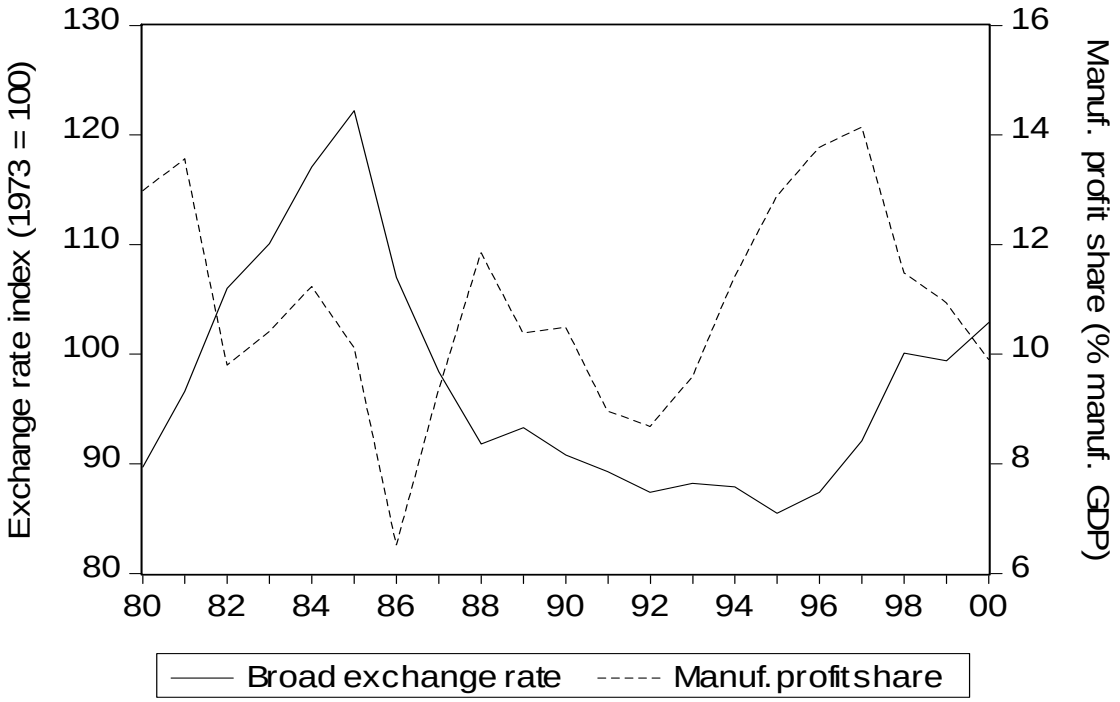

Figure 5 Manufacturing employment in the U.S. and Canada, 1990 - March 2002.

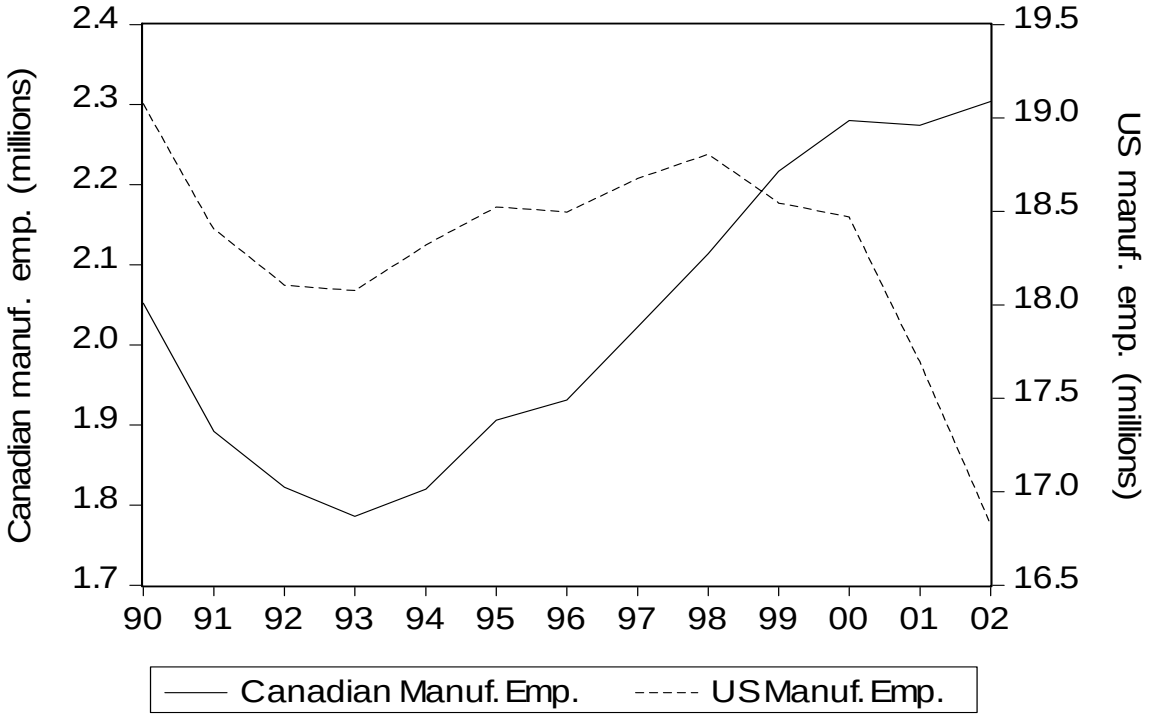

Figure 6 Manufacturing trade deficit as a share of manufacturing output, 1980 - 2000.

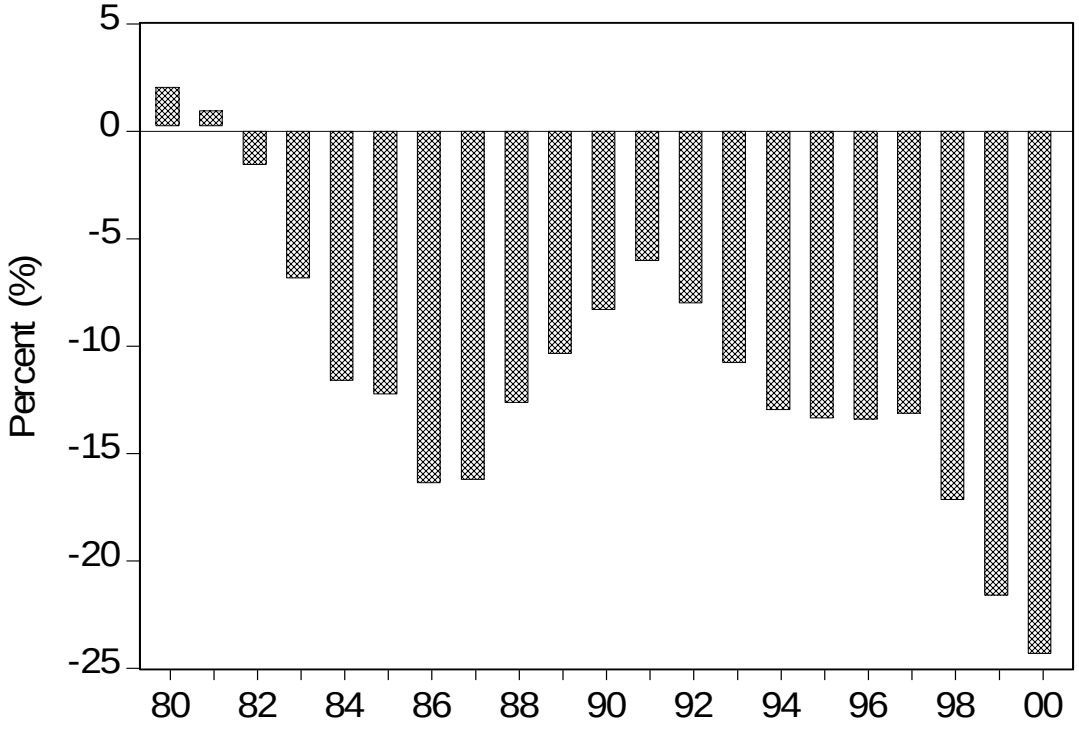

Figure 7 The balance on the U.S. foreign income account, 1980 - 2000.