The over-valued dollar

Policy complacency and the deepening of America's slump

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Between April 1995 and September 2001 the real value of the dollar rose 34 per cent against a basket of major industrial country currencies and 41 per cent against a broader range of currencies that included all major trading partners in Europe, East Asia and Latin America. For most of this period the US economy was in the grip of a powerful and long-lived economic expansion that obscured the accumulating negative effects of this currency appreciation. While the economy was expanding, the rising dollar helped control inflation by keeping the lid on import prices. However, at the same time it cost manufacturing jobs and helped fuel asset price inflation.

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Any justification there might have been for a strong dollar has long since ceased. In 2001, the US economy was gripped by a slowdown and the over-valued dollar has been deepening the slump by hollowing out America's manufacturing industry, a weakness that has spread to other sectors.

In the aftermath of the bursting of the NASDAQ stock market bubble, many have wondered about the resemblance between the US and Japanese economies. There can be no doubt that the US is different in both the scale of its bubble and its capital market arrangements. That said, there are similarities, one of which may be the exchange rate. Japan's asset bubble burst in 1990, yet the yen continued appreciating through to 1995. This appreciation contributed to Japan's continuing economic difficulties.

The broad lesson is that exchange rates can appreciate long after a domestic asset bubble has burst and this is directly relevant to the US. The US stock market bubble burst in the first half of 2000. However, as in Japan, it is taking time for the new awareness to spread from the stock market to currency markets and the dollar has continued to be subject to a bubble psychology. This dollar bubble is negating the effects of the Federal Reserve's string of interest rate cuts, threatening to make for a much harder landing.

Short-term damage

The over-valued dollar is inflicting both short and long-term damage on the US economy. The immediate short-term damage comes from

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the loss of manufacturing jobs and the draining of demand out of the economy at a time when aggregate demand is weak. From early 1998 to the summer of 2001, the US lost almost 1.2 million manufacturing jobs. Those losses can be substantially attributed to the over-valued dollar reducing export demand for US manufactures, while simultaneously displacing domestic production through increased US imports of foreign manufactures.

The US has the most efficient manufacturing industry in the world and, in the second half of the 1990s, US manufacturing posted strong productivity growth that lowered unit labor costs. However, these efficiency gains have now been swamped by the dollar's appreciation. Even US industry cannot compete when confronted by a 30 per cent price disadvantage imposed by the currency markets.

The negative economic impacts of the over-valued dollar show up in two ways. It impacts GDP growth though the trade deficit, and unemployment through job loss. In 2000 the US goods trade deficit was $459 billion, or 4.6 per cent of GDP and the deficit remained close to this level in 2001. In 2000, the rising goods and services trade deficit lowered overall real GDP growth by one fifth. In 2001, economic growth fell precipitously and business cut production because of lack of demand. Increasing domestic demand by lowering imports and increasing exports could provide a powerful jump start to economic activity.

Lower manufacturing output has in turn been accompanied by lost manufacturing jobs. Between July 2000 and July 2001 the US economy lost 837,000 manufacturing jobs. Had these remained, the unemployment rate in July 2001 would have been below 4 per cent instead of at 4.5 per cent. The danger is that the loss of manufacturing jobs, which support service sector jobs, will spread into the rest of the economy. Every 100 steel industry jobs supports 437 other jobs. Every 100 auto sector jobs supports 464 jobs elsewhere. In the service sector, the job multiplier is much lower with every 100 retail jobs supporting just 94 jobs elsewhere and every 100 jobs in the personal and business service sector supporting 147 jobs elsewhere.

Rapid and continuing job losses in manufacturing therefore cause a widening ripple of unemployment, with a subsequent weakening of consumer confidence and spending. As consumer spending is the last robust source of aggregate demand, this could be the proverbial straw that broke the camel's back, pushing the economy into recession.

Along with the threat to consumer spending, weakness in manufacturing has also held back investment. The US slowdown is rooted in a collapse of private sector investment spending. In the first quarter of 2001, declining investment lowered real GDP growth by 2.28 percentage points and continuing investment decline in the second quarter lowered growth by 1.52 points. Reversing the investment decline is therefore key to restoring rapid growth and to this end the Federal Reserve has been cutting interest rates dramatically since the beginning of January 2001.

However, the beneficial effects of these rate reductions are more than offset by excess capacity. According to the Federal Reserve, manufacturing capacity use was 75.5 per cent in July 2001, which is below the 76.6 per cent level reached in March 1991 at the bottom of the last recession. This high rate is discouraging firms from investing.

Low rates of capacity use have contributed to lower domestic corporate profits and the over-valued dollar has amplified this negative profit effect by reducing the foreign profits of US corporations. US multi-nationals have to translate their foreign earnings into dollars and the strong dollar reduces the value of these earnings. This has the twin effect of reducing profits to finance corporate investment and reducing the value of US equities which amplifies the negative household wealth effect of a falling stock market. This risks the further undermining of consumer spending.

Finally, the over-valued dollar has implications for whether fiscal policy can stem the weakness. In the latter half of 2001 many households will receive tax rebates and the hope is that spending of these rebates will stimulate the economy. However, here too an over-valued dollar hurts since it means that a greater proportion of such spending will go to imports, thereby diminishing the stimulus to domestic economic activity.

Long-run damage

The long-run damage to the US economy of too high an exchange rate will remain long after the current slowdown is over. The 1990s expansion is the first in US history in which the economy lost manufacturing jobs. Losing manufacturing jobs carries a high cost. Manufacturing is widely recognised as a principal engine of productivity growth, with evidence of positive productivity spillovers to non-manufacturing. There is also emerging evidence that some of the greatest gains from new economy information technologies may come from their application to manufacturing. Shrinking the manufacturing sector results in a smaller base on which to build productivity growth and on which to apply the new information technologies.

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Another cost of lost manufacturing jobs concerns wages and the income distribution. 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 an educational attainment of a high school diploma or less. In effect, manufacturing jobs have provided a ladder to the middle class for this large group of workers. There is solid empirical evidence that increasing the share of manufacturing jobs in total employment improves the income distribution. Eliminating such jobs stands to entrench America's deteriorated income distribution.

The over-valued dollar and the decline of manufacturing both link intimately with the problem of the trade deficit. Almost 90 per cent of the US trade deficit is accounted for by just twelve industries, ten of which are in manufacturing. The largest contributor is autos and parts, with the two non-manufacturing industries being energy and petroleum products. A declining manufacturing base threatens to embed the US's large trade deficit structurally, which risks lowering future growth and creating conditions conducive to financial instability.

The ability to run a trade deficit requires the willingness of foreigners to finance it. If that willingness declines, the US will be forced to reduce its deficit. If a domestic manufacturing base capable of replacing imported goods is lacking, policy makers could then be forced to grow the economy more slowly and with higher unemployment so as to restrict imports to the level for which financing is available.

Foreign unwillingness to finance the US trade deficit could also result in an eruption of financial instability. For much of the last twenty years the US has run large current account deficits, and financing these has involved a combination of heavy borrowing from abroad and the selling of US-owned assets to foreigners. Having been the world's largest creditor in 1980, the US has now become the world's largest debtor. In 1990, foreign entities owned 18 per cent of the publicly held federal debt, but by 1998 this had risen to 32 per cent and the record large trade deficits since have surely pushed it higher still.

These changed financial circumstances feed back into the current account through interest payments and dividends to foreigners. As a result, the balance on international income in 1998 was negative for the first time since before World War II . This change compounds the problem of financing the trade deficit.

From a financial stability perspective, reliance on foreign financing carries several risks. In the event of foreign investors losing their appetite for US financial assets, US financial markets will stand exposed to a reduced demand that will lower asset prices and raise interest rates. The dollar could weaken precipitously as asset holders seek to exit US markets, thereby creating further financial turmoil. The US would also be exposed to significant imported inflation with a resulting period of stagflation that would be hard to escape.

No one knows exactly where the financial instability threshold for the US is, but huge trade deficits have been run for 20 years and the current account deficit is now running at close to 5 per cent of GDP. Historically, deficits of this magnitude have proved to be harbingers of instability. Policy prudence therefore suggests a course of smooth, gradual adjustment now, rather than running the risk of large disruptions, that leave a debt over-hang from which it is more difficult to escape, later.

Global implications

It is not only the domestic economy that is being hurt by the over-valued dollar. So too is the global economy and in this sense it represents a lose-lose policy for everyone. For foreign economies, the benefit of an over-valued dollar is that it increases their exports to the US. Balanced against this are several costs, the most important of which is imported inflation resulting from most commodities being priced in dollars.

This is clearly illustrated in Europe that has imported inflation owing to higher oil prices. Thus, the near-tripling of dollar denominated oil prices that took place between 1998-2001 was compounded a further 35 per cent by the fall in the value of the euro relative to the dollar.

A second region that has been hurt by the over-valued dollar is the southern cone region of Latin America. Here, the problem is Argentina whose currency board arrangement has the Argentine peso tied at a fixed rate to the dollar. The resulting appreciation has been disastrous for the Argentine economy. Just as America's manufacturing industry is having difficulty competing, so too is Argentina's, only the problem is worse because Argentina's industry is far less efficient and its exports are tilted toward European rather than US markets. Moreover, Argentina is a major commodity exporter and the rising dollar has priced its exports out of these ultra-competitive markets. The net result has been a deep and prolonged recession, which has spilled over to neighboring Brazil as one of its major trading partners.

Argentina's recession, combined with the fact that Europe is its largest export market, has made it even more difficult for Argentina to service its huge dollar-denominated foreign debts. Prospects of an Argentine default have therefore increased, which has raised interest rates on new lending to Argentina and compounded the default likelihood. However, the story does not end there. The increased prospect of an Argentine default has also caused ripples of contagion that have raised loan rates to all developing countries. These higher rates, and the dollar-denomination of most developing country foreign debt (and oil prices), have helped to raise the level of financial distress further.

So the over-valued dollar has helped set the stage for a global recession. Western Europe has been pulled into a slowdown by the ECB's interest rate response to imported inflation, while the developing economies of the world have been hit by increased burdens of servicing their dollar denominated foreign debt. The benefit of exporting more to the US market has been marginal and far outweighed by the costs of the high dollar.

Exchange rate intervention works

What is to be done to mitigate the economically costly over-valued dollar? The objective is to engineer a smooth gradual depreciation of the dollar of the order of 20–25 per cent.

Some argue that foreign exchange market flows are simply too large and that effective intervention is no longer feasible in a world of global financial markets. In making this claim, opponents of intervention point to the many instances where massive intervention has failed to sustain exchange rates as, most recently, in Turkey. In 1999 there was Brazil, in 1998 there was Russia and before that there were the East Asian economies. In each instance, market forces proved too powerful.

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Missing in the discussion though is that this is a case where intervention is designed to lower the value of a currency rather than support it – a huge difference. Turkey, Brazil, Russia and East Asia were all cases where national central banks were pitted against market participants in an attempt to defend exchange rates. The resources available to these banks were their 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 different. It is selling its own unlimited supplies of currency so market speculators can always be defeated.

Evidence for the success of intervention is provided by the Plaza Exchange Rate Accord of September 1985 when the G7 finance ministers agreed to bring down the value of the dollar and a smooth depreciation, that lasted 18 months, followed. Currency markets appear to be driven significantly by psychology, momentum trading and herd behavior, which results in long, sustained swings. Robust co-ordinated central bank intervention and 'open-mouth operations' can change market psychology and the behavior of the herd.

Successful exchange rate intervention is feasible which only leaves the question of when it is warranted. This is an issue over which Federal Reserve Chairman, Alan Greenspan, has mused in connection with domestic equity markets. Thus, in his June 1999 testimony to the Joint Economic Committee of the US Congress, Greenspan commented:

> *But bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgement that hundreds of thousands of informed investors have it all wrong.*

This argument certainly deserves consideration, but it does not warrant abandoning the public interest. In domestic stock markets there are indicators, such as price to earnings ratios, that can guide policy makers. When it comes to exchange rate settings, real exchange rate measures can give guidance.

Economic policy making involves judgements. Chairman Greenspan recognises the pervasive effect of interest rates on economic activity. However, just as interest rate policy is set on the basis of sensible and informed judgement about the economy, so exchange rate policy should be informed.

The dollar and the trading system

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 trade outcomes are profoundly impacted by currency markets.

Milton Friedman's old view 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. Instead, exchange rates appear to behave like asset market prices and exchange rate bubbles driven by speculative expectations can persist for long periods. The current dollar bubble shows that the problem of exchange rate misalignment is not just a problem for developing countries and it points to a need for permanent co-ordinated exchange rate policies.

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

The old Bretton Woods system of fixed exchange rates suffered from the need for large disruptive periodic exchange rate adjustments and it could not withstand the powers of speculation created by liberalising of capital flows. The system that has replaced Bretton Woods allows exchange rates to be set by capital flows irrespective of trade deficits. The result is a system that is dysfunctional. This is illustrated by the current conditions that have seen the dollar appreciate strongly despite a record trade deficit that has conventional early warning financial crisis indicators flashing red.

Conclusion

There is no going back to the Bretton Woods arrangements. However, having a co-ordinated G7 exchange rate policy, predicated on the intervention of strong currency central banks, would go a long way to making the international financial system work more fairly and productively. Small modifications to the rules governing capital flows, so as to allow central banks to slow inflows, would also be needed. However, before this agenda can be effected, policy makers will have to escape an ideology of financial markets that has them abdicating their powers of responsible intervention and governance. In the meantime, this ideology promotes a policy of dollar complacency that is deepening America's economic slump ●