

Overview

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In attempting to provide an overview on the dollar, I shall ask three questions: "Where **are** we? Where **are** we going? and What should be done?" In each case, I shall both draw on several of the papers presented to the conference and express ideas of my own and developed by my colleagues at the Institute for International Economics.

Where are we?

Despite its recent depreciation, the dollar remains massively overvalued in terms of the underlying competitive position of the United States. The correction of the last six months has reduced the extent of overvaluation but represents primarily a reversal of the further sharp appreciation in January and February: the dollar remains five percent above its 1984 average on the Morgan Guaranty index, and only one percent below that level on the Federal Reserve index.

Very little net correction has thus occurred. The overvaluation, as defined above, remains in excess of **30** percent as calculated by Williamson¹ and Marris.² Branson and Krugman endorse this magnitude in their papers for this symposium.

We **are** thus on the path described in detail by Marris, and echoed by Krugman, assuming no further change in the real effective exchange rate of the dollar and even with slower economic growth in the United States than in the rest of the world:

- Steady further deterioration of the U.S. current account position to a

¹ John Williamson, *The Exchange Rate System*, Washington: Institute for International Economics, revised June 1985.

² Stephen Marris, *Deficits and the Dollar: The World Economy at Risk*, Washington: Institute for International Economics, December 1985.

level of about \$300 billion by 1990 (comprising a merchandise deficit of about \$200 billion and net interest payments of about \$100 billion.)

- A continuing drag on GNP growth and, as Roosa has put it to this conference, a growing threat of **deindustrialization**.
- The most rapid plunge into foreign debt ever recorded.
- Accumulation of such debt to about \$1 trillion by 1990.
- A resulting **debt/export** ratio of near 200 percent, the traditional trigger for external debt crises,' by 1988-89.

Roberts suggested in his commentary on Cooper's paper that the problem of U.S. international competitiveness antedates the appreciation of the dollar, and thereby attempts to downplay the importance of that phenomenon. By contrast, the facts show an enormous burst of U.S. competitiveness in the late 1970s. From 1978 to 1980, U.S. exports grew twice as fast as world trade. The United States recouped market share in almost every sector of manufactured trade, in some cases to levels not seen since the 1960s. Our current account improved by almost \$60 billion (excluding the adverse price impact of the second oil shock). In his comment from the floor, Mr. **Harring of Motorola**—one of the companies expressing the greatest concern about America's current competitive problem—explicitly dated the difficulty from mid-1980. The dollar is the major culprit.

Equally clearly, the current situation is unsustainable—for two reasons. One, cited most frequently (included by **Krugman** here), is that foreigners at some point will be unwilling *ex ante* to place enough additional investments in dollar assets, at existing interest rates and exchange rates, to finance the huge U.S. current account deficits. Note that no *withdrawal* of previous dollar investments is needed to occasion this result; any such disinvestment would make the situation worse, as would outflows of American funds in search of gains from appreciation of other currencies against the dollar. **Marris** shows that almost one half of all world savings generated outside the United States would have to be moving into the dollar by the end of this decade to sustain the exchange rate at its current level.

The second source of unsustainability may be even more proximate, if less widely recognized (in this context): the economic and political **unsustainability** of the impact of the dollar overvaluation within the United

³ William R. Cline, *International Debt: Systemic Risk and Policy Response*, Washington: Institute for International Economics, 1984, Appendix A.

States.⁴ **Krugman** notes the growing possibility of U.S. expropriation of foreign assets here as the level of such holdings rises; this risk should not be ignored, as President **Nixon**—in a situation that was the closest postwar parallel to the current overvaluation—did indeed expropriate in a sense in 1971 by ending the convertibility of foreign official dollar holdings into gold. A much greater risk, however, is an extensive outbreak of trade protection.

Historically, the exchange rate of the dollar is perhaps the best "leading indicator" of U.S. trade policy.⁵ As Cooper has noted in his paper, an outburst of U.S. protection—whether via an import surcharge or some other device—is eminently possible in the near future.⁶ This could turn out to be the most costly, and most lasting, of all the adverse effects of dollar overvaluation on the United States and world economies.

Indeed, it may already be too late to avert further extensive protectionist actions in this country. A rapid and substantial correction of dollar overvaluation, however, must be an integral part of any package that has a chance of deflecting such pressures.⁷ It is true that, even with such a correction, the trade deficit would recede only with a lag. The improvement would be assured and widely understood, however, and the promise of such a turnaround in the fundamental competitive position of the United States should offer at least a reasonable chance of avoiding tragic trade policy mistakes.

Where are we going?

It thus seems clear that a very substantial adjustment in the dollar and the external position of the United States is both inevitable and desirable. **Emminger** and **Mussa** may be correct, in their presentations to the symposium, that the United States will not have to totally eliminate its current account deficits. Under any reasonable scenario, however, our merchandise trade position will have to improve by at least \$150-200 billion: from a peak deficit in that range (in 1985 and 1986), and to finance the net interest cost of

⁴ C. Fred **Bergsten**, "The Second Debt Crisis," *Challenge*, May-June 1985.

⁵ C. Fred **Bergsten** and John **Williamson**, "Exchange Rates and Trade Policy" in **William R. Cline**, editor, *Trade Policy in the 1980s*, Washington: Institute for International Economics, 1983.

⁶ I disagree with Cooper's suggestion that a surcharge would be "impossible to remove" once implemented. Indeed, not even the proponents of a surcharge advocate it as a permanent measure. However, foreign retaliation and emulation would still produce massive disruption of the international trading system—and, via **Third** World debt, the financial system as well—if the United States were to initiate such a step.

⁷ Several other steps will probably be needed as well, including the launching of a major new international round of trade liberalizing negotiations and the development of an effective program to support domestic adjustment to trade dislocation. On these topics see, respectively, Gray Clyde **Hufbauer** and **Jeffrey J. Schott**, *Trading for Growth: The Next Trade Negotiation*, Washington: Institute for International Economics, September 1985, and **Hufbauer** and **Howard F. Rosen**, *Trade Policy for Doubled Industries*, Washington: Institute for International Economics, forthcoming.

the rapidly growing external debt (which cannot fail to reach \$400-500 billion before stabilizing and turning down.)

This needed improvement of \$150-200 billion in the U.S. external accounts raises two issues, one domestic and one international. Internally, the improvement will have to be generated by precisely those exporting and import-competing firms which have been decimated by dollar **overvaluation**. A number of these firms, under the pressure of the 1981-82 recession as well as the strong dollar, have demonstrated impressive productivity growth during the past few years and should be able to restore their position fairly rapidly once the burden of dollar overvaluation is lifted; this suggests that the needed dollar correction might be less than suggested above (on the basis of historical relationships). But other firms have scaled back their export efforts or invested abroad or otherwise undergone lasting competitive losses, and may need an even weaker dollar to recoup. The challenge of reversing the massive deterioration of its international competitive position in the last half of the 1980s is one of the greatest ever to face the American economy.

Internationally, the issue is the locus of the trade deterioration which must mirror the American improvement. Japan will have to accept a large part of that adjustment, but even total elimination of its current massive surplus would contribute "only" \$50 billion.⁸ No other industrial countries are **running** substantial surpluses, though their aggregate "contributions" could add another \$50 billion. The **Organization of Petroleum Exporting Countries** is already in deficit, so is unlikely to help in this respect.

This means that an important part of the U.S. adjustment will probably fall on the developing countries, including those with substantial debt burdens, just as these countries have benefitted substantially in their own recent adjustment efforts from the huge increase in the U.S. trade deficit. Indeed, the near-certainty that LDC debtors will experience substantial trade deterioration as a result of the American correction represents one of the most serious threats to their continued solvency—particularly as there is no sign of renewed private capital flows which would finance these larger **deficits**.⁹

Despite these difficulties, the American adjustment will eventually take place. Some fear the adjustment, however, because of its adverse impact on inflation in this country. Such an adverse impact will in fact encompass an end to the anti-inflationary gains of the dollar appreciation as well as an

⁸ "Equilibrium" in the Japanese current account currently translates into a surplus of \$20-\$25 billion, given underlying structural conditions in that economy, so that its position could not be expected to deteriorate by more than \$25-30 billion. See C. Fred Bergsten and William R. Cline, *The United States-Japan Economic Problem*, Washington: Institute for International Economics, October 1985.

⁹ For an analysis of this issue see Donald Lessard and John Williamson, *Financial Intermediation Beyond the Debt Crisis*, Washington: Institute for International Economics, September 1985.

