The International Role of the Dollar

By Otmar Emminger

The dollar is certainly the most frequently discussed economic phenomenon of our times. Wherever I go I am asked (because in the past I had for many years a lot to do with the dollar): what about the dollar? Will it continue to fall? Will it rise again? And if it should continue to fall, will it be a gentle slide towards a soft landing, or will it end in a crash landing? Why is there so much discussion about the dollar? There are three reasons:

The dollar value — the most important price in the world economy

First, the dollar's exchange rate is at present the most important price in the world economy (while ten years ago one would probably have attributed this role to the oil price). The high dollar — even at the present DM 2.80 exchange rate it is still quite high (higher than at the end of 1983) — has had an enormous impact on the world economy. It has affected the competitive position of other industrial countries versus the United States, the U.S. trade balance, the structure and development of world trade, the prices of commodities and other internationally traded goods, and price inflation both in the United States and elsewhere. More recently the high dollar has been called the major drag on the American economy. And it has certainly been the foremost cause of protectionist pressures which threaten to undermine our trading system. No wonder that the high dollar has been a subject of discussion and complaints at several economic summit meetings; although in my view the complaints of other countries have since 1984 assumed more the character of a habitual rite, since most industrial countries have learned to live with a high dollar and have drawn from it more benefits than disadvantages.

A second reason why the dollar is so ardently discussed is because it is such a controversial subject. Its behavior has seemed to defy all conventional wisdom. At least until the beginning of 1985, we could watch a

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rather paradoxical, if not "perverse," spectacle: the more the American budget deficit and trade deficit increased, the higher rose the dollar.[1] What would have made all other currencies weak seems to have strengthened the dollar. We have already heard at this conference some interesting views about this strange connection between high budget deficits and a strong dollar.

A third reason for the worldwide keen interest in the dollar is concern about the future. What will happen to the world economy if and when a definitive reversal of the dollar trend should lead to a much lower level of the dollar's exchange rate? This concern is, of course, based on the belief that the present external position of the U.S. economy is in the longer run unsustainable, and that sooner or later the budget deficit chicken and its consequences will come home to roost — and that this may severely hit the dollar and, in its consequence, also American interest rates. I don't think one can get around the fact that the present external payments position is fragile and represents a "high risk situation." It makes the dollar and the U.S. economy dependent on the unpredictable and uncontrollable whims of international capital flows. The dollar is performing a circus act, and there is no net under it. My view has been for a long time that the uncertain future of the dollar is becoming much more an American problem than a problem for the other countries— although they, and particularly the high-debt countries, may be greatly affected, too.

[1] The height of absurdity was reached when a leading European financial newspaper (Financial Times, July 20) wrote: "This week's news that Congressional talks about cutting the U.S. deficit have broken down may have been the best news for the dollar in months...The budget deficit keeps rates high...and it discourages the Fed from easing further."

The topic assigned to me is the international role of the dollar. So I shall first make a few general remarks on how this role has evolved over recent years. Second, I will discuss the international impact of the high dollar, and third, venture a bit into the foggy area of future prospects.

General remarks on the international role of the dollar

The powerful position of the dollar is not only based on its being the currency of the largest and most powerful economy. It goes beyond that because the dollar fulfills a unique role as a world currency.

This role has undergone some changes over the last 15 years. Until 1971 we had the gold-dollar standard which gave the dollar a key role, as the system's official link to gold and as the anchor for other countries' parities. When President Nixon suspended the gold convertibility of the dollar in August 1971, many experts —both inside and outside America — expected that this had finished the key role of the dollar in the world monetary system. They believed that the dollar had become a normal currency like all the others, and that the United States now had lost what deGaulle had called the "exorbitant privilege" of financing its external deficits with its own domestic currency.

These assumptions have proved thoroughly wrong. The dollar has not only maintained its special position, it has in some fields even enlarged it. Although we no longer have an official dollar-exchange standards, we are living *de facto* in a largely dollar-based international financial system.

First, the dollar has remained by far the most important reserve and intervention currency. Since August 1971, central banks have nearly quadrupled their reserves of inconvertible dollars. And the international banking system has built up even much larger dollar holdings since the beginning of the 1970s. Thus the dollar has remained the main provider of international liquidity — contrary to the well-known predictions of Prof. Triffin and others — and has carried this role even to excess. Even without gold convertibility, the United States enjoyed until recently the "exorbitant privilege" of seeming to have no external financing problem, so that it could afford—and many believe it can still afford—the luxury of a passive balance-of-payments strategy (or "benign neglect"). This phase is probably over.

Second, the dollar has remained the main currency for trade and financial transactions. More than 50 percent of world trade is priced in dollars, and that comprises most of the internationally traded commodities including oil. Thus the ups and downs of the dollar in the exchange markets have a much more than proprotionate effect on the import prices in other currencies. In Germany nearly 30 percent of total imports are priced in dollars (while direct imports from the United States are only about 7 percent), and in France about 40 percent.

The dollar's position is even more pronounced in the financial sphere. It has become the dominating currency in the international financial markets, and this position has been built up particularly during 1970s. As a consequence, 80 percent or more of the external debt of the Third World is expressed in dollars. A large part of this debt bears variable interest rates tied to dollar interest rates. Thus, large movements of the dollar exchange rate and, in particular, of dollar interest rates, have a big impact on the international debt situation. We witnessed the effects a few years ago.

Third, high dollar interest rates have not only been a heavy burden on the high-debt countries, but also an attraction for foreign investors, and thus an important reason for the high dollar. It was certainly not the only factor: in the period between 1982 and 1984, when net annual capital imports into the United States soared by the tremendous amount of $90 billion, a large contribution came also from the decline in American lending abroad; this was to a large extent due to other causes than high American interest rates (debt crisis, stricter banking regulations, etc.). But taking everything together, dollar interest rates and their changes are a major factor in the world payments system, mainly because of the key position of the dollar in the world's financial markets and as an international investment asset.

Fourth, a further distinctive feature of the dollar is the predominant role which capital movements play, both in the U.S. balance of payments and for the dollar's exchange rate. There is no other currency with a similar predominance of capital movements over the so-called "traditional fundamentals" (like inflation differences or the trend of the current account balance). Capital movements may vary quickly under the influence of changing expectations or shifting confidence. This makes the exchange rate of the dollar so volatile and unpredictable, like a "Russian roulette." The fact that in the case of the dollar, the key currency, the capital balance completely overwhelms trade and current account flows is a major problem and a weak point in the present international monetary system for it is bound to lead not only to great volatility, but to long-lasting misalignments measured against cost and price differences.

The overwhelming influence of capital movements and the huge amount of liquid dollar holdings in the world explain another unique feature of the dollar: it is the only currency for which it can be said with certainty that under conditions of capital mobility it can function only as a fully floating currency. Any fixed dollar rate, or even a mere target zone for the dollar, would sooner or later be toppled by irresistible capital flows and the enormous amount of volatile dollar holdings. As a counterpart against that, compare the European currency situation: here we have a group of countries for which the potential for disturbing mutual capital flows is much smaller, and among which the payments flows are mainly dominated by inflation differences and current account trends. Just look at the history of the European Monetary System (EMS) over the last six years: exchange rate adjustments have always been made so as to offset inflation differentials and untenable current account trends. Therefore the deviations of real exchange rates against the other member currencies have never been more than 5 to 8 percent (against up to 50 percent or more for several currencies against the dollar). This explains why inside Europe an adjustable peg system, a "mini-Bretton Woods," has functioned while it could never function again in relation to the dollar.

A currency which is the leading reserve and intervention currency, the dominating currency in the financial markets, and is itself largely dominated by capital movements, cannot be subjected to the same rules for exchange rate policies, for intervention in the exchange markets, etc., which may be appropriate for other currencies. I have always considered it a great mistake that in reviewing our exchange rate system, both economists and government officials, including the most recent Report of the Group of Ten, nearly always try to offer uniform rules for exchange rate policies and do not sufficiently differentiate between currency relations with the dollar on the one hand, and the relations among other currencies. Intervention, for instance, functions reasonably well among the EMS currencies, but it is a very controversial subject — rightly or wrongly — in relation to the dollar. I repeat: there are good reasons for this difference.

The impact of the "misaligned" dollar

Let me add a few remarks on the international impact of the high dollar. When I spoke about the "strong" or the "high" dollar, I might as well have called it the "misaligned" dollar for the value of the dollar has over the last few years been completely out of line with international cost and price relationships, and also out of line with the trend of the American trade and current account. I am reluctant to use the word "overvalued" (if fundamental factors of the capital balance are properly taken into account). I also think one should use the word "misaligned" only if it is accompanied by a clarification against which measure (or standard) the dollar is misaligned, and against which basis period. Used in that sense, a statistically verified "misalignment" may be a useful indicator for a change in competitiveness, etc. For the sake of brevity, however, I shall refrain from quoting figures here.

But there can be no doubt that we have never before had a currency whose "real" exchange rate — the nominal exchange rate compared with price or cost differentials — has risen so much and for so long as has the dollar over the past few years. Inevitably, the prolonged misalignment of the world's key currency has produced distortions and deformations. Let me first look at the American economy because its reactions to the high dollar are so important for the whole world economy. The impact of the high dollar on the American economy was at first mainly positive: in 1983-84 it helped to prevent an overheating by deflecting excessive demand abroad. In addition, it has held the inflation rate down and helped to overcome the inflationary psychology, it has kept interest rates lower than they otherwise would have been, and it has exerted pressures to rationalize production. But the longer the misalignment has lasted, the more the balance has shifted to the disadvantage of the American economy: I note the growing drag on the economy, in particular manufacturing, mining and farming, and the ensuing distortion in the structure of the American economy; the building up of a large external debt the service of which will severely burden the American payments balance on current account for a long time ahead; and the increasing risk that an unsustainably high dollar exchange rate could reverse itself too sharply. This may in the near term become a greater risk for American economic stability than the budget deficit. Paul Volcker said recently: A precipitous decline in the dollar "is the greatest risk we have on the inflation front."

The impact on other industrial countries has developed in the reverse order: at first the negative influences clearly prevailed, with the high dollar and the high American interest rates behind it forcing overly high interest rates on the rest of the world. But the picture has changed. In a number of countries, especially Japan and West Germany, monetary policy has since 1984 been largely (although perhaps not entirely) "uncoupled" from the high dollar. The price-raising effect of the high dollar on import prices was temporarily, especially in 1981, quite disturbing. But since 1983 it has been partly offset by the fall in the dollar prices of commodities — particularly oil — and partly by lower domestic cost increases. Thus, in Japan and Germany the domestic inflation rate declined in 1984 towards 2 to 2 1/2 percent, despite the weakness of their currencies against the dollar, and is now on its way to somewhere below 2 percent.

Between the United States and a group of other industrial countries (and some outlying countries) a queer kind of mutual interdependence has developed over the last few years: these other countries have supplied large amounts of capital to the United States, while the United States has in exchange supplied additional demand to them, which these countries have so badly needed (and did not dare to create themselves because they shied away from an increase in their indebtedness.) Is this going to be a new structure of the world economy — a big capital gap in the United States standing opposite a capital surplus in Japan and other countries? This is, of course, in part simply a reflection of the contrasting policy mixes—a very expansive budget policy here, a restrictive budget policy there. But there lies more behind it, namely deepseated structural differences in the net savings ratio in the private sector. The most striking examples are the United States with its low private savings ratio and Japan with its very high ratio. The Japanese capital surplus appears to be a structural and lasting one, but not necessarily on its present huge scale which is partly a consequence of very high profits on its dollar exports; and it should not go so one-sidely into dollar assets. As concerns other countries it is, in my view, an unreliable structure. At any rate, it is not very satisfactory that the richest country is drawing huge amounts of capital from the rest of the world—more than twice the amount of the net capital imports of the whole Third World! This cannot possibly remain a durable position.

At any rate, it is important to know that many industrial countries have learned to live with a high dollar. More and more the stimulating effects on Japan and Europe due to the combination of American expansion with the high dollar have outweighed the initial negative effects. This external stimulus came just at the right time, namely when domestic demand in Europe and Japan was languishing because of restrictive fiscal policies and other reasons. Without this helpful stimulus from the outside it might not have been possible for some European countries and Japan to carry through the budgetary corrections so badly needed for longer term structural reasons. Now the export-led recoveries of some of these countries have begun to spread also to the domestic field, particularly in Japan, but less so in Europe.

But these other countries, too, live under the shadow of risks arising from the misaligned dollar. A prime risk is that a perpetuation of the distorted competitive positions would lead to very harmful protectionist reactions in the United States. This risk is particularly acute for Japan with its very distorted bilateral trade position vis-a-vis the United States. Another risk is that a continuing drag on the American economy from the misaligned dollar might over time lead to an externally generated dampening effect on the world economy and would aggravate the situation of debtor countries. A third risk is an abrupt and exaggerated decline of the dollar which would unsettle established trade relationships and might provoke interest rate increases in the United States. The worst scenario, particularly for the international debt situation, would, of course, be a continued weakness of the American economy, accompanied by an excessive dollar fall due to a loss of foreign confidence which might force the Federal Reserve to keep interest rates high in spite of the weaker economy.

Future prospects

These various risks for the world economy let it appear useful to form at least a tentative opinion on what we may expect from the dollar in the near future. I shall not be so presumptuous as to forecast the short-run evolution of the dollar. As I said: forecasting the dollar in the short run is a "Russian roulette."

What we can, however, say with some assurance is that the overpriced dollar will sooner or later have to decline to a more normal level. The crucial question is whether this will become a "soft landing" or a "crash landing." Many experts believe that the external balance of the United States is so much out of joint that its correction will inevitably lead to an abrupt and exaggerated fall of the dollar. I believe, however, that there are also some good reasons for expecting a "soft landing." First, there is the unexpectedly low inflation rate in the United States and also the foreign confidence in the Federal Reserve. Second, other countries which are greatly interested too in softening an eventual dollar fall, will probably help by lowering their own interest rates; the dampening influence of a lower dollar on their export and their prices will push them towards such a policy anyway. Third, it is in my opinion wrong to assume that the dollar would have to decline until the U.S. current account is in full balance; there may well remain as continuing net capital inflow over the next few years, although at a reduced scale. And finally, one cannot exclude that Congressional action may still lead to a confidence-inspiring cut in the budget deficit. This is a crucial point. It makes all the difference in the world whether the dollar falls because foreign investors lose confidence in it, or whether it declines because the American capital gap is diminished by budgetary action. In the first case, American interest rates will be forced up in order to attract enough foreign capital, and the budget deficit will crowd out private investment, leading to an economic downturn. In the second case, American interest rates will decline and this will lead to a lower dollar.

Up to now, the decline of the dollar can be considered to have been rather moderate and not precipitous (one commentator called it a decline "at a dignified and tolerable pace"), even though it has fallen by about 17 percent (on a weighted basis) against its peak at the end of last February. But this peak was so clearly an exotic aberration that it was an easy goal for a fully justified, massive (and successful) central bank intervention. The present level of the dollar was considered very high, when it was first reached in 1984. Nobody can say precisely what the "right" exchange rate of the dollar should be. But one can at least say that a further modest downward movement would be in place. This is not a forecast; it remains to be seen whether the dollar, with its exchange rate being a "riddle inside an enigma," will oblige. We should, however, not overlook that even a stronger fall of the dollar would probably have a significant effect on the trade balance only after a considerable time lag. This is one reason why one cannot exclude an overshooting on the downswing.

The dollar as a major risk factor for the American economy

I hope it has become clear that the exchange rate of the dollar, and the huge external deficit which is in part due to the high dollar,[2] have now become acute problems also for the American economy. About a dozen years ago a Secretary of the Treasury said to the Europeans: "The dollar is our currency, but your problem." Now the dollar problem has returned home to the United States, particularly if we look ahead to the somber eventualities for the future.

It corresponds to this new situation that recently the level and trend of the dollar's exchange rate have become an important criterion or indicator for the monetary policy of the Federal Reserve (which seems at present to be "the only guy in town" as concerns American economic policy). Henry Wallich has said: "The exchange rate of the dollar has gained weight as a factor in monetary policy formulation." This is a far cry from "benign neglect."

When the Federal Reserve last May lowered its discount rate to 7 1/2 percent, it made clear that its main concern at the time was the weakness in the U.S. economy as well as the continued strength of the dollar, which had partly caused that weakness. When two months later Paul Volcker explained the Fed's newly rebased monetary targets, he indicated that the Fed was not interested in a further appreciable decline of the dollar, except if it were accompanied by a considerable cut in the budget deficit.

Thus, there seems to be a rather narrow path between what the Fed considers an excessively strong dollar and a dangerously low dollar. After all, the dollar was around DM 3.08 when the discount rate was lowered in May, and around DM 2.85 when Paul Volcker recently showed himself concerned about a further decline. But he may have been looking less at the then existing level than at the apparent speed of the downward trend.

At any rate, one conclusion seems to be warranted. The Fed may find itself before a difficult dilemma: on the one hand, to keep interest rates high enough to attract sufficient funds from abroad and prevent a too steep fall of the dollar and, on the other hand, to keep

[2] The deterioration of the U.S. trade deficit (with equivalent benefit to other countries) over the last three years is estimated to have been due to about half to the high dollar, and for the rest mainly to the relatively stronger expansion in the United States.

interest rates low enough in order to prevent the domestic economy from falling into stagnation or recession. Isn't it a strange reversal of fate that now the Federal Reserve may be more dependent on external factors, while central banks of several other industrial countries are less dependent than before.

There is perhaps one relieving factor. The impact of a further decline of the dollar on American prices may be less than is commonly assumed: First, most commodities traded in world markets are priced in dollars and some, particularly oil, are declining even in dollar terms. Second, many foreign exporters will probably lower their prices for the American market because they are enjoying high profit margins thanks to the high dollar. Third, we have seen in Japan and West Germany that moderate increases in wages and other domestic costs are in the medium term much more important for the inflation rate than movements in import prices; after all, the share of imports in total GNP is much lower in the United States than in Germany, which has shrugged off the price-raising effects of the high dollar fairly quickly.

But one cannot exclude that the external deficit and its possible effect on the dollar may become a critical factor for the American economy, more so and sooner than other offshoots of the big budget deficit. The only reliable way out of this risk situation would, of course, be a gradual improvement in the American budget situation. This would give the Fed more freedom to maneuver. Another possible way out would be a vigorous recovery in other industrial countries, which would lead to a significant improvement in the American trade balance even without a sharp fall in the dollar. Unfortunately, this latter way out does not look very likely at present, even though there are some modest improvements in other industrial countries on the horizon. Even with a further decline in interest rates, a sufficient domestic demand response in these countries will take a lot of time.

Why have I intruded into the field of American monetary policy, about which you understand probably more than I? For the simple reason that the rest of the world is so much dependent on how the United States will cope with the problem of its twin deficits. The exchange rate of the dollar, American interest rates, and the growth rate of the American economy are three of the most powerful influences on the world's economic and financial evolution. To mention just one obvious example: the solution to the international debt crisis is critically dependent on a further steady expansion of the American economy and on moderate dollar interest rates. This puts a heavy international responsibility on the United States. But no country can escape the responsibility arising out of its importance.