

Commentary on 'The Dollar in the 1990s: Competitiveness and the Challenges of New Economic Blocs'

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Rudi Dornbusch loves to be controversial, and by that criterion he has clearly succeeded.

His paper on the dollar touches briefly on a great many issues. I am tempted to make an analogy with yesterday's raft trip on the Snake River. The point is not just that both the paper and the raft trip concern experiences with floating. In both cases, one is breathless by the end of the ride, yet the white-water parts have gone by so fast that one is not quite sure what one has seen. Rather than reviewing the whole ride from beginning to end, I will pick out some of the most spectacular rapids.

One section is on the famous Feldstein-Horioka finding. Feldstein and Horioka upset conventional wisdom in 1980 when they found that changes in countries' **national saving** rates were not offset by borrowing from abroad at the going interest rate, but rather, were mostly reflected as crowding out of investment within the **country**—and when they interpreted the finding as evidence of low international capital mobility. The correlation between saving and investment across countries can be seen in **Rudi's Chart 6**.

Dozens of papers inspired by Feldstein-Horioka have appeared over the last 10 years (25 are cited in **Frankel, 1989a**), many essentially making the econometric point that national saving, particularly the government budget deficit, is endogenous. But when one corrects for such endogeneity, the results change little. In my view, the **saving-investment** correlation does, in large part, reflect failure of real interest rates to be equalized across countries. But real interest differentials

have several components, of which barriers to the movement of capital across national boundaries constitute just one. (The others concern the currency of denomination of assets, rather than the country of issuance.)

The best measure of barriers to international financial integration is the magnitude of the covered interest differential. Covered differentials do show what one would expect: near-perfect financial integration for most major industrial countries by the beginning of the 1980s, with the United Kingdom and Japan having joined the club in 1979. Three-month covered interest differentials show that during the decade the most rapidly liberalizing countries, in descending order, have **been**: Portugal, Spain, France, New Zealand, Denmark, and Australia.¹ In the case of the European countries, the removal of capital controls is associated with the plans for 1992 integration, as discussed in the Dornbusch paper.

There are several reasons why changes in national saving could have large effects on investment despite the perfect international integration of markets in short-term deposits and bills. Rudi raises one of the most interesting and important for future research: due to information imperfections, investments in real estate and other kinds of real capital are not perfect substitutes for short-term deposits, or for similar investments in other countries. This imperfection has as much to do with financial integration within **countries** as across countries. Nevertheless, it can explain why one country's shortfall in, for example, corporate retained earnings, results in less business fixed investment (the cost to the corporation of selling bonds, whether to domestic or foreign residents, being greater than the cost of internal financing).

It follows that, not only liberalization **internationally**, but also deregulation and innovation domestically, should be reducing the saving-investment **coefficient** over time. The paper points out some implications of this greater ease of financing shortfalls in saving.

For the United States in the 1980s, the major implication has been that the large fall in national saving, particularly the increase in the federal budget deficit in the early 1980s, was reflected primarily as a capital inflow from abroad, appreciation of the dollar, and trade

¹ Frankel (1989c).

deficit (especially *vis-à-vis* Japan), rather than as crowding out of investment. One would expect that the saving-investment coefficient would have fallen in the 1980s. The U.S. time series is plotted in Chart 7. As Rudi notes, the inclusion of the 1980s has indeed reduced the correlation. I compute that the regression coefficient has fallen from .9 (in the period 1929 to 1979) to .2 in the 1980s.²

Rudi notes, "It is interesting to speculate whether this new development reflects a worldwide breaking down of reluctance to cross-border lending or whether it is peculiar to the U.S. case." The answer to this question is available from Feldstein's latest work on the subject. Feldstein and Bacchetta (1989) find for a cross-section of countries that the coefficient has indeed fallen, from .9 (in the 1960s) to .6 in the 1980s.

There is also an implication for the 1990s. On demographic grounds, it is widely expected that the saving rate in Japan will decline over the next 20 to 40 years. In a deregulated financial setting, the implication is that the Japanese current account surplus will fall commensurately. (Rudi warns us away from complacency regarding the Japan-U.S. trade imbalance, however, with the assertion that "Of course, Japan is closed to U.S. exports.")

The central topic now is U.S. adjustment. A lot of nonsense has been written on **the question** of how the U.S. trade deficit should or will be reduced, and here I am entirely with Rudi. First, I agree with his view that the U.S. deficit is an issue that merits concern. It is important for economists to keep explaining that some trade deficits are good; but this deficit is not one of them. I don't believe that the American people, if presented the choice explicitly, would opt for the reduced standard of living for their children that current low levels of national saving and current account balance imply. Second, I agree that because policymakers have little control over private saving, the solution lies in raising public saving, in part by raising taxes. (Rudi's preferred tax is a 5 per cent V.A.T. Mine is a federal gasoline tax comparable to those in Europe and Japan. It could be sold politically as necessary on environmental **grounds**—which it is—and at the same time, it would raise enough revenue to solve the deficit problems.) There is also the question of policy

² The regressions use the dependency ratio and the share of military spending as instrumental variables (for private and public saving, respectively). The source is Frankel (1989a), Table 2.

coordination: if we succeed in cutting our budget deficit, should we ask something in return from our **G-7** trading partners, and if so, what? I will return to this question later.

The third point on which I agree with Rudi is that a depreciation of the dollar is a desirable part of the needed U.S. adjustment. One often hears attacks on the "devaluationist school." The empirical proposition is that "no relationship is observed between the dollar and the trade deficit." The theoretical statement is that "a change in the value of the dollar is neither necessary nor sufficient to improve the trade balance." Both of these propositions are true, as literally stated, but they miss the point.

The effect on the trade balance depends on the circumstances in which the dollar falls. Rudi points out the two important lessons of the theory of the transfer problem that are precisely appropriate here.

(1) A dollar depreciation *that resulted from a monetary expansion* would be undesirable under present conditions, because it would lead to excess demand for goods and to inflation. I would also add that the effect on the trade balance would be small, and perhaps not even positive (because the effect of higher demand on imports would counteract the exchange rate effect).

(2) "When and if fiscal policy in the United States (is adjusted), resulting slack (will) need to be corrected by a combination of lower . . . real interest rates and by a real depreciation of the dollar." This is not the same as saying that the dollar necessarily *will* fall; only that a fiscal correction *without* a decline in the real interest rate and the dollar would lead to a possible recession and would thus be undesirable.³

I have been less certain than some economists like Feldstein that the dollar will, in fact, fall in the short run. Calculating from trade fundamentals, Rudi reaches "the conclusion that the **dollar/yen** exchange rate will have to move upward of 45 percent in the next few years." (Elsewhere we are told that the horizon is five or six years, which takes us to 1995, the center of the decade that was the assigned topic for the paper.) At the current rate of 144 ¥/\$, the forecast goes below 100 ¥/\$. This is a bet I would be willing to take. I don't have the usual economists' objection: that if such a

³ In the aftermath of a fiscal contraction, if a real depreciation did not come about as the immediate consequence of a nominal depreciation, it well might come about as the eventual consequence of deflation.

forecast were a good one, market investors would already know it, would sell dollars today, and thus drive the dollar down instantly. My reasoning is rather that the market can and does depart from economic fundamentals for relatively prolonged periods of **time**.⁴

A survey of foreign exchange forecasting services and multinational corporations, conducted the week before this conference by Currency Forecasters' Digest, reported a consensus forecast that the dollar would appreciate to 190 ¥/\$ by the end of 1993, a 33 percent increase (with even a larger appreciation forecast against the mark: 40 percent, to 2.34). This is the sort of forecast that Ron **McKinnon** has been making on Purchasing Power Parity grounds. The Digest also reports a differential in expected inflation rates that, cumulating to 1993, gives an **expected** real appreciation of 45 percent against the yen! This forecast is probably wrong; it is another bet that I would take. With that level for the dollar, in the absence of recession, the **U.S.** trade deficit would probably climb to \$200 billion (with appropriate lags).

One reason that many market participants are bullish on the dollar at the moment is that they have heard forecasts like Rudi's "45 percent depreciation" for years, and such forecasts have usually been wrong. The market shifts over time the relative weight it assigns to forecasts of the Dornbusch type and forecasts of the **McKinnon** type. **Because** there is so little consensus on the right model for the exchange rate, the market is perfectly capable of extrapolating the upward trend that the dollar has shown thus far in 1989, buying dollars and sending its value higher still. If economists like Dornbusch, Feldstein and **Krugman** think that the market is computing fundamentals incorrectly, it is useful for them to point this out. But when making a **one-year forecast**, it doesn't help to know that the current market level is "wrong," if the market might still be wrong one year from **now**.⁵

⁴ *Euromoney* magazine runs a yearly August review of between 10 and 27 foreign exchange forecasting services. During the period 1978 to 1981, most reported that they used models based on economic fundamentals; only one or two said they relied on technical analysis. By the mid-1980s this pattern had reversed. In the 1988 review, 12 reported using only technical models; one, only fundamental models, and 12 employed a combination of techniques.

⁵ Admittedly, Rudi's assigned task of predicting the developments of the coming decade is impossibly difficult.

There is only one part of the paper to which I take definite exception. That is Section IV, where Rudi signs on to the view that Americans should lie awake at night worrying that the dollar economic bloc is losing ground to a yen economic bloc in Asia and a 1992 bloc in Europe. There is alarmist talk of Japan's establishing an "Asian co-prosperity zone," and equally alarmist talk about Europe. The concluding paragraph contains the **striking** sentence, "For the dollar, the intra-European trade integration and the financial integration cannot be seen other than as bad news."

The increasing share of the yen in trade and finance at the expense of the dollar is an undeniable, but relatively minor, phenomenon. The same is true of the deutsche mark and ECU. It is true that the United States as the issuer of the dollar may lose a small amount of resources in the form of seigniorage. However, the dollar will remain the world's key currency, not just in the coming decade, but well into the coming century.

A far more major phenomenon is the increasing share of Japanese and European industry as a percentage of world output. This trend is independent of questions of currency usage or of integration within Europe and Asia. Just because integration is good for Europe (and I believe that it is), does not mean that it is bad for the United States. The problem, I sometimes think, is that the American newspaper readership has confused the financial pages' **rankings** of countries in the Group of 7 with the sports pages' **rankings** of teams in baseball's National League. I agree that slow productivity growth in the **United States** over the last 15 years is a problem: I do not agree that greater success among our trading partners is, in itself, a bad thing.

I return to the central policy proposition of the paper with which I agree: to reduce its current account deficit, the United States should cut its budget deficit and Alan Greenspan should then allow the real interest rate and dollar to decline. The final question is the coordination one: should we ask something of our G-7 partners in return? Rudi **kindly** refers to my results on coordination under uncertainty. Because of uncertainty regarding disturbances, goals, and models, the United States doesn't even know what to ask of our trading partners in a G-7 meeting. Currently, such meetings focus on a list of "indicators," including trade balances, money growth rates, and inflation. I don't think we should ask for trade balance targets; they are too close to "managed trade" (which **Business Week** and the others have recently

pronounced the latest "revisionist" fad). I also don't think the G-7 should set targets for **M1**; there is too much uncertainty in velocity, and we don't even know whether a foreign monetary expansion would have a positive or negative effect on the U.S. economy. Rather, if we are going to coordinate policies to any extent with our trading partners, I favor focusing on targets for nominal **GNP**.⁶

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⁶ As explained in Frankel (1989b).