Overview

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Looking at the dollar, the principal topic of this symposium, it can be said that, at considerable cost to the American economy, considerable benefits have been achieved. At home, inflation has been cut to one-third or one-quarter of its earlier level. Abroad, the United States has acted as a locomotive, pulling the world economy out of a recession. The costs to foreign countries, in terms of higher interest rates and higher prices, are less than the benefits. Higher interest rates are to some extent in the discretion of these countries since on a floating exchange system they can allow their currencies to go down instead of raising interest rates to prevent this. The price increases resulting from the lower value of the currencies evidently have not prevented an almost universal reduction in inflation rates abroad. The reason for this is that the prices of many of their imports, although invoiced in dollars, are actually determined by world markets. A strong dollar depresses the price of world market commodities, especially oil. As for higher interest rates and the alleged draining of investment funds from foreign countries to the United States, most foreign countries operate with substantial excess capacity, unemployment, and therefore, low utilization of potential. Bringing their economies up to full employment would generate additional savings that could offset the drain to the United States.

For the United States, the benefits of the high dollar are, I think, overmatched by its costs. Inflation has been reduced, but some of this gain may have to be given back if and when the dollar comes down. We have had a good investment performance, but not all that much better than in the past. The ratio of business fixed investment to GNP has increased only moderately over past peaks on a gross basis and is lower on a net basis. Meanwhile, the domestic debt burden has increased substantially and the foreign debt of the United States has increased to the point where we have become a debtor country. We have largely lost the net investment income that used to be a great support of our current account.

Even so, if there were a way of changing course now and stopping a continuation of the adverse trends I have cited, one might say that we had incurred an affordable cost in return for substantial benefits. The difficulty lies with the future.

Several of the speakers in this symposium have focused on the Fed and, in my way of thinking, done us more honor than we deserve. The Fed is not the only game in town; there are others. But even if it were, that does not mean that we should play them all. Neither can the Fed be held responsible for the inability of the original administration program to deliver all it promised. Rates of growth that would have raised revenues to the point of balancing the budget after massive tax cuts were not prevented by the Fed. In my view, they were unlikely to begin with. I was somewhat startled to hear one speaker say that the Administration was prepared to settle for an eight percent inflation in the near term, instead of the four percent that developed. I had not heard this from my Washington friends who stayed with the Administration. The clear anti-inflationary stance of the Administration, to my thinking, has often been documented.

To underscore my comment that the Fed is not the only game in town, let me draw your attention to some things that are going on with respect to the international monetary system in which the dollar has had such a spectacular career. A study of the areas in which this system could be improved was completed a couple of months ago and will be at the center of discussion at the Seoul meeting of the International Monetary Fund and other bodies hereafter. I am surprised how little attention has been paid at our meeting here to what, after all, constitutes the principal concerted effort of the major industrial countries in the direction of monetary reform. Granted that the results are modest, a fundamental question nevertheless has been put on the table. It is whether the present system of floating rates, which has not performed satisfactorily in the opinion of most observers, is inherently defective, tending to extreme fluctuations, or whether this performance results from inappropriate use made of the system and excessive pressures placed upon it. In the former case, trying to change the system in the direction of greater stability would merely have the effect of pushing some of the inherent instability of the world economy into some area other than exchange rates, for instance, into growth, inflation, and employment. If, on the other hand, the use made of the system was inappropriate, then agreement on better use may be the remedy.

In the report, there is considerable discussion of "convergence" as a means toward more stable exchange rates. The question, not answered very explicitly, is whether this convergence relates to performance or to both performance and policies. While the report was being developed, increasing convergence of performance occurred, especially in the area of inflation control. Almost all major countries were coming below four percent. Nevertheless, as inflation performance converged, the dollar took off. This seems to suggest that convergence of performance must be supplemented by convergence of policies. This means, unfortunately, that even if the system is not inherently flawed, improvements needed in its use are of very demanding kind.

Let me now turn to the area on which much of the discussion at this meeting has focused—the Federal Reserve's role with respect to the dollar. The great problem that the dollar poses for monetary policy is that the dollar is essentially unpredictable. The papers presented to the conference make clear that we have no reliable theory of exchange-rate determination. In other words, the dollar is a wild card. It is indeed discouraging to find that economics, having demonstrated its inability to predict the stock market and interest rates, now also seems to have failed with regard to exchange rates. The dollar seems to be determined by forces to which perhaps we can give a name, but the workings of which we do not understand.

If we did understand them, it still is not clear in which way policy should seek to influence them. There are risks and costs associated with both a high and a lower dollar. A high dollar, if maintained, would push us toward protectionism. It would increase our foreign debt at an exponential rate, reaching a trillion dollars within very few years. It would continue to erode the core of our economy, manufacturing industry. As for the ultimate level of the dollar, if and when a rate consistent with some sort of equilibrium is reached, that equilibrium rate would have to be lower the longer it takes to reach it, as annual debt service charges build up.

A lower dollar would cause inflation to accelerate. By improving the current account and so reducing capital inflows, it would drive up interest rates unless the budget deficit had been meanwhile materially improved. The negative effects of a decline in the dollar would be the bigger the less orderly a downward movement, and the more severe the loss of confidence and credibility. A substantial rise in interest rates would carry the threat of recession. Even though a rise in interest rates resulting from smaller capital imports should be compensated to some extent by stronger net exports, the timing probably does not match. Markets might anticipate the movement of interest rates, whereas the improvement in the current account would take time. Indeed, we may not have the productive capacity in our weakened manufacturing sector to step up exports very fast without price pressures. For these reasons, an improvement in the budget deficit that would relieve pressure on capital markets is urgently needed as an accompaniment of any decline in the dollar.

It is in light of these considerations that suggestions made in some of the papers and at this symposium that the Federal Reserve should somehow push down the dollar must be examined. I believe that any such deliberate action would be damaging to inflation expectations. It might be damaging to our prospects of getting long-term interest rates down. The markets would find it difficult to adjust to such a Federal Reserve departure. Unpredictable and possibly disorderly movements in the exchange market could follow. I mention only in passing that a policy of pushing down a falling rate is contrary to IMF rules for floating which to be sure are not very closely observed in practice. It might also bring us in conflict with foreign countries whose views as to the proper dollar rate for their currency might not accord with ours, if we operated so as to make them believe that we had a rate objective.

Other speakers have commented on and, to some extent, criticized the proposal by Ron McKinnon. By this proposal, the Federal Reserve and the central banks of Germany and Japan should coordinate their policies. When one of them found its money supply contracting, the others should expand, and vice versa, keeping the "world money supply" approximately stable. There may be situations in which such a procedure was feasible and desirable. But just to give a contrary example at this time, now that the U.S. money supply has expanded strongly in the middle of 1985, should we urge the central banks of the two other countries to engage in countervailing contraction? Would this not completely ignore the situation of the world economy, which is one of slowing expansion both here and abroad, with inflation still relatively modest? McKinnon's suggestion to give attention to the exchange rate as an indicator of the stance of monetary policy is a good one. It is already being followed by the Federal Reserve, as Federal Reserve policy records and Congressional testimony make clear. But the level of the dollar can only be one indicator among others, although one of growing importance. Targeting on the dollar, especially with a downward bias, would require giving up the existing money-supply targets and risk provoking a new burst of inflation.

Monetary policy, now as on many occasions, is in the difficult position of having to pursue several targets with only one instrument. Except on rare occasions where something is seriously amiss, such as the weak dollar in the fall of 1978, and the acceleration of inflation in late 1979, policy cannot ignore the multiplicity of objectives. It can and must, however, bear in mind that by its nature it can be fully effective only in the pursuit of one objective-that of price stability. Its influence on growth and employment is transitory, strong in the short run but with counterproductive side effects in the longer run and eventual washing out of growth and employment effects. Monetary policy will be most effective when it avoids overreaching itself.