

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.

absolute loss from the postulated depreciation, pushing the recorded inflation numbers from perhaps two percentage points below the core rate to perhaps two percentage points above.

The key point, however, is that the inflationary effect of dollar depreciation will be temporary. It will persist for only as long as the dollar declines, and will then (all other things equal) return to the core level once the exchange-rate correction is completed. There is no reason for the temporarily higher numbers to provoke market expectations of permanently higher inflation, higher wage settlements or any other lasting results. Understanding of this point is essential if the adjustment is to be welcomed *ab initio* and to **proceed** smoothly once underway.

The required external adjustment will of course levy **real** costs on the American economy. Some of these costs will occur via expenditure switching, as output is shifted into net exports (primarily via the dollar depreciation), and some may have to occur via expenditure reduction (if the economy slows, albeit temporarily, in response to the higher inflation and possibly—see below—higher interest rates which will accompany that depreciation.) In this sense, the U.S. adjustment is like that of any LDC or other debtor country—although, as Mussa rightly notes in his comments, the ability of the United States to finance its external deficits in its own currency obviates the risk of default and alters the path by which the adjustment occurs (or is forced.)

What should be done?

The key issue for policy is thus how to **minimize** the costs, for both the United States and the world as a whole, of the inevitable and desirable **correction** of dollar overvaluation and America's external deficit. Two specific aspects of this issue are worth special note.

First, the correction can occur either with rising U.S. interest rates or with falling U.S. interest rates. One key issue in resolving this question is whether the correction comes before or after the launching of a significant reduction in the government budget deficit. But if we simply wait for foreign **investors** to "go on strike," which will drive up American interest rates even as the dollar falls, the United States will almost certainly get the worst of all worlds for a time even if budget action has been initiated: inflation (albeit temporary) due to dollar depreciation and declining output due to rising interest rates. On the other hand, initiation of an active **program** to correct the dollar prior to such a "strike" may avoid the **runup** in interest rates and thus lessen the adjustment cost substantially.

Second, the correction should occur as early as possible. As just noted, early movement would help head off the risk of a "dollar strike" by foreign investors and a renewed surge of U.S. interest rates (with particularly

adverse affects on Third World debtors as well as on the United States itself). As discussed above, urgent dollar adjustment is needed to help head off the risk of a protectionist outbreak which could disrupt the entire world **trading** system. And, as elaborated in several of the papers for the symposium, the magnitude of the needed adjustment is rising rapidly over time because of the concomitant buildup in the foreign debt of the United States; early adjustment thus means less adjustment and smaller adjustment costs.

I would advocate a three-part program, adopted as soon as possible, to achieve such adjustment: a substantial reduction in the U.S. budget deficit (by about \$150 billion annually by FY 1988, eliminating most of the *structural* component thereof), a parallel further easing of monetary policy by the Federal Reserve and, crucially important, substantial domestic expansion efforts (preferably via supply-side **tax** cuts) in Japan, Germany and perhaps the United **Kingdom**. Unfortunately, I see little possibility of early movement of macroeconomic policy in the needed directions in either the United States or abroad. For the remainder of this discussion, I shall thus assume that the preferred policy course is unavailable and that alternatives must be sought.

One possibility is that the dollar will now correct without further policy action, as suggested by Scott **Pardee** in his comments at the **symposium**. As noted at the outset, the dollar has depreciated significantly over the past six months as U.S. interest rates have declined substantially, offset only modestly by similar declines in other major countries. Lower growth prospects for the United States may reduce the appeal of dollar investments.

On the other hand, there have been three or four "false starts" toward dollar correction during its five-year appreciation. In each case, depreciation proved temporary and was more than offset by subsequent upward reversal. I would therefore suggest that five steps be taken in an effort to engineer the full correction needed as promptly as possible.

First, even without meaningful action on the budget deficit, the Federal Reserve should ease monetary policy further. Indeed, without fiscal action, the Fed is the proverbial "only game in town." Its easing over the past six months has contributed importantly to bringing the dollar back from its peaks in early 1985. More is needed, however.

It would appear that such further easing would be fully consistent with overall Fed (and national economic policy) objectives. There are no signs of rising inflation, and the temporary inflationary impact of dollar depreciation itself can be reduced by moving sooner rather than later. There are no signs that the dollar decline of March-July 1985 was producing a bandwagon effect or "free fall" for the dollar, with destabilizing effects on interest rates—which, indeed, continued to decline substantially as the dollar declined—or any other economic variables. The economy remains soft. **LDC** debt and other financial vulnerabilities continue to argue for the lowest

interest rates consistent with the broader economic objectives cited.

Second, top U.S. authorities should make clear that they *desire* a correction of the dollar. At least until recently, the markets have believed that leading Administration officials *liked* the strong dollar. Over the past couple of months, however, such officials as Secretaries Baker and Baldrige have commendably indicated the need for an adjustment—indeed, in several instances, seeming to *try* to “talk down the dollar” much more aggressively than Secretary Blumenthal ever did in 1977!

Unfortunately, Chairman Volcker, whose words carry far more *weight* with the markets than all of the Administration officials combined, appears to have prematurely “talked down the decline” of the dollar in mid-July by indicating his doubts over the desirability of a further correction. One can fully understand the Chairman’s concern that an excessively rapid depreciation could push up both inflation and interest rates. But if one agrees that substantial further dollar correction is both essential and inevitable, and that the costs are likely to be less if incurred sooner rather than later, the wiser course may have been to promote rather than retard the movement that was well underway and seemed orderly in every respect.

Third, the major central banks should take advantage of just such occasions—when the markets are already pushing currency relationships in the direction of underlying *equilibrium*—through joint intervention to promote the needed degree of adjustment. Such “leaning with the wind” would have important *signalling* as well as substantive effects, complementing the *first* two types of measures already *proposed*.¹⁰

Some observers oppose such a strategy on the grounds that “the wind could become a gale.” Again, however, that risk would seem to grow the longer the needed correction is delayed. And the United States would derive a second important advantage *from* such intervention: by selling dollars now, it would acquire DM and other foreign currencies which could then be used to counter the decline of the dollar if, at some later point, it becomes too rapid or threatens to overshoot on the downside.

Fourth, Japan could assist in this corrective process by using traditional administrative guidance to limit, *partially* and temporarily, its massive *capital* outflows into the dollar. These outflows *are* now averaging \$7-8 billion per month, and are an important source of continued dollar strength. Cooper’s otherwise excellent analysis of possible capital outflow restraints by Japan, by limiting itself to the impact on Japan itself, misses an important point: such restraints could have an important effect on *the United States* by contributing to a dollar decline.

Japan could make such a contribution if it *were* successful even in cutting

¹⁰ C. Fred Bergsten, “The Case for Leaning With the Wind,” *Financial Times*, October 24, 1984.

its outflows in half, which seems quite plausible. Indeed, this would seem to be by far the most constructive, and least costly, way for Japan to help fight off the protectionist trade pressures in the United States which may otherwise have a substantial effect on both its economy and its (U.S.-oriented) foreign policy.¹¹ The United States would of course have to endorse such a temporary reversal of policy toward capital flows, rather than urging Japan to invest *more* in the United States and thus **exacerbate** the currency and trade problems, as it has been doing since 1983.¹²

Fifth, the United States should seek renewed discussions on improving the international monetary system. Secretary Baker's indication of willingness to call a meeting on the topic, voiced at the OECD Ministerial last spring, should be revived. Several other countries indicated their interest in the topic in the report of the Deputies of the Group of Ten released in Tokyo in June. Systemic reform is no substitute for immediate action on the dollar. But a U.S. initiative on the longer-run issues would reinforce and underline the actions and expressions of concern over the present situation proposed here, as well as launching a **process** to head off the development of new misalignments in the future.¹³

Taken together, these five steps could help promote a prompt correction of the dollar and the external position of the United States. They could thereby reduce the risk of major disruption of the world trading system, and reduce the costs of the inevitable adjustment. To be sure, such a correction in **the** absence of meaningful action on the budget runs a risk of economic downturn—but the postulated monetary easing and underlying economic weakness reduce the risk of a resulting mnup of interest rates. The dollar correction would increase the recorded rate of inflation, but the weakness of the economy would also limit that effect—which, as noted above, would be temporary in any event. The case for action seems clear.

¹¹ Details can be found in Bergsten and Cline, *The United States-Japan Economic Problem*.

¹² Jeffrey Frankel, *The Yen-Dollar Agreement*, Washington: Institute for International Economics, December 1984.

¹³ The need for reform and a "target zone" approach are analyzed in Williamson, *The Exchange Rate System*.