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The Worth of the Dollar

By Ronald McKinnon

During 2006, depreciations of the dollar – about 11.5 percent against the euro, 14.9 percent against the pound sterling and about 2.1 percent against the yen, all more or less floating exchange rates – occasioned intense speculation in the financial press as to whether these currency moves should be welcomed as the beginning of the great "correction" to the U.S.'s current account and trade deficits. After all, the United States has been running such deficits since the early 1980s – and over the last year the current account deficit ballooned to about 6.8 percent of U.S. GNP. Shouldn't the market now discipline the world's biggest debtor and bid the dollar down to reduce the trade deficit?

Essentially, the answer is "no."

Take the case of the euro. From 1970, the figure (below) shows the U.S. dollar's fluctuations against the German mark, which was then transformed into the euro as of Jan. 1, 1999, up to the present. In the last decade and a half, the many ups and downs of the dollar value of the floating euro-mark were quite comparable and sometimes greater than what we observed in 2006. Indeed, in 2005 the dollar strengthened against the euro about as much as it fell in 2006. Only if the change in the dollar's current exchange rate is measured from January 2002 at the peak of the U.S. high-tech bubble would the fall seem to be portentous – and of the order of 30 to 40 percent. But this would be grossly misleading. High-tech

continued on inside...

About The Author

Ronald McKinnon is the William D. Eberle Professor of International Economics at Stanford University, where he has taught since 1961. He is also a SIEPR/SCID Senior Fellow.

His fields of interest are international economics and development finance. McKinnon has written over 100 articles and several books, which include: *Money and Capital in Economic Development* (1973); *Money in International Exchange: The Convertible-Currency System* (1979); *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy,* 1993; *The Rules of the Game: International Money and Exchange Rates,* 1996; *Dollar and Yen: Resolving Economic Conflict Between the United States and Japan (with Kenichi Ohno),* 1997; and *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue*, in 2005.

His books have been translated into many European and Asian languages, and he has been a consultant to central banks and finance ministries the world over-including international agencies such as the World Bank and International Monetary Fund.

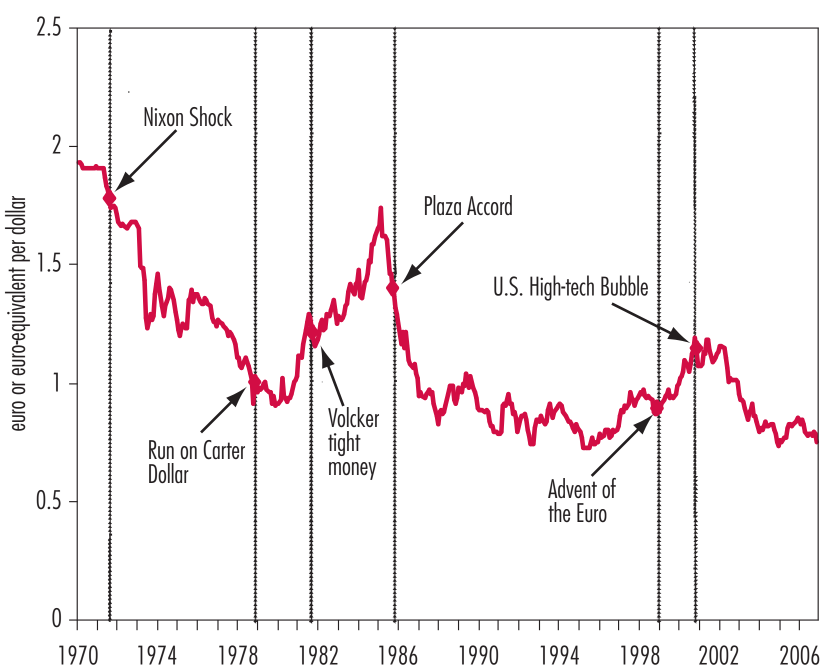
bubble aside, the figure shows the value of the dollar in euros to be about the same now as in the mid-1990s.

Putting aside countries such as Zimbabwe with chronic inflation and ever-depreciating currencies, economists have learned that a floating rate between two financially stable countries moves close to a "random walk." Over the next few days, weeks, months or even years, the dollar value of the euro is just as likely to move up as down. Although such moves can be quite disconcerting, they cannot be forecast. Consequently, the best guess of the future exchange rate is just today's spot value. (Tip for astute corporate executives: Don't bother hiring highly paid consultants, including this one, to forecast how a floating exchange rate will move!)

The one big exception to this essential randomness is when governments force (or "talk") an exchange rate into changing – and then sustain it by altering the future course of monetary policy. The first great depreciation of the dollar started in August 1971, when President Nixon undermined the old Bretton Woods system of fixed exchange rates. He imposed a tariff on all imported manufactures and refused to remove it until other industrial countries appreciated by changing their dollar pegs – which they had done by December 1971. The fixed rate system broke down altogether in early 1973.

But the story doesn't end here. To help insulate the American economy from the inflation ensuing from the dollar's devaluation, President Nixon also imposed price-wage controls from 1971 into 1973 – and leaned heavily on then Federal Reserve Chairman Arthur Burns to gun the money supply to make the economy boom and ensure Nixon's overwhelming re-election in November 1972. But it soon became clear that these wage-price controls for repressing the inflation were untenable and doing great damage to the economy – so they were abolished by the end of 1973. Unsurprisingly, inflation shot up in 1973 and hit almost 12 percent in 1974. Unfortunately,

FIGURE 1
Mark-Euro Exchange Rate / USD (1970-2006)
(Monthly Observations)



the Carter government in 1977 resumed the policy of trying to talk the dollar down – and Treasury Secretary Michael Blumenthal stated that the yen in particular should appreciate against the dollar. With increasing inflation and great uncertainty about Federal Reserve policy, there was another run on the "Carter" dollar in 1978 (see figure) requiring an international rescue operation.

Of course, these shenanigans drove the dollar down and led to the great inflationary turmoil of the 1970s. Not until 1979, when Paul Volcker became chairman of the Federal Reserve and imposed very tight money with extremely high interest rates in the early 1980s, was inflation painfully squeezed out of the American economy. But an incidental side effect was that the dollar shot upward in the foreign exchanges by more than 50 percent because foreign capital inflows were attracted by the high U.S. interest rates. Thus, the shock of disinflation fell disproportionately on American companies producing internationally tradable goods: The decline in manufacturing created the infamous "rust bowl" in the Midwest.

To correct the overshoot, the leading industrial countries in 1985 got together in New York's Plaza Hotel to "talk" the dollar down. And, sustained by somewhat easier money in the United States but also by relatively deflationary (tight) monetary policies abroad, the dollar did fall very sharply against the mark and other major currencies such as the yen. (Indeed, it "overshot" downward and had to be supported by the so-called Louvre Accord in 1987.) In Europe, the sharp appreciations slowed economic growth causing what was then called "eurosclerosis." Japan had appreciated the most, with additional American pressure creating the expectation of further yen appreciations. This thoroughly destabilized Japan's financial system with gigantic stock and land markets bubbles in the late 1980s that crashed in 1991 – but the yen appreciated through 1995. This double whammy from collapsed asset bubbles and the overvalued yen led to deflation and Japan's "lost decade" of the 1990s – and its economy remains very fragile.

Given these unfortunate macroeconomics consequences of large changes in nominal exchange rate cum monetary policies, why is it that so many economists today advocate dollar depreciation? On the one hand, they are transfixed by continuing large U.S. trade deficits that they see to be unsustainable. They also are enamored with a popular, but incorrect, theory – sometimes called the elasticities model of the balance of trade – that seems to point to a straightforward solution. If a deficit country such as the United States can somehow depreciate its "real" exchange rate – its nominal exchange rate depreciates without causing either inflation at home or deflation abroad – then its trade balance should improve. The country's exports become less expensive in foreign monies so that foreigners buy more, while its imports will look more expensive in dollar terms so that Americans buy less. Et voilà!

The crucial flaw in this reasoning is the missing link to monetary policies. Apart from random short-term fluctuations, any substantial nominal depreciation can only be sustained by future monetary adjustments permitting inflation at home or foreign central banks acquiescing to deflation abroad – the trade-off between the two being somewhat arbitrary. True, following a devaluation there are lags before prices begin to rise at home or fall abroad. But even in this short run of price "stickiness," the balance of trade of the depreciating country is unlikely to improve.

Why? First, for imports already contracted for and invoiced in a foreign currency like the euro, the U.S. importer would have to pay more (depreciated) dollars for the European goods he had agreed to buy. Economists call this the "J" curve effect.

Second, with a temporarily real depreciation of the dollar, international investors would see a window of opportunity for a year or two to undertake physical investments at lower cost in the United States. Conversely, they would see countries with appreciated currencies to be more expensive. As a consequence, an investment-led spending boom in the United States would increase imports and a slump abroad would reduce imports of American goods – as in the aftermath of the Plaza Accord described above. The upshot is that the net effect on the U.S. trade balance in this intermediate term of two years or so would be ambiguous – even though the foreign currency prices of American exports in world markets had been (temporarily) reduced.

In the long run, a general depreciation of the dollar's *nominal* exchange rate against other currencies can only be sustained by an increase in the U.S. price level relative to that in foreign countries such that any *real* depreciation washes out! Thus there would be no net price advantage left to U.S. exporters as domestic costs rose to offset the effect of the nominal depreciation. Of course, this is just the end result, which looks unduly clean. In the transition, however, financial turmoil associated with higher inflation in the United States, coupled with deflation abroad, could well lead to major losses in output and declines in productivity growth characteristic of the 1970s and 1980s.

Given these caveats, what can be done about the now huge U.S. current account deficit? The "problem" is not new and there need be no crisis unless the never-ending Greek chorus of editorial writers in the *Financial Times, The Economist, The New York Times* and so on, praising every (random) decline in the dollar as a welcome step in helping correct global imbalances, somehow foment a run on the dollar. However, this need not happen if Treasury Secretary Henry Paulson sticks firmly to the strong dollar policy bequeathed from former Secretary Robert Rubin – and current Fed Chairman Ben Bernanke continues to squeeze U.S. inflation downward.

Unfortunately, Treasury Secretary Paulson, by continuing to pressure China to appreciate the renminbi against the dollar, somewhat undermines his professed strong dollar position. China pegs its dollar exchange rate as an instrument of monetary policy for helping to stabilize its price level rather than deliberately trying to secure an unfair mercantile advantage over its trading partners (McKinnon, 2007). But if China were coerced into large appreciations of the renminbi, it could face the same deflationary fate as Japan in the 1980s and 1990s – and all this without reducing its trade surplus.

The U.S. current account (trade) deficit simply reflects the excess of expenditures in the United States relative to income, or, equivalently, the amount by which America's moderate level of investment exceeds its very low saving rate – both by households and the federal government. So the first order of business in correcting the trade deficit is to reduce the structural fiscal deficit of the United States and possibly run with surpluses. The second order of business is to provide incentives – possibly tax incentives – for American households to increase their saving. Both require major changes in the U.S. public finances and should be phased in gradually but very deliberately.

However, this is not the end of the story. To work smoothly, adjustment has to be two-sided. The East Asian countries with large saving and trade surpluses, notably China and Japan, but also Germany and various oil producing emirates must move to increase consumption in parallel with American efforts to reduce consumption. Federal Reserve governor Ben Bernanke wrote an excellent paper in 2005 (just before he became chairman of the Fed) interpreting trade imbalances to be as much as or more of a saving glut in the rest of the world than a saving shortage in the United States. The very low interest rates prevailing worldwide support Bernanke's hypothesis. If it were only a saving shortage in the United States, we would face much higher interest rates and a possible credit crunch.

This two-sided approach to righting international trade imbalances has a further great advantage of better stabilizing the world economy overall. Some people worry that if the United States were to move unilaterally to raise taxes and reduce private consumption, aggregate demand would be insufficient. U.S. households would no longer be "consumers of last resort" for the world at large. Thus, unilateral moves by the United States to contract consumption, unless done very gradually, could foment a worldwide slump. But if contraction in the United States was offset by expansion elsewhere, such problems would be minimal – and trade imbalances could be reduced more quickly. In neither case, however, would any substantial change in the dollar's exchange rate be necessary or desirable.

To his great credit, Treasury Secretary Paulson has said that he very much wants to engage China constructively. Thus, in considering China's (and other Asian countries') trade surpluses, he should not reach for the wrong instrument – particularly one that is based on faulty theorizing. A major reduction in the yuan value of the U.S. dollar will not correct the saving imbalance between the two countries. However, it could cause a major bout of monetary instability with deflationary consequences in China itself. And if China is the linchpin, such that other countries in Asia and even Europe follow with their own appreciations against the dollar (as many dollar devaluationists seem to want), the inflationary pigeons may well come home to roost in the United States – as in the 1970s.

Reference

McKinnon, Ronald, "Why China Should Keep its Dollar Peg: A Historical Perspective from Japan," *International Finance*, Spring 2007.

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