

The Need for Further Dollar Depreciation

Renewed discussion of target ranges for exchange rates and the continuing large U.S. external deficit (see Figure 1) poses the question whether exchange rates are sustainable near the current levels. This question is explored here in the context of U.S. macroeconomic adjustments.

The real exchange rate of the dollar, using an index which includes developed and newly industrialized countries, is today broadly at the level of the 1970s and of the year 1980 when the U.S. external balance showed a surplus. This position of the dollar offers a starting point for discussing whether the dollar needs to go further. We shall conclude that this is, indeed, the case. That leads to two further questions: If it is obviously the case that the dollar needs to require further, why has this not already occurred? And, what are the costs and benefits of further dollar decline for the U.S., Europe and Japan and for debtor LDCs?

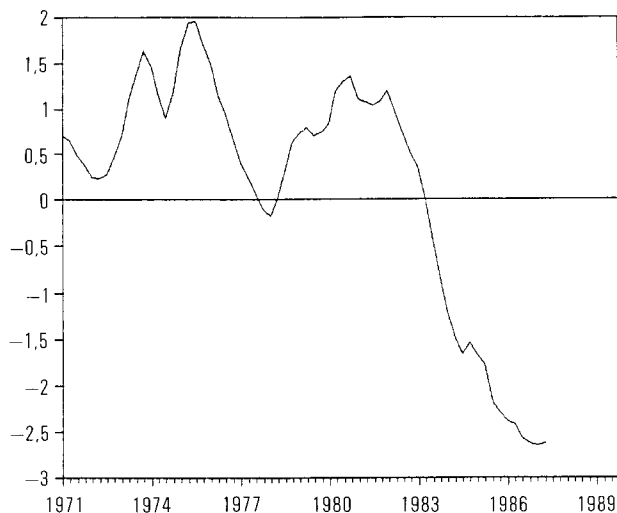


Figure 1: The U.S. External Deficit (NIA, Percent of GNP, 3 quarter moving average).

Sources of the U.S. External Deficit

The massive U.S. deficit of 1986–87 is explained by the conjunction of five factors:

- The extraordinary overvaluation of 1980–85. The impact of the depreciation is apparent not only in the continuing \$150 billion trade deficit. It also shows in the massive increase in import penetration. Since 1980 import penetration in the consumption goods industry has increased from 7 to nearly 13 percent. For capital goods the increase is even more dramatic – from 15 to 38 percent.
- The sharp shift in trade with the NICs: the U.S. has experienced a \$60 billion shift in its manufactures trade with these countries since 1980.
- The debt crisis has forced Latin America and other debtor countries to become net exporters to the U.S. market. Debt service requires foreign exchange, and without new loans these resources can only be obtained by trade surpluses. The impact of the debt crisis is apparent from such data as Mexico's 40 percent manufacturing export growth in 1987.
- The 10 percent cumulative gap in aggregate expenditure growth over the period 1980–87 between the U.S. and other OECD countries which has meant a rapid growth of imports and only moderate export growth.
- The emergence of a current account deficit has brought about a decumulation of external assets and now a growing external debt which generates a worsening current account deficit by its own debt dynamics.

Two questions now arise: Has the dollar depreciated enough? And, since we conclude in the negative, why is the dollar not falling more rapidly? We now turn to these issues.

Arguments Why the Dollar May not Need to Fall Further

Most observers who feel that the dollar now is correctly valued place their confidence in one of two arguments. Either they argue that adjustment lags to the depreciation of the past two years are *very* long and that patience is required to await the full benefits. Alternatively, or else, they believe that there is basically no need for U.S. current account balance because deficits can be financed almost indefinitely.

The adjustment lag argument does not stand up to scrutiny. Econometric studies almost uniformly reveal significant lags in the adjustment to real exchange rates. But forecasts of the U.S. external balance, taking into account these lags, still reveal continuing large deficits by 1990. The latest OECD forecast, for example, shows a U.S. deficit of more than \$100 billion in the second half of 1989. There is virtually no model, public or commercial, that does not predict continuing large deficits.

The alternative to arguing that once lags are overcome adjustment will ensue is to argue say that the U.S. does not really need to adjust because deficits can be financed for a very long period. This view is most frequently supported by reference to an almost unlimited ability of the U.S. to finance current account imbalances by selling off assets.

It is correctly observed that the rest of the world holds as yet a small share of its portfolio in the form of U.S. assets and that accordingly there are years worth of saving from all industrialized countries available to finance a continuation of the deficit even at \$100 billion levels. Just as a country with a terms of trade improvement can spend the extra real income without impairing its creditworthiness so can the U.S. spend the rents that flow from the attractiveness of its assets.

It is certainly true that if the world economy had newly discovered U.S. assets, and if as a result there were massive capital gains, U.S. residents could spend some of that increased wealth. The question is, however, what happens when the capital gains run out. If the exchange rate is allowed to stay overvalued this leads inevitably to disinvestment in the traded goods sector. If ultimately a cut in absorption and a reversal of the current account becomes necessary that adjustment will have to be extra large

because of the disappearance of capacity and other hysteresis effects.

The fact that in 1987 central banks rather than private savers have been financing the U.S. current account calls into question this argument. The international capital flow argument is more likely an argument about two-way diversification rather than one about international one-way lending. There is certainly no life-cycle story of why the U.S. should be running down assets.

An alternative variant of the no-need-to-adjust view is that after a long spree of borrowing inflationary finance can be used to wipe out the real value of the accumulated external debt. The argument has some merit, but there are two related limitations. One is the ability to maintain very negative real rates for a long period, the other the public's willingness to accept the required high rates of inflation.

An entirely different argument asserts that the dollar needs to *appreciate*, not *depreciate*, because it has already moved far outside the range of purchasing power parity. In this view, which is nothing short of peculiar, the low purchasing power of the dollar in terms of foreign goods is seen as an aberration rather than a corrective step to enhance U.S. competitiveness.

Since none of the above arguments carries much persuasion the question now is how much further dollar depreciation is required.

How Much of a Further Dollar Decline?

Figure 2 shows the real exchange rate of the dollar. Most econometric estimates of U.S. trade flows suggest that considerable further depreciation is required to cut the external balance to near zero.

Just how much further depreciation depends on what is believed to be a sustainable level of the deficit and what is assumed about relative growth rates of spending here and abroad. My own estimate is that from the level reached in December 1987 another 15–20 percent real depreciation of the trade-weighted real dollar exchange rate needs to occur. Since many currencies are kept in line with the dollar and inflation differentials are small this implies depreciation of the *nominal* dollar/DM and dollar/yen rates. Furthermore, as discussed below, since there is considerable downward flexibility

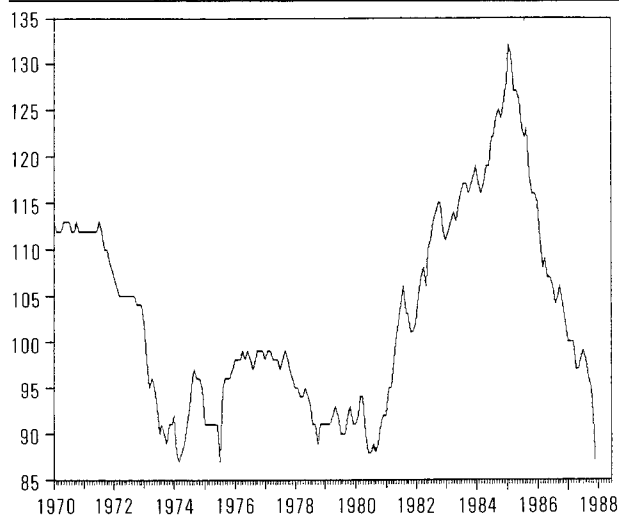


Figure 2: U.S. Real Exchange Rate (Index 1980–82 = 100). The data refer to the trade-weighted, inflation-adjusted exchange rate of the dollar relative to OECD and newly industrialized countries. Source: Morgan Guaranty.

in prices at least in Japan the nominal exchange rate of the yen may have to go very far before the required real adjustment has occurred. A rate of 100 yen/\$ by late 1988 is not at all excluded.

An alternative to dollar depreciation is, of course, a sharp acceleration of foreign relative spending which would eliminate our deficit. Japan is currently experiencing a major increase in the growth of domestic spending, but that is not the case for Europe (see Table 1). The increase in growth of spending of the non-US OECD required to balance the U.S. external accounts is of the order of at least an extra 2.5 percent in each of the next three years. That is certainly very large if judged by foreign intentions. Moreover, an influential current of opin-

Table 1: Growth in the U.S. and Abroad (Percent per Year)

	1984–86	1987	1988*	1989*
<i>U.S.</i>				
Real GDP	3.9	2.8	2.5	1.8
Real Demand	5.1	2.0	1.0	1.0
<i>Japan</i>				
Real GDP	4.0	3.5	3.0	3.0
Real Demand	3.9	4.3	4.0	3.3
<i>Europe</i>				
Real GDP	2.6	2.3	1.8	1.5
Real Demand	2.6	3.3	2.5	2.0

* Forecast Source: OECD Economic Outlook, December 1987

ion holds that these estimates of the required growth fall *by far* short of what would be necessary. Failing such a foreign growth spurt the dollar will need to fall much further, perhaps as much as 30 percent. If that analysis is correct, why has the dollar not yet declined further?

Does Depreciation Work and is it Costly?

Discussion of U.S. external balance adjustment has raised several challenges to depreciation as the easy way. There is first the concern about the inflationary impact at home and the recessionary consequences abroad. Inflation at home was a dramatic issue in the aftermath if two previous major dollar realignments – 1970–73 and 1978–80. In each of those instances inflation reached double digit levels and led to hard-landing scenarios when the monetary authorities used tight monetary policy to bring about a recession with the aim of stopping inflation. At present inflation does, of course, reflect the continuing depreciation. But the level and increase in inflation, for the time being, has been so moderate that it is not a political issue. But, for the time being wages have not reflected the increase in inflation and thus the full effects remain to be seen.

The consequences of further depreciation of the dollar for Europe and Japan are prominent in public discussion. The authorities favor the view that a steep dollar decline could trigger so large a recession abroad – including as a trigger a sharp decline in investment – that in the end the U.S. might be hurt rather than benefitting from depreciation. That view is not broadly shared in the academic community or at least it is not seen as decisive. The prevalent view is that Germany needs enough heat – directly or from the EMS partners – to implement a major shift to growth oriented policy. Such a shift toward growth is necessary if, in the face of U.S. restrictive budget policies in the next few years, world growth is to continue at a satisfactory rate.

The next concern is that depreciation does not work, at least not on the side of imports. The striking fact is that import prices of manufactures have scarcely increased relative to domestic goods despite a major depreciation over the past few years (see Figure 3). The explanation is the entry of newly industrialized

countries and strategic pricing (including major cost reductions) of U.S. trading partners, especially Japan. The large initial profit margins and major cost reductions have allowed Japanese firms to maintain their competitiveness in the U.S. market. As a result import U.S. volume continues to rise (see Figure 4). On the side of exports real depreciation is showing strong results, on the import side there is continuing deterioration. An obvious answer to this challenge is to test Japanese cost cutting ability by further depreciation. Depreciation should be rapid to forestall the ability of U.S. trading partners to adjust and thus force price adjustment.

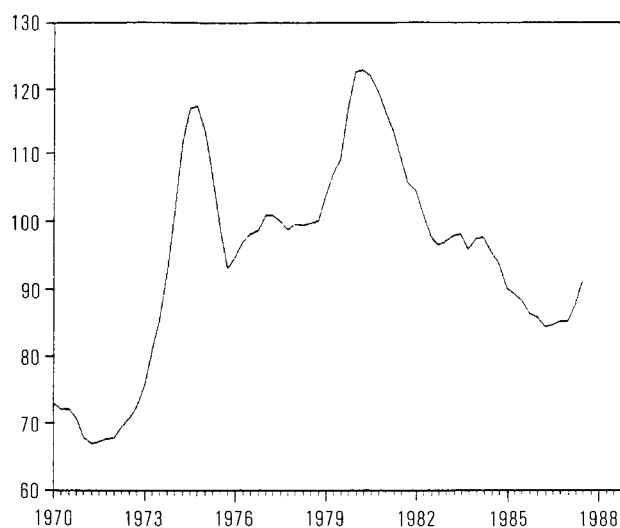


Figure 3: The Relative Price of Imports (Index 1977 = 100). Price of non-oil imports into the U.S. relative to the price of domestic industrial goods.

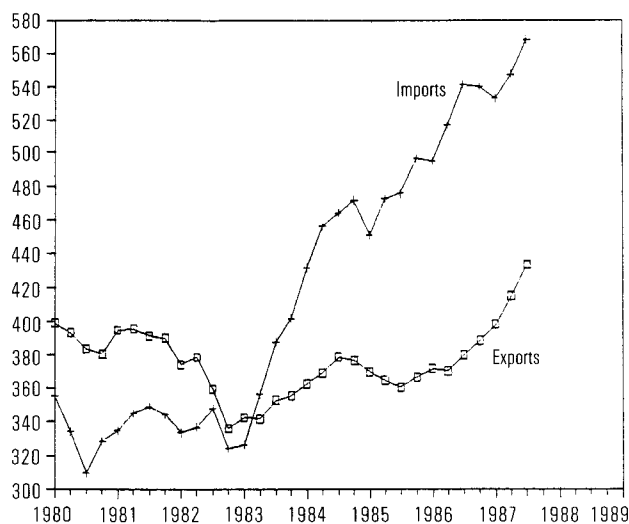


Figure 4: Real Exports and Imports (NIA, 1982 Prices).

The final argument, brought very effectively by MICHAEL PIORE, is that depreciation is a policy of immiserization. His point is that depreciation, while allowing U.S. firms to sell, also takes away pressure for productivity adjustment. Because productivity is the only source of sustainable growth in the standard of living, depreciation is the wrong policy. It is a cheap labor policy, not a growth policy.

There is a matching, strong argument for depreciation. Until recently protectionism was a major issue in the U.S. Partly as a result of full employment, but also as a consequence of dollar depreciation, protectionist pressure has subsided. Further dollar depreciation is a safe way of killing off the dangerous possibility of a resurgence of protectionism in the U.S. altogether.

Overvaluation and Intervention

If the dollar is significantly overvalued – perhaps as much as 20 percent – the interesting question is surely why there have not been more decisive speculative attacks? It is certainly a fact that there are no compensating interest differentials that would support rationally holding U.S. assets. This is a hard question which a more prudent writer might avoid. The probable answer lies not in irrationality but rather in the short horizon of speculation.

Asset markets are dominated by speculators who are limited in their ability to provide long-term stabilizing speculation. Regulatory reporting requirements and above all quarterly performance competition prevent financial institutions and corporations from engaging in long-term speculation if the short-term uncertainty is too high. Thus, even though there may be a consensus that over a two-year period the dollar will undergo a 30 percent depreciation, few institutions take a long-term position and sit out that depreciation. The reason is that a short run adverse trend is seen as much more costly than the ultimate, almost certain profit. Of course, there is some long-term speculation. But there is also some central bank intervention, in fact an extraordinary amount. But more than the magnitude of intervention counts the willingness of central banks to stop one-way speculation by creating sufficient uncertainty about the near term pace of depreciation. That means depreciation occurs in chunks, with irregular inter-

vals of stability or even partial reversal in between.

Looking back we observe that a massive dollar depreciation has taken place without any significant influence on U.S. interest rates or on inflationary expectations. Looking forward it seems hard to believe that another 30 percent is possible without speculators catching on. But small action on interest rates is enough to check speculation. Moreover, the further the depreciation is carried the more diffuse are expectations about the magnitude and timing of any remaining depreciation and hence the easier the task of destabilizing the speculators.

A further argument in this direction is frequently made: continuing dollar depreciation in the near term would imply that the J-curve is persistently at work. Further depreciation, with its adverse effects on valuation, keeps dominating the quantity adjustments and hence current account improvement simply does not come into sight. The failure of current account improvement to emerge in time tests the patience of speculators who take an excessively pessimistic view of the currency and might stage a run that costs control. Hence the need to space out depreciation to allow volume adjustments to become significant and thus elicit stabilizing speculation.

This interpretation of foreign exchange markets in the second half of 1987 assumes that central banks agree on the need for much further dollar depreciation but chose to bring it about in a controlled fashion. If so, there must presumably also be an idea of how Europe and Japan absorb the gain in U.S. competitiveness. The alternative explanation is that the U.S. accepts that the dollar has gone far enough, on whatever basis, and is simply helping to demonstrate to the market the new equilibrium rate, if necessary with increased interest rates. Of course, it might also be a much more shortsighted policy pursued for the convenience of an election year and motivated by concern about increasing U.S. inflation in the next twelve months. Whichever the motivation, defending an overvalued exchange rate is a dead-end street. The costs in terms of disruptive high interest rates and ultimate collapse are extremely high. There is no conceivable merit for the U.S. or the trading partners in perpetuating the overvaluation, other than as a policy of a controlled dollar decline.

We conclude the discussion with two questions: First, in the long run, where will the real exchange rate of the dollar go? Second, what are the scenarios for U.S. adjustment in the next two years?

The Need for Trend Dollar Depreciation

It is worth emphasizing one factor which suggests a need for trend depreciation of the dollar arising from the special role played in the U.S. market by the NICs. The emergence of NICs as suppliers of manufactures in world trade is largely acted out in the U.S. market: the U.S. market is wide open and large, thus inviting any infant industry to try itself. By contrast Europe and Japan are heavily protected. This suggests that over the next decade the U.S. will suffer an unusually large share of the exports of the NICs.

In the 1960s and 1970s U.S. exports of capital goods and technology equipped these countries as exporters of manufactured goods. Today they import technology and capital from Japan and export increasingly to the U.S. market. These facts are apparent from Table 2 showing the shift in our manufactures trade balance with the NICs.

Table 2: U.S. Manufactures Trade With Developing Countries (Billion \$)

	Imports	Exports	Balance
1980	29.5	55.6	26.1
1981	35.1	61.5	26.4
1985	65.5	46.0	-19.5
1986	77.3	49.4	-27.9

Source: GATT and U.S. Department of Commerce

U.S. political interests make it very difficult to try and close that gap by protection. Thus, unless the NICs can be pushed into real appreciation and inward-looking growth there is a need for U.S. depreciation relative to Europe and Japan to provide the room for increased net exports from the developing world.

The increasing share of the NICs in U.S. imports of manufactures is another indicator of their growing importance. Some of this trade, of course, reflects new trade in intermediate products and may well enhance U.S. competitiveness. This is the case, for example, when car

engines are imported from Mexico or Brazil. But the shift in the manufactures trade balance points to the fact that trade is seriously unbalanced. The common view that developing countries will spend what they earn misses an important point: in part they are high savers (as for example in Korea), in part they do spend, but they spend on imports from Japan or Europe.

Thus, as a longterm issue there is a triangle problem. The U.S. will be importing increasingly from the NICs, and thus there is a need to create room by gaining competitiveness and increasing net exports to Europe and Japan. There is accordingly an expectation of trend depreciation of the dollar relative to the currencies of Europe and Japan.

Soft and Hard Landing

The post-crash budget summit in the U.S. had as its major result that during 1988 – an election year – there would be no discussion of the budget. That postpones budget cutting to January 1989, when the new President takes office.

There are two scenarios. In the soft landing scenario rising inflation in 1988 motivates the incoming President to undertake immediately a budget cut. The budget cut – to assure full employment – is accommodated by easy money. As a result investment and net exports improve while consumer spending growth declines. GNP growth is sustained and the twin deficits evaporate over the next few years. The key point here is the recognition that increasing inflation provides the political excuse for raising taxes, an excuse that was missing in 1987.

The hard landing scenario shows too little inflation in 1988 and hence imprudent talking by all the candidates (competitively) about never

raising taxes. By 1989 inflation will come and at that time, because the initial opportunity was missed, fiscal policy is slow to respond since an election year is ahead. The monetary authorities will raise interest rates, keeping the dollar overly strong and creating a recession. The external balance improves but the budget deteriorates and no problem is solved.

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