A Personal Perspective on the Dollar

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On February 6, the finance ministers from the G-7 countries will meet in Florida to discuss the recent decline of the dollar against the euro and to see whether an intervention is needed. Since its high point in February 2002, the dollar has lost approximately 40 percent of its value against the euro.

The dollar's movements over the past few years gave rise to concerns. The high value of the euro pushed many European economies, who already found themselves in a slump, to the brink of recession. European countries partially depend on exports for economic growth because domestic demand remains subdued, despite the stimulus that the low value of the euro provided them with before 2002. However, the specter of a renewed surge in the dollar is not without its problems, either. If the dollar rises again against the euro, without an offsetting decline elsewhere, the U.S. trade deficit could rise again. So far, the U.S. trade deficit appeared to have leveled off in the second half of 2003 partly due to the dollar's decline starting in early 2002[1].

Understanding the recent decline of the U.S. dollar helps to frame possible policy responses that could allow policymakers to address all of these concerns. In early 2002, pressures on the dollar to depreciate mounted. The combination of record high U.S. trade deficits, growing long-term structural deficits and a unilateral U.S. foreign policy raised doubts about the sustainability of the dollar's value in financial markets. The dollar declined against freely floating currencies, such as the euro. Smaller declines were registered against currencies of countries that regularly intervened in foreign exchange markets to stabilize their currencies, such as Japan. And the dollar did not budge against currencies that were fixed against the dollar, such as the Chinese yuan.

The dollar's decline has to be addressed carefully. A reversal of its decline against the euro is not a viable option because the initial pressures that led to the dollar's decline have not subsided. Alternatively, a larger decline against the Japanese yen seems an unattractive option since it would hurt the fledgling recovery of the Japanese economy. Consequently, one policy response could be to encourage movements by China to revalue the yuan against the dollar. This would allow China to pursue its own development goals, which would not be possible if the yuan was made free floating, instead of revalued. Second, an appreciation of the yuan would give the euro some room to depreciate against the dollar as the U.S. trade deficit should benefit from an improved trade balance with China. Even without any movements of the euro against the dollar, Europe should see smaller trade deficits with China due to such a revaluation of the yuan. Also, an appreciation of the dollar against the euro would help to attract foreign capital, whereas a depreciation of the dollar against the yuan should have a negligible effect on international capital flows from and to the United States.

[1] A decline in the dollar translates into a trade deficit improvement with a 12-18 month lag (Dixit, 1994).

Mounting Pressures on the Dollar

The dollar came under pressure after 2001 because many financial market participants saw the path of ever expanding trade and current account deficits as unsustainable in the prevailing economic and political climate. Because the United States has to borrow from abroad to finance the trade deficit, the current account, which includes the debt service on the United States' outstanding debt in addition to the trade deficit, gives a better sense of the United States' external imbalances. Since 1992, the current account deficit has almost continuously been greater than the trade deficit, while both reached record highs in the first half of 2003 (figure 1).

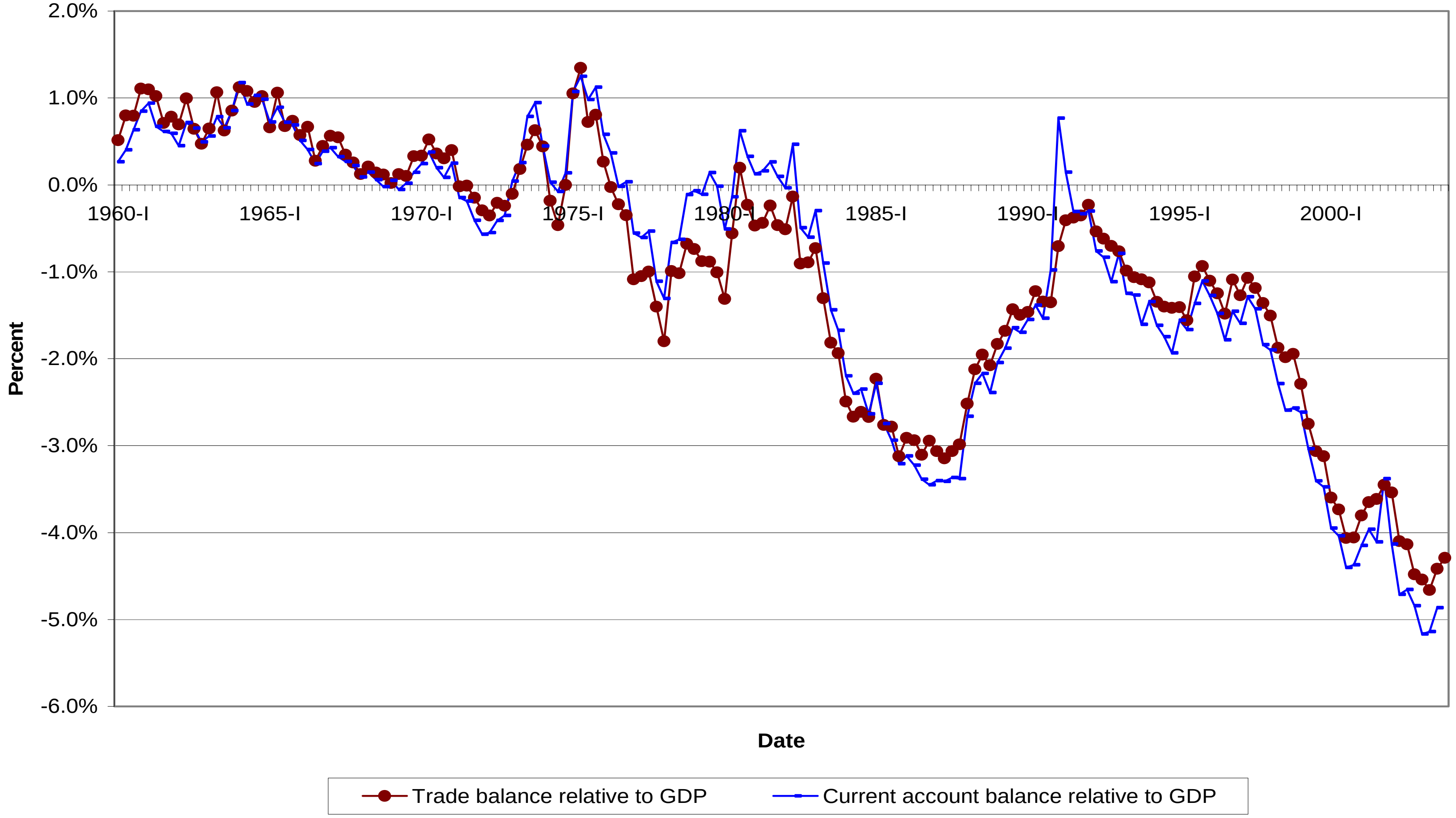
Current account deficits approaching or even exceeding 5 percent of GDP may not necessarily pose a problem for the U.S. economy when it is growing strongly. In fact, part of the rise in the U.S. trade deficit to new record highs in the latter part of the 1990s was driven by the fact that the U.S. economy grew faster than many trading partner countries. Consequently, imports grew faster than exports. But because the strong economy led to an increase in expected stock market returns, foreign investors flocked to the United States, in the process raising the value of the dollar and further lifting the trade deficit. As long as the U.S. economy was expanding strongly, it was easily able to finance its trade deficit with borrowed capital.

The record high trade deficits, though, became a cause of worries among financial market observers when the United States found itself saddled with large budget and trade deficits in 2001 (WSJ, 2002a). Due to massive tax cuts enacted in 2001, the United States required capital inflows, keeping the dollar initially high, due to low national savings. Household savings were low because household income growth remained weak in the recession and recovery, while prices for many items, particularly health care rose substantially. More importantly, government deficits increased due to large tax cuts in early 2001. Research suggests that higher budget deficits are not compensated for by higher private sector savings (Gale and Orszag, 2003). Consequently, capital inflows were necessary to cover the shortfall in national savings, thus keeping the value of the dollar initially high[2].

After 2001, an unsustainable combination of current account deficits, budget deficits, and U.S. unilateralism emerged. Following increasing budget deficits, additional capital inflows kept the dollar value high, although import demand diminished due to the recession. Hence, the U.S. economy was saddled with record current account deficits in the middle of a recession. The situation was further exacerbated by the fact that the United States' unilateralism made the United States a less attractive investment target, and thus contributed to the decline in the value of the dollar, as international and domestic investors alike looked for alternatives.

[2] Truman (2003) points out that the expected fiscal imbalances would have made coordinated efforts to reduce the value of the dollar unpredictable and likely ineffective, if they had been desired.

Figure 1: Trade and Current Account Balance Relative to GDP, 1960 to 2003



Source: Bureau of Economic Analysis, National Income and Product Accounts, Balance of Payments.

Since a resolution to the record high trade deficits had become harder due to the high value of the dollar and U.S. unilateralism, financial investors began to worry about the sustainability of high current account deficits. Put differently, financial investors perceived the combination of trade deficits and budget deficits as ultimately unsustainable[3] (Orszag et al., 2004). One reflection of this was the fact that global investors became increasingly reluctant to invest in long-term assets in the United States and instead put more funds in short-term portfolio investments, among worries about further terrorist attacks (DJN, 2002a). Ultimately, the dollar came under pressure to depreciate because the combination of current account deficits, large budget deficits, and weak export growth was perceived as unsustainable, leading international investors to invest fewer funds in the United States.

Decline of the Dollar Unevenly Distributed Amongst Trade Partners

Having come under pressure, the dollar began declining after February 2002 (WSJ, 2002a). When the dollar declined, it went the path of least resistance. The dollar was confronted with three exchange rate regimes that made adjustments more or less difficult. Adjustments against the euro and other currencies that were free floating were largest. As dollars were sold and these currencies were bought, the value of the dollar against them dropped consistently since early 2002. By the end of 2003, the euro, for instance, had fallen by more than 40% since its record low in February 2002 (figure2).

Other currency movements, though, were not quite as easy. Some countries resisted, not always successfully, the downward movements of the dollar. For instance, Japan intervened numerous times to slow the decline of the dollar since its fledgling recovery depended on the yen to remain comparatively weak in order to support exports. Between mid-May and early June 2002, Japan intervened in the foreign exchange markets to slow the dollar’s decline (DJN, 2002b). The Japanese government employed three methods to influence the dollar’s value, verbal threats, pressures on financial institutions and direct interventions. In mid-May 2002, the government issued statements warning they would take direct action if the yen did not depreciate against the dollar (WSJ, 2002b; DJN, 2002b). Following the final direct intervention, Tokyo again warned if the yen continued to appreciate the government would purchase additional dollars (DJN, 2002c). Concurrently, rumors circulated that the government was pressuring pension funds to buy foreign assets. Moreover, during the week of May 16, 2002 there was speculation the government-run postal life insurance fund was switching funds to dollar denominated assets (DJN, 2002c). Since threats and pressures on financial institutions did not halt the dollar’s decline, the Bank of Japan purchased dollars directly on four separate occasions in late May and early June 2002, totaling as much as $20 billion (DJN, 2002d). In 2003, interventions by Japanese authorities on behalf of the yen reached record highs with $187 billion (Jopson, 2003). In January 2004, interventions by Japanese authorities to stabilize the yen hit another record high of $67 billion (Y7,155 billion) (FT, 2004). However, given the comparatively small size of these interventions relative to the size of currency markets, the effectiveness of the interventions on behalf of

[3] Orszag et al. (2004) express such fears for the future, too, suggesting that financial turmoil may result if twin deficits remained unresolved.

the dollar was limited[4]. Consequently, the dollar declined only about 22 percent against the Japanese yen (figure 2), or only about half of its decline against the euro.

Lastly, the dollar did not decline against currencies that were fixed against the dollar. An important example is the Chinese yuan. China has fixed the value of its currency against the dollar to maintain a trade surplus and to attract foreign investment. As a result, China has amassed large official foreign exchange reserves (figure 3), which allow the Chinese government to pursue domestic policy goals by manipulating its exchange rates. Consequently, the dollar's value remained stable against the Chinese currency (figure 2).

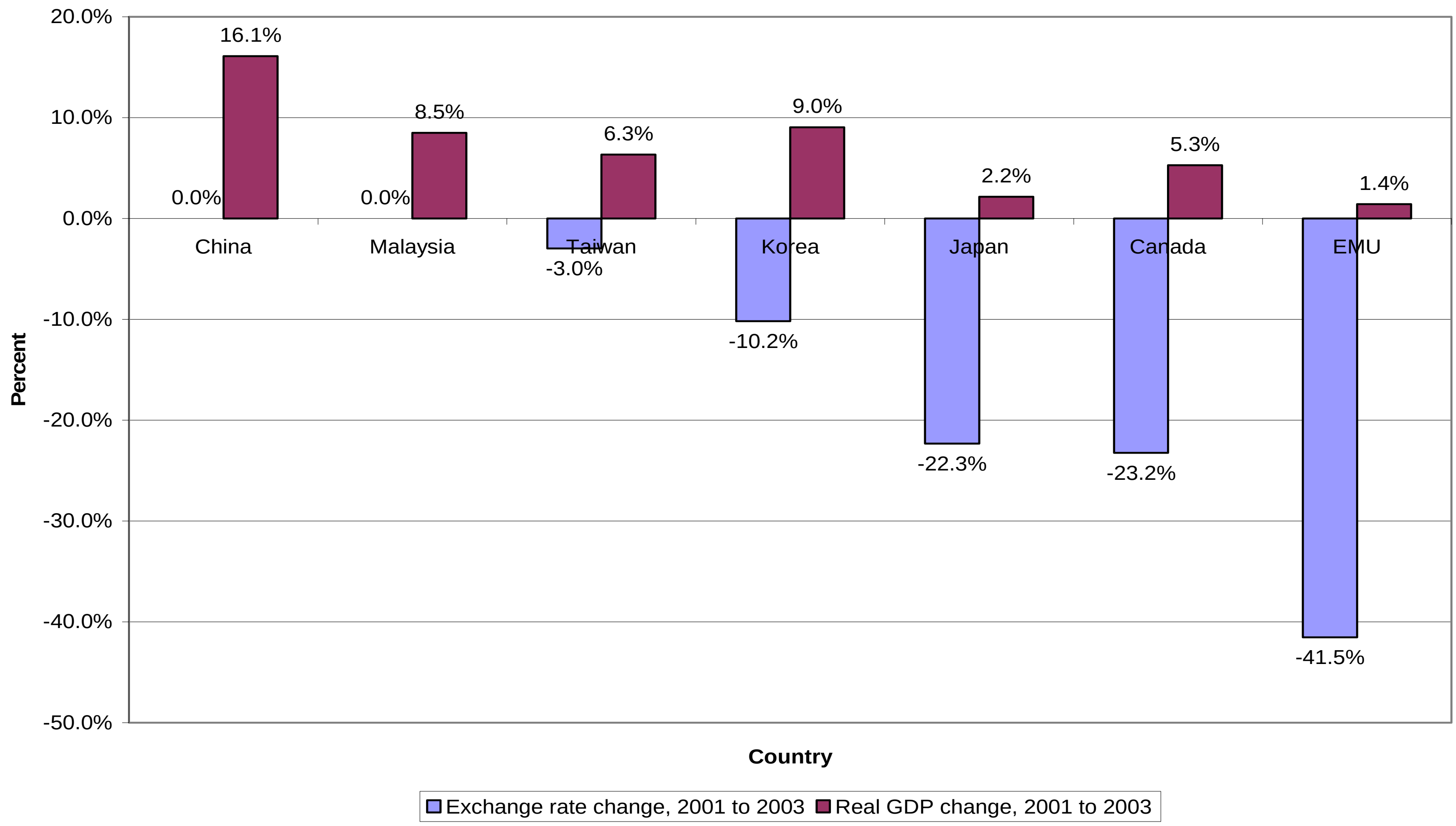
An issue of concern arises because the dollar declined most against currencies of countries that grew at a fairly slow rate in 2003 and are expected to continue to grow at a slow rate in 2004 (Bivens, 2003; IMF, 2003) (figure 3). For instance, China and Malaysia had pegged their currencies from 2001 through 2003, seeing no change in their nominal exchange rates, while their economies expanded in inflation adjusted terms by 16.1 percent and 8.5 percent, respectively, from the end of 2001 to the end of 2003. In comparison, the euro declined by 41.5 percent, whereas the real GDP of the euro area grew by 1.4 percent over the course of two years. That is, in order to have a substantial effect on the trade deficit, the dollar had to decline further than it would have to if these countries grew faster. Conversely, if the dollar had fallen faster or anything at all against countries that grew more rapidly, the adjustments would have had to be smaller to generate similar results in terms of the U.S. trade deficit.

Policy Conclusion

The decline in the dollar against some trading partner countries, especially against the euro, will be subject to a discussion of the G-7 finance ministers in Florida in February. A reversal of this decline is unattractive, unless there is a compensating decline against other trading partner countries, since the reasons that led to the initial decline of the dollar, specifically worries about the U.S. budget deficits amid high current account deficits, have not disappeared. A larger decline against the Japanese yen, which could be achieved if Japanese authorities abandoned their "managed float," would likely hamper the fledgling Japanese recovery. A more attractive option would be to encourage fast growing countries that peg their currencies against the dollar, particularly China, to allow for a revaluation of their foreign exchange rates. A number of observers have estimated that the Chinese currency is undervalued by about 30 to 40 percent compared to the dollar (Becker and Andrews, 2003; FIND, 2003), leaving room for a serious revaluation. For example, Goldstein and Lardy (2003) suggest a revaluation between 15 and 25 percent.

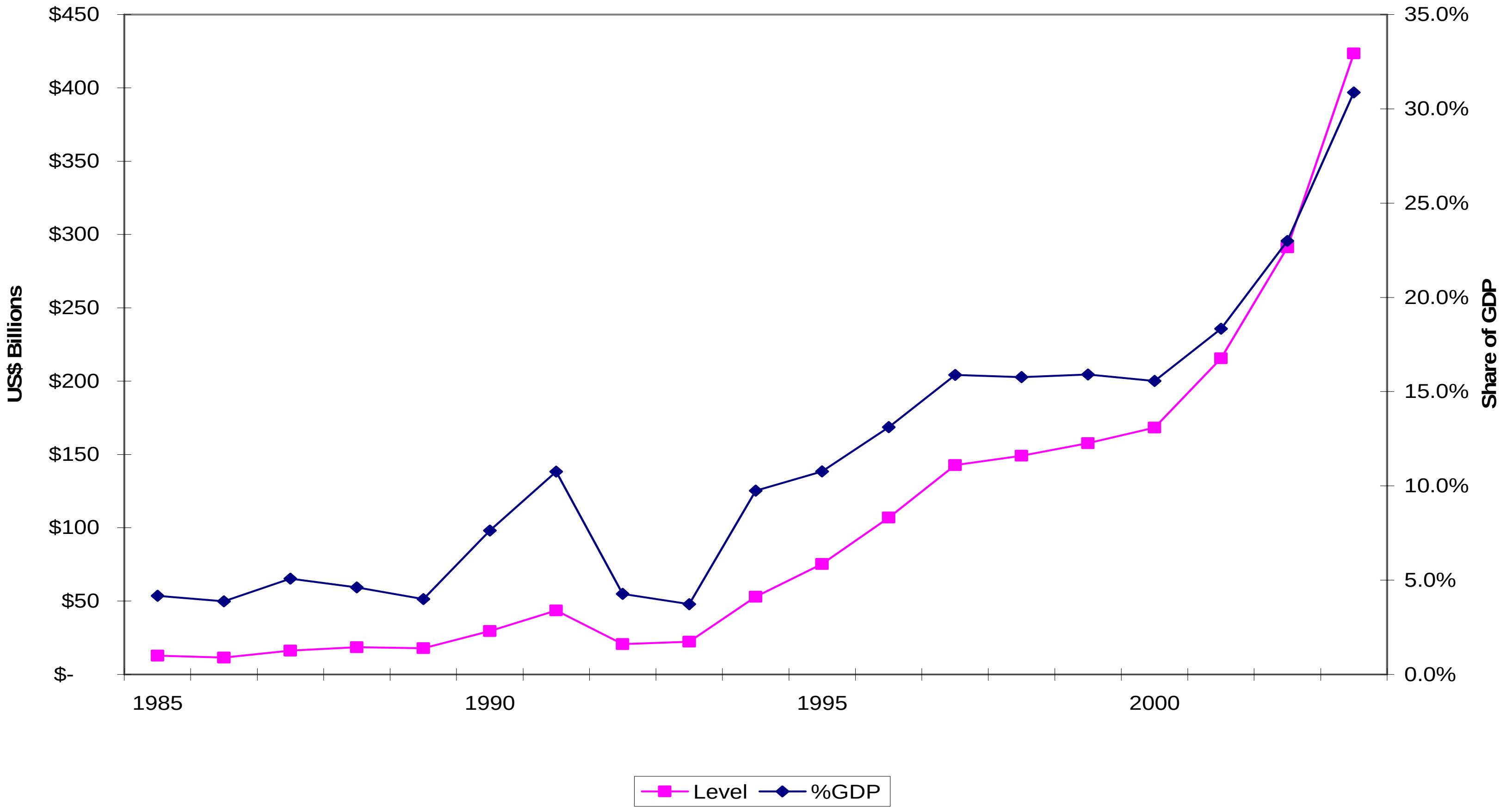
[4] Truman (2003) argues that despite widespread use of intervention as a policy tool, it tends to be a "blunt and blunted instrument" for policy as the history of Japanese efforts in recent years demonstrates, too.

Figure 2: Exchange Rate and Real GDP Changes, 2001 to 2003



Source: Board of Governors, Federal Reserve System, Release H.10; IMF, World Economic Outlook.

Figure 3: China's Official Foreign Reserves



Source: IMF, International Financial Statistics, World Economic Outlook; Hersh (2003).

The goal of such negotiations cannot be to make the Chinese yuan fully convertible. There are fears that capital account liberalization – a necessary accompaniment to the yuan's full convertibility – would result in large scale capital outflows. Currently, China is experiencing large unrecorded capital inflows, despite capital controls, presumably in anticipation of a revaluation of the yuan. Consequently, Goldstein and Lardy (2003) suggest, for instance, that China gradually moves towards capital account liberalization, while stabilizing its domestic financial system first.

Moreover, China is currently growing fast enough to absorb a decline in its exports and a rise in its imports. In fact, recently, economists have voiced concerns that the Chinese economy may be overheating (Goldstein and Lardy, 2003; Schafer, 2004). It appears that, partially in response to such concerns, Chinese policymakers have taken steps to temper growth, e.g. by limiting approvals for new factories and new construction projects (Goodman, 2003). A revaluation of the yuan would help to cool the red hot transition economy. In fact, there are signs that Chinese authorities are already taking steps to allow the Chinese currencies to appreciate slowly against the dollar by widening the band width of the fluctuations of the dollar against the yuan (Kynge, 2004). Moreover, because there are expectations of a yuan revaluations, China has already seen large (mostly illegal) short-term capital inflows (Jianhua, 2003), which can cause problems for China's monetary management if they continue.

In comparison, there are indications that much of the discussion at the meeting of the G-7 finance ministers in Florida in early 2004 will focus on getting Japan to abandon its managed float. If Japan abandoned its interventions to stabilize the yen, both Europe and the U.S. could receive a boost to their trade balances. However, the question is whether Japan's economy is strong enough to sustain a decline in its exports. The frequent interventions by Japanese authorities suggest that there are serious concerns about Japan's ability to sustain such a decline.

Alternatively, a concerted intervention to stabilize the euro against the dollar would undoubtedly help boost European exports, but it could potentially reverse the decline in the U.S. trade deficit. As long as the U.S. current account deficit remains high amid large structural budget deficits, concerns over the long-term stability of the U.S. economy will linger. Consequently, an appreciation of the dollar against the euro, without an offsetting depreciation against other trading partner countries, could damage the U.S. long-term financial stability (Orszag et al., 2004).

However, upward pressures on the euro will probably ease if the Chinese yuan were revalued. The U.S. trade deficit would receive a larger bang for the buck from revaluations against the currency of a fast growing economy than from a similar decline of the dollar against the euro as Europe's growth rates are currently low.

A number of factors speak for a revaluation of the yuan against the dollar. Many investors already expect such a move as illegal short-term capital inflows into China have recently grown. At the same time, if China maintains its peg against the dollar, a revaluation would also help the bilateral trade deficit between China and the euro area, which amounted to $48 billion in 2002, and $25 billion in the first half of 2003 (Eurostat, 2003). Consequently, Europe could sustain higher values of the euro after a revaluation of the yuan since its trade balance should improve.

Simple exchange rate adjustments between the United States and its trading partner countries alone are unlikely to create stronger and more stable economic growth in the global economy. Much has to be done in Europe and Japan to get long-term growth to higher levels. However, adjustments of the dollar, especially with respect to trading partner countries, where recent depreciations have been exceptionally large, and with respect to trading partner countries, where adjustments have not happened at all, appear to be a necessary first step. Specifically, a revaluation of the Chinese yuan could result in a gradual adjustment of the U.S. current account deficit. A revaluation of the Chinese currency appears to be a good opportunity to stabilize the global economy, at a time, when most major economies are slowly recovering from a prolonged slump.

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