

THE CASE AGAINST A DOLLAR POLICY

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Paper Prepared for the Cato Institute's 23rd Annual Monetary Conference "Monetary Institutions and Economic Development," Cosponsored with *The Economist*, November 3, 2005, Washington, D.C.

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Background

The natural way for me to begin preparation for this talk was to reread Milton Friedman's classic "The Case for Flexible Exchange Rates" which was published in 1953 (*Essays in Positive Economics, University of Chicago Press*) but which dates back in its inception to 1950 when the author was a consultant to the US Economic Co-Operation Administration which was responsible for implementing the Marshall Plan.

When he was writing it was taken for granted that the Western nations were committed "to a system of international payments based on exchange rates between their national currencies fixed by governments and maintained rigid except for occasional changes to new levels". Little did he know that at the time the essay was being prepared for publication that in 1952 the British Treasury had proposed – in a very pessimistic vein and as a result of gloomy and wrong-headed forebodings – that sterling should move to a floating rate. The plan, known as "Robot" was defeated in the British Cabinet. The country had to wait until 1972 to move to floating and another 20 years – after its was forced out of the European Exchange Rate Mechanism - to learn how to operate economic policy under such a system. Internationally the big shift to floating dates to the early 1970s, between President Nixon's suspension of gold convertibility in 1971 and the collapse of the Smithsonian attempt to rebuild a fixed exchange rate system in 1973.

The fixed rate system broke down because of the inherent tensions between the goals of free multilateral trade, national freedom to determine monetary policy and fixed exchange rates. It is fortunate that fixed exchange rates was the element that

gave in the end. The main force for change was as usual the pressure of events. Insofar as there was an intellectual influence it was the coming together of a coalition of “sound money” economists who wanted to be free to run stable domestic policies and the so-called “expansionists” who wanted to experiment with a more rapid increase in domestic nominal demand.

A newcomer to the Friedman essay would have to read it backwards: in other words as an argument for keeping the present system and not moving back towards currency pegs or some hybrid such as target zones. The fundamental analysis, however, is unaffected. It is still true that there are only four ways in which pressures on international payments can be met:-

1. Counterbalancing changes in currency reserves;
2. Adjustments in the internal level of prices and incomes;
3. Direct controls over foreign exchange transactions.
4. Exchange rate adjustments.

The heart of the argument is that the first three methods are either unworkable beyond certain limits, or harmful or a mixture of both.

The one counterargument that Friedman told me privately that he found most difficult to answer was that a flexible exchange rate might remove a barrier to inflationary policies by governments that then believed that they were following advanced thinking. Indeed in the 1970s it looked as if this fear was vindicated. But as time went on inflationary policies became unfashionable through the demonstration that they were counterproductive in practice and did not promote growth and employment, but only that ugly condition known as stagflation. Since the late 1980s

flexible exchange rates have been increasingly used as a safety valve to allow each monetary authority to pursue the goal of non-inflationary growth in its own way.

Stability

When the essay appeared most of the controversy was over the contention that floating rates would prove stable. Indeed Friedman had to contend with another school of thought that agreed with him on the advantages of more exchange rate flexibility, but believed that exchange rate changes should be determined by governments at discrete intervals on the best available econometric evidence. This is something that many policymakers and economists still in their hearts believe.

How stable have flexible rates proved to be in practice? It is like the old question of how long is a piece of string? The case that floating rates would be stable was vastly oversold at least by European exponents of the system. It is fair to say that few of them anticipated the extent of over-shooting and under-shooting that developed.

Any judgement would have to set up as a counterfactual what might have happened if there had been discontinuous lump sum adjustments of the kind advocated by those who wanted a revived Bretton Woods. Any such study would also have to make a judgement on the likely feedback from this alternative exchange rate regime on monetary and trade policies and numerous other variables. As far as I know, no such study has been attempted and I suspect that the results would depend on the beliefs of those who organised it.

Optimal Currency Areas

The biggest omission from the Friedman essay was any discussion of the areas between which currencies should be allowed to float. The nearest he got to it was in discussing non-committally whether the sterling area should break up or float as a unit against the rest of the world. There has of course been a huge, and in my view inconclusive, subsequent literature on optimal currency areas.

My own hunch, mainly derived from events in Europe, is that an optimal currency area in practice is one where nominal labour costs are subject to much the same forces. Optimists on the euro believed that its very existence would make for such harmonisation. But so far events have not worked out that way. Germany, after a long delay and many years of unnecessary stagnation, is at long last adjusting its labour costs to the euro exchange rate – in Friedman's terminology getting up earlier in the morning as a substitute for daylight saving time. Italy however has not made such adjustments and is experiencing all the drawbacks of an overvalued currency without the safety valve of devaluation.

The Changing Problem

There is a more prosaic difference between the time when Friedman wrote his essay and the present. The background to his writing was the balance of payments problems of many European countries, by which was meant current account deficits and ways of dealing with the downward currency pressures to which they gave rise. There is some discussion in the Friedman essay of surplus countries; but the big new development has been the combination of large current account deficits with relatively high exchange rates made possible by inward investment flows.

The peculiar aspect of the present supposed dollar problem is that the US currency is not under much pressure in either direction. Of course it has not been as stable as a millpond - although it has fluctuated a good deal less in the last decade and a half than it did in the 1980's. A key IMF chart suggests that the real effective dollar rate has fallen by 20pc from its 2001 peak (WEO Sept 2005, Fig. 1.26). The case of those who want a more active dollar or balance of payments policy is basically that, even though it is about the same as the average for the last 30 years, the dollar is still too high.

The advocates of a dollar policy usually start from disquiet about the *composition* of the US balance of payments. To be brief: it consists of a large and growing current account deficit offset by an investment inflow. Moreover the inflow, which previously consisted mainly of foreign purchases of US equities, now often consists of accumulation of official short-term dollar assets by overseas monetary authorities; and it is difficult to sustain the argument, popular in the late 1990s that the inflow is mainly financing a US investment upsurge.

The Cline Study

The most sophisticated and moderate case for policy intervention to lower the dollar has recently appeared in a study by William R Cline for the Institute for International Economics (*The United States as Debtor Nation*). The author is careful not to exaggerate. He takes into account several reasons why conventional figures for the US net international position (NIIP) exaggerate the problem.

One distortion arises from the fact that US earnings from overseas capital holdings are a good deal higher than the foreign earnings from holdings in the USA.

In addition, and in contrast to other countries, most US external debt is denominated in the home currency. So when the dollar depreciates the liabilities section of the balance sheet need not rise, while the dollar value of equity assets owned abroad increases.

The author employs a new version of the US external balance sheet, which he entitles “capitalised value of net capital income” (CNCI). On this improved CNCI measure US external assets were still positive at the end of 2004 to the extent of 7 per cent of GDP. But this only buys time. According to the author the US current account deficit will rise from around 6 per cent of GDP to 10 per cent by 2010. This will take even the CNCI measure of net external liabilities to about 22 per cent of GDP, from which level it will continue to rise.

What harm will result? The author discusses the possibility of a dollar crash which he admits is less likely than not. But he thinks there is enough of a chance to take precautions. The main internal danger to the US economy from a dollar crash is that it will lead to a large rise in interest rates. Even if the Fed does not panic and raise short term rates, overseas holders might demand higher returns on newly purchased US assets. So too might domestic bond holders. There will be an obvious penalty for new borrowers and a deterrent to new investment.

The more likely danger in the author’s view is that the dollar will continue to be overvalued for quite some time; but when the reversal comes it will bring a jerky and painful adjustment in the US terms of trade, as net exports have to rise to make up for the drying up of foreign capital inflow. I cannot help feeling that this slow motion long term danger does not have the same sex appeal, even for the author, as the possibility of an old fashioned crash.

What then should policymakers do? Cline argues for a depreciation of the dollar, equivalent to a 20 per cent appreciation of foreign currencies. He accepts that the dollar has already declined enough in relation to most other industrial countries, by which he means largely the eurozone. So in practice he is really demanding a large revaluation of a mixed group of currencies, not all of them East Asian but now including Middle Eastern oil producers. The most interesting point he makes is that although each Asian currency on its own would need a large bilateral appreciation against the dollar to secure equilibrium, the net trade weighted change might be quite modest if they all moved together.

Cline freely admits that dollar depreciation would do little without accompanying measures to restrict domestic demand. But simply reducing US demand and devaluing the dollar would have a contractionary effect on the rest of the world: it would be what you would, I believe call a “double whammy”, that is enforced currency appreciation outside the USA plus worldwide demand restriction.

The author tries to resolve the dilemma by advocating more expansionary financial policies in both Asia and the eurozone. As lower foreign interest rates run counter to the objective of revaluation against the dollar one is back again with the main line recommendation of fiscal expansion abroad to offset fiscal contraction in the USA.

The whole package makes a kind of sense. The problem is that any one or two elements enacted on their own would be worse than muddling through. It would need a world political authority to enforce the whole package. But I doubt if even such an authority would have the knowledge to decide, for instance, how much each currency should move or the degree of demand restriction required on the US side and expansion on the side of other countries.

The Cline study focuses on the US domestic budget deficit as a source of domestic dissaving. The most concrete proposal emerging from the study is that the Administration and Congress should aim to reduce that deficit to zero instead of merely halving it. It is surely not disrespectful to say that this is a conclusion one could reach without undertaking an intricate study of the whole world macro-economy.

Third World Implications

A different kind of argument, more often heard outside the USA, is that it is wrong that the most prosperous economy in the world should be attracting inward investment from other countries. Would it not be more appropriate for the US to be a net overseas investor in emerging economies?

This is really an ethical position, which does not of course make it wrong. Here is not the place for an argument on the pros and cons of official aid or subsidised investment in the Third World. But if there is a sufficient political constituency for this position, surely the way to proceed would be to increase aid and investment flows directly, which no doubt would lead to some depreciation of the dollar but without any need to manipulate the foreign exchange market or to guess how far it needs to go. Indeed there is no need to wait for Federal action. Individuals are perfectly free to subscribe to a whole variety of charities and non-government development bodies. I would merely caution people to make sure that they really are non-governmental and that their hard-earned contributions do not end up one way or another in the coffers of corrupt Third World dictators.

Chinese Distortions

There is a further more subtle argument. The present world payments structure is not the result of the free choices of consumers or private investors, but of deliberate intervention by governments such as China who have distorted their own economies in order to build up foreign exchange reserves or to promote a pattern of growth artificially biased towards investment. Just as Soviet five-year plans concentrated on tanks and tractors, Chinese plans concentrate on foreign exchange reserves and the promotion of artificial export-led growth.

It is a wise maxim to take another country's policies as part of the external environment, especially when that country is still totalitarian in its politics. It is not as if China were trying to undermine the US in some form of economic warfare – if so we would be having a very different kind of conference. Chinese policymakers are reluctant to revalue the renminbi very far partly because they still want to accumulate foreign exchange assets and partly because of their export growth strategy. The last change in the Chinese exchange rate could have been a prelude either to a genuinely floating rate or a small technical adjustment involving mainly slightly wider margins and a switch to a basket reference rate. So far it has looked mainly like the latter. Some China watchers can find technical grounds to justify these policies whereas others regard it as a diversion of resources that could be used to living standards of ordinary Chinese. There are clearly divisions of opinion among Chinese leaders, some of whom do want a more genuinely flexible exchange rate but to move in their own time in their own way.

It is ironical that western statesmen play down the genuine grounds for criticising Chinese leaders, such as their still appalling human rights record - from

Tiananmen Square to the occupation of Tibet and the continued veneration of Chairman Mao - and instead lecture the Chinese on the need to revalue the renminbi.

There is a legitimate international interest in the timing and the mechanics of any Chinese currency changes – above all the need to prepare the ground by domestic financial reform and to avoid sudden and unexpected lurches and policy reversals. But beyond this the country's economic policy is its own concern.

The Argument Summarised

As anything that can be misunderstood will be misunderstood, I want to emphasise that I am not denying the existence of imbalances in world trade and payments. There are analysts whom I respect who are pretty sceptical. They include Prof. Richard Cooper, who is a former member of a Democratic administration. There clearly must be dissenting voices. Otherwise the dollar would already be much lower. *But my case in no way rests on any denial of the imbalances.*

Cooper's thesis needs to be read in full (Is the US current account deficit sustainable, CS IFO Forum Spring 2005). His bottom line is that the world is affected by a surplus outside the US of high net savings relative to investment opportunities. In continental Europe this reflects the fact that post war baby boomers are now at their peak earning and savings years. In China and other Asian countries there is no dearth of investment, but savings ratios so high that it is almost inconceivable that they can be absorbed at home at least under current political regimes. This excess of savings over potential investment opportunities is reflected in the so-called puzzle of low real long term interest rates. Cooper takes the view that these alone are not enough to balance the world economy and that the real equilibrilator outside the USA is government deficits and/or overseas investment leading to export surpluses. The

various mechanisms other countries use to bolster the dollar are a form of insurance for those making the overseas investments, including their own monetary authorities. Cooper adds however that this beneficial circular flow will not work if “Americans are providing government securities, financing the difference between what the government spends and what it receives in taxes, rather than building productive capacity for the future.” Thus Americans should be concerned not about borrowing from abroad, but about borrowing from abroad to finance large budget deficits rather than domestic investment. I imagine that this part of the Cooper thesis will meet with widespread approval except perhaps from administration.

The first point I want to emphasise most strongly is that whatever the arguments for concerted action the world’s main players, a unilateral attempt by the USA to reduce drastically its current balance of payments deficit would do far more harm than good.

Let us take the US domestic budget deficit which is at the heart of so many recommendations. A Blitzkrieg attempt to slash the deficit quickly would have a contractionary affect on the world economy unless it was mirrored by more expansionary fiscal policies elsewhere. The likelihood of this is more than doubtful. I cannot really speak for Asian countries; but European governments are already being censured all round for failing to live up to the spirit of the euro Growth and Stability Pact and running into too much red ink. If they are now to be criticised for not running sufficiently expansionary fiscal policies, they will be running around like headless chickens. Or more likely tell the US administration where to put its policy advice.

The second point is one of agnosticism. Since this meeting is taking place in the Hayek Auditorium it is appropriate to remind ourselves of the title of Hayek’s

Nobel Prize Address, which was “The Pretence of Knowledge”. Nowhere is the pretence more glaring than in the sphere of exchange rates. *I hope I am not alone in being extremely sceptical of all estimates of equilibrium exchange rates either today or five years ahead.* The IMF World Economic Outlook contains a chart of the real effective rate for the dollar since 1973. It is remarkable that, having come down from its 2001 high, it is now at almost exactly the average of the last 33 years.

This fact does not of course mean that it is appropriate. Equilibrium exchange rates can change; and there is room for argument about the weighting of different currencies in official dollar indices. But there are some specific reasons for scepticism. I grew up against a background of complaints about dollar shortage only to be succeeded by complaints about excessive dollars floating around the world economy. My own country the UK, which has for at least the last ten years if not longer had an exchange rate considered too high by many mainstream economists and against which manufacturing industry has complained bitterly. Yet despite immediate uncertainties the UK has not only lived with this supposed over-valued exchange rate but maintained a combination of growth, which the OECD has described as “robust” and “cyclical fluctuations smaller than in almost any other member country.”

But there is a more positive aspect too. If the main economic areas really carried out policies which were sensible on domestic grounds, the exchange rates would fall into place. If the US embarked on a credible policy of deficit reduction, if the eurozone were to be a little less doctrinaire in its monetary policies and the east Asian countries were to give more attention to the welfare of their own citizens, the pattern of exchange rates would take care of itself.

The Record

Having started off as a historian I am more inclined to look at the record than engage in crystal gazing. There have been a few notable occasions in which the US Administration was in a sufficient panic to take action to influence the dollar. The first was in 1971 when President Nixon took the dollar off gold and effectively allowed the US currency to float. He was in a sense doing the opposite of what is now being recommended and removing a currency peg in favour of floating rates. Unfortunately he spoilt the effect by a belt and braces policy, which also included a temporary import surcharge, which really did upset US trading partners and served little purpose inside the country. It looked as if the President or his advisers did not know what a floating rate was.

Leaving aside the Smithsonian flirtation in 1973 with a new set of fixed rates, which proved short lived, the other main examples of currency intervention were the Plaza agreement of 1985, and the Louvre accord of 1987. In addition there was the early flight back to Washington by the newly appointed head of the Fed Paul Vocker from Belgrade meeting of the IMF in 1979 to introduce internal tight money policies to halt a falling dollar. The exception, which seems most relevant today was the Plaza accord of 1985. Its distinguishing feature was concerted intervention by the main G7 countries who all agreed that the dollar was too high. There is disagreement to this day on whether the Plaza had much influence on the dollar which had already started to turn down.

The whole 1985-1987 experiment in managed exchange rates came to an end because of lack of agreement on accompanying interest rate policy – as Nigel Lawson, the British finance minister at the time put it in his memoirs – on “how any change in differentials should be shared between the countries whose interest rate

needed to rise in relative terms and countries whose interest rates needed a fall.” (*The View from No. 11*, 1992)

The experiment effectively came to an end towards the end of 1987 when the Bundesbank raised interest rates against the whole spirit of Plaza – an event which is said to have sparked off the Wall Street crash of that year. Today there seems even less agreement on either appropriate levels of world interest rates or differentials between countries.

In fact I have no fear whatever of a Blitzkrieg by the Bush administration on the US budget deficit. We will be very lucky indeed if it gets anywhere near the goal of halving it. Nearly all the policy announcements made this year have been of a deficit enlarging kind. Whatever else it is, it is not a sound money administration.

My fear however is that, egged on by business anxieties about competitiveness, the Treasury and Fed may be bullied into buying up foreign currencies to depreciate the dollar. Whether this can be effective without cheap money I very much doubt. So we could end up with both large fiscal deficits and loose monetary policy with not much gain to anyone at all.

The 1985 about turn towards intervention was rationalised by fear that Congress would otherwise go protectionist. Every unwise move in American economic policy has been rationalised by this protectionist fear, just as every unwise move in foreign policy has been rationalised by the fear of isolationism. Both unprincipled currency intervention and import restrictions are very much third, fourth and or fifth best policies and I do not want to choose between them.

Conclusion

Whatever any of us in this room may believe, I have little doubt that if the real exchange rate of the dollar becomes sufficiently high or the trade balance sufficiently

adverse, there will be emergency action. Conversely if the dollar falls sufficiently low there will be calls for another Louvre type deal from the Eurozone countries, although they are less likely to get their way than in the 1980s.

What form would emergency action to right the balance of payments take? I have spent some time on the unwisdom of a blitzkrieg on the budget deficit. But this is for the sake of analytical completeness and because it emerges from so many studies. Frankly the chances of this are negligible. Whatever one thinks of the Bush presidency it is not a sound money administration. My crystal gazing does not extend to what a Democrat administration might do after 2008 if one is elected.

How then can this world currency realignment be accomplished? Surely not merely by saying so. The knee jerk reaction is to advocate Treasury or Fed intervention in the foreign exchange market. I am not going to delve into the unresolved scholastic controversy about whether fully sterilised intervention is either possible or desirable. The last official international investigation led by Philippe Jurgensen for the G7 in 1982 concluded that only unsterilised intervention was of much use.

Such a course might or might not coincide with domestic needs. In addition cheaper US money would be an influence increasing the overvaluation of the euro currencies and may not be at all appropriate to the new international currency settlement that the Institute for International Economics would like to see.

Other emergency policies are stronger possibilities. The Treasury and Fed might be prevailed upon to sell dollars and stockpile foreign currencies in an attempt to push down the dollar. I do not want to enter into scholastic arguments about the possibilities of sterilisation; but common sense suggests that the creation of dollars for this purpose would amount to a substantial loosening of monetary policy. Moreover,

such a policy would be regarded by the Eurozone and other industrial countries as a hostile act.

Nevertheless currency intervention might be less dangerous than a possibility unfortunately advocated as a last resort by Cline. I mean something like a tax penalty on foreign investment in the US. It would both be an unjustified distortion of trade and payments flows and would be ultimately ineffective. But the USA has gone down this road before in the relation to the opposite problem of a weak dollar in the shape of President Johnson's Interest Equalisation tax.

Last in the list comes trade protection itself. This would cause great damage and – in the probable absence of fiscal and monetary measures – would ultimately prove ineffective in realising its aim. I mention protection last among the list of horrors because this is a bogey so often cited to justify otherwise unwise policy intervention.

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It is not for an outsider to list an order of preference among all these horrors. My main hope is that Alan Greenspan was right when he told the Jackson Hole meeting last summer that the US housing boom “will inevitably simmer down... home price increases will slow and even decrease. As a consequence home equity extraction will cease and with it some of the strength in personal consumption expenditure... The surprisingly high correlation between increases in home equity extraction and the current account deficit suggests that an end to the housing boom could induce a significant rise in the personal savings rate, a decline in imports and a corresponding improvement in the current account deficit.” The Fed chairman went on to make a customary central banker's plea for economic flexibility at home and

abroad in adapting to these changes. What he could not openly say was that a US downturn or slowdown prompted by a housing bust might justify a reduction in official short term interest rates which in turn would nudge the dollar in the required direction.

Nowadays it seems to be a sign of virility to prophesise gloom and disaster; or more modestly emphasise that if anything can go wrong it will. May I therefore be unfashionable and put my own money on something like Greenspan's judgment, which if valid would reduce the pressure for undesirable emergency expedients.