The Case against a Dollar Policy

Samuel Brittan

Milton Friedman's classic "The Case for Flexible Exchange Rates" was published in 1953, but its inception dates back to 1950 when the author was a consultant to the U.S. Economic Cooperation Administration that was responsible for implementing the Marshall Plan. At that time, it was taken for granted that the Western nations were committed to a system of fixed exchange rates, except for periodic adjustments to new parities. Little did he know that in 1952 the British Treasury had proposed—in a very pessimistic vein and as a result of gloomy and wrongheaded 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 it 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 a fixed exchange rate regime was the element that gave way 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 "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

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backwards: in other words as an argument for keeping the present system and not moving back toward 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, and (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 noninflationary growth in its own way.

Stability

When Friedman's 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 overshooting and undershooting that developed.

Any judgment 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 judgment 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 organized 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 noncommittally 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 labor costs are subject to much the same forces. Optimists on the euro believed that its very existence would make for such harmonization. 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 labor 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 U.S. 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 1980s. A key International Monetary Fund chart suggests that the real effective dollar rate declined by 20 percent between its 2001 peak and the third quarter of 2005 (IMF 2005: Fig. 1.26). There was a slight net further decline up to the spring of 2006. 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 U.S. 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 U.S. 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 U.S. 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 Cline (2005) for the Institute for International Economics. The author is careful not to exaggerate. He takes into account several reasons why conventional figures for the U.S. net international investment position (NIIP) exaggerate the problem.

One distortion arises from the fact that U.S. earnings from overseas capital holdings are a good deal higher than the foreign earnings from holdings in the United States. In addition, and in contrast to other countries, most U.S. 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.

Cline employs a new version of the U.S. external balance sheet, which he entitles “capitalized value of net capital income” (CNCI). On this improved CNCI measure U.S. external assets were still positive at the end of 2004 to the extent of 7 percent of gross domestic product. But this only buys time. According to the author, the U.S. current account deficit will rise from around 6 percent 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? Cline 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 U.S. 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 U.S. assets. So too might domestic bondholders. There will be

an obvious penalty for new borrowers and a deterrent to new investment.

The more likely danger, according to Cline, 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 U.S. terms of trade, as net exports have to rise to make up for the drying up of foreign capital inflows. I cannot help feeling that this slow motion long-term danger does not have the same sex appeal, even for Cline, 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 percent 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 U.S. demand and devaluing the dollar would have a contractionary effect on the rest of the world: it would lead to currency appreciation outside the United States 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 mainline recommendation of fiscal expansion abroad to offset fiscal contraction in the United States.

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 U.S. side and expansion on the side of other countries.

The Cline study focuses on the U.S. budget deficit as a source of domestic dissaving. The most concrete proposal emerging from the study is that the Bush 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 macroeconomy.

Third World Implications

A different kind of argument, more often heard outside the United States, 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 United States 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 subsidized 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 government action. Individuals are perfectly free to subscribe to a whole variety of charities and nongovernmental development bodies. I would merely caution people to make sure that they really are nongovernmental 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 that have distorted their own economies in order to build up foreign exchange reserves or to promote a pattern of growth artificially biased toward 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 United States in some form of economic warfare. 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 July 2005 reform of the Chinese exchange rate regime 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 improve 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 on their own terms.

It is ironic that Western statesmen play down the genuine grounds for criticizing 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 Summarized

As anything that can be misunderstood will be misunderstood, I want to emphasize that I am not denying the existence of imbalances in world trade and payments. There are analysts whom I respect who are pretty skeptical. They include 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 (2005) thesis needs to be read in full. His bottom line is that the world is affected by a surplus outside the United States of high net savings relative to investment opportunities. In continental Europe this reflects the fact that postwar 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 are 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 equilibrator outside the United States is government deficits and 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 (2005) 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 conductive 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 Cooper's thesis will meet with widespread approval except perhaps from the Bush administration.

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

Let us take the U.S. budget deficit that is at the heart of so many recommendations. A blitzkrieg attempt to slash the deficit quickly would have a contractionary effect 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 censored 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 criticized for not running sufficiently expansionary fiscal policies, they will be running around like headless chickens. Or more likely telling the Bush administration where to put its policy advice.

The second point is one of agnosticism. It is appropriate to remind ourselves of the title of F. A. Hayek's (1974) Nobel Memorial Lecture, "The Pretence of Knowledge." Nowhere is the pretense more glaring than in the sphere of exchange rates. I hope I am not alone in being extremely skeptical of all estimates of equilibrium exchange rates either today or five years ahead. It is remarkable that, having come down from its 2001 high, the U.S. dollar's real effective rate is now at only 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 indexes. But there are some specific reasons for skepticism. I grew up against a background of complaints about the so-called dollar shortage only to be succeeded by complaints about excessive dollars floating around the world economy. My own country the United Kingdom has for at least the last decade if not longer had an exchange rate considered too high by many mainstream economists and against which the manufacturing industry has complained bitterly. Yet, despite immediate uncertainties, the United Kingdom has not only lived with this sup-

posed overvalued exchange rate but also maintained "robust" growth along with "cyclical fluctuations smaller than in almost any other member country" (OECD 2005).

But there is a more positive aspect too. If the main economic areas really carried out policies that were sensible on domestic grounds, the exchange rates would fall into place. If the United States embarked on a credible policy of deficit reduction, if the eurozone were a little less doctrinaire in its monetary policies, and if 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 United States 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 dollar to float. He was in a sense doing the opposite of what is now being recommended and removing a currency peg in favor of floating rates. Unfortunately, he spoiled the effect by a belt-and-braces policy that included a temporary import surcharge, which upset U.S. trading partners and served little domestic purpose. 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 by Paul Volcker, the newly appointed head of the Federal Reserve, back to Washington from the 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 agreement. 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 agreement had much influence on the dollar, which had already started to turn down.

The whole 1985–87 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: the problem was "how any change in differentials should be shared between the countries whose interest rates needed to rise in relative terms and countries whose interest rates needed to fall" (Lawson 1993: 540–41).

The experiment effectively came to an end toward the end of 1987 when the Bundesbank raised interest rates against the whole spirit of the Plaza agreement—an event that 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 U.S. budget deficit. We will be very lucky indeed if it gets anywhere near the goal of halving it.

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

Conclusion

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 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 sterilized intervention is either possible or desirable.

The last official international investigation led by Philipe Jurgensen for the G7 in 1982 concluded that only unsterilized intervention was of much use.

Such a course might or might not coincide with domestic needs. In addition, cheaper U.S. 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 sterilization, but common sense suggests that the creation of dollars for this purpose would amount to a substantial loosening of monetary policy. Moreover, the eurozone and other industrial countries would regard such a policy 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 United States. It would be both an unjustified distortion of trade and payments flows and would be ultimately ineffective. But the United States 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 equalization 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 realizing 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.

It is not for an outsider to list an order of preference among all these horrors. My main hope is that Alan Greenspan (2005) was right when he told the Jackson Hole meeting last summer that the U.S. 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 U.S. 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 prophesize gloom and disaster, or more modestly emphasize 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?

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