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The Dollar at Home -- and Abroad

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For more than a decade, under Democrats and Republicans, Washington has emphasized that "a strong dollar is good for America." It's time to change the message. We need a strong dollar at home and a competitive dollar abroad: i.e., an exchange rate that will make American goods more attractive to foreign buyers and that will cause American consumers and firms to choose American-made goods and services. The administration has called for such a competitive dollar relative to the Chinese yuan. But while that bilateral exchange rate is important, it is responsible for only a fraction of our trade deficit. The overall international value of the dollar must be more competitive if we want to shrink our enormous trade imbalance and limit the rise in our debt to the rest of the world.

It is important to distinguish between the strength of the dollar at home and the value of the dollar relative to foreign currencies. A strong dollar at home is one that maintains its overall purchasing power in the domestic market -- that is, one whose purchasing power is not eroded by domestic inflation.

These two goals -- strong at home, competitive internationally -- are compatible in practice. With an appropriate monetary policy, we can shift to a competitive level of the dollar without raising the future rate of inflation. Consider what happened in the '80s, the last time that the dollar fell sharply. In April 1985 the dollar began a decline, falling 23% in 12 months and a total of 37% by the beginning of 1988. Although the price of imports rose sharply, the overall inflation rate did not increase. CPI inflation, 3.9% in 1984 (and almost exactly the same in the previous two years), actually declined to 3.8% in 1985 and to 1.1% in 1986. Between 1985 and the start of 1988, while the dollar fell 37%, the inflation rate averaged only 3.1%. Although a decline in oil prices contributed to this lower rate of inflation, the core rate of inflation that excludes energy prices also fell. That's not a guarantee that a dollar decline now wouldn't raise inflation, but it shows that it is possible to have a sharp dollar decline with no adverse effect on inflation.

The fall in the value of the dollar turned around the trade deficit. Merchandise exports rose more than 40% in two years while the corresponding imports increased at only half that pace. Since imports were initially much larger than exports, it took a few years for the trade deficit to decline. But by 1989 it was down by more than 40% from its peak. The decline of the dollar in the '80s also had no adverse effect on economic activity. The rise in national saving that was needed to reduce net imports happened without higher unemployment. Thanks to the improved trade balance, aggregate demand increased and the unemployment rate came down from 7.5% in 1984 to 5.5% in 1988. Bond yields also fell and the stock market rose sharply, with the S&P index up 40% from 1985 to 1988.

This favorable experience was different from the recent experience of emerging market countries in which sharp currency declines occurred. In Korea, Thailand and Argentina, currency declines in the late '90s led to falling GDP and rising inflation. The primary reason for the poor performance is that business firms there had borrowed in dollars rather than in their own currency. When their currency fell sharply relative to the dollar, their debts measured in domestic currency rose sharply, often pushing them into bankruptcy. Because we in the U.S. finance our current account deficit by borrowing in our own currency, we can move to a more competitive dollar without the adverse effects that followed currency declines in other countries

Skeptics argue that a more competitive dollar would not reduce our large trade deficit. Despite the favorable impact of the lower dollar on our trade deficit in the '80s, they fear that U.S. exporters can no longer compete with foreign products and that U.S. manufacturers could not compete with imports from low-wage countries even if the dollar declined again by nearly 40%. These skeptics are wrong. The U.S. is a major exporter even with today's overstrong dollar. In 2005, the U.S. exported $892 billion worth of goods, including $450 billion of capital goods, $116 billion of consumer goods and $230 billion of industrial supplies and materials. A lower dollar would raise sales volume in all of these categories.

The response of imports to a more competitive dollar would be more complex. Although U.S. manufacturers would still generally be unable to compete with producers in low-wage countries, it is important to realize that nearly half of our imports come from high-wage Europe, Canada and Japan. A dollar that is more competitive relative to currencies there will cause Americans to buy more U.S.-made products instead of imports from those countries. The increase in the relative price of products from low-wage manufacturers in Asia and Latin America that would result from a lower dollar would also make those products less attractive to American consumers. Even if the same kinds of products are no longer made in the U.S., consumers will respond to the higher price of those products by buying less of them and spending more on other goods and services produced in the U.S.

Although economists have studied the sensitivity of import and export volumes to changes in the exchange rate, there is still much uncertainty about just how much the dollar must change to bring about any given reduction in our trade deficit. But that should not be interpreted as saying that the deficit reduction will not happen in response to a lower dollar. Rather, it says that we cannot know how large the fall in the dollar must be to bring the trade deficit down to a sustainable level.

There are two reasons to hope that the dollar will become more competitive soon. First, the longer we wait, the larger our accumulated debt will be to the rest of the world. And when that imbalance is larger, it will take a larger fall for the dollar to repay the debt incurred by today's imports. The gain in purchasing power we enjoy as a result of the overstrong dollar today will be offset by the extra loss in future purchasing power of the dollar that will be needed to service and repay the future debt.

But the primary reason for wanting the dollar to become more competitive in the near future is that we may need an improved trade balance over the next few years to sustain the economy's expansion. Although forecasters generally believe that the likely outlook for the economy in 2006 and 2007 is a continuation of solid economic growth, there is a serious risk that the

combination of falling house values and an end to the low-interest incentive to refinance mortgages will cause consumer spending to decline relative to incomes. A sharp slowdown in consumer spending could cause an economic downturn.

What can take the place of the lower consumer spending to maintain overall aggregate demand? Business investment is unlikely to rise faster when sales to consumers are declining. Housing construction is already in decline. The key to maintaining aggregate demand, i.e., the key to our continued expansion if consumer spending slows, must be a shift in our trade balance -- increased exports, lower imports and more spending on goods and services produced in the U.S. For this, the dollar must decline to make U.S. goods and services more attractive.

Even if the dollar does decline during the coming months, the delays in the response of exports and imports to the more competitive dollar will mean that the increase in aggregate demand from this source may not happen for a year or more. That's why the U.S. needs to shift to a more competitive dollar as soon as possible.

What would make that happen? A rising U.S. saving rate and a narrowing gap between U.S. and foreign interest rates provides the right macroeconomic framework for the dollar decline. But exchange market participants are understandably reluctant to pursue a lower dollar when they hear the Treasury advocating a strong one. The 1985 Plaza Accord suggests a possible approach: Then, G-5 finance ministers acknowledged that the dollar was overvalued and needed to decline further. Monetary policies and national saving rates were changing appropriately in the U.S. and foreign countries, just as they are beginning to now. With the official statement that the dollar needed to decline relative to our trading partners, the markets did the rest, confident that the U.S. government did not have a plan to punish those who sold dollars by engineering a sudden reversal of the dollar.

G-5 finance ministers may not be the appropriate group now, since much of the U.S. trade imbalance is with countries that are not part of G-5. It might be best to start with a meeting with major Asian trade surplus countries that leads to a call for coordinated appreciation. But the specific institutional arrangement is less important than the official acknowledgment that the dollar has to come down and that there is no program or desire to support it at its overvalued level.

If the Fed pursues a strong dollar at home while the dollar becomes more competitive in global markets, we can achieve price stability and a more balanced path of economic growth.

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