THE DOLLAR AND THE US ECONOMY

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The dollar rose by a real trade-weighted average of about 40 percent from 1995 to early 2002, contributing to a sharp increase in US current account deficits that ultimately reached unsustainable levels of almost $800 billion and exceeded 6 percent of GDP. Since early 2002, the dollar has reversed this earlier rise and is back to where the large swing began over a decade ago (see Chart 1).

These fluctuations mirror to a remarkably similar extent the previous largest swing of the dollar, in the 1980s, when it rose by about 50 percent during the first half of the decade and then fell by an equivalent amount during 1985-87. The dollar is now at a very similar level to where it stood in both 1980 and 1995. It is certainly weaker today than it was six years ago but no weaker than in those earlier periods. With the United States still running very large external deficits, the dollar at present can hardly be characterized as "weak."[2]

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[2] Indeed, an alternative approach to measuring the real value of the dollar that highlights the importance of growing trade with low-cost developing countries such as China implies that the dollar's broad value in real terms is still well above the 1980 and 1995 lows. See Charles Thomas, Jaime Marquez, and Sean Fahle, "Measuring U.S. International Relative Prices: A WARP View of the World," International Finance Discussion Paper No. 917, Board of Governors of the Federal Reserve System, 2008.

There are two noteworthy features of the latest decline of the dollar in addition to its substantial magnitude. The first is its gradual and orderly nature over a period that now exceeds six years. There has been no free fall of the exchange rate nor hard landing of the US economy.

The second is its skewed geographical composition. The great bulk of the dollar's fall has occurred against currencies which have been permitted to fluctuate freely in the markets, most notably the euro and other European currencies (pound, Swiss franc, etc.) along with the Canadian and Australian dollars. By contrast, several of the major Asian countries, most notably China but several others as well, have intervened heavily in the currency markets to limit the rise of their exchange rates, which thus remain substantially undervalued. The yen also remains substantially undervalued though Japan has not intervened overtly for over four years.

Our Peterson Institute for International Economics has just published a comprehensive analysis of "fundamental equilibrium exchange rates" for the dollar and about three dozen of the world's major currencies[3]. It concludes that <u>the dollar has already declined almost enough to reduce the US global current account deficit to a sustainable level of 3 percent of GDP</u>, from its peak above 6 percent and about 5 percent now, and may in fact have overshot modestly on the downside against the euro and a few others. Further upward adjustments of 20-30 percent against the dollar are still needed for China, Japan and several other surplus countries to reach equilibrium, however, which would produce a "final decline" of another 5-10 percent for the trade-weighted dollar. Market exchange rates could of course significantly overshoot (or undershoot) these calculated target levels (which are summarized in table 1).

[3] William R. Cline, and John Williamson, "New Estimates of Fundamental Equilibrium Exchange Rates," Policy Brief 08-7, Peterson Institute for International Economics, Washington, DC, July 2008. All our estimates assume that the countries adopt policies to maintain internal balance, i.e., full employment with price stability.

The Impact on the US Economy

A weaker dollar reduces the prices of US products to foreigners and increases the prices of foreign products (and domestically produced substitutes for them) to Americans. It has a similar impact on the prices of financial assets. It therefore has three important effects on the US economy:

- it strengthens our international competitiveness and contributes to the necessary reduction in our large trade and current account deficits, generating additional output and employment in the United States;
- it increases the level of prices in the United States; and
- it may affect foreign investment in the United States and thus our ability to finance our large external imbalances.

The good news is that the weaker dollar has already contributed to substantial improvement in the US trade balance and will clearly lead to much more improvement. Every fall of 1 percent in the trade-weighted dollar tends to strengthen our current account position by $20-25 billion after a lag of two to three years (as long as other economic policies support the adjustment). Our "net exports of goods and services" in real terms, as included in the GDP accounts, have strengthened by about $150 billion, expressed as an annual rate from 2006 through the first half of this year. We can expect a further improvement of like magnitude over the next eighteen months or so.[4]

This sharp reduction in the external deficit in real terms has provided all of our (very modest) economic growth during the final quarter of 2007 and first quarter of 2008. There was

[4] The current account in nominal dollars has not gained nearly as much because of the sharp rise in the price of oil imports, discussed below.

no increase in domestic demand over those six months but net exports grew by an annual rate of about 1 percent of GDP. Hence they have kept the US economy out of recession, at least to date.[5] The OECD's new global forecast for 2008-09 posits that 80 percent of total US expansion during that period will come from further gains in our international trade position.

<u>This likely trade gain of about $300 billion in real terms translates into the creation of more than 2 million jobs in the tradable goods sector of the US economy</u>.[6] Moreover, these export jobs pay 15-20 percent more than the national average wage. With domestic demand flat and the aggregate unemployment rate rising, such trade gains are extremely important. <u>The lower dollar and globalization are providing a major boost for the economy just when we need it</u>.[7]

The bad news is that a weaker dollar means higher prices in the United States. <u>Every decline of 10 percent in the dollar tends to produce a subsequent increase in the CPI of about 1 percentage point</u>. Hence the fall of 25 percent in our exchange rate over the past six years could be expected to produce a rise of 2-2½ points in the level of US prices.

It is important to realize, however, that a one-shot fall in the dollar leads to a rise in the <u>level</u> of prices but not to a higher <u>rate</u> of inflation on a continuing basis. The inflation <u>rate</u> would increase permanently only if the dollar <u>continued</u> to decline, just as the trade balance would record further gains only if the currency were to keep falling to lower (and even more competitive) levels.

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[5] C. Fred Bergsten, "Trade Has Saved America from Recession," *Financial Times* July 1, 2008. The other key factor is the continuing robust economic growth in the rest of the world, especially in emerging market economies.
[6] Using the standard ratio of 7,500 jobs per $1 billion of exports calculated by the Department of Commerce.
[7] The steady deterioration of the current account balance during 1995-2005 likewise reduced output and employment in the tradable goods sector. During most of that period, however, US domestic demand expanded rapidly and thus the unemployment rate declined steadily to below 4 percent in the late 1990s and near that level again as recently as last year.

Concern has nevertheless been expressed that the weaker dollar of the past five years has been an important contributor to the sharp rise in the price of oil. Since oil is generally priced in dollars, one might expect the exchange rate to have little effect on the price of imported oil. However, OPEC and other producers clearly seek to offset their losses of real income from a falling dollar by seeking to raise the nominal price of the commodity. Thus a falling dollar may be associated with a rising dollar price of oil just as it is associated with a rising dollar price of other imported commodities.

Historically, however, there has been very little correlation between the dollar and world oil prices (Chart 2). In fact, the sharp inverse correlation that is the focus of current attention can only be observed during some parts of the period from about 2003 to the present. When the dollar declined by over 30 percent in 1985-87, for example, the oil price collapsed to less than $10 per barrel – its first large correction after the two oil shocks of the 1970s. The sharp if short-lived upward spike in oil in 1990-91, around the Iraqi invasion of Kuwait, correlated with a flat or rising dollar. Oil and the dollar rose together at the end of the 1990s. Energy economist Philip Verleger notes that "(any) mechanism that links the movement of oil prices and the dollar has never been satisfactorily explained…Certainly no one to date has advanced a coherent theory for their coincident movement."[8] He and others suggest that the recent coincidence between the two derives primarily from a common cause: market fears of renewed inflation.

During this latest period, the global price of oil has risen about seven-fold – from around $20 per barrel as recently as 2002 to a recent high above $140 per barrel – while the dollar has fallen by "only" 25 percent. This is a far higher ratio of oil price rise to dollar fall than has

[8] Philip Verleger, "The Oil-Dollar Link," *The International Economy* Spring 2008. Similar analyses, throwing doubt on any systematic causal relationship from the dollar to oil prices, have recently been published by three private banks: "Quantifying the USD-Oil Link," Barclays Capital, 11 July 2008; "Dollar and Oil—Which is the Chicken and Which is the Egg?" Commerzbank Corporates and Markets Economic Research, 18 July 2008; and "FX Pulse," Morgan Stanley, 17 July 2008.

existed over any previous, let alone extended, period. Moreover, the price of oil has risen sharply in all currencies rather than just the dollar. Other commodities, even those that do not trade on organized exchanges, have risen as much or even more than oil. Even for the very short run, the dollar has stabilized over the last six weeks or so while the oil price continued to escalate until very recently.

These relationships clearly indicate the dominance of factors other than the exchange rate:

- world demand for oil has grown twice as fast over the latest five-year period (2003-07) as over the previous five years;
- "aggregate supply disruptions" (most notably Nigeria, Venezuela, Iran, Mexico) have taken two to three million barrels per day off the market fairly consistently;
- the cost of finding new supplies has doubled over the past four years, slowing the production response; and
- a "flight to commodities" reflects growing worldwide fears of inflation (and perhaps a common cause of the oil price rise and the dollar decline).[9]

Concern has also been expressed that OPEC, or at least some major oil exporters, might stop denominating their oil sales in dollars. In economic terms, this would make absolutely no difference; the sellers can alter their prices however they want regardless of whether they denominate in dollars, euros or something else. Iran in fact shifted to euros some time ago with no noticeable impact.

Having said that, a dramatic announcement by OPEC (or perhaps even Saudi Arabia alone) that it was shifting away from dollars could have a substantial psychological effect on the currency (and perhaps other) markets. Such an effect might be magnified if the Saudis, or the

[9] This analysis is drawn from Daniel Yergin, "Oil at the Break Point," testimony to the Joint Economic Committee of the Congress, June 25, 2008.

Gulf Cooperation Council members more broadly, also (or instead) decided to stop pegging their currencies to the dollar. Kuwait has already done so, and the others should do so as well, both to ward off imported inflation and to reduce their own very large current account surpluses.[10] The only step of this type that would have major substantive effects, however, would be decisions by large oil exporters – who are also large reserve holders – to sell their dollar holdings or not buy any more. This takes us to the final effect of the weaker dollar on the US economy.

The most uncertain impact of a weaker dollar relates to foreign financing of the US external deficits. Even with the improvements noted above, the United States will still be running annual current account deficits of around $500 billion (3-4 percent of GDP) for some time. This will require us to continue attracting a net capital inflow of a like amount from the rest of the world. This in turn generates a further increase in the net foreign debt of the United States, which reached about $2.5 trillion at the end of 2007 and is by far the largest of any country in the world (although it still amounts to less than 20 percent of our GDP and is thus not worrisome by most international standards).

The lower dollar makes US assets cheaper for foreigners and thus should <u>increase</u> their interest in investing here. So should the prospect of further reductions in the US current account deficit and an eventual stabilization of the ratio of our net foreign debt to GDP. On the other hand, fears of <u>further</u> dollar declines could deter investors and in fact lead them to seek higher returns to offset that risk.[11] <u>The central question is thus foreign expectations of the future exchange rate of the dollar</u>.

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[10] Brad Setser, "The Case for Exchange Rate Flexibility in Oil-Exporting Economies," Policy Brief 07-8, Peterson Institute for International Economics, Washington, DC, November 2007.

[11] There is little risk, however, that China or Saudi Arabia or other large reserve holders will "dump" their dollars and trigger a free fall of the currency. Since they could not possibly divest anything like all their dollars at the same time, doing so would sharply devalue their very large remaining holdings and thus shoot themselves in the foot financially. It would also stamp them as international pariahs for disrupting global financial markets and the world economy, which none of them want. The more likely prospect is that they will diversify away from the dollar

The Dollar and US Economic Policy

This in turn poses the central challenge of the dollar for US economic policy. Fears of further falls in the exchange rate could lead to a flight from dollar assets (by Americans as well as foreigners). The consequent sharp depreciation of the dollar could force the Federal Reserve to raise policy rates to fight the incipient rise in inflationary pressures; the higher interest rates would of course also help attract the essential financing for our continuing large external deficits. The monetary authorities already face an acute policy dilemma, as the economy remains both sluggish and susceptible to inflationary pressure, but a sharp dollar fall (or even acute fears thereof) would make it much worse. This problem will be yet even more severe if the economy weakens further and financial fragility again intensifies, in which case the Federal Reserve's likely desire to ease further could be severely constrained by the risk of a dollar collapse.

As noted above, our analysis suggests that the dollar is now fairly close to its equilibrium level. The remaining correction can be achieved through appreciation of a few (mainly Asian) currencies rather than any further generalized decline of the dollar. It is thus extremely important for the global economy and systemic financial stability that China, Japan and the other large surplus countries with undervalued exchange rates complete their adjustments in an orderly manner that commands market confidence.

It is nevertheless quite possible that market sentiment will remain bearish on the dollar, particularly if our economy remains sluggish and the gap between US and foreign interest rates widens in favor of the latter as the European Central Bank and other monetary authorities raise

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gradually and over time by accumulating larger shares of euros and other assets at the margin as their reserves continue to grow.

their policy rates to respond to inflationary pressures. This will be especially true if the markets perceive the Federal Reserve as "soft on inflation," particularly relative to its counterparts abroad.

In this circumstance, the United States would need another policy instrument to enable it to counter concerns over the dollar without altering monetary policy in a direction that would exacerbate the problems of the domestic economy. The chief possibility is direct intervention in the currency markets. The specific techniques can range from "jawboning" or "oral intervention," which our authorities have in fact already begun to deploy over the last several months with some success in stabilizing the dollar, to direct purchases of dollars for other currencies to limit (or even stop) any renewed slide. The Federal Reserve traditionally neutralizes the impact of such intervention on the US money supply to keep it from altering the chosen course of monetary policy; hence it is called "sterilized intervention."

The Bush Administration has never intervened in the currency markets in its 7½ years in office. Hence intervention to support the dollar would have an enormous shock effect on market psychology and would almost certainly be quite effective in strengthening sentiment toward the dollar.[12] This is particularly true since it would surely intervene in concert with at least the other G-7 countries whose currencies have already become a bit overvalued with respect to the dollar (which excludes Japan).

Conclusion

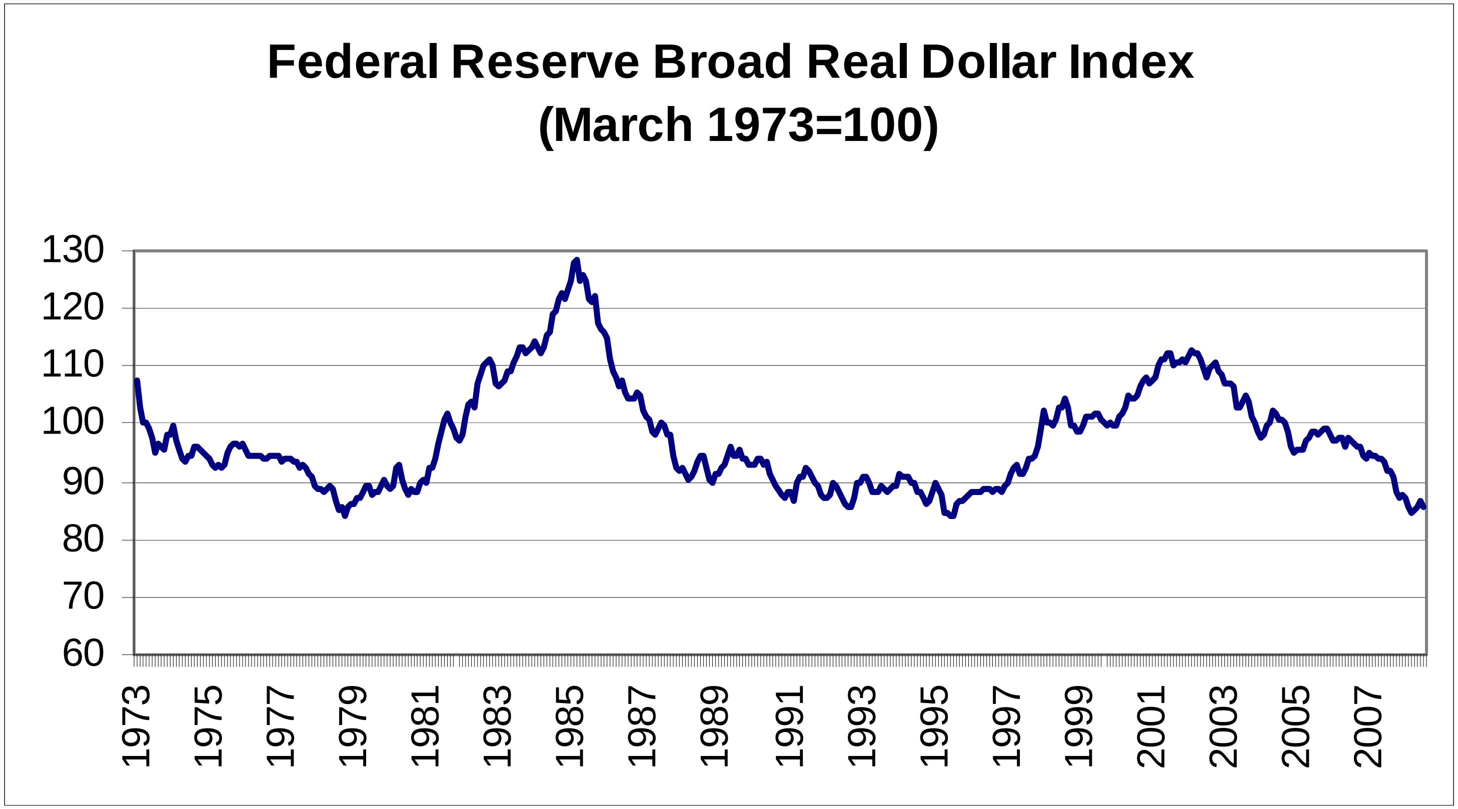
As the Congress and the country as a whole continue to grapple with the housing and financial crises, the exchange rate of the dollar could play a critical role in both the evolution of the basic problem and the needed policy responses. A renewed fall of the dollar, especially if it were sharp and substantial, could deepen the housing crisis and the weakening of the economy

[12] The Clinton Administration disliked intervention too but all three episodes in which it used the tool – to strengthen the dollar in 1995, to strengthen the yen in 1998 and to strengthen the euro in 2000 – were quite successful.

by pushing up prices and interest rates (with the offsetting further improvement in the trade balance occurring only with a considerable time lag of 2-3 years). Efforts to ease monetary policy in response to a renewed slide in the economy and/or further financial fragility would be severely hampered because doing so could exacerbate the dollar's weakness and trigger still more inflation and even greater upward pressure on interest rates.

It may therefore be necessary to consider including new policy measures, particularly currency intervention, in the strategy for responding to the crisis. I applaud the Committee for addressing this underappreciated dimension of the issue and hope my remarks will contribute to fashioning a constructive response to it.

Chart 1



Federal Reserve Broad Real Dollar Index
(March 1973=100)
130
120
110
100
90
80
70
60
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007

Chart 2

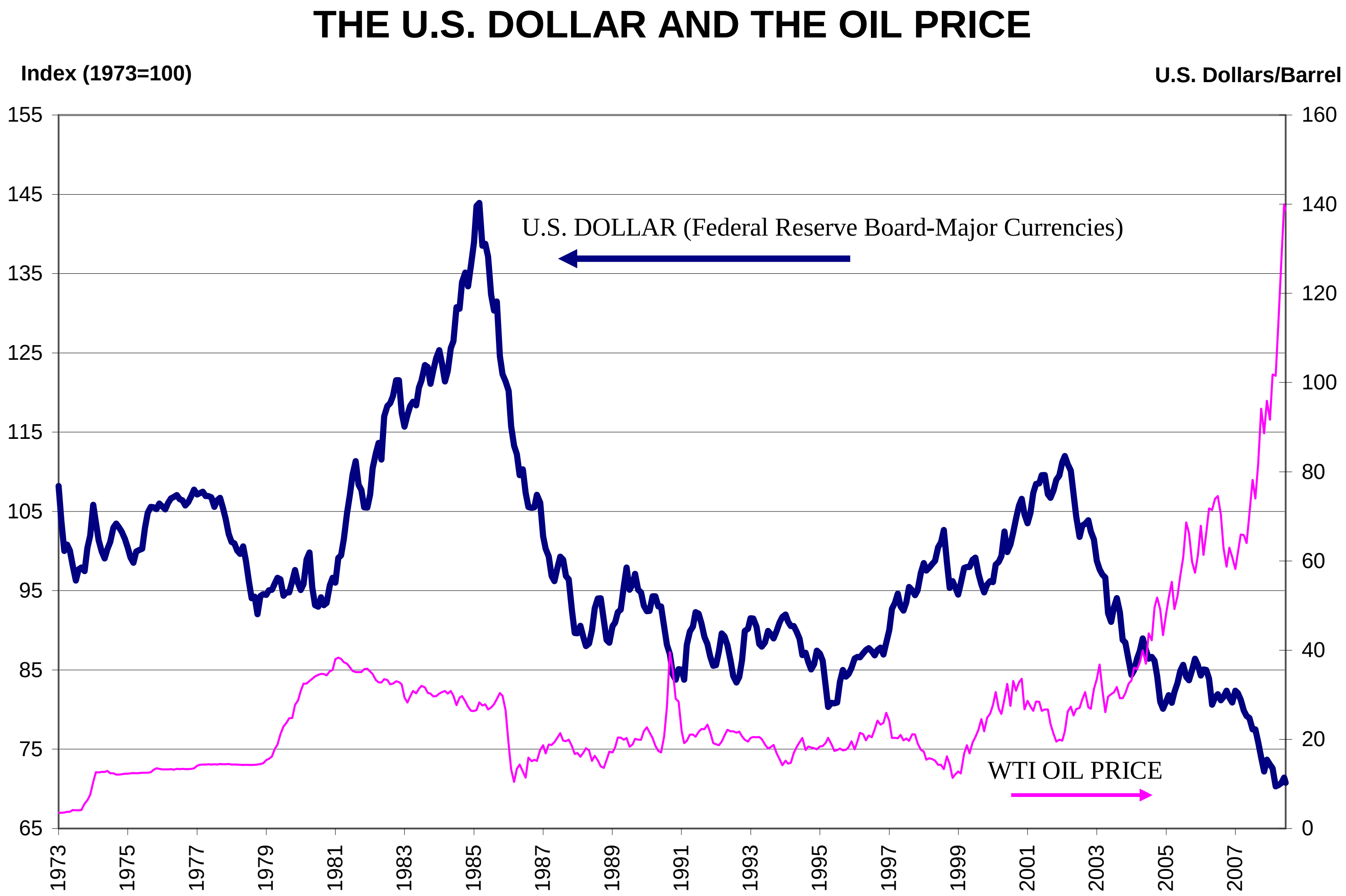

THE U.S. DOLLAR AND THE OIL PRICE
Index (1973=100)
U.S. Dollars/Barrel
155
145
135
125
115
105
95
85
75
65
160
140
120
100
80
60
40
20
0
U.S. DOLLAR (Federal Reserve Board-Major Currencies)
WTI OIL PRICE
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007

Table 1 Currency realignments needed to reach fundamental equilibrium exchange rates (FEERs)

Country/region	Percent change from base[a]		Currency level against the dollar		
	Trade-weighted average	Bilateral vs. the dollar	FEER equivalent	July 1-15, 2008	Percent change needed
Industrial countries					
Canada	–4.1	–1.5	1.02	1.01	–0.6
Euro area[b]	–7.2	–0.2	1.47	1.58	–7.0
Japan	5.7	19.0	90.1	106.5	18.2
Switzerland	21.4	23.9	0.88	1.02	16.3
United Kingdom[b]	–6.6	–2.5	1.91	1.98	–3.7
United States	–8.6	0.0	1.00	1.00	0.0
Developing Asia					
China	18.4	31.5	5.45	6.85	25.7
Korea	–3.5	11.2	850	1,024	20.5
Malaysia	12.3	30.7	2.47	3.25	31.8
Singapore	24.7	41.2	1.00	1.36	36.2
Taiwan	9.0	26.0	25.1	30.4	21.2
Other developing					
Mexico	–0.4	2.0	10.6	10.3	–2.5
Poland	–8.6	–6.1	2.59	2.10	–19.1
South Africa	–14.6	–6.7	8.21	7.73	–5.9
Turkey	–13.0	–8.5	1.32	1.23	–7.0

a. February 2008
b. Dollars per currency unit