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WHAT TO DO ABOUT THE DOLLAR

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The depreciation of the exchange value of the dollar since 2002 to some observers is a judgment on the future viability of the U.S. economy. They revive a notion that was popular from the 1980s until it lost its appeal in the late 1990s. The notion was the twin deficits. From 1983 to 1989, domestic private savings and domestic investment were about equal, as were the trade deficit and the federal budget deficit, fostering the notion of a relation between the twin deficits.

The idea was that domestic private saving and the trade deficit were sources of supply of capital. Private sector investment and the federal budget deficit were sources of demand for capital. Expansionary fiscal policy created budget deficits that increased domestic demand for capital and imports. Tight monetary policy raised interest rates, which induced foreign investment and appreciated the dollar exchange rate. The strong dollar made American goods expensive for foreigners and imports cheaper for Americans. Thus the current account deficit was related to the effects of the twin deficits. The validity of this framework was shattered by developments in the late 1990s when budget deficits declined and became a surplus while the current account deficit surged.

What happened to the twin deficits view was that business investment boomed in the 1990s along with productivity increases while private savings declined as low inflation, low unemployment, and soaring stock market values increased private wealth. The contribution of the budget surplus to national saving was insufficient to close the gap with domestic investment. Foreign capital inflows in response to the then US boom closed the gap.

. In the current version of the twin deficits notion, expansionary fiscal policy has created budget deficits that have increased spending for capital and imports. Loose monetary policy has lowered interest rates, which discourage foreign investment and depreciate the dollar exchange rate. The weak dollar ultimately will cheapen American goods for foreigners and make imports expensive for Americans. In the meantime, the budget deficit has reduced national saving, while private domestic investment has continued to grow, so the gap between the two requires higher foreign capital inflows. So there is no abatement of the current account deficit. And that is the point at which apocalyptic predictions by some observers begin.

They believe that at some point global investors will regard their portfolios as unbalanced with dollar-denominated assets, and will decide to limit their holdings of such assets. They expect the share of euro-denominated assets in time will replace dollar-denominated assets with the ultimate consequence of narrowing the US current-account deficit. The main foreboding of those who entertain these views is that foreign holders of dollars may decide to sell them off quite precipitously, dumping dollars on world markets. As a result, the foreign exchange value of the dollar would plummet, U.S. interest rates would rise to limit the fall in the dollar's exchange value, the economy would plunge into recession, and the rest of the world would suffer a contraction in exports to the U.S.

Countering the apocalyptic view of what is in store for the U,S. and the rest of the world of a catastrophic decline in the exchange value of the dollar, is the projection that as long as the US maintains price stability and its economy is vibrant, while the European and Japanese economies are stagnant, the US will not encounter constraints on borrowing from the rest of the world. If there should be a run on the dollar, it would alarm foreign central banks and foreign exporters. Foreign central banks would intervene to prevent appreciation of their national currencies and a loss of their exports.

As of the first quarter of 2005, there has been no indication that China, Japan, and Taiwan are shifting their reserves out of dollars. China is reported to have increased its $610 billion total at end of 2004 to $659 billion at the end of 2005I. A flight from the dollar would not be a winning strategy for the Asian countries. Exporting to America is their main priority. Exports mean growth. Their growth-oriented trade surpluses are a main source of finance for the US current account deficit, channeled through their central banks as official providers to the US. The apocalyptic view would prevail only were the Asian countries to trash their model of exports as the engine of growth and instead promote domestic spending and consumption That may eventually happen, but not soon and not precipitously.

The Asian countries are little concerned about the risk/return of their US investment position. It is not the Asian countries that have become worried about their US exposure. It is. private investors in Europe, Canada, and Australia who have been responsible for the dollar's decline, by limiting their purchases of US assets until there is a rise in US yields, and have been responsible for the euro's appreciation. European domestic savings have remained at home, and their yields have fallen..

I would worry less about a fall in the exchange value of the dollar because of some foreign private investor concerns about US indebtedness than I would about growing demands for protection against imports of goods and services. Complaints about unfair trade practices of foreign exporters are not unique to the present situation. Subsidies to promote US crop exports have been a perennial feature of protectionist trade policy here. Current protectionist targets are undervalued Asian currencies, especially the Chinese yuan.

The US has attributed the size of its bilateral trade deficit with China to its undervalued yuan, which is pegged at 8.28 to the dollar. Pressure on China to float the yuan has been exerted by the G-7, not only by the US. The textile industry in the US and also in emerging market economies has borne the brunt of Chinese competition, particularly so since early 2005, when the Multi-fiber Agreement that limited Chinese textile exports expired. A motion was lost to kill a protectionist measure, supported by members of both parties in Congress, that would impose tariffs of up to 27.5 percent on all Chinese imports if it does not permit the yuan to float more freely. China has responded to the call to relax the exchange peg by agreeing to do so at some unspecified date. It is doubtful, however, that even a dramatic appreciation of the yuan would be sufficient to balance US trade with China, much less the overall US trade with the rest of the world.

The decline in profitability of US textile firms and the loss of employment by its workers creates a political problem for the administration. Protectionist measures and government subsidies will not prolong the life of an industry facing low-cost competitors. US moderate-priced textiles may ne doomed by developing country proficiency. One solution would be for the US industry to restructure itself to specialize in the production of expensive high=fashion goods. Younger workers should be offered compensation and retraining under the federal Trade Adjustment Assistance program for manufacturing. Older workers should be given financial aid for a transitional period. Regions with concentrated textile firms should aim to attract other industries.

Conclusion

What to do about the dollar? My answer is, Nothing. If the market has overstated the decline in the dollar's exchange rate, the market will correct the overstatement. In a floating exchange rate system, currencies fluctuate. Correction of the underlying problem of an imbalance between US national saving and investment is dependent to a great extent on the behavior of US trading partners. They have surplus savings and seek investment opportunities in the US. Activist solutions for policy changes in the US, such as reducing real government spending as a percentage of GDP, are likely to backfire by depressing economic activity. The single beneficial thing the administration can do is to oppose protectionism. It has not served to narrow the current account deficit in the past, and won't do so now.

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