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THE CASE AGAINST TRYING TO STABILIZE THE DOLLAR

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ABSTRACT

Better domestic economic policies in the 15 years since the collapse of the Bretton Woods system would have prevented the extreme fluctuations of the dollar's exchange value during those years. The pursuit of policies here and abroad that are appropriate for domestic growth in the future should reduce the likelihood of such substantial exchange rate swings in the years ahead. But elevating exchange rate stability to a separate goal of economic policy could have serious adverse consequences. Trying to achieve that goal would mean diverting monetary and fiscal policies from their customary roles and thereby risking excessive inflation and unemployment and inadequate capital formation. Succeeding in the efforts to achieve dollar stability would mean harmful distortions in the balance of trade and in the international flow of capital.

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<u>The Case Against Trying to Stabilize the Dollar</u>

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It is easy to understand why dollar stability has widespread political appeal. To businessmen, a fluctuating dollar means an uncertain competitive environment. Relatively small exchange rate fluctuations can eliminate previously profitable markets at home and abroad. To consumers, a declining dollar can mean inflation and a lower standard of living. And looking beyond economic self-interest, there is an atavistic nationalism that confuses the dollar and the flag, incorrectly regarding a strong dollar as a measure of national virtue and a declining dollar as an indication of national weakness.

Despite the popular support for the notion of a stable dollar, the analysis summarized in this short paper implies that a stable dollar, if it could be achieved, would prevent desirable adjustments and induce unwarranted ones. The process of trying to stabilize the dollar would require diverting monetary and fiscal policies from their customary goals and thereby create more inflation, more unemployment, or an inferior rate of capital formation than would otherwise be possible.

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There is, of course, nothing wrong with dollar stability if it happens to come about as a by-product of otherwise appropriate economic policies. That is not the issue that economists have in mind when they argue against trying to stabilize the dollar. The real issue is whether a stable exchange value of the dollar should be a separate target of economic policy and, to the extent necessary, other policy goals should be sacrificed in order to achieve dollar stability.

The appropriate exchange rate policy depends on the country and its economic circumstances. A small country within Europe that trades a major share of its GNP with its neighbors may find it appropriate to fix its exchange rate relative to its major trading partners even though that requires sacrificing the independence of its monetary policy and accepting German economic hegemony. Alternatively, even without important trade links, a country may choose to tie its currency to that of a low inflation country in order to achieve a monetary discipline and credibility that would not otherwise be possible. In considering the appropriate policy toward the dollar, it is important to recognize that U.S. trade is only 10 to 15 percent of GNP, that we can control our inflation rate through our own domestic monetary policy without an exchange rate anchor, and that the United States will not permit our monetary policy to be made in Frankfurt or Tokyo.

One final word of introduction is appropriate. Economists who oppose pursuing policies to stabilize the dollar are sometimes accused of favoring inflation or other destabilizing domestic policies. It is easy to understand the source of this misunderstanding. The major swings of the dollar during the 15 years since the collapse of the Bretton Woods system can be traced primarily to the pursuit and subsequent corrections of inappropriate monetary and budget policies: the inflation of the 1970s followed by the anti-inflationary monetary policy at the beginning of the 1980s; the surge in actual and projected budget deficits in the early 1980s followed by a gradual decline in actual and projected budget deficits after 1985 (see Feldstein, 1988a). But the case against making dollar stability a separate goal of national economic policy should not be confused with condoning bad economic policies. An economist can be a firm advocate of sound domestic policies while still rejecting the notion of dollar stability as a separate goal of economic policy.

I. Capital Markets, Goods Markets and Exchange Rates

Before looking at the consequences of trying to stabilize the dollar by explicit policy manipulation, consider how exchange rates naturally vary over time in response to supply and demand conditions in financial markets and in the international markets for goods and services.

Consider first the role of international capital markets. At any time there exist in each country desired levels of saving and investment corresponding to prevailing interest rates. If there were no opportunity to invest or borrow abroad, each country's domestic interest rate would adjust to bring saving and investment into balance. With completely integrated world capital markets, there would be a single world real interest rate that balanced world-wide saving and investment while the individual domestic saving and investment rates would in general be unequal. In practice, capital markets are less than perfectly integrated and real interest rates differ among countries. It nevertheless remains true that the saving rate in each country will not in general be equal to the desired level of investment at the interest rate prevailing in that country. If the desired level of domestic saving exceeds domestic investment, there will be a capital outflow; if desired saving is less than desired investment, capital will flow into the country.[1]

Since the capital flow is by definition equal to the current account balance which in turn is equal to the sum of the trade balance plus net international investment income, changing the capital flow in or out of the country requires a change in the trade balance. And since the trade balance is a function of the exchange rate, the only way in which a sustained change in the capital flow can be brought about is by a change in the exchange rate.

Of course, conditions in the markets for goods and services also affect the exchange rate. Any shift in the supply or demand for exports or imports (at given exchange rates) will alter the exchange rate. For example, if American consumers increase their demand for foreign products at the existing dollar exchange rate (because of a shift in tastes or an improvement in the relative quality of foreign products or a reduction in their foreign currency prices), the value of the dollar will fall in order to maintain the initial level of the trade surplus or deficit and therefore the initial level of the international capital flow. Thus shifts in forces that influence the demand and supply of goods and services alter the exchange rate in a way that is directly linked to the equilibrium capital flow.

Since exchange rate changes play such a central role in balancing the supply and demand in capital markets and in the markets for goods and services, how can anyone believe that exchange rates could remain constant? The textbook answer is that exchange rate changes are not needed to achieve a capital flow between two countries if the products of the two countries are "perfect substitutes" (in the sense that the cross-price elasticity of demand is infinite). For example, an increased desire to invest in one country would put upward pressure oon its local prices, thereby inducing an increase in net imports sufficient to maintain the initial level of demand. This increase in imports automatically entails a capital inflow equal to the desired increase in investment.

This "purchasing power parity" theory of fixed exchange rates is good textbook economics but only holds if the traded goods are perfect substitutes. Experience shows repeatedly that the demand elasticities of similar products produced in different countries are far from infinite even over rather long periods of time. As the experience of the 1980s confirms, imports and exports are slow to respond to changes in relative prices and therefore large departures of exchange rates from purchasing power parity are required to achieve significant shifts in trade balances, current account balances and capital flows.

With all of this as background, I can now consider the effects of trying to stabilize the dollar. I will begin by examining the effects of a stable dollar, if it could somehow be achieved, on trade and capital flows. I will then turn to the effects of trying to stabilize the exchange rate.

II. Adverse Effects of Artificial Dollar Stability

Although shifts in saving and investment and in the supply and demand for internationally traded products might just happen to keep the dollar stable, such a singular coincidence can be ruled out as extremely unlikely. In general, the dollar will have to shift to achieve or maintain the desired net international capital flow described in the previous section.

It is important in this context to distinguish real and nominal exchange rates. Changes in nominal exchange rates are simply the changes in exchange rates quoted in the market, while changes in real exchange rates are those changes adjusted for differences in inflation rates between the home and foreign countries. Although it is of course the real exchange rates that influence patterns of trade and therefore the associated capital flows, popular discussions and official pronouncements do not make the distinction and therefore implicitly discuss the stabilization of nominal exchange rates. (See Feldstein, 1988b)

Whenever domestic inflation rates differ among countries the nominal exchange rates must change just to maintain the initial real exchange rates. The prices of tradable products in the United States are currently increasing at about six percent a year while the corresponding price index in Japan is not increasing at all. Maintaining the real yen-dollar exchange rate therefore requires the nominal dollar-yen exchange rate to decline at a six percent annual rate. Failure of the nominal dollar exchange rate to decline in this way would, all other things equal, lead to an increasing U.S. trade deficit and a more rapid accumulation of debt to the rest of the world.

Shifts in the nominal exchange rate that maintain a constant real exchange rate may provide nothing more than a first approximation to the required shift in the dollar's value. For example, the sharp increase in the world oil supply in 1988 that caused a fall in the dollar price of oil during the past year was of greatest help to those countries that are most dependent on imported oil. Thus Japan, which imports all of its oil and for which oil imports are a large part of total imports, was particularly benefited. The yen therefore had to rise relative to the dollar to prevent an increase in the Japanese trade surplus and a resulting unwanted additional capital outflow from Japan.

In addition to the shifts of the exchange rate that are needed to balance differences in inflation rates and to offset shifts in supply and demand in world product markets, the dollar has to shift to permit changes in desired levels of domestic saving and investment to be financed efficiently. The most obvious example of this in the 1980s was the dramatic decline in the U.S. saving rate caused by the surge in the budget deficit. Without an increased net capital inflow from the rest of the world, the U.S. net investment in plant and equipment, housing and inventories would have had to decline by approximately one third. In fact, the higher real U.S. interest rates attracted capital from abroad, inducing a rise in the real value of the dollar that caused an increased trade deficit that permitted the increased net capital inflow. Without the capital inflow, the decline of U.S. saving would have caused a substantial misallocation of worldwide investment with the productivity of capital significantly higher in the U.S. than abroad. Although the associated trade deficit had painful effects on some sectors of the American economy, the overall U.S. unemployment rate declined and total GNP rose throughout the period of the increasing trade deficit.

III. Dangers of Trying to Stabilize the Dollar

Trying to stabilize the dollar requires diverting monetary and fiscal policies from their traditional roles. The result of such policy distortion can be a substantial sacrifice of the traditional goals of price stability, high employment and an appropriate level of national capital accumulation.

Although currency market intervention is the most obvious tool of exchange rate manipulation, it is also the least effective. Experience continues to confirm that "sterilized intervention" (i.e., the buying and selling of foreign currencies with offsetting changes in government debt to keep the total money supply unchanged) has little or no effect on exchange rates (Obstfeld, 1988) and that any such effect is likely to last for only a few days or at most a few weeks. Some research suggests that even the modest impact of sterilized intervention exists only because financial markets interpret exchange market intervention as a "signal" that the government is prepared to shift monetary or fiscal policy to achieve the desired currency shift.

In contrast to the ineffectiveness of exchange market intervention, changes in monetary policy can alter nominal exchange rates in the long run and real exchange rates in the nearer term. Consider first the long term effects of monetary policy on nominal exchange rates. An increase in the U.S. money supply eventually causes a corresponding rise in the U.S. price level. If the U.S. price level rises, a stable real exchange rate requires a proportionate fall of the nominal value of the dollar. This mechanism shows also how an expansionary monetary policy that raises the U.S. domestic price level can stabilize

the nominal exchange rate when the real value of the dollar is rising.

It is important to emphasize, however, that the effect of an expansionary monetary policy on the real exchange rate is only transitory. An expansionary monetary policy can temporarily lower the real interest rate, causing the value of the dollar to decline. Since the prices of goods and services increase only with a lag, the initial nominal decline of the dollar is temporarily a real decline as well. Over time, however, the rise in domestic prices matches the fall in the dollar. There is a nominal dollar decline but no change in the real value of the dollar. In the long run, a shift in monetary policy can have only a monetary or nominal effect and cannot alter real values.

The experience in 1983 and 1984 illustrates the consequences of trying to use monetary policy to stabilize the nominal value of the dollar when its real value is being increased by fundamental real factors. At that time, increases in the current and projected budget deficits were raising the dollar's real value. The rising dollar induced substantial pressure on the U.S. government from foreign as well as domestic sources to take steps to reverse the dollar's sharp rise. Although a contractionary fiscal policy was widely advocated on the basis of domestic policy consideration at the time and would also have reduced the dollar's value, no fiscal action was taken. If the pressure had succeeded in inducing the U.S. administration to stabilize the dollar, the responsibility would have fallen to the Federal Reserve. An expansion of the money supply would have produced a temporary reduction in the real exchange rate and a sustained reduction of the nominal exchange rate. The important point is that after a temporary period the real exchange rate that influences trade would have been unaffected while the progress of the early 1980s in reducing inflation would have been reversed.

The futility and the danger of using monetary policy to stabilize the dollar is not just hypothetical. In the spring of 1987 the Federal Reserve began a policy of restricting the money supply and raising interest rates in order to support the value of the dollar. The two percentage point rise in interest rates was one of the factors that precipitated the October stock market crash. Had the Fed not then explicitly abandoned the goal of supporting the dollar and allowed interest rates to decline, the American economy might well have slid into recession in 1988.

Although neither exchange market intervention nor monetary policy can have a sustained effect on the real value of the dollar, budget and tax policies could in principle be used to stabilize the real value of the dollar over a sustained period of time. As the experience in the early 1980s demonstrated, fiscal policies that reduce national saving raise real interest rates, thereby increasing the attractiveness of dollar securities and causing the dollar to rise. The opposite is true when fiscal policies increase the national saving rate.

But it is difficult to imagine circumstances in which the gain from using fiscal policy to stabilize the dollar would outweigh the losses from an otherwise inappropriate fiscal policy. At the present time, for example, the continued decline of the dollar could be delayed by fiscal actions that increase the real interest rate on dollar securities. But there are no economists who advocate an increase in the budget deficit or a tax change that penalizes private saving in order to stabilize the dollar.

One final word about the harmful effects of trying to stabilize the dollar. Although economists focus on real exchange rates, official pronouncements and policy decisions within the group of G-7 finance ministers are always in terms of nominal exchange rates. In a world in which nominal interest rates differ because of differences in inflation rates, the promise of nominal exchange rate stability is itself destabilizing. In 1988 U.S. interest rates exceeded corresponding Japanese rates by about four percentage points, approximately the difference in inflation rates. Portfolio investors who believed the G-7 assertions that the nominal dollar-yen exchange rate would nevertheless remain stable were induced to buy the higher yielding dollar securities. The result was a dollar increase of nearly 15 percent relative to the yen between January and October despite the evidence that the U.S. trade deficit and the Japanese trade surplus would remain very large unless the dollar fell further. When the credibility of the G-7 forecast evaporated in November, the dollar fell back to its January level. The counterproductive emphasis on nominal exchange rates does not reflect a lack of understanding on the part of the key G-7 finance ministers, central bankers, and advisors but appears to be dictated by the political character of official efforts at exchange rate stabilization.

IV. Conclusion

Better domestic economic policies in the 15 years since the collapse of the Bretton Woods system would have prevented the extreme fluctuations of the dollar's exchange value during those years. The pursuit of good policies here and abroad in the future should reduce the likelihood of such substantial exchange rate swings in the years ahead. But elevating exchange rate stability to a separate goal of economic policy would have serious adverse consequences. Trying to achieve that goal would mean diverting monetary and fiscal policies from their customary roles and thereby risking excessive inflation and unemployment and inadequate capital formation. And succeeding in the effort to achieve dollar stability would mean harmful distortions in the balance of trade and in the international flow of capital.

FOOTNOTES

1. The degree of capital market integration appears to be increasing over time but is still far from complete. See Feldstein and Bacchetta (1988).

2. The price indices used to convert nominal exchange rates to real exchange rates provide only a very imperfect measure of the changes in actual price competitiveness because of the impossibility of adequately reflecting changes in quality and the introduction of new products. These measurement problems raise serious doubts about any attempt to calculate purchasing power parity exchange rates.

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