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THE DOLLAR AND THE TRADE DEFICIT IN THE 1980s: A PERSONAL VIEW

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ABSTRACT

The sharp gyrations of the dollar and of the trade deficit in the 1980s were among the most novel and least understood economic developments of the decade. This paper, which was written as part of the NBER project on American economic policy in the 1980s, examines the reasons for the dollar's swings and the nature of the policy debate about the appropriate government response to the rising and then falling dollar.

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The Dollar and the Trade Deficit in the 1980s: A Personal View

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This paper is part of a longer essay on American economic policy in the 1980s. The other parts of that essay appear as three NBER working papers that deal with monetary policy, tax policy, and government spending and budget policy.

These essays are not intended as a detailed history of economic policy during the decade. Excellent analytic histories have been written by others as part of the NBER project on American Economic Policy in the 1980s. The study of the dollar and exchange rate policy for that forthcoming book was written by Jeffrey Frankel and has been distributed as NBER Working Paper No. 3539. A related chapter dealing with trade policy issues written by David Richardson also appears as NBER Working Paper No. 3725.

My own essays, which will be combined in the first chapter of that book, are an attempt to analyze some of the reasons for the policy changes that occurred in the decade and to offer my judgements about some of those changes. I have, therefore, not commented on the papers by Frankel and Richardson or on other published discussions of the dollar and exchange rate policy during this period. I do provide some bibliographic references to my own papers, particularly nontechnical ones, in order to incorporate their content into this paper.

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The sharp gyrations of the dollar and of the trade deficit in the 1980s were among the most novel and least understood economic developments of the decade. The rise and fall of

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the dollar's international value reflected the major changes that were taking place in American monetary, tax, and budget policies. These fluctuations of the dollar altered the relative prices of American and foreign goods. The nation's international trade responded to these relative price changes, producing a massive trade deficit by the middle of the decade followed by a return toward trade balance after the dollar began to decline.

1. The Rising Trade Deficit

In 1980, America's international trade was nearly in balance. Our imports of goods and services exceeded our exports by only $15 billion, about 0.5 percent of GDP. Our net earnings on overseas investments were nearly twice as large, leaving us with a positive current account balance and therefore an ability to add to our investments abroad.

Just seven years later, the trade deficit had increased nearly tenfold to $143 billion or more than three percent of GDP. Our growing debt to the rest of the world increased our nation's payments on foreign assets in the United States to a point where they were nearly equal to what we were earning on American assets abroad. The current account deficit in 1987 was $160 billion and foreign investors increased their net stake in the United States by that amount.

Economists recognized from the start that the deteriorating trade balance in the early 1980s was a natural reaction to the rising value of the dollar. When I arrived at the CEA in the fall of 1982, the real trade-weighted value of the dollar had increased 35 percent since 1980. Although the closely watched merchandise trade deficit had not yet begun to deteriorate, I was soon warning my Administration colleagues that, because of the strong dollar, the trade deficit was about to surge. It subsequently rose from $36 billion in 1982 to $67 billion in 1983 and $113 billion in 1984.[2]

Manufacturing industries were particularly hard hit as manufactured exports slumped while the imports of manufactured products surged. A commonly expressed concern was that the mid-west manufacturing areas had become a "rust belt" and that our industrial sector was being "hollowed out." At the same time, the economy as a whole showed remarkable resiliency; because unemployed workers shifted from one industry to another and from one region of the country to another, the overall economy expanded and total employment increased continually from the end of 1982 until 1990.

The weakness of manufacturing and the expansion of imports caused a national self-examination and self-criticism. The list of criticisms included short-sighted management, a poorly educated labor force, confrontational labor relations, inadequate capital formation, and a lack of corporate concern about competing in world markets. Unfortunately, this self-evaluation did not produce a program of self-improvement. Instead, the political response was to restrict access to American markets while blaming foreign governments for the inability of American firms to export.

As the trade deficit rose, some business executives and Commerce Department officials argued vehemently that the increased trade deficit was due to foreign practices that had to be stopped and that justified a more active U.S. trade policy. There was no doubt

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[2] See chapter 3 of the 1983 Economic Report of the President and chapter 2 of the 1984 Economic Report of the President for the view of the Council of Economic Advisers about the trade deficit and the dollar. The CEA's senior staff international economist was Paul Krugman in 1982-83 and Jeffrey Frankel in 1983-84. For a less technical summary of the same views, see Feldstein (1983 and 1985).

that some foreign markets were closed to American products, that some foreign governments were subsidizing export industries, and that some foreign firms were pursuing strategies designed to increase market share rather than to earn a return on capital similar to that sought by American firms. But none of this was new. If anything, foreign markets were becoming gradually more open and export promotion less common. Foreign practices could not account for the explosion of the U.S. trade deficit and economists both in the government and elsewhere generally opposed any moves toward protectionism and managed trade.

Similarly, although many of the criticisms of American industry were justified, these problems did not arise in the few years that it took the United States to shift from an approximate trade balance to a massive trade deficit. Moreover, even if there had been a recent decline in the overall level of American productivity relative to that in other countries, that would not have been a reason for a sharp rise in the trade deficit. Most countries of the world have much lower productivity than the United States, but manage to achieve trade balance or surplus. As the British economist David Ricardo pointed out a century and a half ago, trade is governed not by overall productivity, but by the differences in the relative productivity of different industries in different countries. Even if the United States were less productive in every industry than our foreign trading partners -- something which is clearly not true -- we would still be able to balance our trade (and raise our standard of living in the process) by exporting those things at which we are relatively more productive than our trading partners. Some serious problems undoubtedly did affect the competitiveness of particular American industries in the 1980s, but the source of our rapidly growing overall trade deficit was the dramatic rise of the dollar rather than a sudden fall in the productivity of American industry as a whole.

There were, of course, some special factors other than the strong dollar that did adversely affect our trade balance in the first half of the 1980s. The international debt crisis that began in 1982 forced the Latin American countries to shrink their imports from the United States as well as from other countries. A second important development of those years was the sharp improvement in Chinese agriculture as a result of Deng Xiaoping's economic reforms. Those reforms switched China from being a major food importer to a nation that was essentially self-sufficient in agricultural products. Since the United States is a major food exporter, the events in China reduced the demand for American agricultural exports. And there is no doubt that some of the newly industrialized nations in Asia had become much more formidable competitors in world markets for manufactured products.

But the primary reason for the sharp rise in U.S. imports and the stagnation of our exports was undoubtedly the dramatic rise of the dollar. According to the Federal Reserve, the trade-weighted value of the dollar relative to ten industrial currencies rose 73 percent between 1979 and the first quarter of 1985 after adjusting for differences in inflation. With a 73 percent rise in the price of American goods relative to the prices of foreign products, it was not surprising that American firms had a hard time exporting. And even though some foreign firms selling in the United States took advantage of the exchange rate shift to increase their profit margins by raising their prices rather than just increasing the volume of their sales, it is easy to see why a 73 percent rise in the value of the dollar would lead to a surge in imports.

2. The Rise of the Dollar

The rise of the dollar began in 1980, reversing a decline that started in 1971 and that had accelerated in 1978 as a result of our increasingly rapid rate of inflation and the low real return on dollar assets. The initial impetus for the dollar's upturn was the tightening of Federal Reserve policy at the end of 1979. The increase in the real interest rate and the reduced risk of runaway inflation made dollar securities more attractive to international investors.

The election of Ronald Reagan reinforced the expectation that the Fed would pursue a tough anti-inflation policy. The Reagan plans for cutting taxes and increasing defense spending implied larger future budget deficits and caused real interest rates to rise further, thereby increasing the attractiveness of dollar investments and raising the value of the dollar.

The idea that larger budget deficits could increase the dollar's attractiveness and raise its value seemed paradoxical to many noneconomists who resisted the notion that the budget deficit was responsible for the dollar's rise and the resulting loss of competitiveness of American products. History seemed to teach the opposite lesson: that a country that had a large budget deficit would see its currency decline in value. One had only to look at Latin America to see countries in which large budget deficits were associated with rapidly declining currency values.

The difference of course was that large budget deficits in those other countries were usually accompanied by rising inflation because in those countries the central banks bought the increased debt and thereby added equal amounts to the nations' money supplies. In many less developed countries, this link was an inevitable consequence of the lack of domestic capital markets in which budget deficits could be financed by selling government bonds to the public. In such cases, the rapidly rising inflation caused the nominal value of the currency to decline at a correspondingly rapid rate.

But in the United States in the early 1980s it was clear that the Federal Reserve would not alter its tough anti-inflationary policy in response to the increased budget deficit. The budget deficit would therefore mean higher real interest rates with no increase in inflation. The market's response was therefore a rising dollar. Each percentage point rise in the real long-term interest rate would raise the dollar's exchange value by several percentage points. Investors would be content to hold what was clearly an "overvalued" dollar that they knew would fall in the future because they would be compensated during that decline by the higher interest yield on dollar assets than on foreign securities.

The dollar continued to rise in 1982 and 1983 even after it was clear that inflation had stabilized and that the Fed had allowed short-term interest rates to decline. This made it clear that the dollar's continuing rise was not due to a very tight monetary policy (as some monetarists continued to claim), but rather to the increasing budget deficit in the context of a monetary policy that would prevent deficits from leading to higher inflation.

Although much of the budget deficit's initial surge was due to the deep recession, it gradually became clear that the structural deficit would grow even after the cyclical deficit declined. The structural deficit rose from about $49 billion in 1982 to $108 billion in 1983 and $134 billion in 1984 (according to 1992 estimates by the Congressional Budget Office). It reached a temporary peak of $177 billion in 1985 and $185 billion in 1986 before dropping to $120 billion in 1987. As investors adjusted up their projections of the future deficits during 1983 and 1984, real interest rates and the value of the dollar rose accordingly.

3. National Saving and the Twin Deficits

Although economists understood the links from budget deficit to real interest rates to the dollar and finally to the trade deficit, the logic of this process seemed less plausible to noneconomists. During my time as CEA chairman, whenever I explained this chain linking the budget deficit with our trade problem, I could see that the skeptics thought there were too many invisible links for the process as a whole to be plausible. Their skepticism was encouraged by the strict monetarists (including Treasury Undersecretary Beryl Sprinkel) who argued that the dollar's value is determined by monetary policy alone and by the supply side extremists who argued that the budget deficit could do no harm. Others claimed that the dollar's rise was due to an increased attractiveness of the United States as a "safe haven" for funds, although it is hard to imagine why the United States had suddenly become so much safer than Switzerland or Germany.

A more plausible alternative explanation was that the 1981 tax changes raised the return on investments in equipment and buildings, bidding up real interest rates and the dollar. Although I accepted that that could in principle help to explain the dollar's strength, my judgement was that the magnitude of the decline in national saving was substantially greater than the increased demand for investment. But assigning relative weights to these two components was not relevant to the two key policy questions that were debated within the Administration as well as outside it: Would a lower budget deficit help to bring down the dollar's value and ease the trade deficit? Did shrinking the trade deficit require government action to block imports, to open foreign markets, and to subsidize U.S. exporters? As long as the budget deficit was a major cause of the dollar's strength, the answer to the first question was a clear "yes" and to the second question was a clear "no".

Because of the difficulty of persuading noneconomists (and some of the Administration's economists as well) of the links from the budget deficit to interest rates and then to the dollar and the trade balance, I frequently emphasized a more direct explanation: A country's trade balance is just equal to the difference between the amount that it saves and the amount that it invests. When a country saves more than it invests, it has a surplus of output that can be exported to the rest of the world. Conversely, when investment in plant and equipment, in housing and in inventories exceeds the amount that is saved by households, businesses and government, the extra investment requires an inflow of resources from abroad. The rise of the dollar was only the price mechanism by which the budget deficit caused the U.S. to go from trade surplus to trade deficit.

A larger budget deficit reduces national saving and therefore forces an increased trade deficit unless private saving rises or investment declines by sufficient amounts. In fact, net private saving declined relative to GDP in the first half of the 1980s while net private investment increased slightly relative to GDP. Given these conditions, the rise in the trade deficit was inevitable.

The advantage of this explanation is that the basic relation -- that national saving (net of the budget deficit) minus national investment equals exports minus imports -- is neither an economic theory nor an empirical generalization, but a basic accounting identity. Skeptics who doubted the more complex chain of reasoning or who resisted the idea that the budget deficit raised interest rates could accept that the budget deficit was nevertheless responsible for the increased trade deficit.

Not everyone was persuaded, however. In early 1984, when Treasury Secretary Don Regan was testifying to the Senate Budget Committee, one of the Senators read him a passage from the CEA's recently released Economic Report of the President in which the link between the budget deficit and the trade deficit was explained. The source of the passage was not revealed and the Secretary was asked what he thought of the statement that he had just heard. He said it was wrong and that it should be thrown in the garbage. When the Senator revealed the source of the quote, the Secretary, who seemed to enjoy public disputes with me, did not alter his view of its appropriate disposition.[3]

The episode would just be humorous if it were not indicative of the difficulty of achieving decent policy. The President could see for himself that, contrary to much of the conventional wisdom, the budget deficit was not raising the rate of inflation. The Secretary of the Treasury, who claimed to speak not only with the authority of his Wall Street experience but also on the basis of the expert advice of the Treasury staff, repeatedly denied my assertions that the budget deficit was reducing investment and creating a trade deficit that hurt manufacturing industries. Fortunately, although Don Regan resisted efforts to create a realistic package of deficit reduction measures, he did not compound the problem by supporting the trade protectionists and did not favor currency intervention to lower the dollar.

[3] When I testified to the same committee the next day, I was asked about my reaction to the Secretary's remark. I said that his comment was "just a throw away line" and the hearing moved on to a more substantive discussion.

4. Pressure to Reduce the Dollar

Although some people might dispute the role of the budget deficit in raising the dollar's value, there was no doubt that by 1983 the strong dollar was inflicting significant pain on American manufacturing firms and their employees. Manufacturing employment in 1983 was 11 percent lower than in 1979-80 and manufacturing profits were 33 percent lower.

The value of the dollar had increased from 1.81 marks per dollar in 1980 to 2.55 marks per dollar in 1983, a rise of 40 percent. The dollar also rose more than 50 percent relative to the British pound during this same brief interval. The secular trend in the dollar-yen ratio that had lowered the dollar by 37 percent relative to the yen in the 1970s had ended and the dollar had instead risen relative to the yen in the early 1980s.

Not surprisingly, American exporters and those firms that competed directly with imported products appealed to Washington to adopt policies that would lower the dollar's value. They were joined by European governments that didn't like the inflationary pressures caused by the relative decline in their own currencies, particularly the higher costs of dollar-denominated energy imports.[4] The Japanese government also worried that the bilateral trade imbalance caused by the overstrong dollar would exacerbate anti-Japanese protectionist pressures in the United States.

The obvious desirable policy response would have been a reduction in the U.S. budget deficit. But as a participant in the budget process during those years, I can say with

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[4] Some European politicians also claimed that the strong dollar was slowing the pace of recovery in Europe. Although this may have been a politically useful assertion for some European governments, it was not correct (see Feldstein, (1983)). The apparent paradox of European governments objecting to the rise of the dollar that was creating an export boom for their economies is discussed more fully in Feldstein (1986a).

confidence that the Administration's budget policy did not respond to the trade deficit and the high dollar. Since neither the President nor the Treasury Secretary recognized the links between the budget deficit, the dollar and the trade deficit, there was no way that the goal of reducing the dollar and the trade deficit could cause a willingness to accept tax increases or other budget changes that would not otherwise have been acceptable.

Without a reduction of the budget deficit, I argued that the case for trying to reduce the dollar was doubtful at best. The only practical way to have reduced the dollar would have been by an easier monetary policy. The resulting rise in the price level would have reduced the dollar's nominal value, but it would not have changed the real value of the dollar. Since the trade balance depends on the real value of the dollar, the net result would have been higher prices, higher inflation, and no improvement in the trade balance. Only to the extent that the easier monetary policy also increased the fear of even higher future inflation and thereby reduced the attractiveness of dollar securities to international investors would there have been a reduction in the real value of the dollar. Hardly an attractive option!

There were, of course, those who hoped that a policy of exchange market intervention could have lowered the dollar's value without any change in monetary or fiscal policy. But a careful analysis of past experience summarized in an official international study by the finance ministries of the G-7 countries that was released in April 1983 (the Jurgenson Report) confirmed the long-standing academic conclusion that sterilized intervention (i.e., intervention that does not alter national money supplies) would have no significant lasting impact on exchange rates.

Moreover, even if the real value of the dollar could somehow have been reduced, I worried that lowering the dollar without shrinking the budget deficit would have been counterproductive. A lower dollar would have meant a smaller trade deficit, but that would have meant a smaller gap between saving and investment. With nothing done to increase saving, the level of domestic investment in the United States would have declined. Lowering the dollar without shrinking the budget deficit would have reduced the pain felt by exporters and by those who competed with imports, but only by transferring the pain to other sectors of the economy that were directly sensitive to higher interest rates. If anything, without the trade deficit, the crowding out caused by the budget deficit would have been concentrated on a smaller number of industries and, therefore, even more painful. Moreover, the reduced level of investment in plant and equipment would have left the economy in a worse position for future years.

In short, the trade deficit was a safety valve by which the pressures caused by a massive budget deficit could be partly reduced through the resulting inflow of capital. The inflow of capital was the natural market response to the fall in national saving. There seemed no reason to believe that shrinking the trade deficit without lowering the budget deficit would represent an improved allocation of resources.[5]

Fortunately, despite the political pressures for currency intervention to drive down the dollar, the noninterventionists prevailed. Paul Volcker had an instinctive dislike for a lower

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[5] I discussed these ideas within the Administration and in testimony and public talks. I also wrote an article for the Economist magazine spelling out these reasons for believing that, without a reduction of the budget deficit, it would be wrong to try to reduce the value of the dollar; see Feldstein (1983).

dollar and understood that the Fed could lower the dollar's value only by returning to higher inflation. The Treasury also supported the view that intervention would be inappropriate. Treasury Secretary Regan liked to argue that the high value of the dollar was an indication of the strength of the U.S. economy and the high regard of investors worldwide for U.S. economic policies.

The issue was discussed with the President as part of the preparation for the Williamsburg summit. He had heard from many businessmen who were being hurt by the dollar's strong value, urging some action or international agreement to lower the dollar's value. We knew that President Mitterand would argue at Williamsburg for an agreement to lower the dollar and to stabilize its exchange rate, leaving the details of how that might be accomplished to be worked out later. The President himself expressed a nostalgia for the days when exchange rates were fixed and worried about the damage that the dollar's rise was doing to the industrial sector of the economy. But after a brief flirtation with the idea of a currency policy, the President was persuaded that the exchange rate is a price that, like other prices, was better left to the market without government interference. He went to Williamsburg prepared to argue this case to the French.

5. <u>The Dollar's Decline</u>

Economists recognized that the dollar would eventually decline. A rise in any country's real interest rates causes a temporary surge in the international value of its currency leading to a trade deficit and resulting capital inflow. In this process, the currency temporarily overshoots its long-term sustainable value. After this initial increase, if there are no further jumps in the country's real interest rate, the currency can then be expected to decline gradually at a speed that balances the higher interest rate, thereby eliminating both the desire of investors to flee the currency and the prospect for a new rise in the currency's value. As a result, the trade deficit itself could be expected to decline in the future.

My own research some years earlier had shown me that changes in domestic saving rates would temporarily be offset by international capital flows but that for periods of a decade or longer the domestic rate of investment would adjust to domestic saving (Feldstein and Horioka, 1980). I was convinced that that decline in the capital inflow would be brought about by a natural decline of the dollar leading to a smaller trade deficit.

There was much confusion in the early 1980s about the notion that the dollar was "overvalued." A currency can be willingly and rationally held by private investors even if it is overvalued in the sense that it leads to an unsustainable trade deficit and that everyone agrees that the currency's value will eventually fall. Investors are prepared to hold an "overvalued" dollar despite its expected decline if the interest rate on dollar bonds is high enough, relative to the interest rate on foreign bonds, to compensate the investors for the dollar's expected rate of decline.

The interest differential between dollar bonds and foreign bonds in the early 1980s implied an expected rate of dollar decline that might or might not be realized in practice. If the budget deficit were eliminated rapidly, the interest rate might fall quickly and bring with it a rapid fall of the dollar. Alternatively, if the budget deficit persisted, U.S. interest rates might remain high with the dollar falling only as the risk to foreign investors associated with an increased share of dollar assets in foreign portfolios outweighed the interest differential.

But at each point in time, the actual level of the dollar was sustained by the market's belief that its expected rate of decline was balanced by the risk-adjusted interest differential.

In practice, the decline of the dollar was delayed by the rising levels of projected structural budget deficits and real interest rates. Each such reevaluation of the likely future budget deficit ratcheted the dollar higher through 1983 and 1984.

By early 1985, however, the dollar had reached a level relative to the Japanese yen and the Deutschemark that could not be reconciled with the existing interest differentials. Even if the dollar declined from that level at rates equal to the interest differentials between U.S. bonds and Japanese and German bonds, the U.S. current account deficits would grow explosively. While the dollar would eventually be low enough to eliminate the trade deficit, the amount of U.S. debt held by foreigners (and foreign investment in the United States) would by then cause our annual interest payments to foreigners to be rising faster than GDP was growing.

Such an explosive growth of our current account deficit and our international debt was not possible. A speculative bubble had pushed to dollar too high at the end of 1984 and early 1985. Many private economists, as well as Fed Chairman Paul Volcker, recognized that the dollar was now overvalued in the more fundamental sense that a smooth decline at a rate of three or four percent a year (the interest differential) was no longer possible.

When the rate of decline of the dollar became greater than the interest differentials, some investors would lose money by being in dollar bonds rather than in Japanese or German bonds. As investors came to recognize that the dollar was irrationally overvalued in this sense, the speculative bubble burst and a sharp decline in the dollar began in February 1985.

The change in the leadership at the Treasury from Don Regan to Jim Baker in early 1985 combined with the decline of the dollar to induce a change in the government's avowed policy. Baker would probably have wanted to have "his own policy" in this area and one that was more favorably regarded by foreign governments and the press. Moreover, the significant fall of the dollar between February 1985 and mid-summer (bringing the dollar down by 15 percent relative to the DM and nearly 10 percent relative to the yen) meant that the Treasury could no longer continue to claim that the dollar's value was a measure of the high international regard for the United States and its economic policies.

Baker and Volcker met with the Finance Ministers and central bank heads of the other G-5 countries (Germany, Japan, France and Britain) at the Plaza Hotel in September 1985 and announced to the world that the G-5 had agreed that the dollar's value should decline. There was an immediate sharp drop of a few percentage points, followed by a resumption of the same overall rate of decline that had prevailed since February. Although the dollar's average rate of decline in the six months after the Plaza meeting was the same as in the prior six months (Feldstein, (1986b)), the world press persistently credited the Plaza meeting with causing the dollar's decline.

A falling currency is usually regarded as an indication of a finance minister's poor performance, but that was not so with Jim Baker. Baker was not only able to disregard the Administration's previous rhetoric about the dollar as a measure of American virtue, but even to turn the dollar's decline into a personal advantage by arguing that if other countries did not do what the United States wanted (i.e., expand their domestic demand so that the U.S. trade deficit would decline), the U.S. dollar would be reduced. It was a relatively safe prediction -- if foreign demand did not rise, the dollar would fall to shrink the trade deficit -- but it gave the impression of a powerful U.S. Treasury Secretary defending American interests. It was one of the unfortunate consequences of the apparent success of the Plaza meeting in lowering the dollar that it gave credibility to this type of claim.

Between the first quarter of 1985 and the first quarter of 1987, the real trade weighted value of the dollar (as measured by the Federal reserve's ten country index) had fallen 36 percent, reversing more than 80 percent of the dollar's climb from 1979 to its peak in early 1985. Although it took about a year for importers and exporters to adjust their behavior, our trade balance then began to decline rapidly. Between the middle of 1986 and the middle of 1988, the real volume of U.S. exports rose by 35 percent and the real trade deficit fell by nearly 40 percent.

6. Stabilizing the Dollar

A further decline of 15 to 20 percent in the value of the dollar during 1987 and 1988 might have eliminated the trade deficit before the end of the decade and saved the United States and the industrial world more generally from an increase in trade barriers and government managed trade (Feldstein, 1987a). If market forces had been left alone, the dollar might well have made that adjustment.

But that was not to be. The U.S. Treasury and the Federal Reserve worried that the falling dollar would substantially increase inflationary pressures in the United States. Foreign governments worried that the dollar's decline was undermining their ability to export to the United States and to compete with American imports in their domestic markets, thus increasing the risk of recession in their own countries. Instead of focusing on domestic monetary policies to achieve their desired macroeconomic goals, the finance ministers of the seven major industrial countries met at the French Finance Ministry in the Louvre in February 1987 and agreed to try to stabilize the dollar at approximately the then current level.[6] To do that, the United States raised short-term interest rates; the federal funds rate rose from 6.1 percent in February 1987 to 7.3 percent in October 1987. Although the dollar did continue to decline for a few months, the finance ministers and central banks eventually persuaded the financial markets that they were serious about preventing a further slide of the dollar -- even if that mean a substantial change in domestic monetary policy and, in the case of Japan, a backdoor purchase of dollar securities of the same magnitude as the U.S. current account deficit.

If there was ever an example of a sterilized intervention that was large enough to matter, it was the Japanese government's purchase of approximately $100 billion of dollar securities. I recall commenting to a Japanese Ministry of Finance official at the time that I thought his government would lose a substantial amount on that "investment" since the dollar was then at 150 yen per dollar. He replied that his government didn't mind the expectation of losing money since it would be cheaper than the cost of unemployment benefits and lost tax revenue that would result if the dollar were allowed to continue falling and weakening the

[6] I was and remain opposed to such attempts to target specific values of the dollar or to achieve "exchange rate stability" by diverting monetary policy from its task of managing domestic demand. See Feldstein (1987a), (1987d), (1987e), (1988c) and (1989).

ability of Japan to compete. Supporting the dollar would give Japanese industry time to develop new ways to be competitive at the higher yen-dollar rate that they knew was coming.

7. International Policy Coordination

Based on the apparent success of the Plaza meeting, Jim Baker pursued a policy of well-publicized "international policy coordination" meetings among the G-7 finance ministers. Frequent meetings of those ministers after September 1985 produced communiques promising to promote economic growth and currency stability with a variety of detailed promises for domestic policies, particularly in the U.S. and Japan.

In practice, discussion at the international policy coordination meetings focused on setting and revising exchange rate targets. Ironically, this was generally done without consulting the central banks and without any commitments on monetary policy among the finance ministers themselves.

I was (and remain) strongly critical of such public pursuit of policy coordination.[7] To the extent that such coordination meetings actually produced action to target exchange rates, it was necessary to sacrifice the domestic goals of monetary policy. These actions encouraged the tightening of monetary policy in the U.S. in 1987 that contributed to the 1987 stock market crash and to the easing of monetary policy in Japan that led to overvalued real estate and equity prices. The exchange rate targets themselves were also objectionable because they were generally set to achieve "stability" of whatever happened to be the current nominal rates rather than on any more objective basis.

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[7] See Feldstein (1988a), (1987b), (1987c), (1988b) and (1989).

In addition to their attempt to manage exchange rates, the international policy coordination meetings focused on encouraging macroeconomic expansion, emphasizing the interdependence among countries and the positive effect of expansion in one region on the level of GDP in the others. In fact, however the degree of such interdependence among the U.S., Europe and Japan is quite limited. An extra dollar of GDP in one area has only a very small impact through trade flows on the GDPs in the other regions, an effect that could easily be achieved or offset by domestic fiscal or monetary policy.[8]

The highly publicized policy coordination meetings of the finance ministers unfortunately served as a substitute for much needed policy changes at home. They gave domestic voters the impression that "something was being done" and offered the promise that international coordination would achieve stronger economic growth, greater price stability, and a more stable environment for international trade.

European and Japanese promises to stimulate their economies were, of course, not commitments to particular actions. If stronger growth did not materialize, it could always be blamed on external forces. Because of the Congressional form of government and the independence of the Fed, the U.S. Treasury could easily claim that it was powerless to make firm commitments. The undertakings of the U.S. Treasury at these meetings, which emphasized promises to reduce our budget deficit, simply corresponded to restatements of the budget requests that the Administration had submitted to Congress.

Despite these problems in defining and enforcing agreements about macroeconomic coordination, it was convenient to blame any problems of domestic economic performance on

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[8] See Feldstein (1983) and Stanley Fischer's estimates in Feldstein (1987b).

the failure of foreign governments to live up to their promises. International policy coordination not only failed to coordinate policy, but actually created international tensions among the participants.

It was, of course, naive to expect that governments would sacrifice their own national interest in the spirit of international coordination. Unlike trade or arms negotiations where the quid pro quo is explicit and tangible, macroeconomic coordination involves promises that are neither explicit nor tangible.

The frequent repetition of the theme of mutual interdependence eventually persuaded many in the United States that our economic performance depended more on decisions in Frankfurt and Tokyo than on decisions in Washington. This may have been a convenient excuse for U.S. officials, but it frightened the American public and financial investors in particular that an unwillingness of foreign governments to act in the American interest could do substantial damage to the American economy. The very public conflict between the United States and Germany in October 1987 over Germany's unwillingness to pursue a more expansionary policy was undoubtedly one of the factors that frightened financial markets and contributed to the stock market crash.

The stock market crash caused a temporary shift away from using monetary policy to target the dollar. Alan Greenspan, the recently appointed chairman of the Federal Reserve, announced at the time of the crash that the Fed would provide the liquidity needed to prevent the stock market collapse from becoming an economic downturn and the Treasury Secretary announced that economic policy would focus on the domestic economy, regardless of the consequences for the dollar. Interest rates were lowered and the dollar declined. The public displays of international policy coordination and the attempts to target the dollar were over for a while (Feldstein, (1987f)).

But by the middle of 1988 it was clear that the stock market crash would not precipitate a recession. The Federal Reserve began to raise interest rates and to withdraw the excess liquidity that had been provided after the crash. The Treasury resumed its old rhetoric about stabilizing the value of the dollar.

Many participants in the financial markets, having seen the United States and other key countries willing to use monetary policy to manage the dollar's exchange rate, accepted the governments' forecast that the dollar's value would remain in a relatively narrow range -- generally assumed to be 120 to 140 yen to the dollar and 1.7 to 1.9 marks to the dollar. The combination of this expected dollar stability and the higher interest rates that prevailed on dollar bonds than on yen bonds or German bonds, induced international financial investors to buy dollar bonds. Investors reckoned that if a dollar bond paid three percent more than a yen bond, the extra yield of more than 20 percent over seven years would more than offset any minor fluctuations of the dollar-yen rate that might occur over than time.

Economists and other analysts who emphasized the fundamental determinants of the exchange rate warned that the higher rate of inflation in the United States than in Japan, our substantial remaining trade deficit, and Japan's massive trade surplus meant that the dollar-yen exchange rates would eventually shift and probably by much more than enough to outweigh the 3 percent a year interest differential. But the preponderance of market participants were prepared to go along with the implicit promise of the finance ministers to stabilize the dollar. And as they bought dollar bonds, they bid up the value of the dollar.

This rise in the dollar caused those portfolio investors who trade currencies on a so-called "technical momentum basis" rather than on the basis of "fundamentals" to be attracted to even further dollar buying.

By the early summer of 1989 the dollar had risen in value to more than two marks and 150 yen. The improvement in the U.S. trade deficit had run out of steam and the outlook shifted to an increasing U.S. trade deficit in 1990. The attempt to use international coordination to stabilize the exchange rate had actually caused the exchange rate to move further from equilibrium and to worsen the U.S. trade deficit.

When the G-7 finance ministers met at the IMF-World Bank meeting in September 1989, they recognized publicly that the exchange value of the dollar had to decline. Although continuing to stress the desirability of stable exchange rates, their communique also noted (in the internally inconsistent manner not uncommon in such communiques) that the dollar was then "too high to be consistent with long term fundamentals." To leave little doubt about their meaning, the central banks of the G-7 countries engaged in extensive exchange market intervention during the following weeks, selling dollars in exchange for other currencies. The Federal Reserve also continued to ease monetary policy and to lower U.S. interest rates while foreign central banks raised their interest rates.

By the late fall, the interest rates on U.S. Treasury bonds and on German government bonds had reached equality. Investors could no longer justify buying dollar bonds instead of Deutschemark bonds because of the higher yields. The U.S. current account deficit was at an annual rate of more than $100 billion while Germany's current account surplus continued to exceed $50 billion. In that context, there was a sharp rise in the value of the DM, from 1.98 DM per dollar in June of 1989 to 1.68 DM per dollar a year later.

Although the yen also appreciated from its low point during the summer of 1989, it only rose enough by the end of the following year to return to its level at the time of the Louvre agreement despite the fact that the prices of tradable manufactured products had increased by 15 percent in the United States during that interval and had not increased at all in Japan. By achieving nominal currency stability at the level prevailing at the time of the Louvre, Japanese policy, encouraged and assisted by the United States, had caused the yen to fall 15 percent in real terms, exacerbating the bilateral trade imbalance and the associated political friction.

8. No More Twin Deficits

By 1990, the dollar and the trade deficit had resumed their decline. The overall national income measure of the trade deficit in 1990 was less than 1.5 percent of GDP. The budget deficit had also declined from its peak, but still represented three percent of GDP. This experience confirmed that the close parallel relationship between the budget deficit and the trade deficit was only a temporary one (Feldstein, (1992)). The decline in the dollar and the resulting decline in the trade deficit meant that the budget deficit was now crowding out domestic investment to a greater extent than it had before.

A country that has a low net rate of national saving will eventually have a correspondingly low net rate of national investment. At this time, the prospect for increasing both remains uncertain.

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