

The U.S. Dollar—Recent Developments, Outlook, and Policy Options

By Craig S. Hakkio and J. Gregg Whittaker

Widespread concern has been expressed about the strength of the U.S. dollar. While the sharp increase in the dollar since 1980 has contributed importantly to a lowering of inflation, many analysts argue that it has also contributed to the large trade deficit and to imbalances in the U.S. economy. Moreover, many analysts feel that the strength of the dollar cannot be sustained and that the dollar could fall precipitously. As a result of these concerns, some have argued for a reduction in the federal budget deficit, exchange market intervention, and increased protection for U.S. industry.

To achieve a better understanding of these concerns about the U.S. dollar and to discuss alternative policy recommendations for the dollar, the Federal Reserve Bank of Kansas City sponsored a two-day symposium on "The U.S. Dollar—Recent Developments, Outlook, and Policy Options." The symposium was held at Jackson Hole, Wyoming, on August

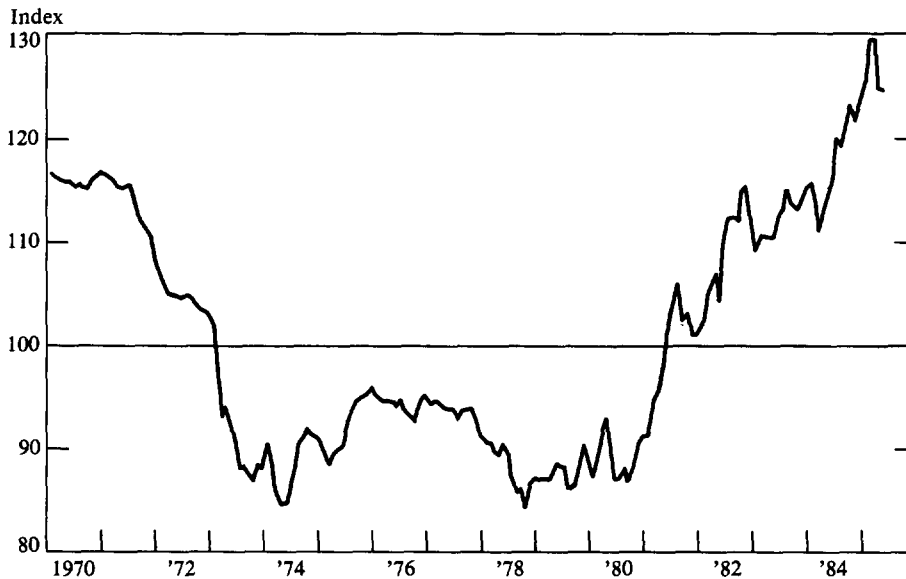
21-23, 1985. The consensus view at the symposium was that the dollar is overvalued and will eventually decline. However, the consensus view was not shared by all participants. There was disagreement on whether the dollar was actually overvalued and on how fast the dollar would, or should, decline.

This article summarizes the presentations and discussions of the participants at that symposium.¹ The organization of this summary

¹ Members of the program include Robert Roosa, partner at Brown Bros. Harriman & Co.; Richard Levich, associate professor of finance at New York University; Robert Lawrence, senior fellow at the Brookings Institution; William Branson, professor of economics at Princeton University; Jacob A. Frenkel, professor of economics at the University of Chicago; Robert Solomon, guest scholar at the Brookings Institution; John Flemming, economic advisor to the Governor of the Bank of England; Otmar Emminger, former president of the Deutsche Bundesbank; Walter Heller, professor of economics at the University of Minnesota; Paul Krugman, professor of economics at the Massachusetts Institute of Technology; Michael Mussa, professor of economics at the University of Chicago; Richard Cooper, professor of economics at Harvard University; Paul Craig Roberts, professor of political economy at Georgetown University; Jeffrey Sachs, professor of economics at Harvard University; Ronald McKinnon, professor of economics at Stanford University; C. Fred Bergsten, director of the Institute for International Eco-

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CHART 1
Real effective exchange rate of the U.S. dollar



follows the formal agenda of the symposium. The first section discusses recent developments in the value of the dollar, the second section reviews the international role of the dollar, the third section discusses the outlook for the dollar and various policy options for dealing with the strong dollar, and the final section summarizes the remarks of the overview panel.

Recent developments in the value of the dollar

Several issues relating to recent developments in the value of the dollar were addressed on the first day of the symposium.

nomics; William Poole, professor of economics at Brown University; and Henry Wallich, member, Board of Governors of the Federal Reserve System.

These included the strength and volatility of the dollar, and the causes and effects of the strong dollar. This section summarizes the views of the participants on these issues.

The strength of the dollar

In a paper entitled "Gauging the Evidence on Recent Movements in the Value of the Dollar," Richard M. Levich claimed that the recent rise of the dollar was unprecedented. Since 1980 the dollar had appreciated nearly 50 percent relative to the pound and the Deutsche mark. While the dollar's rise was dramatic, the nominal movements were similar to those of other major currencies during the period from March 1977 to November 1978. However, there has been no parallel for the appreciation of the dollar in conjunction with an ever growing current account deficit.

Chart 1 shows the behavior of the inflation-adjusted, or real, value of the dollar since 1970. The real value of the dollar provides a measure of the purchasing power of the dollar that takes into account movements in the nominal exchange rates and the inflation rate in the United States relative to its trading partners. A rise in the real value of the dollar means U.S. goods are more expensive relative to foreign goods. From 1970 to 1973, the real value of the dollar fell almost a third; from 1973 to 1980, the real value fluctuated in a narrow range between an index value of 82.0 and 97.0. Then, from its low in 1980 to its high in 1985, the real value of the dollar rose 47.5 percent. Since March 1985, the real value of the dollar has declined 10 percent. Although the dollar appears to be volatile, Levich pointed out that exchange rates are actually less volatile than many financial and real asset prices.

According to Levich, the extent of overvaluation—or misalignment of the dollar—is difficult to estimate, resulting in a wide range of estimates. One reason for the difficulty is that because the exchange rate is determined in a world capital market, a wide range of exchange rate behavior is possible. Another reason is that if the dollar is overvalued, it must be overvalued relative to some benchmark. Several benchmarks have been proposed, but all could be in error as much as 10 percent. Taking all factors into account, Levich estimated that the extent of dollar overvaluation could range from 20 percent to as much as 40 percent.

In discussing Levich's paper, Robert Lawrence agreed that while economists cannot provide good explanations for short-run movements in the exchange rate, they can explain longer run movements. After considering various explanations, Lawrence concluded that the federal budget deficit was the major factor

accounting for the strength of the dollar since 1980.

Lawrence then questioned whether the United States "should have let the dollar get as high as it did." He agreed that intervention in the foreign exchange market would not have been appropriate. However, he also noted that if the United States had fixed exchange rates, then the United States would have needed more inflation and much higher real interest rates to generate the current account deficit needed to finance the budget deficit. Therefore, he concluded that floating exchange rates enabled the United States to finance its budget deficit with less inflation and lower real interest rates. But it also meant that U.S. industries competing in world markets suffered as a result.

Causes of the strong dollar

In "Causes of Appreciation and Volatility of the Dollar," William H. Branson discussed why the dollar had risen almost 50 percent since 1980. Based on an analysis of the goods market and the asset market, Branson argued that the major cause of the historic increase in the real value of the dollar was the shift in the federal budget position that was announced in early 1981.

Equilibrium in the goods market requires that the budget deficit equal the excess of domestic saving over investment plus net foreign borrowing. The sources and uses of funds framework shows why this is true. Investment spending and the budget deficit are the two domestic uses of funds. Domestic saving and net foreign borrowing are the two sources of funds. Therefore, funds to finance investment spending and the budget deficit must come from either domestic saving or net foreign borrowing. This relationship is shown in Equation 1.

$$(1) \quad (G-T) = (S-I) + NFB$$

where G = government spending,

T = government tax revenues,

S = domestic private saving,

I = domestic private investment
spending, and

NFB = net foreign borrowing.

Using this model of equilibrium in the goods market, Branson argued that an increase in the budget deficit raised U.S. interest rates and raised the real exchange rate. A higher budget deficit must be financed by an increase in saving relative to investment, or an increase in net foreign borrowing. As the Treasury bid for funds to finance the budget deficit, interest rates rose. With the rise in interest rates, saving increased and investment was reduced. Since a current account deficit is financed by borrowing from abroad, the current account deficit must equal net foreign borrowing. Therefore, the real appreciation of the dollar—which increased the price of U.S. exports and decreased the price of U.S. imports—led to a current account deficit and an increase in net foreign borrowing.

Branson then showed that equilibrium in the financial markets also requires that an increase in the budget deficit lead to an appreciation of the dollar. Equilibrium in the financial market requires that the return to holding U.S. assets equal the return to holding foreign assets. The return to holding U.S. assets is the U.S. real interest rate plus the expected appreciation of the dollar. The return to holding foreign assets is the foreign real interest rate. Thus, if the budget deficit caused the U.S. interest rate to rise relative to the foreign rate, equilibrium

required that people expect the dollar to depreciate to offset the higher interest rate. Therefore, the dollar must have risen above its current level so that people would expect the dollar to depreciate back to its constant long-run level. As Branson put it, "What must go down in the future, must go up today."

Although the budget deficit did not worsen until 1982, interest rates and the exchange rate jumped in 1981 because people expected the budget deficit to worsen. The expected increase in the budget deficit meant people expected an increase in the value of the dollar and interest rates. Therefore, because interest rates and the dollar were expected to rise, they rose immediately.

Alternative explanations for the strength of the dollar were proposed by Branson and others. For example, a change in corporate or investment taxation, as well as financial deregulation, could have had effects similar to those attributed to the budget deficit. However, Branson found little evidence to support such a conclusion. The "safe haven" argument—that investors are attracted to the relative security of the United States—cannot explain simultaneous increases in the interest rate and the exchange rate. Consequently, Branson argued that while these arguments might have some credence, the dominant factor has been the budget deficit.

In discussing Branson's paper, Jacob A. Frenkel argued that the budget deficit could not be the only cause of the strong dollar. While agreeing that U.S. fiscal policy had a major effect on the dollar, he said the relationship between budget deficits and the value of the dollar has been ambiguous. Budget deficits are sometimes associated with a strong currency, sometimes with a weak currency. Therefore, he concluded that other factors must have also explained the rise in the dollar.

Frenkel then argued that U.S. monetary pol-

icy caused the initial increase in the real value of the dollar. Inflation had been increasing throughout the 1970s. When the Federal Reserve changed operating procedures in October 1979 to reduce inflation and inflation expectations, there was a sharp increase in interest rates and the value of the dollar. That is, actual monetary policy, not expected future fiscal policy, caused the dollar to rise in 1980.

Finally, Frenkel argued that tight fiscal policy abroad was also responsible for the strong dollar. While the United States was pursuing a loose fiscal policy, the United Kingdom, West Germany, and Japan were following tight fiscal policies. According to Frenkel, it was this combination of tight fiscal policy abroad and loose fiscal policy in the United States that contributed to the rise in the dollar.

Effects of the strong dollar

Robert Solomon, in "Effects of the Strong Dollar," argued that the appreciation of the dollar had a significant effect on the U.S. current account deficit. The U.S. current account changed from a near-zero balance in 1980 to a deficit of more than \$100 billion in 1984. Part of this deterioration was due to a real appreciation of the dollar that caused the price of U.S. goods to rise and the price of foreign goods to fall, leading to a shift in demand from U.S. goods to foreign goods. Solomon estimated that the appreciation of the dollar accounted for about two-thirds of the increase in the U.S. current account deficit from 1980 to 1984.

Appreciation of the dollar also contributed to the decline in U.S. inflation by reducing the price of imports. Inflation in the United States, as measured by the consumer price index, averaged 6.0 percent between 1981 and 1984. In the absence of dollar appreciation,

Solomon estimated that inflation would have averaged 7.6 percent. That is, the strong dollar reduced U.S. inflation by an average of 1.6 percentage points between 1981 and 1984.

According to Solomon, the net foreign borrowing associated with the current account deficit meant that U.S. interest rates were lower than they would have been without the net foreign borrowing. As shown in equation 1, a budget deficit and domestic investment are financed by domestic savings and net foreign borrowing. If the United States could not borrow from abroad, then the entire budget deficit would have to be financed from domestic sources. As the Treasury bid for domestic funds, interest rates would rise and crowd out domestic investment. Therefore, by supplementing domestic savings, net foreign borrowing enabled the budget deficit to be financed at lower interest rates.

Solomon also argued that the United States is not becoming a two-tiered economy, with an expanding service sector and a depressed manufacturing sector. According to Solomon, the ratio of goods output to GNP has been relatively stable since 1950. The fall in manufacturing employment is part of a long-term trend, in which rising productivity, not declining production, has caused employment in manufacturing to fall relative to total employment.

Solomon saw the strong dollar and the large U.S. current account deficit as having a stimulative effect on foreign economies. As noted above, the current account deficit reflected a shift in demand from U.S. goods to foreign goods. Therefore, the current account deficit increased the demand for foreign goods, which stimulated foreign production.

John Flemming discussed Solomon's paper from the point of view of a foreign monetary policy advisor. In discussing capital inflows to the United States, Flemming said the global

supply of savings could not be taken as given and then split between domestic and foreign investment. For example, he felt that the U.S. budget deficit was not the only reason for the U.S. capital inflow. The dismantling of exchange controls in the United Kingdom was also important in accounting for the U.K. capital outflow to the United States. Reducing obstacles to capital outflow meant higher interest rates and a lower exchange rate for the United Kingdom, which led to higher savings and lower investment in the United Kingdom.

Flemming also discussed the role of the dollar-pound exchange rate in the conduct of monetary policy in the United Kingdom. In conducting monetary policy, Flemming stated that the Bank of England uses the effective exchange rate—the average exchange value of the pound relative to the currencies of all of the United Kingdom's trading partners—rather than the dollar-pound exchange rate. However, he pointed out that not all changes in the effective exchange rate are treated the same—changes in all components of the effective rate call for responses different from those if only one rate changes a great deal. Flemming disagreed with Solomon's argument that a fall in the dollar would allow foreign countries to reduce their interest rates and stimulate their economies. He doubted that the United Kingdom would reduce its interest rates if doing so would increase the U.K. inflation rate.

The international role of the dollar

Otmar Emminger, former president of the Deutsche Bundesbank, discussed "The International Role of the Dollar" in a luncheon address.² He argued that the dollar is the most

important price in the world economy, because of its effects on the world economy. He then discussed the role of the dollar in the world economy, the impact of the misaligned dollar, and the future prospects for the dollar.

Emminger argued that the dollar is a world currency, and therefore must be freely floating. It is the most important currency for intervention in the foreign exchange market, and for trade and financial transactions. In addition, more than any other currency, the dollar is determined by capital movements. Therefore, Emminger argued that the dollar exchange rate must be flexible. Any fixed exchange rate would eventually be "toppled by irresistible capital flows."

The strength of the dollar had both positive and negative effects on the world economy, according to Emminger. The strong dollar initially benefited the U.S. economy by keeping the economy from overheating in 1983 and 1984, by reducing inflation, and by keeping interest rates lower than they otherwise would have been. But, the strong dollar and U.S. trade deficit are now a drag on economic growth. The situation in the other industrial countries developed in reverse order. The strong dollar hurt foreign economies initially since high U.S. interest rates forced other countries to raise their interest rates. But, the strong dollar and U.S. trade deficit are now a stimulus to foreign economies and interest rates in those countries are no longer so closely tied to U.S. interest rates.

Emminger concluded by saying that the dollar will eventually decline. He felt that the current strength of the dollar could not be justified, and therefore he expected a moderate decline in the value of the dollar. However, there is the risk that the dollar might fall too fast or overshoot its long-run level. Since the Federal Reserve cannot solve the problem of the strong dollar by itself, Emminger con-

² His address is published as the second article in this *Economic Review*.

cluded that the U.S. budget deficit must be reduced.

Outlook and policy options for the strong dollar

The outlook for the dollar and policy options for dealing with its strength were discussed on the second day of the symposium. It was concluded that the dollar would decline sometime in the future. Some participants thought the Federal Reserve should intervene in the foreign exchange market to bring the dollar down quickly. However, others thought the dollar should decline only gradually. Finally, alternative exchange rate systems, designed to respond optimally to various disturbances, were discussed. This section summarizes the views of the participants on these issues.

Outlook for the strong dollar

In "Is the Strong Dollar Sustainable?" Paul Krugman argued that the dollar's strength represents a speculative bubble soon to burst. Krugman argued that the dollar was overvalued relative to its long-run level, which implied an implausible buildup of U.S. debt. Therefore, he concluded that the current strength of the dollar was not sustainable, and the dollar would plummet some time in the future.

According to Krugman, in May 1985 the market implicitly expected the dollar to decline 2.4 percent a year for the next several years. The reason was that Krugman estimated that long-term real interest rates were 2.4 percent higher in the United States than in other countries. Therefore, financial market equilibrium required that the market implicitly expect the dollar to decline by 2.4 percent a year, the difference between U.S. and foreign real inter-

est rates. Otherwise, there would have been an opportunity for profit from investing in U.S. securities.

If the dollar declined at a rate of 2.4 percent a year, then the dollar would be too high for too long, leading to an infeasible level of foreign debt. As long as the dollar remains strong, the United States will run a current account deficit. If the dollar was 33 percent overvalued, as Krugman assumed, and if market expectations of a 2.4 percent depreciation in the dollar were correct, then Krugman estimated that the dollar would remain overvalued for 23 years. This would mean that the United States would continue to run current account deficits for 23 years. However, since a current account deficit is financed by net foreign borrowing, a current account deficit means an increase in the foreign debt of the United States. Therefore, as long as the dollar is overvalued, the United States will accumulate foreign debt, eventually reaching a level of debt equal to 45.7 percent of GNP. Krugman believed that this level of debt, comparable to that of Mexico and Brazil, was infeasible.

On the basis of this analysis, Krugman concluded that the market is irrational and that the strength of the dollar cannot be sustained. His reasoning was that the implicit expectation of a 2.4 percent decline in the value of the dollar implied a debt to GNP ratio of 45.7 percent. But, Krugman believed this level of debt was infeasible. He concluded, therefore, that the current value of the dollar was not justified by economic fundamentals: the dollar was on a speculative bubble. Since the current value of the dollar was not justified, the dollar must fall—sometime. A fall in the dollar, by reducing current account deficits now and in the future, would prevent the buildup of an infeasible level of foreign debt. Unfortunately, Krugman could not say when the decline would occur or by how much the dollar would

fall. All he could say with assurance was that when the dollar fell, the fall would reveal its speculative component either by plunging for no apparent reason or by overreacting to some stimulus.

Krugman admitted that the safe-haven argument mitigated the consequences of these calculations. While this argument—that the dollar is strong because investors view the United States as a safe place to invest their funds—may be relevant for the value of the dollar relative to the Latin American currencies, Krugman argued that it had little relevance for the value of the dollar relative to the currencies of the industrialized countries.

Some have argued that since the government would not allow the strong dollar to endure indefinitely, forecasts of an infeasible level of foreign debt are irrelevant. For example, suppose there is a possibility that the government will reduce its budget deficit so that the dollar falls. If this possibility is strong enough, then the possibility of accumulating a large amount of foreign debt would be small. Although the United States may accumulate a large amount of foreign debt, it is unlikely to do so. Therefore, it is argued that the previous analysis is irrelevant for practical purposes.

Krugman contended that the possibility of government intervention strengthens his argument that the dollar is on a speculative bubble. The possibility of intervention must be accounted for in market forecasts. That is, the U.S. real interest rate must compensate for the expected depreciation of the dollar and for the possibility of government intervention. Therefore, given an interest rate differential of 2.4 percent a year, the possibility of government intervention implies lower expected rates of dollar depreciation. If the depreciation is less than 2.4 percent a year, then the dollar will remain overvalued longer and, consequently, will accumulate even more foreign debt.

Michael Mussa, in discussing Krugman's paper, disagreed with the assertion that the dollar is on a speculative bubble; he argued that economic factors explain the current strength. Mussa agreed with Frenkel that factors other than the budget deficit were critical in explaining the strength of the dollar. Much of the dollar's strength, he said, arises from the increased confidence in the anti-inflationary monetary policy adopted in October 1979. A variety of temporary factors have also caused the United States to run a current account deficit and the dollar to be strong. As those factors abate, the current account deficit and the value of the dollar will fall. For these reasons, Mussa argued that the current value of the dollar was explainable by economic factors. Therefore, Mussa saw no reason for asserting that the dollar was on a "speculative bubble."

Even though Mussa did not believe the dollar was on a speculative bubble, he did agree with Krugman that the dollar will fall in the future, but by less than Krugman asserted. Mussa said that the dollar was undervalued in 1980 and therefore using 1980 as a base year was misleading. Also, economic factors imply that the United States should run a current account deficit in the long run.³ These two factors mean the dollar did not have to fall as far as Krugman assumed. Mussa also said that assuming a constant real interest rate of 8 percent, as Krugman did, was not realistic. With

³ Mussa argued that the population of the United States is growing faster than the populations of Western Europe and Japan. Therefore, the United States will need more investment than Western Europe and Japan to maintain a constant capital to labor ratio. Also, since the average age in Western Europe and Japan is rising faster than in the United States, Western Europe and Japan will need high savings rates to support their older, retired workers. Therefore, since investment should be high in the United States and savings should be high in Western Europe and Japan, the United States should run a "structural" current account deficit.

a real interest rate of 5 percent, Mussa found that the level of debt implied by Krugman's analysis was not excessive. Therefore, he did not expect the dollar to plummet for this reason. In addition, Mussa noted that Krugman's estimate of a \$1 trillion foreign debt was only 1 or 2 percent of U.S. wealth and, therefore, not excessive.

U.S. policy options for dealing with the strong dollar

In "The U.S. Payments Deficit and the Strong Dollar: Policy Options," Richard N. Cooper discussed the various policy options for countering the effects of the strong dollar and the large U.S. current account deficit. He agreed with Branson that the budget deficit was the major cause of the strong dollar. He also agreed with Frenkel and Mussa that tight monetary policy led to high interest rates and the strong dollar. Therefore, he proposed a reduction in the budget deficit and an easing of monetary policy to reduce the value of the dollar. Protectionism, he said, is not the solution.

Using a framework similar to Branson's, Cooper concluded that a reduction in the budget deficit was needed to reduce the value of the dollar and the current account deficit. However, he argued that a reduction in the current budget deficit would have undesirable side effects. Specifically, a sharp reduction in the budget deficit, through a decrease in government spending or an increase in taxes, would push the economy into a recession.

Cooper concluded, therefore, that the most effective policy option was for the United States to gradually reduce its budget deficit and immediately ease monetary policy. A gradual reduction in the budget deficit would slowly reduce the demand for funds, reducing U.S. interest rates and the value of the dollar,

thereby allowing for a gradual reduction in the current account deficit. An easier monetary policy would further reduce U.S. interest rates and the value of the dollar. Given the lags inherent in the economy, a decline in the dollar would eventually stimulate the manufacturing and agricultural sectors of the economy, offsetting the recessionary effects of a gradual reduction in the budget deficit.

Cooper also recommended that the Federal Reserve intervene in the exchange market, despite the possible inflationary consequences. He argued that the Federal Reserve should increase the money supply by purchasing foreign securities, instead of domestic securities. This would reduce the value of the dollar directly. He also argued that such a move would have symbolic significance, showing that the Federal Reserve was concerned about the dollar and not simply printing money to finance the deficit. Cooper argued that the price increases resulting from a fall in the dollar are inevitable, and therefore should occur as soon as possible.

According to Cooper, protectionist policies, such as an import surcharge or a tax on interest payments to foreigners, would be inappropriate and ineffective. They would be inappropriate, he said, because the dollar would rise instead of fall, making U.S. exporters and farmers worse off. Also, although protectionist policies might be installed as temporary measures, they would probably become permanent. Moreover, foreign repercussions and emulations are likely, which could offset any U.S. gains and leave the world worse off than before. A tax on interest payments to foreigners would be ineffective because it would be difficult to effectively implement such a tax in an efficient world capital market.

The changes in Japanese policy many seek—trade liberalization, export taxes, and restrictions on capital outflows—would not be

effective in reducing the Japanese trade surplus with the United States. Liberalization of Japanese trade might reduce the Japanese trade surplus, but Cooper argued that the result would probably be a change in the composition of the trade surplus rather than a reduction in its size. Moreover, the U.S. trade deficit would not necessarily fall; that would depend on how other countries respond. An export tax designed to reduce Japanese exports to the United States would be counterproductive, according to Cooper. Such a tax would reduce the Japanese budget deficit. Also, because Japanese firms would likely cut prices to remain competitive, profitability would be reduced, which would reduce Japanese investment and income. Therefore, Cooper argued that an export tax would increase the Japanese trade surplus, not reduce it. Finally, Cooper argued that although restrictions on capital outflow from Japan might reduce the Japanese trade surplus and depreciate the dollar, it would run counter to pressure for liberalization of the Japanese capital markets.

Fiscal expansion abroad would help to reduce the value of the dollar, according to Cooper. As Frenkel noted, tight fiscal policy by foreign governments contributed to the rise of the dollar. Easier fiscal policy by Japan, Germany, and the United Kingdom would reduce the value of the dollar by stimulating the economies of these countries. With more vigorous economic growth, domestic and foreign investment would be attracted and their currencies would appreciate relative to the dollar. However, Cooper noted that these policy suggestions require action by foreign governments that might not be willing to undertake them.

In discussing Cooper's paper, Paul Craig Roberts argued that restrictive monetary policy and the Reagan administration tax cuts led to the strong dollar. The rapid fall in inflation in

1981 and 1982, not loose fiscal policy, caused the large budget deficits, he said. The reduction in inflation increased the demand for dollars by making the dollar a more desirable currency. With no change in the supply of dollars, the value of the dollar rose. The Reagan tax cuts also made the United States a more attractive place to invest. This increased the demand for U.S. assets and led to an increase in the value of the dollar.

As a result of his analysis, Roberts agreed that there should be a reduction in the budget deficit and an easing in monetary policy. Whereas Cooper argued for a reduction in the budget deficit without specifying how the reduction should be made, Roberts argued that the budget deficit should be reduced by cutting federal expenditures, not by increasing taxes. A reduction in government spending would make the United States more competitive, while an increase in taxes would make the United States less competitive.

Alternative exchange rate system

Jeffrey D. Sachs considered various national and global exchange rate policies in his paper entitled "The Case for More Managed Exchange Rates." Many observers have viewed the appreciation of the U.S. dollar after 1980 as a failure of the floating exchange rate system and have called for a return to a more managed global exchange rate system. Sachs discussed the arguments for and against a managed exchange rate system.

The choice of an optimal exchange rate policy depends on the source of the disturbance. Policies that seem appropriate for some types of shocks are not appropriate for other types of shocks. For example, fixed exchange rates are best if most disturbances are monetary in origin. Flexible exchange rates, however, are best if most disturbances are due to shifts in

the demand for goods. Sachs argued that the large swings in global economic activity since 1971 can be traced to synchronized shifts in the money supplies of the major countries. A major reason for these synchronized shifts was a joint attempt by the major non-U.S. countries to intervene in support of the dollar in the 1970s and in support of their own currencies in 1980 and 1981. However, Sachs argued that this did not mean most future shocks would also be due to synchronized shifts in the money supplies of the major countries. Therefore, the exchange rate system that is chosen must be able to withstand the wide variety of shocks that could hit the economy.

Sachs argued that a managed exchange rate system can enforce policies that benefit all countries. For example, a country faced with domestic inflation has an incentive to pursue a tight monetary policy and a loose fiscal policy. The hope is that its currency will appreciate without a recession. But, if all countries attempt to fight inflation in this way, their efforts would cancel out. As a result, all countries would suffer from large budget deficits and tight monetary policies. Since a fixed exchange rate would force every country to have the same inflation rate, a managed fixed exchange rate system would allow countries to decide together on less restrictive monetary policies. Another argument for a managed exchange rate system is that the current system has an inflationary bias. However, an international gold standard, for example, would eliminate discretionary monetary policy and thereby reduce the inflation bias.

Ronald McKinnon, in discussing Sachs' paper, argued that Sachs assigned too much responsibility to the Federal Reserve. One of Sachs' proposals was that the Federal Reserve stabilize nominal GNP. McKinnon argued that this is not technically feasible. Instead, he felt that the goal of the Federal Reserve should be

to ensure price stability in the long run. To do this, the Federal Reserve should stabilize the exchange rate or the growth of money. McKinnon felt that such a policy would be technically feasible.

In fact, McKinnon argued that the Federal Reserve should use the exchange rate as a target for monetary policy for two reasons. First, the exchange rate is available daily. Second, he argued that changes in the exchange rate accurately predict changes in future inflation. McKinnon argued that a rise in the value of the dollar reflects an increase in the demand for U.S. assets. If the Federal Reserve did not accommodate the increased demand, then the U.S. price level would decline in the future. Therefore, he concluded that when the dollar rises the Federal Reserve should increase the money supply to accommodate the increase in demand; conversely, when the dollar falls, the Federal Reserve should decrease the money supply to offset the decrease in money demand.

An overview

The symposium ended with three prominent observers of the international monetary system offering their views on the strong dollar and the policy options for dealing with it. The three overview panelists were C. Fred Bergsten, director of the Institute for International Economics; William Poole, professor of economics at Brown University and former member of the Council of Economic Advisors; and Henry Wallich, member of the Board of Governors of the Federal Reserve System.

C. Fred Bergsten believed the dollar is massively overvalued, a continued drag on the economy, and unsustainable. He stated that the dollar is approximately 30 percent overvalued. This overvaluation means the United States will continue running current account

deficits that will be a drag on economic growth. Bergsten argued that the strength of the dollar cannot be sustained, however, because the strong dollar and associated current account deficit imply an implausible level of debt accumulation. He did not believe foreigners would be willing to continue providing sufficient funds to the United States. In addition, he argued that a major risk associated with the strong dollar is the outbreak of trade protection.

As a result of this assessment, Bergsten argued that the dollar and the current account deficit must fall. He stated that the merchandise balance of trade would need to move into surplus in order to finance the net interest cost of the high level of foreign debt and to maintain current account balance. Such an improvement would require a fall in the dollar and must come from both domestic and foreign sources. Domestic export industries, hurt by the rise in the dollar, will have to provide some of the improvement. Foreign countries that are currently running surpluses would need to run deficits.

To deal with the strong dollar, Bergsten advocated a reduction in the budget deficit over three to five years, an easing of monetary policy, and stimulation of foreign economies. However, he did not see much action on the budget deficit or stimulation of foreign economies. Therefore, he recommended that the Federal Reserve engineer a rapid and substantial decline in the value of the dollar. When the dollar moves, the Federal Reserve should "lean with the wind." He also argued that the authorities should make it clear that they want a dollar correction. Bergsten argued that the inflationary consequences of this policy are temporary, lasting only as long as the dollar fell. Finally, he also recommended that Japan limit its capital outflows.

William Poole disagreed with the consensus

view at the conference. He did not believe the dollar was overvalued. The strength of the dollar was due to the nature of the 1981 change in fiscal policy, and not the budget deficit per se. The 1981 change in fiscal policy cut business taxes. In addition, the reduction in inflation led to a further cut in the effective corporate tax rate through the interaction of inflation with existing tax laws. Both of these factors led to an increase in the after-tax rate of return on new business investment. According to Poole, the increase in the after-tax rate of return accounted for about two-thirds of the increase in the value of the dollar.

On the basis of this analysis, Poole felt chances were about even that the dollar would rise further or fall. The change in business taxes and lower inflation were permanent changes in the economy that required permanent changes in the real value of the dollar. As long as business taxes are not raised and as long as inflation remains subdued, Poole saw no reason for the dollar to fall. In fact, if the budget deficit crisis could be "satisfactorily" solved, he believed the dollar might rise further.

Governor Wallich agreed with much of the consensus view expressed at the symposium. He felt the strong dollar and associated current account deficit benefited the rest of the world. And by helping finance the large federal budget deficit, the strong dollar kept U.S. interest rates lower than they otherwise would have been. Finally, less developed countries also benefited from the strong dollar and lower U.S. interest rates.

Contrary to Cooper and Bergsten, Wallich felt that a rapid fall in the dollar could be harmful for two reasons. First, a rapid fall in the value of the dollar, without action on the budget deficit, would be counterproductive. It would lead to higher inflation and higher

interest rates. Second, although some argued that the rise in inflation would be temporary, Wallich said the rise in inflation would be built into wages and prices and would become permanent.

Wallich also disagreed with McKinnon's proposal that the Federal Reserve use the exchange rate as the sole target for monetary policy. He argued that the Federal Reserve has several targets—inflation, the state of the economy, and the exchange rate.

Wallich concluded that a reduction in the budget deficit was the only real solution to the strong dollar. Since he felt that the budget deficit was the major cause of the strong dollar, he concluded that a reduction in the budget deficit was needed to reduce the value of the dollar. Without action on the budget deficit, monetary policy can do little to reduce the real value of the dollar. Finally, Wallich was opposed to protectionist policies as a cure for the strong dollar.

Conclusions

The consensus view was that the dollar would eventually decline, but participants disagreed on how far the dollar would decline. They also disagreed on whether the dollar was on a speculative bubble, or whether its strength could be explained by fundamental factors. Most participants felt the federal budget deficit was the main cause of the dollar's strength and should be reduced. However, several participants also pointed to tight monetary policy in the United States, to tight fiscal policy abroad, and to the Reagan tax cuts. Since low inflation and low tax rates benefit the economy, no one suggested reversing these policies. However, some participants felt that the Federal Reserve should ease monetary policy to engineer a rapid decline in the dollar. Finally, there was general opposition to trade restrictions as a means of reducing the dollar and the trade deficit.

The U.S. Dollar—Recent Developments, Outlook, and Policy Options

To examine the strength of the U.S. dollar, the Federal Reserve Bank of Kansas City brought together several leading economists to discuss recent developments, outlook, and policy options. The symposium was held August 21-23, 1985, at Jackson Hole, Wyoming. Contents of the symposium proceedings are listed below.

Moderator: *Robert Roosa*

Gauging the Evidence on Recent
Movements in the Value of the Dollar,
Richard M. Levich
Commentary, *Robert Z. Lawrence*

Causes of Appreciation and Volatility
of the Dollar, *William Branson*
Commentary, *Jacob A. Frenkel*

Effects of the Strong Dollar,
Robert Solomon
Commentary, *John S. Flemming*

The International Role of the Dollar,
Otmar Emminger

Moderator: *Walter Heller*

Is the Strong Dollar Sustainable?
Paul R. Krugman
Commentary, *Michael L. Mussa*

The U.S. Payments Deficit and the Strong
Dollar: Policy Options,
Richard N. Cooper
Commentary, *Paul Craig Roberts*

The Case for More Managed Exchange
Rates, *Jeffrey D. Sachs*
Commentary, *Ronald I. McKinnon*

Overview Panel, *C. Fred Bergsten,*
William Poole, and Henry Wallich

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the 1980s (1982)*

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