

Why the Dollar Needs to Fall Further

Robert Blecker

The author presents a comprehensive analysis of why the U.S. dollar is still too high. A lower dollar, he argues, is vital to sustain future growth. He believes a coordinated policy, led by the U.S. Treasury and the Federal Reserve, is required to bring the dollar down. Pressure must also be placed on Asian states to restrain them from keeping the value of their currencies so low.

NEWSPAPERS OF THE DOLLAR'S DRAMATIC FALL against the euro and certain other currencies in the first half of 2003 sent shock waves through the international financial community. By late May 2003, the euro had risen above its initial level (on January 1, 1999) of about \$1.15 per euro, after falling to \$0.86 at its low point in February 2002. Signaling an apparent shift in U.S. policy, Treasury Secretary John Snow announced his acceptance of a market-driven lower value of the dollar at a meeting of G-8 finance ministers in mid-May.¹ Only two weeks

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later, however, President George W. Bush reversed the administration's gears by reiterating his support for a "strong dollar policy" at the G-8 summit in Evian, France, after which the dollar stabilized.

The recent drop in the dollar was a development both necessary and welcome. By early 2002, the dollar had reached a level that was unsustainable in financial markets and injurious to the domestic U.S. economy. Nevertheless, the dollar's decline to date has been too limited to make much of a dent in the country's mammoth trade deficit and growing international debt. Thus far, its fall has been limited in two important ways. First, the dollar has lost only part of the value it gained relative to the "major" currencies such as the euro (and its predecessors) since 1995. Second, many important U.S. trading partners have fixed or managed exchange rates that do not respond to the same market forces that have generated the recent decline in the dollar. Compared to these other currencies—which belong to developing nations that account for nearly half of U.S. trade—the dollar has actually risen, not fallen, in the past year. As a result, the average value of the dollar relative to all currencies has not declined nearly enough to undo the damage caused by misaligned exchange rates over the past eight years.

For these reasons, the Bush administration's revival of "strong dollar" rhetoric is a step in the wrong direction. U.S. economic officials need to encourage the dollar to fall further, using methods that include pressuring countries that artificially undervalue their currencies to abandon their manipulation of exchange rates. At the same time, a falling dollar poses a number of potential problems, including the risk that it could fall too far too fast, thus precipitating a financial crisis, or that the rise in foreign currencies will stymie economic growth in Europe and elsewhere. Hence, more active management of the dollar's decline and

greater cooperation with U.S. trading partners are essential to ease the dollar down in a stable fashion and to ensure that the outcome of this currency realignment is a renewal of global growth instead of a collapse of global demand.

Causes of the Dollar's Rise

The sharp rise in the U.S. dollar from 1995 to 2002 and its partial fall in 2002–3 are only the latest episodes in the gyrations of the dollar's value since the major industrialized nations switched to floating exchange rates in 1973. As shown in Figure 1, the dollar fell for most of the 1973–79 period, but then rose to new heights in 1980–85, before falling precipitously in 1985–87. After that, the dollar had a more gradual declining trend through mid-1995, when there was another abrupt reversal. The dollar began rising, reaching a new peak in early 2002, at which point its value returned to levels not seen since the mid-1980s.

The decline in the dollar since early 2002 has reversed only part of the increase after 1995. By the “broad” measure shown in Figure 1, which includes most other global currencies, the dollar rose by 34 percent between July 1995 and February 2002, and has fallen by only 9 percent since. Figure 1 makes it clear that the dollar's fall thus far in 2003 has taken it back only to about where it was in 1999, not to its much lower level of the early and mid-1990s. Also, while the dollar briefly had a higher value in the mid-1980s, it has been more persistently overvalued in the last several years than it was during that earlier episode.

Although there are many explanations for the dollar's rise in the late 1990s, the most fundamental one is the strength of the U.S. economy during the “new economy” boom, at a time when most of the rest of the world was relatively stagnant. The dollar's strength was, to a large extent, the mirror image of severe economic weaknesses abroad that resulted in falling values of foreign currencies. Japan's decade of stagnation, continental

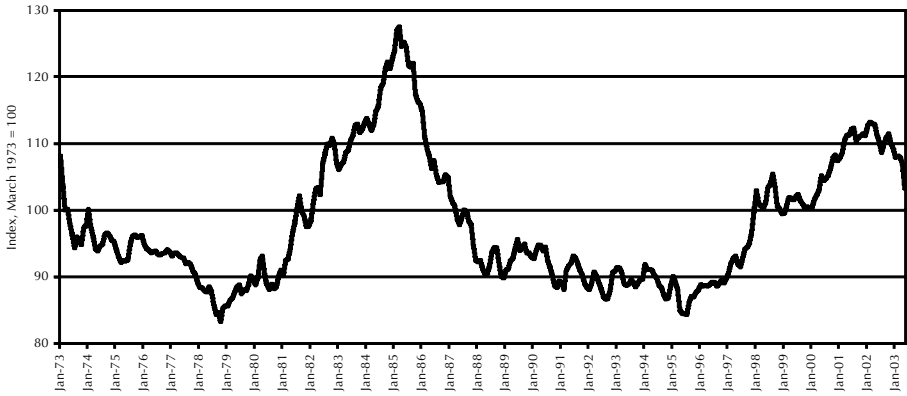


Figure 1. Real Value of the U.S. Dollar, Monthly Broad Index, January 1973 to January 2003

Source: Federal Reserve Statistical Release H.10, Foreign Exchange Rates, downloaded from www.federalreserve.gov/releases/h10/Summary/.

Note: Data for January 2003 are preliminary.

Europe's slow growth and high unemployment, the Asian financial crisis, and the subsequent financial turmoil in other countries from Russia to Argentina led to massive flight of capital funds out of those countries and into the one "safe haven" in the global economy, the United States. Meanwhile, in 1995–2000 the U.S. economy enjoyed six consecutive years of rapid growth with low inflation. A robust business climate and a booming stock market helped to attract investment into U.S. financial markets, thus pushing up the value of the dollar. As Figure 2 shows, rapidly increasing foreign holdings of U.S. financial assets throughout 1996–2002 drove the dollar to ever-higher heights in each succeeding year.²

In addition, several specific events contributed to stimulating dollar appreciation. In the mid-1990s, the governments of several important countries, especially Japan and China, intervened to halt the dollar's previous decline and to prevent their own currencies from appreciating further.³ These interventions effectively started the dollar on its new upward course. Another

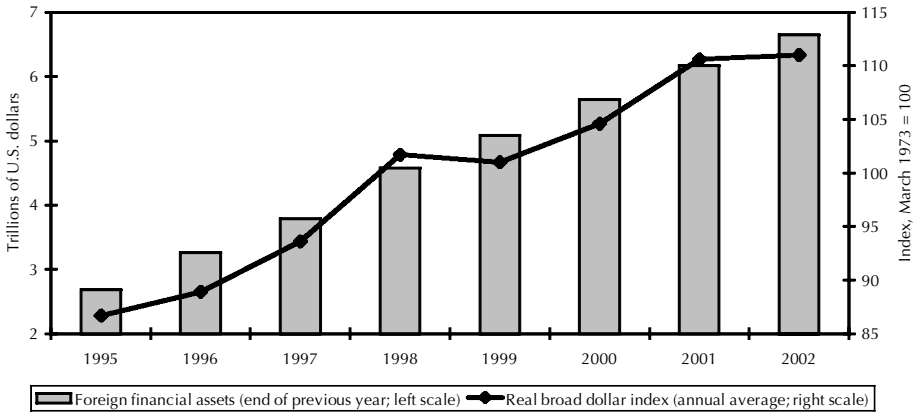


Figure 2. Foreign Financial Assets in the United States and the Value of the Dollar, Annually, 1995–2002

Sources: Federal Reserve Statistical Release H.10, Foreign Exchange Rates (see Figure 1); U.S. Department of Commerce, Bureau of Economic Analysis, Net International Investment Position, www.bea.gov/bea/di/intinv1976_2001.xls; and author’s calculations.

important event was the Asian financial crisis of 1997–98, the importance of which can be better understood if we distinguish the dollar’s exchange rate versus the “major currencies” of the other industrialized countries and what the Federal Reserve calls America’s “other important trading partners,” i.e., developing nations and transition economies.

Figure 3 (which focuses on the period since 1990) shows the strikingly different behavior of the dollar compared with these two groups of currencies.⁴ Compared to the “major” currencies (the euro and its predecessors, plus the Japanese yen, British pound, and a few others),⁵ the dollar started rising in mid-1995 and trended upward until February 2002. Since that time, the dollar has fallen 17 percent versus these currencies, but this represents a loss of only one-third of the 51 percent increase in the value of the dollar relative to those currencies between April 1995 and February 2002.

Compared to the other (nonmajor) currencies, however, the

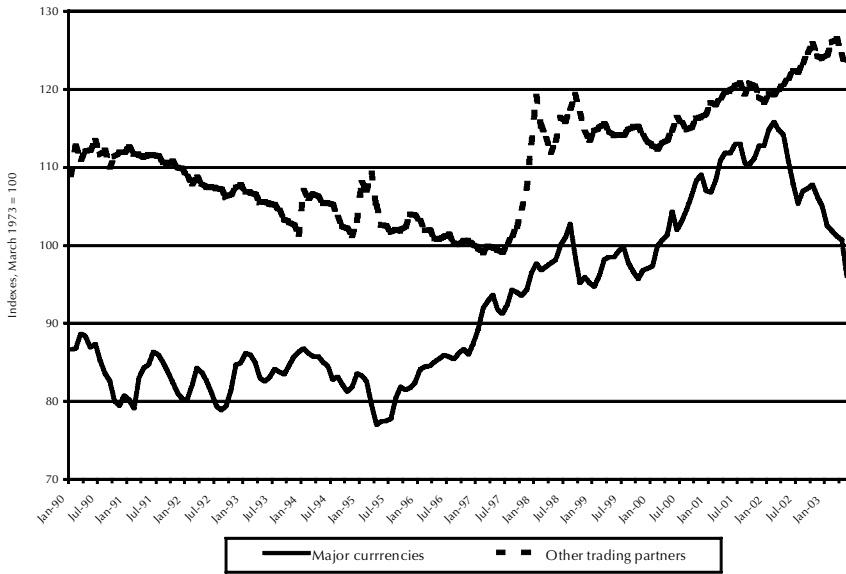


Figure 3. Real Value of the U.S. Dollar, Monthly Indexes for Major Currencies and Other Trading Partners, January 1990 to January 2003

Source: Federal Reserve Statistical Release H.10, Foreign Exchange Rates (see Figure 1).

Note: Data for January 2003 are preliminary.

dollar did not begin to rise until the Asian financial crisis of 1997–98, which led to the sudden collapse or devaluation of several important currencies in Asia and elsewhere (notably the Thai baht, Taiwanese dollar,⁶ Korean won, Indonesian ruppiah, Malaysian ringgit, Philippine peso, and Russian ruble). As a result, the dollar jumped in value relative to the “other” currencies in 1997–98. Most of the Asian currencies that initially collapsed began to stabilize by 1999, but subsequent currency crises in other developing countries (such as Brazil, Turkey, and Argentina) and smaller depreciations elsewhere (e.g., Mexico) have led the dollar to rise even higher relative to these other currencies. As of May 2003, the dollar was 23 percent higher compared to these (developing country) currencies, compared with its low point (relative to the same currencies) in 1997, and it shows no sign of a sustained fall (see Figure 3).

These other currencies represent countries that account for nearly half of overall U.S. trade and more than half of the U.S. trade deficit. Thus, the dollar's continued strength relative to these currencies has imparted a significant upward thrust to the overall value of the dollar and has had a notable impact in worsening the trade deficit. In effect, *the dollar is still rising and not falling compared to the currencies of countries accounting for most of the nation's trade deficit.*

A few developing countries (such as Argentina) have suffered more recent financial crises that have made their currencies plummet in value. But the main reason the dollar has stayed so high relative to the "other" currencies—especially those of the East Asian countries that have large trade surpluses with the United States—is that many of their governments follow interventionist policies in currency markets that short-circuit the type of market correction in the dollar's value now occurring with the euro and other major currencies.

Many East Asian countries either peg their exchange rates at artificially low values or intervene heavily to keep their currencies undervalued relative to the U.S. dollar (the latter policy is also followed by Japan, which issues a "major" currency). Such manipulative exchange-rate policies are pursued as part of an export-led growth strategy that fosters chronic trade surpluses with the United States and hence effectively exports unemployment to this country. Not coincidentally, the most egregious offenders in this regard account for disproportionately large shares of the U.S. trade deficit (Japan, China, and Taiwan alone accounted for nearly 40 percent of that deficit in 2002).

The way that countries keep their currencies undervalued (and the dollar overvalued) is to buy up the excess supplies of dollars that enter their countries and hold those dollars as foreign exchange reserves. As shown in Table 1, several leading Asian countries have had truly prodigious increases in their international

Table 1

Total International Currency Reserves (excluding gold), Selected Countries and Years (end-of-period, in billions of U.S. dollars)^a

	1990	1995	2002
Japan	78.5	183.2	461.3
China	29.6	75.4	291.2
Taiwan	72.5	90.3	161.7
Hong Kong	24.6	55.4	111.9
Singapore	27.8	68.7	82.1
Subtotal: Four Asian NICs ^b	154.4	289.7	646.9
Memo: Euro area ^c	290.8	299.1	246.6

Source: International Monetary Fund, *International Financial Statistics* (www.imf.org).

Notes:

^aData were converted from special drawing rights (SDRs) using the end-of-period U.S. dollar-SDR exchange rate for each year.

^bNewly industrializing countries, i.e., China, Taiwan, Hong Kong, and Singapore.

^cData for 1990 and 1995 are the sums for the countries that later joined the European Monetary Union (EMU) in 1999. Data for 2002 are EMU totals, including reserves of the European Central Bank (ECB) not counted in the individual countries' statistics.

currency reserves since 1995.⁷ Japan increased its foreign currency reserves by two-and-a-half times between 1995 and 2002, reaching a world-leading \$461.3 billion at the end of 2002. To put this number in perspective, Japan's reserves at that time were nearly double those of the entire euro area (\$246.6 billion), even though the euro area is much larger by other economic criteria (e.g., gross domestic product) and the reserves of the future euro area countries exceeded those of Japan in 1995 and earlier.

China's reserves nearly quadrupled between 1995 and 2002, and at \$291.2 billion were also larger than those of the euro area at the end of 2002. Taiwan, Hong Kong, and Singapore's reserves are also enormous for relatively small countries, and grew substantially between 1995 and 2002. These four newly industrializing countries (NICs)—China, Taiwan, Hong Kong, and Singapore—together amassed \$646.9 billion of foreign reserves

by 2002, more than double what they held in 1995, and more than double the level of the euro area.

Of course, some growth of international reserves is important for sustaining global liquidity and facilitating trade, and the evidence from the financial crises of the late 1990s shows that countries with larger arsenals of reserves were more successful in avoiding speculative attacks on their currencies or contagion effects from other countries' crises. But the sheer magnitude of the reserves accumulated by these East Asian countries and the rapidity with which they have increased in recent years is *prima facie* evidence of efforts to keep their currencies undervalued and prevent them from appreciating to exchange rates that would be conducive to more balanced trade relations with the United States.⁸

Although the dollar's rise in the late 1990s can be explained by the factors discussed above, its final ascent between 2000 and early 2002 (especially with respect to the major currencies) is more mysterious. By this time, the U.S. economy had slowed down and passed through a recession that ended in an unusually sluggish recovery. The Fed began cutting interest rates in 2001, in an effort to fight the recession and stimulate a recovery. The U.S. stock market peaked in the winter of 1999–2000 and fell subsequently, while the terrorist attacks of September 11, 2001, shook confidence in U.S. national security. Yet, aside from short-term fluctuations, the dollar continued its climb through February 2002, after which time a series of accounting scandals undermined faith in the reported profits of major U.S. corporations, and the stock market took another nosedive.

The fact that the dollar continued to rise even after the economic fundamentals were no longer in its favor makes it likely that the dollar developed a "speculative bubble" between 2000 and early 2002 (as occurred previously in 1984–85). A speculative bubble occurs when investors buy and hold an asset on the mere expectation that the asset will rise in value, and the result-

Table 2

Average Growth Rates of U.S. Real Exports and Imports of Goods, 1990-1995 and 1996-2002 (average annual percentage rates)

	Nonagricultural exports	Nonpetroleum imports
1990 to 1995	8.9	8.0
1996 to 2002	4.4	9.7

Source: Author's calculations based on data in U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, table 4.4, downloaded from www.bea.gov.

Note: The average annual growth rates shown are the simple averages of the quarterly growth rates (measured at annual rates) for the years indicated.

ing increase in the demand for the asset causes its price to rise as expected. This is known as a “self-fulfilling prophecy,” and it has been observed to occur in various asset markets, including equity and currency markets. Although, as noted above, there were objective reasons for the dollar's rise in 1995–99, these reasons were less and less apparent in 2000–2001 and early 2002.

Consequently, it is reasonable to surmise that the dollar's sustained upward momentum in the late 1990s was amplified by a set of self-fulfilling expectations of further increases that carried through early 2002. However, it is in the nature of a speculative bubble that it must eventually burst, because a bubble implies that an asset's value has risen beyond a level that can be justified by the underlying fundamentals.

Why the Dollar Had to Fall

Thus, although there were reasons the dollar rose for nearly seven years, there were equally strong reasons it could not remain at its peak level of early 2002. The overvalued dollar contributed to a series of worsening macroeconomic imbalances that made a significant “correction” of the dollar's value inevitable.

The rising dollar since 1995 has had a devastating effect on

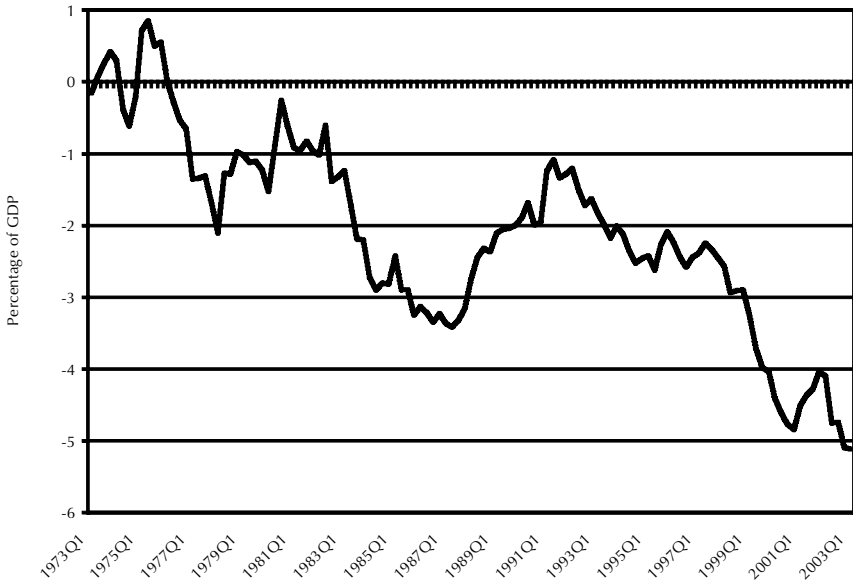


Figure 4. U.S. Trade Balance for Goods, Percentage of GDP, Quarterly, 1973-Q1 to 2003-Q1

Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, downloaded from www.bea.gov; and author's calculations.

U.S. trade performance. A high dollar makes U.S.-produced goods less competitive compared with foreign-produced goods, thus disadvantaging U.S. exporters while encouraging imports into the U.S. market. As Table 2 shows, the growth rate of non-agricultural exports was *cut in half* in 1996–2002 (the period of a rising dollar) compared with 1990–95 (a period of a gradually falling dollar),⁹ while the growth rate of nonpetroleum imports increased over the same time frame.

The result of this growing imbalance between export and import growth was record-setting trade deficits, as shown in Figure 4. Measuring the trade balance for goods (what used to be called the “merchandise” balance) as a percentage of the gross domestic product (GDP), we can see that the trade deficit has grown sharply relative to the rest of the economy since the late 1990s. By the fourth quarter of 2002, the U.S. trade deficit had

Table 3

Indicators of U.S. Financial Vulnerability, Selected Years, 1990–2002

(billions of U.S. dollars)

	1990	1995	2000	2002
Trade balance, goods	-111.0	-174.2	-452.4	-484.4
Trade balance, goods and services	-80.9	-96.4	-378.7	-435.5
Current-account balance	-79.0	-105.8	-410.3	-503.4
Net international investment position ^{a,b}	-245.3	-496.0	-1,387.7	-2,387.2
Foreign financial assets in U.S. ^{b,c}	1,919.0	3,267.9	6,198.6	7,072.0

Sources: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, U.S. International Transactions, and U.S. Net International Investment Position, downloaded from www.bea.gov; and author's calculations.

Notes:

^aIncluding foreign direct investment valued at current cost; a negative sign indicates a net debt position.

^bEnd-of-period data.

^cGross U.S. liabilities to foreigners, excluding foreign direct investment in the United States.

passed the historically unprecedented level of 5 percent of GDP. By comparing Figure 4 with Figure 1, we can also see that the trade deficit has roughly followed the trends in the dollar, with a lag of about one year: The trade deficit widened in the mid-1980s when the dollar was high, then moderated in the late 1980s and early 1990s when the dollar fell, and worsened again in the late 1990s and early 2000s following the most recent appreciation of the greenback.¹⁰

The worsening trade deficits of recent years were not confined to trade in goods, but were also found (to an even larger extent) in broader measures such as the trade balance in goods and services and the current account in the balance of payments. As Table 3 shows, between 1995 and 2002, while the trade deficit for goods nearly tripled, the trade deficit for goods and services more than quadrupled, and the current account deficit nearly quintupled. The amount that the United States had to borrow

each year to cover its current-account deficit thus jumped five-fold, from about \$100 billion in 1995 to over \$500 billion in 2002.

As a result of this continuously increasing borrowing, the U.S. net international debt (i.e., the negative “net international investment position,” which is the difference between U.S.-owned assets abroad and foreign assets in the United States) jumped from \$496 billion at year-end 1995 to \$2.4 *trillion* at year-end 2002. The total (gross) amount of foreign-owned financial assets in the United States—bonds, bank deposits, equity, etc., but excluding direct investment—more than doubled from about \$3.3 trillion at year-end 1995 to \$7.7 trillion at year-end 2002.

These worsening indicators show a rapidly increasing degree of vulnerability in the U.S. external financial situation.¹¹ Under current conditions, the United States has to borrow over \$500 billion a year, or about 5 percent of its GDP, just to pay for the excess of its imports over its exports. The resulting large international debts have to be serviced, and thus constitute a further drain on the U.S. balance of payments. When these deficits and debts were smaller, they could essentially be ignored by financial markets. But by 2002, they had reached proportions that began to set off alarm bells among currency traders and other international investors. Combined with the crisis of confidence in the accounting practices of major U.S. corporations and the continuing decline of the New York stock market, it is no wonder that foreign investors began to move out of U.S. assets and thereby to push the dollar downward in 2002.

In fact, the trade deficit figures of the last few years have reached what is usually thought of as the threshold for inviting a currency collapse: 5 percent of GDP. In countries such as Mexico in 1994 and Thailand in 1997, trade deficits that surpassed this threshold became signals to financial markets to sell short those currencies and to speculate on their devaluations. Once financial market speculators come to believe that a currency has to

fall, they will begin to sell off their holdings of that currency, thus pressuring it to fall as expected. Because the United States has a floating exchange rate (at least in relation to the major currencies such as the euro), the downward pressure on the value of the dollar is felt immediately, unlike in countries like Mexico or Thailand where the exchange rate was pegged and the pressure was felt instead in the form of reduced foreign exchange reserves as central banks attempted to defend the unsustainable pegs.

For the future, the data in Table 3 imply that foreign investors would only have to sell off a small percentage of their liquid investments in the United States to put very substantial pressure on the dollar to fall further. With outstanding U.S. liabilities to foreigners of \$7.1 trillion and a current-account deficit of about \$500 billion needing to be financed, a sell-off of only about 7 percent of those foreign holdings would drain the U.S. financial system of the entire value of the current-account deficit. If the United States was unable to finance that deficit any other way, truly draconian adjustments in the U.S. economy (i.e., massive dollar depreciation, huge interest rate hikes, and a severe recession) would be required to bring the current account into balance—just as occurred in Mexico in 1995, the Asian crisis countries in 1997–98, and Argentina in 2001–2, when international lending to those countries was cut off.

In focusing on the problems caused by the overvalued dollar, it is important not to overlook the benefits that it brought to the U.S. economy and the reasons U.S. officials have been reluctant to let it fall until recently. A high dollar helped to keep inflation low during the boom of the late 1990s by keeping import prices down. Low prices of imported goods benefited U.S. consumers. Low inflation in turn induced the Fed to keep interest rates lower than it would have otherwise. The capital inflows that pushed the dollar ever higher also helped to finance the U.S. trade deficit and domestic investment in the face of a growing shortfall of domestic saving.

U.S. financial markets gained from the inflows of foreign funds that helped to push up asset values, while U.S. investors benefited from the inflated purchasing power of the dollar in foreign countries.

Also, although domestic producers of tradable goods were hurt by the high dollar, especially in the U.S. manufacturing sector,¹² multinational corporations were able to insulate themselves from the negative effects of the high dollar by shifting production abroad (or outsourcing). By producing in countries where low exchange rates meant low production costs in dollar terms, U.S. multinationals could actually profit from the high dollar, although their American workers (and those companies that did not or could not move abroad, such as in the steel industry) did not share in those gains.

But these benefits of a high dollar could not be maintained indefinitely. Contrary to the “new economy” mythology that developed in the late 1990s, the basic laws of international financial economics were not repealed by the run-up of the dollar in 1995–2002. No country can run perpetually growing trade deficits and increasing foreign debts without eventually facing major adjustments, usually involving currency depreciation and income contraction. The United States has proved to be no more immune to a possible fall in its currency than it was to a stock market decline or a recession—the currency decline just took longer to get started. Indeed, if steps are not taken to manage the dollar’s decline more actively, there is a danger of speculative momentum building in the downward direction, if investors start to sell dollars and buy euros and other foreign currencies on the mere expectation that the dollar will fall further.

How to Manage the Dollar’s Decline

Since the dollar’s decline accelerated in April–May 2003, Treasury Secretary Snow and other U.S. officials have begun to ad-

just their rhetoric, signaling that the U.S. will accept a market-driven realignment of the dollar's exchange rate but indicating no desire to manage the process or to coordinate it with other countries. What remains constant in the Bush administration's dollar policy is a laissez-faire attitude toward currency markets.¹³ Although the new willingness to accept a market-driven dollar decline is a welcome shift in policy, this administration has not

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yet accepted the need for more active management of the dollar's decline by the United States and its trading partners, as well as for an extension of the dollar's fall to encompass more currencies (especially those with managed or manipulated exchange rates).

A partial decline of the dollar relative to only some currencies (mostly European) that account for less than half of the U.S. trade deficit will not suffice to reverse the damage done to the domestic U.S. economy by the dollar's broad-based overvaluation in recent years. At the same time, however, there are risks that the dollar's fall vis-à-vis the euro and other floating-rate currencies could turn into a panic-driven rout, with the dollar collapsing so fast as to threaten global financial stability. Thus, although the dollar needs to fall significantly further, its fall needs to be cushioned as its value begins to reach a more acceptable level.

Moreover, the dollar also needs to fall relative to those foreign currencies that have been deliberately undervalued through exchange rate manipulation by their governments (especially in East Asia), so that we do not place an excessive share of the adjustment burden on those countries (mainly in Europe) that let

their currencies adjust to market-determined levels. This is especially important in order not to exacerbate the depressing effects of the falling dollar on foreign economies, such as those in Europe, which are already suffering from slow growth and high unemployment. With the entire global economy teetering on the verge of a worldwide depression, the way the current realignment of exchange rates is managed will be a crucial determinant of whether that realignment helps to revive the global economy or to sink it further.

A more effective dollar policy has to begin by recognizing the vital distinction between the major currencies with floating exchange rates and the currencies of the developing nations that have mostly pegged or managed rates. For the major, floating-rate currencies (such as the euro), U.S. officials should—in cooperation with their foreign counterparts—announce a desire for a further decline in the dollar, but set a lower target range for the dollar's level in order to encourage an orderly and limited depreciation. For those countries that keep their currencies artificially undervalued by accumulating large amounts of dollar reserves (above all, China, but also Japan and the other Asian countries identified in Table 1), the United States should pressure them to abandon such intervention in currency markets and allow their exchange rates to appreciate. This section explores how these twin objectives can be achieved and sustained.

Given the importance of market psychology in determining the value of any financial asset, including a currency such as the U.S. dollar, statements by prominent U.S. officials have profound effects on international currency markets. Administration rhetoric in support of a strong dollar helped to brake the dollar's decline in mid-2003, after the previous apparent acceptance of a weaker dollar had contributed to accelerating that decline. Thus, it is vital for leading economic policy makers such as the Fed chairman and Treasury secretary to clearly and publicly accept

the need for further dollar depreciation beyond what has been achieved to date.

At the same time, it is vital to stabilize market expectations to prevent a speculative, panic-driven collapse of the dollar. Therefore, U.S. officials should not only suggest that the dollar needs to fall more, but also state a target range for the necessary dollar depreciation and suggest a floor for the dollar's level relative to the other major currencies. Even implicit suggestions of this sort proved effective in the 1985–87 period (when no specific targets were mentioned); more specific targets for sustainable exchange rates could be very effective today. Based on the data in Figure 3, it may be suggested that another 15–20 percent depreciation of the dollar relative to the major currencies (starting from the level in May 2003) would bring the dollar back to about where it was in 1995 (roughly an index of 80 on the scale shown in Figure 3). Such announcements would be more credible if they were agreed to by the major U.S. trading partners, such as through an announcement at a meeting of leading finance ministers or a G-8 summit.

The Federal Reserve could help to support such a policy by modifying its monetary policies to take into account the value of the dollar. For example, the Fed could announce that it will not raise interest rates to prevent further dollar depreciation until the dollar reaches the new (lower) target level. The Fed could also pre-commit to raise interest rates (modestly) after the dollar has fallen to the desired target level, which would help to foster a set of self-fulfilling expectations that would encourage a significant but controlled depreciation of the dollar.

Direct intervention in currency markets—that is, central banks or treasuries buying and selling foreign exchange in order to influence exchange rates—can also be helpful. It is often argued that the volumes of currencies traded in today's global financial markets dwarf the relatively meager foreign exchange reserves

of most central banks. Although this is true, it does not mean that currency market intervention cannot be successful. If such intervention is coordinated with policy announcements and undertaken in a concerted fashion by several leading central banks simultaneously, exchange market intervention can help to shift exchange rates in a desired direction.¹⁴ Once the dollar starts to fall, efforts by foreign countries to intervene to prevent this should be strongly opposed until the dollar has reached its new, lower target value.

Given the importance of foreign countries' macroeconomic policies in determining the values of their currencies relative to the dollar, it is vital for the United States to negotiate with our trading partners for the adoption of policies that would permit a sustained appreciation of their currencies. For the European countries, Japan, and other economically depressed areas, this means above all convincing them to revive their economies through the use of *domestic* demand stimuli and structural reforms, so that they no longer rely on low currency values to promote export-led expansion at U.S. expense. Such stimulus policies would also help to boost U.S. (and developing country) exports and prevent a global slump. In addition, foreign countries should be persuaded that allowing a realignment of currencies with a lower dollar could be helpful for resolving their trade disputes with the United States, such as the recent steel controversy, which have been exacerbated by the anticompetitive effects of the high dollar for U.S. producers.

For countries with pegged or managed exchange rates, the appropriateness of pushing for them to revalue their currencies upward depends on their economic conditions. Those countries that have recently been through financial crises and have depressed domestic economies (e.g., Argentina today) should not be pressured to revalue their currencies and would probably be unable to do so anyway. On the other hand, those countries that

are accumulating large amounts of reserves in order to artificially undervalue their currencies, such as China, Japan, and the other Asian countries shown in Table 1, should be induced to abandon such policies and allow their currencies to appreciate to market equilibrium levels.

The United States needs to use its political leverage to pressure such countries to stop manipulating their exchange rates. For example, support for future trade liberalization efforts and access to the U.S. market should be linked to the establishment of exchange rates that allow for more balanced trade relationships. It was a mistake to negotiate so many trade liberalization agreements (such as NAFTA, the WTO, and China's accession thereto) without paying attention to the need for keeping exchange rates at levels that prevent excessive trade imbalances. It is not too late to make sure that this need is addressed in future trade negotiations.

In addition, the U.S. government can act under the 1988 U.S. Trade Act, which requires the secretary of the Treasury to "analyze on an annual basis the exchange rate policies of foreign countries and consider whether countries . . . manipulate" their exchange rates. If manipulation is found, the secretary is required to enter into negotiations with countries that have significant surpluses with the United States. This provision was implemented with regard to three countries (South Korea, Taiwan, and China) during the Bush I administration, with varying degrees of success (the most success was with Korea, the least was with China), but has not been utilized since 1992.¹⁵ It is time to dust off this legislative provision and use it with regard to China, Japan, Taiwan, and any other countries that achieve large trade surpluses by keeping their currencies artificially undervalued.

Looking to the future, it is important to consider systemic reforms that could prevent a recurrence of the kind of exchange rate misalignment that we have experienced in the past eight

years. There have been several useful proposals for stabilizing exchange rates.¹⁶ Although it would be beyond the scope of this paper to endorse any particular such plan, what is most important is to target exchange rates at levels that would be consistent with more balanced trade, and which would allow all nations to grow at respectable rates with full employment. A full and sustainable recovery of the global economy depends on all countries' being able to share in the growth of the world market, and not allowing some countries to grow faster and employ more workers at the expense of their trading partners by undervaluing their nation's products.

Notes

1. Snow's statement that the dollar's fall versus the euro was only "a fairly modest realignment in currencies" was interpreted by financial markets as indicating the administration's acceptance of a market-driven decline in the dollar. Snow also sowed confusion by redefining a "strong dollar" so that the term no longer referred to the dollar's exchange rate with other currencies. The new meaning was that the dollar should be "a good medium of exchange" that "people are willing to hold." See Paul Blustein, "Treasury Chief's Words Send Dollar Lower," *Washington Post*, May 20, 2003, pp. E1, E6.

2. Note that the dollar values in Figure 2 are annual averages of monthly indexes, while the foreign-owned assets in the United States are year-end figures for the *preceding* year.

3. See Peter Morici, *The Trade Deficit: Where Does It Come From and What Does It Do?* (Washington, DC: Economic Strategy Institute, 1997).

4. Note that the "broad" dollar index in Figure 1 is a trade-weighted average of the major currency and other currency indexes shown in Figure 3.

5. The other "major" currencies are the Canadian and Australian dollars, the Swiss franc, and the Swedish krona.

6. Unlike the other currencies listed here, the Taiwanese dollar was not subject to a speculative attack. However, Taiwan devalued its currency in the fall of 1997 to offset the collapse of the Thai baht, thereby helping to provoke other Asian currency depreciations such as Korea's.

7. The data shown in Table 1 are for "total reserves minus gold" from the International Monetary Fund (IMF), *International Financial Statistics* (www.imf.org). These are total holdings of foreign currencies; the IMF does not publish separate data for official and private reserve holdings, nor does it reveal the currency composition of the reserves. Nevertheless, most of these total reserves are likely to be official reserves of U.S. dollars, especially in the Asian countries, and they are the best avail-

able indicator of the degree to which those countries are accumulating foreign currencies in an effort to keep their own currencies undervalued.

8. See Ernest H. Preeg, "Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China," in *Dollar Overvaluation and the World Economy*, ed. C. Fred Bergsten and John Williamson (Washington, DC: Institute for International Economics, 2003), chap. 13.

9. The slowdown in U.S. export growth in the late 1990s was also exacerbated by the growth slowdown in many U.S. export markets discussed in the previous section.

10. In spite of this correlation of the trade deficit with the value of the dollar, the trade balance also shows a secular worsening trend that cannot be explained by the ups and downs of the dollar. For an analysis of the factors causing the long-run deterioration in the U.S. trade balance, see Stephen D. Cohen, Robert A. Blecker, and Peter D. Whitney, *Fundamentals of U.S. Foreign Trade Policy: Economics, Politics, Laws, and Issues* (Boulder, CO: Westview Press, 2003), chap. 4, and Robert A. Blecker, "The Causes of the U.S. Trade Deficit," statement to the U.S. Trade Deficit Review Commission, Washington, DC, August 1999, available at www.ustdrc.gov/hearings/19aug99/extpub1.html.

11. For a related analysis, see Thomas I. Palley, "The Overvalued Dollar and the U.S. Slump," in Bergsten and Williamson, ed., *Dollar Overvaluation*, chap. 7.

12. For statistical estimates of the lost jobs, profits, and investment in the U.S. manufacturing sector caused by the overvalued dollar, see Robert A. Blecker, "The Benefits of a Lower Dollar: How the High Dollar Has Hurt U.S. Manufacturing Producers and Why the Dollar Still Needs to Fall Further," briefing paper (Washington, DC: Economic Policy Institute, May 2003), available at www.epinet.org. Portions of this briefing paper have been reproduced here with permission of the Economic Policy Institute.

13. See Blustein, "Treasury Chief's Words," p. E6.

14. For recent evidence on the effectiveness of currency market intervention, see Kathryn M. Dominguez, "Foreign Exchange Intervention: Did It Work in the 1990s?" in Bergsten and Williamson, ed., *Dollar Overvaluation*, chap. 11.

15. See U.S. Trade Deficit Review Commission, *The U.S. Trade Deficit: Causes, Consequences and Recommendations for Action* (Washington, DC, 2000), Democratic Commissioners' Views, pp. 73–74, 191–92.

16. For recent discussions of such proposals and citations of earlier ones, see Robert A. Blecker, *Taming Global Finance: A Better Architecture for Growth and Equity* (Washington, DC: Economic Policy Institute, 1999), pp. 125–43; John Grieve Smith, *There Is a Better Way: A New Economic Agenda* (London: Anthem Press, 2001), chap. 5; and Christian E. Weller and Laura Singleton, "Reining in Exchange Rates: A Better Way to Stabilize the Global Economy," briefing paper (Washington, DC: Economic Policy Institute, September 2002).

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