

The falling dollar

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I am pleased and honoured by the invitation to present this year's annual BIS lecture.

My subject tonight is the falling value of the dollar. My theme is that the dollar will continue to fall over at least the next few years relative to a trade-weighted index of other currencies and that, on balance, this will be good for the US economy. Indeed, the falling dollar may be the only major economic change that can accelerate the current anaemic pace of economic recovery and prevent a new downturn in US economic activity.

As you know, the official mantra of the US government is now, and has been for some time, that “a strong dollar is good for America”. I say the official “mantra” rather than the official “policy” because neither the US government nor the Federal Reserve does anything to strengthen the dollar or to prevent it from falling.

A more accurate description of US policy – and one that I have advocated in the past – is to have a strong dollar at home and a competitive dollar abroad. A strong dollar at home means a low inflation rate that maintains the purchasing power of the dollar domestically. This is clearly the goal of the Federal Reserve and one that has been achieved reasonably well over the past three decades with an average inflation rate of 3%.

In contrast, the competitiveness of the dollar abroad requires a decline in the trade-weighted value of the dollar to make US exports more attractive to foreign buyers and foreign goods less attractive to American consumers by reducing the relative price of American goods and services. The dollar has in fact fallen over the past several decades and fallen sharply in the past year despite the mantra favouring a strong dollar. And the fall in the international value of the dollar has not prevented maintaining the low inflation rate at home.

Here are the facts: In the 12 months through May of this year, the real trade-weighted value of the dollar fell 10.6% against the Federal Reserve's index of major currencies and 9.1% against the broader index of currencies that is also calculated by the Federal Reserve.

The government's willingness to allow this rapid decline of the dollar – and perhaps even to encourage it by urging the Chinese to cause the dollar to depreciate relative to the renminbi and by the Fed's policy of quantitative easing – shows that US policy is more about achieving a competitive dollar than about a strong international value of the dollar.

The same is true if we look at the dollar's performance over a longer period. Over the past 10 years, the real trade-weighted value of the dollar fell 31% against the index of major currencies and 26% against the broader index of currencies.

The future

But what of the future? There are four major reasons why the dollar is likely to continue falling for at least the next few years. Note that I am not advocating policies to make that happen. I am just looking at the fundamental economic forces that I believe will cause that continued decline to occur.

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The primary reason is that major investors around the world want fewer dollars in their portfolios. I talk with major fund managers in Asia, in the Middle East, and elsewhere. These individuals are responsible for sovereign wealth funds and for national pension funds. A common theme in their comments about their current investments is that they believe that they are overweight dollars and want to diversify their portfolios away from that overconcentration on dollar securities.

Those governments accumulated large amounts of foreign exchange as a result of trade surpluses. In some countries this was caused by undervalued exchange rates that led to increased exports and reduced imports. In the oil-producing countries, it was the result of the rapid rise in the price of oil. They initially regarded these foreign exchange holdings as traditional foreign exchange reserves to be held as a way of bridging future temporary gaps between the cost of imports and the country's export earnings.

Eventually, however, these countries recognised that they did not need such large amounts of foreign exchange to bridge the temporary import-export gaps that might arise in the future. Korea, Taiwan, Singapore and others with more than \$200 billion in foreign exchange each came to understand that only a small portion of that was needed for the traditional purpose of foreign exchange reserves. That is even more true of the major oil-producing countries and of China with \$3 trillion of foreign exchange.

Once they recognised that these were really important national investment funds, they asked themselves in what currencies they should be held, in what asset classes, in what maturities. The traditional investment in short-term US Treasury bills ceased to make sense.

So they began shifting out of the dollar and into other currencies. The primary currency that they bought was the euro. Although funds also went into the Swiss franc, the Australian dollar, the Norwegian krone and other smaller currencies, only the market for euro bonds was large enough to absorb substantial shifts of funds. The result of this portfolio shift was to reduce the value of the dollar relative to the euro and to the other currencies.

This diversification into the euro was temporarily halted by the start of the crisis in Greece and the other peripheral countries. The result was a fall of the euro relative to the dollar and other currencies. But after a while these investors realised that the problem of Greece and the other peripherals was not a problem of the euro as such but of the individual countries with excessive national debts and deficits. They concluded correctly that these problems should be reflected in the interest rate spreads and in the cost of credit default swaps rather than in the value of the euro.

So the euro began rising again, increasing from about \$1.35 per euro to \$1.50. The more recent confusion and uncertainty about the resolution of Greece's need for additional credit temporarily reduced the euro back to \$1.43 but, in my judgment, it will start rising again. The recent reports that China has invested some three fourths of its increased foreign assets this year in euros is consistent with this pattern of renewed portfolio reallocation.

Predicting that the euro will continue to rise may seem to ignore the very high prices that anyone who now travels to France or Germany must pay. It is easy to conclude that the euro is fully valued and not likely to increase further. This casual empiricism is supported by official government calculations of purchasing power comparisons. But both bits of evidence are misleading. What matters are the prices that drive current account balances. The prices paid by tourists are only a small part of the relevant price of tradables. And the price calculations of government officials do not accurately reflect the quality differences as judged by consumers. So while government statisticians may believe that German cars are expensive relative to American cars, consumers around the world are clearly willing to buy German luxury cars at the existing high prices. That's one of the reasons why Germany has a current account surplus of nearly \$200 billion. In short, the apparent high price of European goods and services is not a reason why the dollar will not continue to fall relative to the European currencies.

The second reason that the dollar will decline is the enormous size of the US current account deficit. During the last 12 months the merchandise trade deficit was \$680 billion (more than 4% of US GDP) and the current account deficit was \$470 billion.

Reducing the large US current account deficit can only be done by reducing the value of the dollar relative to the currencies of other countries. The United States is a major exporter with exports last year of more than \$1.3 trillion. A more competitive dollar would increase the volume of exports and reduce the volume of imports.

Which currencies are able to rise relative to the dollar, leading to a decline of the US current account deficit? The euro is again the natural candidate. The euro zone represents a large capital market and has a current account deficit of only 1/2% of the euro zone's GDP. Other countries with large current account surpluses, implying that they have the room to absorb the effect of a currency increase, include China with a current account surplus of more than \$300 billion, Japan with a current account surplus of nearly \$200 billion (causing the yen to rise despite the problems of the Japanese economy), Switzerland with a current account surplus of \$80 billion despite the strength of the Swiss franc, and the key Asian countries – Singapore, Taiwan and South Korea – that together have a current account surplus of more than \$100 billion.

In short, the large US current account deficit and the corresponding large current account surpluses elsewhere provide a natural pressure for the dollar to decline relative to those other currencies.

The third reason that the trade-weighted value of the dollar will decline over the next few years is China's new goal of increasing consumer spending in China.

Although China's rapid economic growth has led to a substantial increase in the standard of living of Chinese households, the level of consumer spending has not increased as rapidly as China's overall GDP. The new 12th five-year plan calls for a rise in consumption as a share of GDP, plus increased government spending on services for consumers like health care and education.

This in turn will imply a decline in China's enormous national saving rate, estimated by some to be nearly 50% of China's GDP. Since any country's current account surplus is the difference between its national saving and its national investment (ie investment in business structures and equipment and in housing), China's very high saving rate allows it to have both a very high investment rate and a current account surplus of about 3.5% of its GDP.

If China's net saving rate falls by just 4% of its GDP, China's current account surplus will end and will change to a current account deficit. An end to its current account surplus would mean that China would no longer be a net buyer of foreign securities. Until now, China has been the largest lender to the United States to finance our current account deficit. If China will no longer be buying dollars in order to invest in dollar bonds, the dollar will fall.

Moreover, if China wants to continue to make real investments in the rest of the world – buying oil in the ground, agricultural land in Africa, businesses in various western countries, etc – it will have to become a net seller of some of the \$3 trillion of foreign securities – primarily dollars – that it currently owns. That means further downward pressure on the dollar.

Although the fall in the dollar that would result from the reduced Chinese demand for dollars need not mean a fall in the dollar relative to the renminbi, the Chinese government's policies are likely to cause that rise in the renminbi-dollar exchange rate. The renminbi is of course a controlled exchange rate. The government of China has allowed the renminbi to rise relative to the dollar by about 5.5% over the past 12 months. But since the dollar was falling during this time relative to the euro, the yen and other currencies, the trade-weighted value of the renminbi did not rise over this period.

During the past year, the Chinese government prevented a faster rise of the renminbi relative to the dollar because it wanted to protect Chinese export manufacturers. But in coming years the rise in spending by Chinese consumers and by the Chinese government will substitute for the reduced value of net exports that occurs as China's current account surplus declines.

The Chinese government has been reassuring its domestic manufacturers that it will not let the renminbi jump sharply as some foreigners have advocated. But it has also made it clear that the renminbi will continue to rise and it has advocated that its manufacturers shift production to products for the domestic market.

The implication of all this is that China can now allow the renminbi to rise more rapidly. There is also a further reason why the Chinese government is now likely to let the renminbi rise faster. The increased domestic spending in China will increase demand and raise inflationary pressures. A stronger renminbi would offset this inflationary pressure in two ways. By increasing the relative cost of Chinese exports, a stronger renminbi will reduce the demand for those products and therefore limit that source of inflation. A stronger renminbi also reduces import costs, including the costs of raw materials that are used in Chinese production.

This brings me to the fourth and final reason to expect the dollar to continue declining over the next few years: the relatively low level of real interest rates in the United States. Because of the weakness of the US economy, the Federal Reserve has set the short-term federal funds rate at near zero and promised to keep it at that level for an extended period of time. Based on this promise of continued low short rates, multi-year rates are also very low. After allowing for current and expected inflation, the implied real rates are negative.

In contrast, the ECB has raised the short-term rate and indicated that it will raise it further. The ECB needs to do this in order to prevent imported inflation from food and energy prices triggering a wage-price spiral in Europe's heavily unionised economy. In the United States, real wages are declining and unions hardly exist. Since only 7% of private sector workers are unionised, there is little current danger of a price-wage spiral. So the real interest gap will widen, making investment in short-term Eurobonds of Germany or France more attractive than investment in the corresponding US bonds.

In summary then, there are four reasons to expect that the dollar will continue to decline relative to the euro and other major currencies over the next several years: a portfolio rebalancing by investors who regard their portfolios as overweight dollars, a continuing large US current account deficit, a Chinese policy to reduce net exports, and interest rate differences that make dollar investments less attractive.

It is of course impossible to say how fast the dollar will decline. Although it may fall only gradually, it could continue to fall at the 10% rate of the past 12 months or even faster if the holders of large dollar investments want to exit their positions to avoid the losses that will result from the dollar's decline.

How likely is that? China is of course reluctant to reduce its dollar position rapidly because of the adverse effect that that would have on the dollar-renminbi exchange rate. In contrast, smaller countries and private investors could shift from the dollar to other currencies without causing a significant impact on the value of their dollar exchange rate. But if each of these countries – Korea, Taiwan, etc – wants to move before selling by others causes the dollar to decline further, the cumulative effect as they all try to do so could be a sharp decline of the dollar. And if China sees that coming, it might want to move more rapidly to shrink its dollar position.

The effect of the dollar decline

A declining dollar would have a powerful positive effect on the short-run performance of the US economy. A continued decline of the dollar will raise the current annual exports of more than \$1.3 trillion and will induce American consumers to shift from imports to American-made products and services. Although exports are less than 10% of US GDP, more than one third of the increase in US GDP over the past four quarters was accounted for by the increase in exports.

Without a boost to demand from a future increase in net exports, the American recovery is likely to remain weak and could run out of steam, leading to a new downturn of GDP. Although the US recession officially ended in the summer of 2009, the expansion since then has been very weak. In the first three quarters of 2010 GDP grew at an annual rate of just 2.7% and more than half of that increase was just inventory accumulation rather than final sales. Although the fourth quarter of last year saw a temporary surge of consumer spending, this improvement of final demand and GDP did not follow through in the current year.

The annualised rate of growth fell from 3.1% for the fourth quarter of last year to just 1.9% for the first quarter of 2011. Moreover, two thirds of this first quarter GDP increase was just inventory accumulation. Final sales rose at an annual rate of only 0.6% or a quarterly rate of just 15 basis points, very close to no increase at all.

Even this understates the extent of the slowdown in 2011. Private estimates of monthly GDP by Macroeconomic Advisers indicate that the level of GDP actually fell between December of 2010 and January of 2011, and then fell further in February. March was the only positive month in the first quarter. The average level of GDP was 0.6% higher in the first quarter than in the previous one only because December was a strong month, allowing GDP to fall after that and still be higher for the first quarter as a whole than the average of the previous quarter.

The data for April and May showed renewed weakness with a rising unemployment rate, a sharp fall in employment gains, lower real weekly earnings, reduced retail sales and industrial production, declines in business and consumer confidence, a continued collapse of housing prices and the first decline in the index of leading indicators since early 2009, before the upturn began.

Without a dollar decline the near-term outlook is very negative. A decline in the value of the dollar can change this significantly. Cutting the US trade deficit from the current level of 3% of GDP by 2 percentage points of GDP would provide an initial demand stimulus equal to 2% of GDP. This would be more powerful than a comparable size fiscal stimulus and would provide that stimulus without adding to the national debt. It would also provide more stimulus than anything that the Federal Reserve might do at the current time.

There are of course also negative effects of a falling dollar. The unambiguously adverse effect is to reduce the real value of any given level of personal incomes by raising the cost to households of the imported products that they consume. The magnitude of this effect is substantial but should not be exaggerated. Since imports are only 16% of GDP, a 20% cumulative fall in the dollar would reduce real incomes by no more than about 3%. Even this overstates the adverse effect of the weaker dollar on real incomes since various imports are either priced in dollars (like oil) or experience adjustments in the foreign currency price as foreign exporters seek to offset the adverse effect of the weaker dollar on their exports.

The other adverse effect of a lower dollar is to create inflationary pressure. Again, the effect is relatively small. A 10% annual fall of the dollar would raise the price level and the rate of inflation by less than 2%. Given the state of the labour market, this would only affect the price level and would not be the beginning of a price-wage spiral.

In conclusion, there would be both strong positive effects of a dollar decline on aggregate demand but also adverse effects on real incomes and on the price level. If I am right, the

decline of the dollar during the next few years is not a matter of choice to be decided by weighing the advantages and disadvantages of a lower dollar. It is something that will happen. We will see a continuing decline of the dollar and with it a greater hope for a stronger economic recovery.