

Commentary on 'The Dollar in the 1990s: Competitiveness and the Challenges of New Economic Blocs'

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At the risk of oversimplifying and of losing both the subtlety of the argument and the many insights contained in its development, Rudiger Dornbusch's message can be summarized in three major points.

First, persistent current account imbalances are evidence of the lack of a (satisfactory) adjustment mechanism in today's world economy. To correct such imbalances from a U.S. perspective requires a massive improvement in the U.S. trade balance and, for that purpose, given foreseeable productivity trends, a large real depreciation of the dollar will have to take place in the 1990s. The real depreciation will have to be the larger if, as should occur, a correction of the U.S. budget deficit takes place. As for monetary policy, it should be eased to maintain full employment and stable growth. In addition, an aggressive commercial policy that pries open foreign markets, especially the closed Japanese one, should be pursued and, if successful, would help correct the U.S. external deficit significantly.

Second, domestic financial market deregulation will increase international capital mobility or, more precisely, the portion of changes in national savings rates that result in changes in the current account rather than in changes in investment. Thus, budget cutting in the United States would result in a significant, though far from one-to-one, improvement in the U.S. current account, the counterpart to which will, again, have to be dollar depreciation in real terms.

Third, this will not be enough to make what Dornbusch calls "the Japan problem"^M—the Japanese current account surplus and desire

to accumulate foreign and especially U.S. assets, thus "overvaluing" the dollar—go away. When the U.S. budget is finally brought into equilibrium, and with rising resentment against Japanese direct foreign investment in the United States and in Europe, Japan will have to look elsewhere for an outlet for its excess saving. A Japanese led Asian co-prosperity zone is the likely outcome leading, with the emergence of post-1992 Europe, to a tri-polar economic and currency world. And the tone, if not the letter, of Dornbusch's argument suggests that the three blocs are likely to be inward looking and hostile to one another. The conclusion, in Dornbusch's words, is that these trends certainly reinforce the dollar decline that is already required by the current account imbalance.

I will divide my comments on Dornbusch's paper into three parts. I will begin by addressing some of the points made in the paper itself. I will do so only briefly since a detailed commentary would add another paper to the conference proceedings. Second and again briefly, I will raise a few questions as to the future role of the dollar in the international financial and monetary system—rather than as to its future value. Finally, I will sketch, but only sketch, some of the implications I see for the conduct of macroeconomic policy and for international coordination of such policies.

The latter two parts of my remarks are offered to provoke a discussion of some of the issues raised in the agenda prepared by this conference's organizers but not taken up in detail in Dornbusch's paper.

Dornbusch's argument

Even though I agree with a number of Dornbusch's conclusions, notably on the trend toward a tri-polar world, the declining international role of the dollar, or the proper assignment of U.S. fiscal and monetary policy, I also have qualms about some of his reasoning, about some of his policy recommendations, and about his vision (explicit or implicit in the tone of some of his remarks) of Japan, Europe, the United States, and of the relationship among the three. Let me try to group my many comments on individual parts of his argument into five main points.

(1) On the required real depreciation of the U.S. dollar, Dornbusch may well be right, but then, he may almost as well be wrong. Among the many reasons I would be skeptical about any prediction

such as his, let me just list four. First, we don't know how much of a given transfer can be effected at constant terms of trade. Second, we have very little information on the elasticity of the trade balance with respect to the terms of trade, and even less with respect to the real exchange rate. And it is not simple regressions of one endogenous variable on another one over an arbitrary sample period that will sort this issue out. Third, even if we had a fair idea of the response of the trade balance and the real exchange rate to a particular shock, we have little idea where on that path the economy currently is. (Put another way, has the dollar already depreciated as much as it should, given the initial supposedly fiscal shock of the early eighties, or does it have still some way to go before it starts up again and then, when?). Fourth and specifically on the yen-dollar rate, Rudiger Dornbusch's estimate may be overpessimistic since that rate affects not only Japanese-American trade but also U.S. competitiveness in third markets.

In any event, the importance of dollar depreciation can be overemphasized and tends to raise the real exchange rate to the status of a target, or intermediate instrument of policy, a status it does not deserve. After all, the real exchange rate is an endogenous variable set, in the long run, by real factors such as “real” (structural or which possibly fiscal) policies, tastes, technology and endowments, something that Dornbusch fully recognizes.

(2) Underlying much of Dornbusch's discussion is the notion of an equilibrium or target current account and of the lack of an adjustment mechanism to reach it. I would argue that there indeed exists an effective adjustment mechanism: current accounts, real exchange rates, interest rates, and output levels all adjust to underlying saving-investment balances. Of course, we may not like the outcome. The basic reason why we may not is, I believe, because existing differences between national saving and national investment and the associated current account imbalances may reflect distortions in savers' and investors' choices, a socially inappropriate level of the budget deficit, an inappropriate **structure** of taxes, and so on. The obvious way to deal with the problem is to remove the distortions and do so at source, without overdue attention to the impact on real exchange rates. After having adopted the proper policies we may not—we will certainly not—end with current account balance, but with a pattern of current account deficits and surpluses we can live with.

(3) An immediate policy implication of this last point is the assignment that Charles Freedman emphasizes in his paper for this conference, that Rudiger Dornbusch also proposes, and that Hans Genberg and I have recently analyzed and developed.¹ The natural assignment to adopt under floating exchange rates is to assign fiscal policy (both the level and structure of taxes and spending) to the current account, and monetary policy to the price level in the long run and, possibly, to income stabilization in the short run.

(4) **Does all** this have a bearing, as Dornbusch sometimes seems to imply, on the choice between fixed and flexible rates? Some but not **all** that much. The traditional argument that countries subject to large terms of trade shocks would, if they peg, suffer large incipient variations in nominal prices and, if the latter are rigid downward, in employment is, of course, correct. But, as the variability of the real exchange rate (RER) is itself a function of the exchange rate regime, the evidence on the required variations in **RERs** drawn from the flexible rate period, where nominal exchange rate fluctuations dominate RER fluctuations, is not much of a guide to the magnitude of domestic price-level variability that pegging would have entailed.

(5) There is, finally, Dornbusch's view of Japan and Europe as inward-looking, protectionist, areas. There is here an underlying "Japan-bashing" tone which I find, to say the least, unhelpful. Not only does the attitude not help if, as is obvious, we should all hope the emerging tri-polar world will be open, competitive in markets, and cooperative in policy, it also raises false hopes. The decline of the United States, if there is one (which I personally doubt), cannot, in my view, be arrested by an opening up of Japan and the dismantling of "Japan Inc." The opening up of Japan and the reform of its distribution system is no doubt desirable, would benefit world income, and should, indeed, be pursued, partly with the help of an active commercial policy. But the prime beneficiary will be the Japanese and the contribution to redressing saving-investment imbalances and moderating required **RER** changes is at best marginal.

The international role of the dollar

Dornbusch's paper focuses on the future value rather than on the

¹ See Genberg and Swoboda (1987) and (1989).

future role of the dollar in the international monetary system. To do justice to the latter topic would take a full paper but a few comments are, nevertheless, offered below.

First, there is no doubt that the dollar is still, and by far, the dominant international currency, be it as a reserve currency, an invoicing currency, or in the denomination of internationally traded financial assets. The question is whether it will continue to play this leading role and if so, for how long? A few figures, taken from a recent paper by Black (1989), indicate that the role of the dollar is decreasing, but fairly slowly. For instance, although the dollar remains the main currency of issue in the international bond market, its share declined from 56.5 percent in 1982 to 43.2 percent in 1987, while that of the yen rose from 6.5 percent to 12.4 percent. The share of the other important currencies, the Swiss franc and the deutsche mark, held relatively steady over the same period. As far as the currency composition of banks' external assets is concerned, the dollar again plays the dominant role by far with 56.9 percent of the total. However, the role of the yen has been rising rapidly to third place with 14.6 percent, thus coming very close to the deutsche mark's 14.9 percent in 1987. Turning to the role of the dollar as an international reserve asset, Black's figures confirm that it is declining slowly, though it still retains a very high share of 70.6 percent of the total by the end of 1987.

There are several reasons to believe that the role of the dollar will decline further but only slowly, unless U.S. policy turns unstable and the three emerging blocs become very hostile. In the first place, the decline of the dollar reflects changes in the underlying world structure of economic and political power. But the evolution toward a tri-polar currency world is likely to lag behind geopolitics. Just as becoming an international financial center and an international currency is a slow process in which geography and historical accident have important roles to play, the decline of such centers and currencies is a drawn-out process as the case of sterling illustrates. Substantial capital has been built up and invested in the dollar's role and the United States still has the world's most open, broad, deep, resilient, and transparent financial markets.

One might still ask, with this conference's organizers, whether a continued strong international role of the dollar is compatible with a U.S. net debtor status? I think the answer must be yes but not with

a continuously rising net debtor position, continued large current account deficits which are seen as signalling an incipient crisis and the closing down of U.S. financial and goods markets. This is why inappropriate macroeconomic policies on the part of the United States **and/or** a threat of economic warfare could abruptly accelerate the otherwise slow decline of the international position of the dollar.

But, you may ask as Robert Mundell recently has, would not continued demand for "quality international assets" imply a continued net capital inflow into the United States and force a continued U.S. current account deficit? I think not, even though I do agree that the United States remains a dominant supplier of quality international assets. For, continued foreign demand for U.S. assets can be satisfied with a balanced American current account. We are back to the questions of the 1960s. It is not impossible to envisage U.S. gross foreign assets and liabilities growing while the U.S. international investment position remains balanced, the growth in short-term liabilities being matched by a growth in its long-term assets.

That having been said, we are moving toward a tri-polar world. The crucial question, of course, is whether the blocs will be hostile and closed, or open and cooperative; here I am more optimistic than Dornbusch. Be that as it may, in the medium run the decline in the international role of the dollar should give some scope for increased concentration on U.S. domestic goals without bringing forth policy reactions from abroad that frustrate U.S. policy.

Implications for macroeconomic policy and coordination

Assuming that we are, indeed, moving toward a tri-polar world, at least at the industrialized countries core, what are the implications for the conduct of monetary policy within the blocs and for coordination among them if a breakdown into hostile blocs is to be avoided? This is obviously too broad a topic to be taken up in any depth **here**.² A few remarks may, however, be in order.

Within the currency blocs, national monetary policy will have to be dictated by the requirements of external balance if exchange rates are to be credibly fixed within each area. And, within each area,

² For a discussion of this topic see Swoboda (1989).

the $n-1$ problem will have to be faced and solved. These are the requirements for the smooth internal functioning of the blocs which, in turn, would seem to be necessary for relatively open competition and effective coordination of policy among them. The twin hypotheses that goods and asset markets will be even more closely integrated worldwide tomorrow than today—and Dornbusch would agree, I believe, that all market pressures are working in that direction,—and that current account imbalances will continue for better or for worse to be concerns of policy have a number of implications for the shape that such coordination of policies should take.

In such a world, it is particularly important that fiscal policy, or more broadly saving-investment policy, be assigned the task of correcting current account imbalances. (It is also important that some modicum of international agreement exist as to what constitutes, roughly speaking, balance in that respect.) Focus on the exchange rate, real or nominal, as an instrument for, or intermediate target with respect to, current account balance distracts attention from the basic problem and may well prove destabilizing rather than stabilizing. Whether relations between the three blocs should be ruled by a fixed or a flexible exchange rate system is a separate issue, to be settled on other than current account equilibrium grounds. Having said that, it must be recognized that it is hard to imagine a fixed exchange rate system surviving large and protracted current account imbalances; but it should also be recognized that a flexible rate system is unlikely to function smoothly with such imbalances.

Whichever exchange rate system is chosen to rule relations among the three blocs, what matters is that the choice must be a clear one and that national monetary and macroeconomic policies will be run in a fashion that is consistent with the logic of the chosen system. Contingent rules of the assignment type would be helpful in that respect. In addition, there is a need for a credible commitment on the part of all major players to a basic code of conduct that includes openness of trade in goods, services and assets, multilateralism and the avoidance of competitive depreciation. With such a code, an appropriate coordination of policies of the type just outlined, and the will to address international imbalances at source, there is no reason why relations among the three emerging blocs should not be characterized by competitive markets, cooperation, and a modicum of civility.

References

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