Commentary on "Gauging the Evidence on Recent Movements in the Value of the Dollar"

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The title of Richard Levich's paper is somewhat misleading. Although it includes mention of the dollar, in fact he has written a paper appraising exchange rate movements in general, rather than about the recent dollar movements in particular. In these comments I will provide some reactions to the paper but, in addition, I will make some comments about the reasons for the dollar's strength.

Levich describes the volatile nature of recent exchange rate movements (both real and nominal), discusses how in principle we ought to evaluate them, and then surveys the empirical evidence in the light of these principles. Throughout the paper he emphasizes the complexities of the theoretical and empirical considerations that inhibit definitive conclusions given the appropriate configuration of disturbances and adjustment mechanisms. Theory appears able to rationalize almost any degree of volatility. The very concept of a fundamental equilibrium exchange rate value is tenuous and certainly not to be confused with the purchasing power parity rate or the rate consistent with a zero current account. The empirical evidence is also disquieting—it provides compelling evidence that the market predictions of rates are poor, and disquieting indications that they may be biased and perhaps inefficient.

I found the paper full of insights and judicious observations. I think its central message, that few firm conclusions about the recent exchange rate movements are warranted, is probably correct. It strikes an appropriately cautionary note for us to keep in mind in the course of our policy discussions. In my view the models we build using theory are unlikely to be very useful in tracking short-run exchange rate movements.

In fact, experience in trying to model copper prices (much easier than exchange rates) suggests to me that simple supply (depending on long-run costs) and demand (on income and the availability of substitutes) curves may help in tracking 20-year movements, but over shorter periods such as a decade, one needs to model mining and smelting capacity and, over periods

less than three years, inventories are important. Even after all these factors are taken in account, there remains a large degree of short-run variance we just cannot explain. For somewhat different reasons, theory is also unable to provide us with a set of rules for an exchange rate system which is likely to be optimal under all circumstances. Thus neither over the very long run nor in the short run are our conclusions likely to be very firm.

The policymaker reading Levich's paper or listening to my statements is likely to feel extremely frustrated. Our science seems to offer few guides to short-run action. Indeed it reminds me of the story of the two men who were taking a ride in a balloon. At the outset, their trip went well but all of a sudden they were blown into some thick clouds and were totally lost. Eventually the clouds parted, and they found themselves over a field. They looked down and saw a man in the field. "Where are we?," they cried to him in desperation. "You're in a balloon," he replied. Whereupon the winds blew again, the clouds came together and again they were lost. "You know, that man down there must have been an economist," said one of the balloonists. "Only an economist could have given us an answer with such great precision and so little use."

But while caution is in order, I do feel theory is of some guide in allowing us to deduce the dominant reasons for medium-run exchange rate movements, and I would recommend Branson's paper in this conference as an example of this reasoning. Branson's firm conclusions are a striking contrast to Levich's tentative conclusions. I think they illustrate the kinds of questions economists can and cannot answer, rather than the particular achievements of the authors. Theory *does* help to pin point the crucial role of the U.S. budget deficit in causing high real U.S. interest rates and exchange rates.

There are some who have argued that perhaps more important than the U.S. budget deficit has been the dramatic increase in U.S. domestic investment in this recovery. They suggest that tax cuts, directed towards business, have been the main cause of this behavior. Indeed, interpretations about the nature of this recovery differ widely. Some authors such as Branson, Cooper, and Frankel see an aggregate savings bust (via the budget deficit) rather than an investment boom. Others such as Bill Poole, Bill Niskanen, and Alan Melzer place much more emphasis on strong domestic investment. Levich quotes the BIS which asserts the dollar strengthening with a growing current account deficit is unique. In magnitude it may be but Norway in the mid-1970s had a similar experience that related to the increased attractiveness of oil investment. For these authors, the U.S. has experienced an analogous shift in the investment climate. The third interpretation, which provides a dominant role for autonomous inflows of foreign savings (either because of safe havens or tighter budgets abroad) is not compatible with the configuration of both high real U.S. interest rates and a strong dollar. If cap-

ital inflows because of an increased supply of foreign capital were the dominant shock, interest rates should be low in the U.S., not high.

But is investment really unusually strong in this recovery? Interpretations differ about the role of investment because people look at different numbers. The real and nominal measures of investment tell different stories because of a significant fall in the relative price of investment goods. In both nominal and real terms, the first two years of this recovery were quite typical. But in this recovery, while nominal investment growth accounted for about 32.7 percent of the growth (compared with 23.7 percent in the postwar average) real investment growth accounted for 51.6 percent (compared with the 29.0 percent in the postwar average). For the purposes of the exchange rate I would argue it's the nominal rather than the real measures that are relevant, and they suggest the investment share of GNP in this recovery could have been financed domestically had the budget deficit also been its average level. In my view, therefore, while it is significant from the viewpoint of productivity and the issue of deindustrialization that investment has been strong because of relative price declines, the overwhelming source of the dollar's strength is the budget deficit.

There is also the question of whether we should have let the dollar get as high as it did. Rick Levich is reluctant to advocate active intervention and suggests the exchange rate is the symptom rather than the disease. Again, I would agree with him. Many commentators in this conference place the blame for the dollar on international (net) capital movements. In my view, too much emphasis is placed on the capital flows, and insufficient attention is paid to the lack of substitutability in the goods market. It takes rather large shifts in relative prices (given overall elasticities in the region of 1 to 1.5) to shift the current account of an economy such as the U.S. Paul Krugman in his paper points out that it takes about a 10 percent increase in the real U.S. exchange rate to shift the current account by 1 percent of GNP.

It is instructive to ask whether the U.S. could have run a full employment fiscal deficit of the current magnitude under fixed exchange rates? For analytical purposes, we can assume that over the medium run the same real outcome would have resulted. Yet, under a fixed rate system, it would have required a massive rise in the nominal prices of U.S. products and a highly inflationary U.S. monetary policy. Alternatively, substantial deflation abroad would have been required. Under fixed rates, in my view, the Federal Reserve would never have supplied the liquidity, and thus at full employment the real dollar would have been much weaker, and real U.S. interest rates much higher. The system has therefore enabled the U.S. to borrow from abroad and hence to have its budget deficit. Indeed it has allowed much greater international transfers of capital but with the associated pressures on the goods markets of large relative price changes. Feldstein and Horioka have presented evidence, using for the most part data

from the fixed exchange rate period, that shifts in domestic savings and investment have been closely associated. I believe the imperfect substitutability in the goods markets which often induce domestic policies to prevent international transfers explain this finding.

While the day to day and even month to month movements in the dollar will remain a mystery, the broad medium term (three-year movements) suggest strongly we have the real exchange rate our fiscal policy requires. Had we intervened, some of the problems in the traded goods markets may have been reduced but at the expense of high inflation and less investment. As Levich has put it, we have the exchange rate we deserve.