

Commentary on "Effects of the Strong Dollar"

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Sitting as I usually do in Threadneedle Street, it is natural for me to comment on this paper not only from a foreign viewpoint but also from that of someone close to policy—particularly monetary policy. This I shall do despite the fact that I prepared these comments while enjoying the hospitality of, and playing the academic at, the National Bureau of Economic Research in Cambridge, Massachusetts.

Robert Solomon starts his analysis from the proposition that the exchange rate is one of many endogenous variables in a general equilibrium system. To consider alternatives to recent history we must specify alternative courses for some exogenous variables and recognize that endogenous variables, other than the exchange rate, will also be affected. Typically there will be many alternative scenarios associated with, for example, a lower dollar, so that the effects of a strong dollar are not uniquely defined.

I sympathize with this approach. The counterfactual scenarios are said to consist of a tighter fiscal and looser monetary policy. Solomon also considers another alternative: "the dollar appreciation (might have) been kept in bounds by market forces while U.S. macroeconomic policies were as they actually have been." In its context this seems to relate to a world in which the supply of funds from other countries was less sensitive to relative interest rates than has in fact been the case.

If the supply of capital to the U.S. were less elastic, interest rates in the U.S. would have been higher and elsewhere lower; with lower capital imports the U.S. would probably have invested less and had a smaller current deficit. It would have been more competitive and the real exchange rate lower; what that would have done for aggregate demand in other countries depends crucially on the strength of the boost from lower interest rates there on expenditures—which is disputed.

There is, moreover, a third possibility which does not fit Solomon's general equilibrium argument so well. What if the height of the dollar is not an equilibrium phenomenon? Paul Krugman's paper suggests that the market

has made one, or a series, of mistakes. If they had not, the world would have been different: the set of exogenous variables must include as independent variables, the expectations, or fears, which underlie such potential errors.

Absent such "mistakes" it seems that the dollar could (should?) have been lower without any change in relative interest rates, implying greater U.S. competitiveness and a loss of demand elsewhere not directly offset, even partially, by an interest rate stimulus. There could, however, still be a stimulus if the lower dollar reduced inflation pressures elsewhere and thus facilitated an effective relaxation of currently restrictive policies.

When considering the impact of capital inflows to the U.S., Solomon suggests that they may have inhibited investment in other countries. I have two difficulties with this argument. The first is that the multiplier effects of exports to the U.S. almost certainly have profit and accelerator effects on investment which outweigh any interest rate effect. This is indeed Solomon's own conclusion but he, like William Branson, does not, for my taste, adequately emphasize that the global flow of savings is yet another endogenous variable so that the charge that the U.S. is taking too much of Europe's savings may be misleading. This is particularly important in the context of the U.K. where our capital exports owe as much to Mrs. Thatcher's dismantling of exchange controls as to Mr. Reagan's need for funds to finance his deficit. (The fact that investment has remained somewhat sluggish reflects the fact that despite the strong dollar the U.K. remains uncompetitive).

Reduced obstacles to capital outflow from the U.K. certainly lead to larger outflows, and possibly slightly higher interest rates, but also to a lower exchange rate, more domestic activity, higher profits, and, almost certainly, more domestic saving and investment. We cannot take savings as given and then allocate them to domestic or foreign investment by manipulating interest and exchange rates even hypothetically.

The most direct effect on other countries of the strong dollar is on trade account. Solomon makes the point that Canada and Japan have experienced the largest growth of exports as a result of the expansion of demand in the U.S. since 1982 and "yet" that their domestic demand increased faster than in other industrial countries except for the U.S. He also notes that growth in "some countries" (Germany seems to be referred to) has been held back by "restrictive policies." For any given policy stance, Keynes/Harrod multipliers would tend to make export and domestic demand move together. Or is the suggestion that policy was less restrictive in Canada and Japan? If so, how is this related to their currencies' relatively small depreciation against the U.S. dollar and thus perhaps a smaller perceived threat of imported inflation? Or does the causality run from tight German fiscal policy to a weak DM just as the strength of the dollar is due to the U.S. deficit? I notice that Dr. Emminger finds this implausible.

An aspect of the strong dollar which can easily be overlooked by someone

in a polar country like the U.S. is what an extreme exchange rate misalignment looks like to a third country such as the U.K. which attaches high weight to both the U.S. dollar and the DM in its effective exchange rate. (Incidentally we have no trouble with the MERM weights as opposed to bilateral weights—the importance of competition in third markets and the role of dollar influence on commodity prices makes it appropriate that its weight in £'s EER be about twice that of our bilateral trade.)

When we "take the exchange rate into account" along with the monetary aggregates and other asset prices in assessing monetary conditions, we (nearly always) use the effective rate rather than any particular rate. (Indeed on as many occasions the dollar has been excluded from the basket as the dollar parity overweighted.) This is consistent with our finding the MERM weighted EER a good explanatory variable for both prices and net trade.

This does not, however, imply that all sets of rates generating a given £ EER have identical effects on U.K. inflation and output. If an already high dollar rises, and an already low DM falls, leaving the £ EER unchanged, I would expect the volume of the U.K.'s net exports to decline. This is because the dollar rate in particular is perceived to be too good to last; capacity will not be enlarged to take a transient opportunity; rather the sterling price of U.K. exports to the U.S. will be raised with effects, for example, on London hotel prices. On the other side, German import volumes to the U.K. will probably rise and our sales to and in competition with, them fall. The German supply response is greater than the U.K.'s because it is more competitive overall even if the dollar is overvalued relative to sterling by a similar amount to that of sterling relative to the DM.

The argument is similar to one that ~~used to be~~ popular amongst regional economists. Given a non-linear short-run regional or industrial Phillips curve, a greater regional or industrial dispersion of unemployment rates raises inflation for a given average unemployment rate. Non-linearities in price and quantity responses to bilateral exchange rates mean that the dispersion of deviations of other countries' exchange rates from equilibrium may have adverse implications. To the extent that currency misalignments worsen the short-run trade-off governments with consistent preferences will choose policies leading to lower average levels of activity.

Solomon includes the ultimate fall of the dollar among the effects of its having earlier been strong and in his brief discussion refers to the reaction of monetary policymakers in other countries. It certainly matters to all the parties whether the adjustment is taken on exchange rates, with consequent upward pressure on U.S. interest rates, or whether, for example, European countries react to dollar weakness by lowering their own interest rates thus facilitating a move towards less misaligned currencies at a lower structure of world real interest rates.

Solomon suggests that Germany, at least, would be unlikely to change its

monetary policy much, if at all. The **U.K.** would certainly like to see a lower structure of interest rates but its monetary policy has not formally been conditioned on movements in the £/\$ exchange rate; any adjustment of **U.K.** monetary policy would have to be consistent with the maintenance of downward pressure on inflation through restrained growth of monetary aggregates and a satisfactory path of the effective exchange rate. The contribution of these factors changes from time to time as things go better or worse than had previously been expected, but the probability of a general favorable shift is not very high, and any one country's failure to respond would diminish the response likely from others.

When considering effects on LDC's, Solomon concentrates on the alternative of a lower interest elasticity of capital flows so that the real appreciation of the dollar is associated with lower dollar interest rates than otherwise. He concludes that this has benefited LDC's, although the cost of other currencies they might have borrowed must have been raised. If he had considered an alternative policy mix in this context his conclusion that LDC's have benefited from the strong dollar might have been changed. Moreover, as was pointed out in discussion, he does not address the "political economy" consequences of the strong dollar—U.S. protectionism and greater sympathy for interference with international capital movements. These may be the most adverse and lasting consequences of all.