
The Overvalued Dollar and the US Slump

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Dangers of the Dollar Bubble

Over the past seven years the value of the dollar has appreciated dramatically against almost all major currencies. Since bottoming out in 1995, the real value of the dollar has steadily risen against both the Federal Reserve's broad basket of currencies (which includes all major trading partners in Europe, East Asia, and Latin America) and against the Fed's basket of currencies for major industrialized countries.¹ Relative to the broad basket, the appreciation has been 32 percent as of September 2002, and relative to the major industrialized currencies basket, it has been 40 percent. This appreciation pushed the dollar to a 16-year high in early 2002, and it remains stubbornly close to this peak despite the much ballyhooed recent talk of a weakening dollar. Thus, as of September, the broad basket of currencies was just 1 percent below the February 2002 peak.

From 1996 through mid-2000 the US economy was in the grip of a powerful economic expansion that obscured the accumulating negative

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1. In these exchange rate indices, each country is given a weight equal to its share of trade with the United States; the exchange rate is also adjusted to take account of differences in cross-country inflation rates.

effects of this appreciation. The rising dollar did help control inflation by keeping a lid on import prices, but there was already a cost in manufacturing jobs, which began to decline in early 1998. Even if a strengthening dollar could once have been justified, that justification has long since ceased. Today the US economy is in the grip of an economic slump, and overvaluation of the dollar is obstructing recovery by undermining manufacturing. Robust consumption spending—financed by home price appreciation and mortgage refinancings—has helped mitigate the slump, but there is now an imminent danger that continued dollar overvaluation could trigger a deep double-dip recession. Unwinding the dollar's overvaluation should therefore be an urgent policy priority.

In the aftermath of the US stock market bubble, many have wondered about resemblances between the United States and Japan. There can be no doubt that the United States is different in both the scale of its bubble and its capital market arrangements. That said, however, there are also clear similarities, and one of these may be the exchange rate. Japan's asset bubble burst in 1990, yet the yen continued appreciating until 1995, thereby deepening Japan's economic difficulties. One reason for the strong dollar is continuing robust financial flows into the United States driven by investor hopes that asset markets will resume an upward course. In this, the United States may be similar to Japan. A second reason is the strength of US consumption spending, which, although unsustainable, has mitigated the recession. Given simultaneous weakness in foreign economies, this has made the United States look relatively attractive, thereby increasing capital inflows and appreciating the dollar. This shows how asset market considerations can drive the dollar without regard to the impact on economic activity and employment. It is a serious policy problem. The stock market bubble has shown the destabilizing nature of asset price inflation, and the dollar's appreciation represents another instance of asset inflation, this time located in foreign currency markets. Yet, thus far policymakers have shown little inclination to engage with the question of how to guard against asset market bubbles.

Short-Term Damage: Manufacturing and the Recession

The overvalued dollar is inflicting both short- and long-term damage on the US economy. The damage is inflicted via the impact of the overvalued dollar on exports, imports, business investment spending, and the financial position of the US economy.

The trade deficit is the major damage transmission channel, and it especially affects manufacturing, since the deficit is largely accounted for by manufactured goods trade. In 2001, nonagricultural goods exports accounted for 65 percent of all exports, and nonpetroleum goods imports

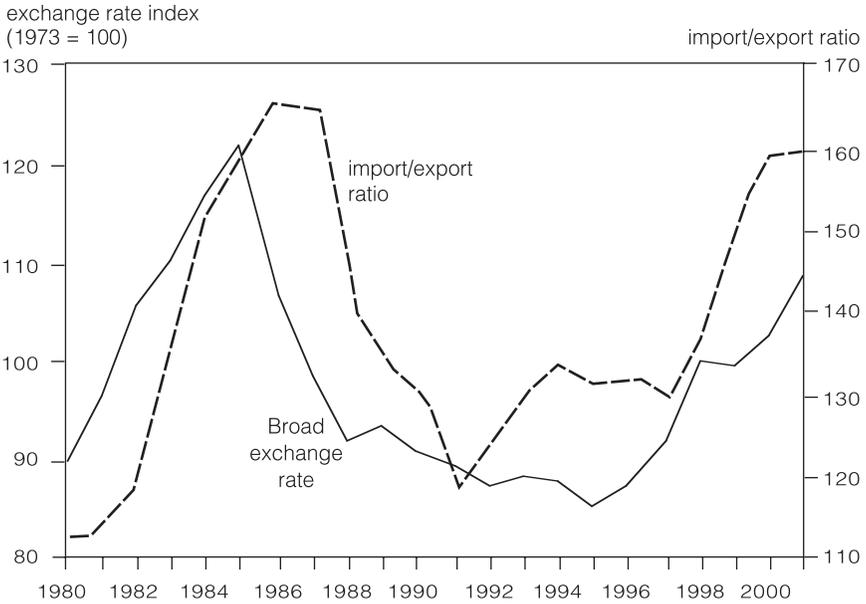
accounted for 81 percent of total imports. The immediate damage comes from the draining of demand for domestically manufactured goods, thereby causing manufacturing job losses. Between April 1998 and September 2002 the United States lost 2.2 million manufacturing jobs, of which 1.9 million were lost after July 2000. These losses can be substantially attributed to the overvalued dollar, which has reduced export demand for US manufactures while simultaneously displacing domestic production through increased imports of foreign manufactures. Before 1998, manufacturing employment was growing, but since then the strong dollar has placed persistent downward pressure on manufacturing employment. Indeed, the manufacturing sector lost jobs in 1999 and 2000, when the overall economy was still booming. The United States has some of the most efficient manufacturing industry in the world, and for the past decade US manufacturing has posted rapid productivity growth that has lowered unit labor costs. However, these efficiency gains have been swamped by the dollar's appreciation, which has lowered prices of foreign competitors' products. The bottom line is that even US industry cannot compete when confronted by a 30 percent price disadvantage imposed by currency markets.

These impacts of the overvalued dollar are documented in a recent study by the National Association of Manufacturers (2002). The study reports that US exports have fallen \$140 billion since August 2000, accounting for the loss of over 500,000 factory jobs. Moreover, these export-related job losses are only those of one side of the ledger. Surging imports that have grabbed market share have also caused job losses. In 2001 the deficit in goods trade was \$426.7 billion, approximately 25 percent of manufacturing GDP. Reducing this deficit by \$200 billion to the level that prevailed in 1997-98, before the overvalued dollar began to bite, would add 12.5 percent to manufacturing GDP. This in turn would translate into approximately 2.1 million additional jobs.² This calculation shows how the entire job loss in manufacturing over the past four and a half years can be attributed to the ballooning trade deficit.

Analytically, the trade deficit impact of the dollar works via the twin channels of exports and imports. This effect is clearly shown in figure 7.1. The solid line represents the Federal Reserve's broad trade-weighted real dollar index, which includes exchange rates for all major US trading partners and is adjusted for cross-country differences in inflation. The broken line represents the ratio of US goods imports to goods exports. When the dollar is strong, imports go up and exports go down, and the

2. Manufacturing GDP in 2000 was \$1,567 billion. Reducing the goods trade deficit by \$200 billion to \$226 billion represents 12.8 percent of manufacturing GDP. Manufacturing employment in April 2002 was 16.8 million, and increasing this by 12.8 percent would add 2.14 million additional manufacturing jobs.

Figure 7.1 Real broad dollar index and import/export ratio, 1980-2001



Source: *Economic Report of the President*, February 2002; and author's calculations.

ratio therefore rises. The figure shows a clear robust positive relation that is supported by the following regression:

$$D(GM/GX) = 1.91 + 1.07D(\text{broad exchange rate});$$

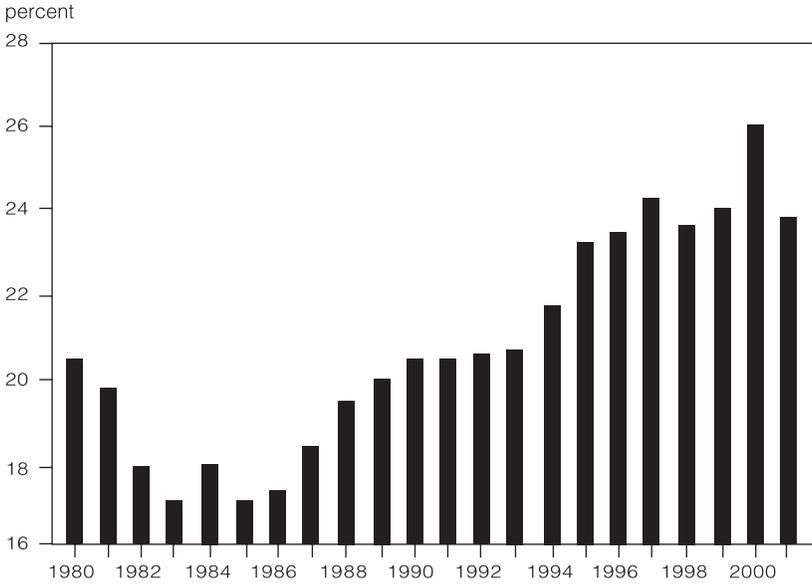
adjusted $R^2 = 0.41$; Durbin-Watson = 2.16

where $D(GM/GX)$ is the change in the ratio of goods imports to goods exports, and $D(\text{broad exchange rate})$ is the change in the lagged broad exchange rate. The regression indicates that a one-point increase in the broad exchange rate results in a 1.07 point increase in the import-export ratio (with a t-ratio of 3.7).

Furthermore, the impact of exchange rate movements has become larger over the past two decades because the US economy has become more engaged in trade. This is shown in figure 7.2, which shows exports and imports as a share of GDP. In 1980 exports and imports were 18.3 percent of GDP, but by 2001 they were 23.8 percent of GDP. Even more dramatic is the change in manufacturing openness, defined as manufacturing exports and imports as a share of manufacturing GDP. This is shown in figure 7.3.³ In 1980 manufacturing exports and imports were 60 percent

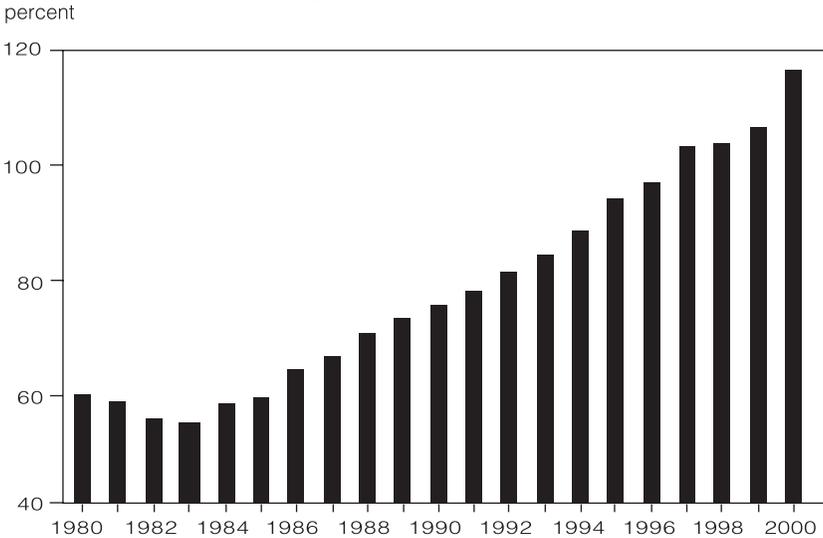
3. Manufacturing exports are measured as goods exports minus agricultural exports. Manufacturing imports are measured as goods imports minus petroleum and petroleum-based products.

Figure 7.2 Exports plus imports as a percentage of GDP, 1980-2001



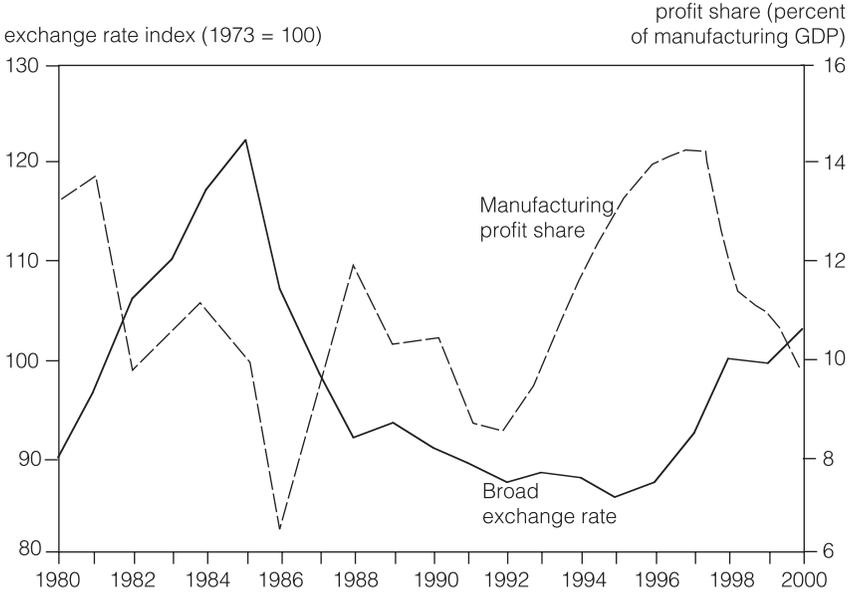
Source: *Economic Report of the President*, February 2002, updated by *Economic Indicators* published by the Joint Economic Committee, April 2002.

Figure 7.3 Manufacturing exports plus imports as a percentage of manufacturing GDP, 1980-2000



Source: *Economic Report of the President*, February 2002, and author's calculations as described in footnote 3.

Figure 7.4 Real broad dollar index and manufacturing profit share



Source: *Economic Report of the President*, February 2002, and author's calculations.

of manufacturing GDP, but by 2000 they had risen to 116 percent of manufacturing GDP. The value of manufacturing trade (exports plus imports) now exceeds the total value of manufacturing output. Manufacturing exports are 46 percent of manufacturing output, and manufacturing imports are 70 percent of manufacturing output. Given this exposure, overvaluation of the dollar whipsaws the manufacturing sector.

A second indirect damage channel is investment spending, which is negatively affected for two reasons. First, by reducing exports and domestic sales, an overvalued dollar contributes to excess capacity, which diminishes the need to invest. Second, by making foreign goods cheaper, an overvalued dollar lowers profitability and reduces firms' ability to finance investment. In August 2002, manufacturing capacity utilization was 74.6 percent, 6.3 percentage points below the average for the period 1967-2001, and manufacturing capacity utilization in 2002 is running at its lowest level since 1983. Figure 7.4 shows the Federal Reserve's broad currency index and the manufacturing profit share, and it reveals a clear inverse correlation. These heuristic arguments can be supported by formal econometric analysis; Blecker (2002) reports that the dollar enters negatively and statistically significantly in regressions of the manufacturing profit share and the manufacturing investment rate. Indeed, a hallmark of the current recession has been the collapse in business fixed investment spending.

The policy implications are clear. The overvalued dollar has contributed significantly to the current recession, and it now risks triggering a double-

dip recession. The benefits of Federal Reserve easing, mortgage refinancings, tax cuts, and increased government spending have all been diluted to the extent that spending has bled into imports. The inventory rebuilding of the first half of 2002 also had weaker employment effects to the extent that it relied on imports. A robust sustained recovery will require renewed business investment spending, but the likelihood of such spending is reduced as long as the overvalued dollar undermines domestic manufacturers' competitive position and creates incentives to shift production offshore.

Long-Term Damage: Manufacturing and Financial Stability

Not only has the overvalued dollar inflicted short-run damage on the US economy, it has also inflicted long-run damage. In September 2002 US manufacturing employment fell to 16.6 million jobs, equal to the level of January 1962. This decline threatens the long-run commercial outlook for the US economy. The threat is illustrated in the aircraft industry, where Boeing has been forced to make significantly larger cuts to production schedules than has Airbus.⁴ Given that airlines order on a "fleet" principle, sales lost today mean lost future sales, as airlines tend to stick with their current supplier when placing new aircraft orders.

In the textile industry, there were on average two mill closures a week in 2001, and there were 240 mill closures between 1997 and September 2002.⁵ Modern textile-making equipment from these closures is being sold overseas in secondhand markets at rock-bottom prices. In this fashion, US capacity is being permanently reduced while that of foreign competitors is built up.

Loss of manufacturing jobs carries a high cost. Manufacturing is widely recognized as a principal engine of productivity growth, and there is evidence of positive productivity spillovers from manufacturing to non-manufacturing (Palley 1999). Some of the greatest gains from "new economy" information technologies may come from application of these technologies to manufacturing. A shrinking manufacturing sector results in a smaller base for productivity growth and on which to apply the new

4. See "Boeing's Bleak Outlook: It's a Desert Out There," *The Economist*, January 24, 2003, and "Airbus: Battering Boeing," *The Economist*, July 18, 2002.

5. These statistics are drawn from "Crisis in US Textiles," posted on the Web site of the American Textile Manufacturers Institute, <http://www.atmi.org>. 1997 was a record year for US textile industry profitability, fiber consumption, shipments, and exports. According to ATMI, "Since then the dollar's relentless rise, particularly against the currencies of major Asian exporters, has shattered the competitive structure of the industry, causing a huge import surge while collapsing major export markets."

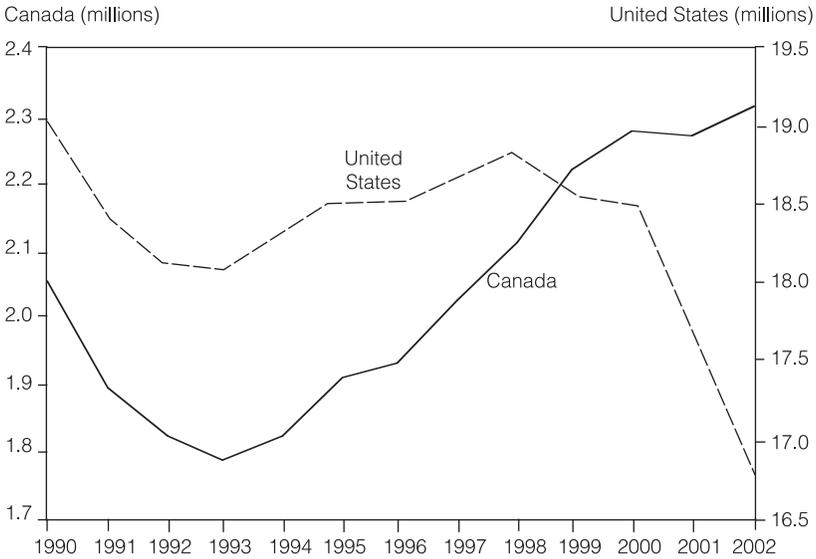
information technologies. Consequently, the United States is at risk of having slower productivity growth in the future, which will result in lower living standards.

A second cost of lost manufacturing jobs concerns wages and income distribution (Palley 1999). Historically, manufacturing jobs have been “good” jobs in the sense of paying above-average wages and health benefits. Moreover, these jobs have gone disproportionately to those with educational attainment of a high school diploma or less, a group still constituting 75 percent of the labor force. Manufacturing jobs have historically provided a ladder to the middle class for this large group, and there is solid empirical evidence that increasing the share of manufacturing jobs in total employment improves income distribution. Eliminating these jobs is therefore tantamount to kicking away the ladder, and the decline in manufacturing employment stands to entrench America’s deteriorated income distribution.

A widespread misapprehension is that declining manufacturing employment is an inevitable feature of economic development, and a parallel is often drawn with the experience of US agriculture. However, this parallel is misleading. First, the decline in agricultural employment occurred as the United States became agriculturally self-sufficient and a net exporter of agricultural products, whereas the decline in manufacturing is marked by increasing import dependence. Second, while it is true that the manufacturing share of employment tends to decline owing to manufacturing’s faster productivity growth, this need not mean a falling absolute level of manufacturing employment. Instead, manufacturing employment can actually grow slightly over time. This is illustrated by the Canadian experience. Figure 7.5 shows manufacturing employment in the United States and Canada for the period 1990 to March 2002. After the recession of the early 1990s, manufacturing employment in both countries bottomed out in 1993. Thereafter, in Canada it proceeded to rise steadily, from 1.8 million in 1993 to 2.3 million in 2000, making for a 28 percent gain over seven years. Moreover, manufacturing employment has held constant since then, and was 2.3 million in March 2002.

The difference in the Canadian and US experiences holds a number of important lessons. First, there is no automatic tendency for manufacturing employment to fall. Canada and the United States have similar economic endowments, measured in terms of quality of governance, capital stock, and labor force educational attainment. Yet in Canada manufacturing employment has significantly grown, whereas in the United States it has not. Moreover, during the 1990s the United States had more favorable macroeconomic conditions than Canada, since it enjoyed a stronger consumption and investment boom and had lower interest rates. The one significant difference between the two economies was the exchange rate, with the US dollar showing sustained appreciation relative to the Canadian dollar.

Figure 7.5 Manufacturing employment in the United States and Canada, 1990-March 2002



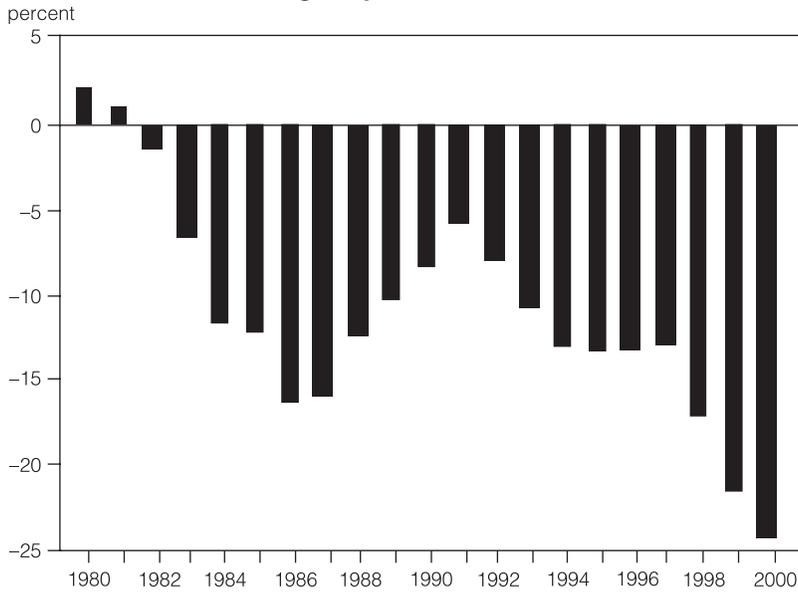
Source: *Economic Report of the President*, February 2002, and author's calculations. Canadian data provided by the Canadian Labor Congress.

Some have claimed that the loss of US manufacturing jobs is due to the global economy's slowdown. But if this were so, there should have been a similar loss of jobs in Canadian manufacturing, which is not the case. Nor can the US recession entirely explain the loss of jobs, since Canadian manufacturing is enormously dependent on the US market, which absorbs 85 percent of Canadian exports. If the US recession were decisive, Canadian manufacturing should also have been negatively affected.

As noted earlier, the overvalued dollar and the decline of manufacturing are both intimately linked with the problem of the trade deficit. A declining manufacturing base threatens to entrench structurally the large US trade deficit, which risks creating conditions conducive to financial instability. The ability to run a trade deficit requires a willingness of foreigners to finance the deficit. If that willingness diminishes, lacking a domestic manufacturing base capable of replacing imported goods, the US economy could become constrained to grow more slowly with higher unemployment.

This danger is illustrated in figure 7.6, which shows the manufacturing trade deficit as a percentage of manufacturing output. In 1980 the United States had a small surplus on manufacturing trade equal to 2.04 percent of manufacturing GDP, but since then this surplus has turned into a widening deficit. As of 2000, the manufacturing trade deficit was 24.56

Figure 7.6 Manufacturing trade deficit as a share of manufacturing output, 1980-2000



Source: *Economic Report of the President*, February 2002, and author's calculations as described in footnote 3.

Table 7.1 Selected US trade and international financial wealth statistics (percent)

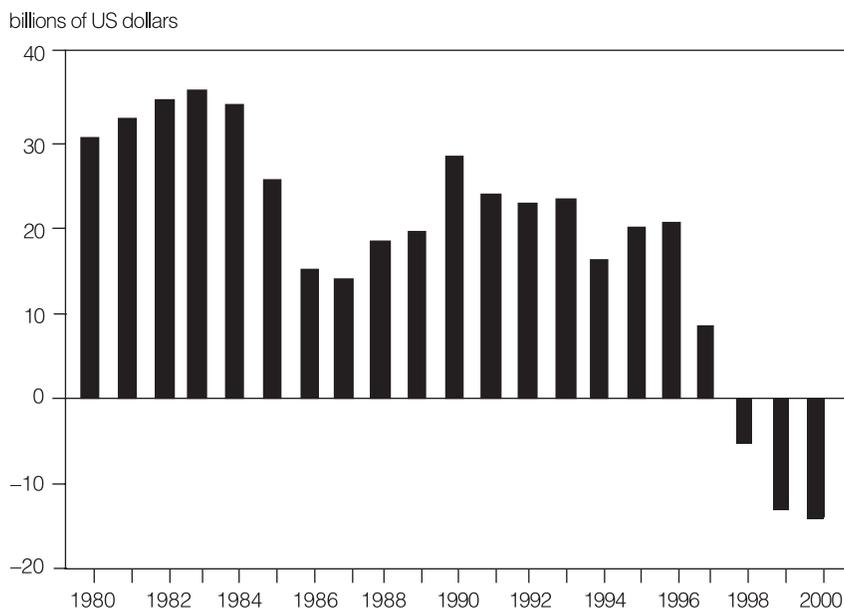
As percent of GDP	1990	1995	2000	2002Q1
Trade balance, goods	-1.9	-2.4	-4.6	-4.1
Current account balance	-1.4	-1.4	-4.2	-4.3
Net US international financial position	-2.8	-4.6	-16.0	-22.6
Foreign financial asset holdings in United States	33.1	44.2	62.5	65.1

Source: Blecker (2002).

percent of manufacturing GDP. The size of this deficit suggests that the United States may now be critically short of manufacturing capacity, exposing it to a risk of stagflation triggered by financial instability.

The logic is as follows. For much of the past 20 years the United States has run large current account deficits that have been financed by a combination of borrowing from abroad and selling US-owned assets to foreigners. Having been the world's largest creditor in 1980, the United States has become the world's largest debtor. This change is captured in table 7.1, which shows how persistent trade deficits have contributed to a deterioration in the US net international financial position and an increase in foreign-owned US financial assets. Moreover, this changed financial

Figure 7.7 The balance on the US foreign income account, 1980-2000



Source: *Economic Report of the President*, February 2002.

circumstance is feeding back on the current account deficit, since the United States must now pay interest and dividends to foreigners. The balance on international income turned negative in 1998 for the first time since before World War II, and in 2001 the income account was in deficit to the tune of \$19.1 billion. These changes, illustrated in figure 7.7, promise to grow as a result of compounding of interest on past loans and investments.

The increased size of foreign asset holdings means that even a minor rebalancing of foreign portfolios away from the United States could have large financial market effects. In the event that foreign investors lose their appetite for US financial assets, US financial markets will stand exposed to reduced demand, which will lower asset prices and raise interest rates. The dollar also stands to weaken precipitously as asset holders exit US markets. Higher interest rates would then choke off economic activity, while a sharp decline in the dollar would make for significant imported inflation because of dependence on imported manufactured goods. Hence, stagflation.

The nexus of the trade deficit and financial instability described above can be understood through the metaphor of a bathtub. Water in the tub represents accumulated indebtedness, and water entering through the tap represents new borrowing. As long as there is room in the tub, more

water—that is, new debt—can flow in. But once the tub reaches its limit, the water immediately starts to overflow. This metaphor captures the nature of financial crises. One minute everything appears sound, and the next, financial markets are in turmoil. No one knows exactly what the US financial instability threshold is, but the United States has run large trade deficits for 20 years and the current account deficit was 4 percent of GDP in 2001. Historically, deficits of this magnitude have proved harbingers of instability. Policy prudence therefore suggests a course of smooth gradual adjustment now, rather than risking larger future disruptions.

Global Economic Problems Stemming from the Overvalued Dollar

It is not only the domestic economy that is being hurt by the overvalued dollar. So too is the global economy. Although foreign economies benefit from the overvalued dollar to the extent that it lowers their export prices and increases export sales to the United States, foreign economies also bear several costs.

One cost comes from imported inflation resulting from the fact that most commodities are priced in dollars. This is illustrated by the European experience where, after the introduction of the euro in January 1999, inflation surged because of higher oil prices. The near-tripling of dollar-denominated oil prices that took place over the period 1999-2001 interacted with the 35 percent fall in the value of the euro relative to the dollar to cause higher inflation. This prompted the European Central Bank to raise interest rates, which slowed the European economy.

A second cost is related to debt service for developing countries. Most developing countries have significant dollar-denominated foreign debts. A rise in the value of the dollar makes it more difficult to service this debt, requiring countries to export more to meet their debt service obligations. By increasing the debt service strain, the overvalued dollar creates financial instability in developing countries. Moreover, this comes on top of the problem of higher dollar costs of imported oil, which also has a negative effect on developing countries.

The third and most important cost pertains to the US economy, which is the locomotive of the global economy. If the US economy is pushed back into a double-dip recession as a result of the overvalued dollar, the global economy will be profoundly and negatively affected. A double-dip recession can be expected to significantly reduce US imports, and these losses stand to far outweigh the sales gains at the margin that foreign economies gain as a result of the overvalued dollar. In effect, the negative

income feedbacks resulting from a dollar-induced double-dip recession will dominate any positive relative price effects on foreign country exports.

Arguments for a “Strong” Dollar Do Not Wash

The arguments against an overvalued dollar are compelling, yet some continue to argue that a “strong” dollar is desirable. One argument is that the strong dollar helps keep down inflation by lowering import prices and keeping the lid on prices of domestic manufacturers. This argument had some support in the late 1990s when the United States was in the midst of a huge credit-driven boom, but that is no longer the case. Inflation is not an imminent economic danger, and there are reasons to believe that deflation is actually the greater danger, given the highly indebted state of the US economy. In these circumstances, slightly higher inflation could be a benefit to the extent that it reduces debt burdens.

A second argument is that a strong dollar is needed to finance the trade deficit. This argument has the reasoning backward. There is a need to finance the trade deficit because the dollar is hugely overvalued. Absent this overvaluation, exports would be higher and imports lower, which would diminish the trade deficit and the amount needed to finance it.

The above financing argument can also apply to claims that the US trade deficit is the product of inadequate domestic saving rather than the overvalued dollar. These undersaving claims misunderstand the nature of the national income identity from which they derive. The national income identity is given by

$$\begin{aligned} &(\text{private saving} - \text{private investment spending}) + \\ &(\text{taxes} - \text{government spending}) = (\text{exports} - \text{imports}) \end{aligned}$$

The logic of this identity can be understood through the logic of credit markets, which require that for every lender there be a borrower. The trade deficit represents foreign lending to the United States, and by implication there must be either a private-sector borrower (when private saving is less than private investment) and/or a public-sector borrower (when taxes are less than government spending). A higher-valued dollar drives up the trade deficit, thereby inducing additional foreign borrowing, the counterpart of which must by definition be a domestic saving shortfall.

Exchange Rate Intervention Works

Having made the case that an overvalued dollar is economically damaging, I turn now to the problem of what is to be done. Some argue that

foreign exchange market flows are simply too large and that effective intervention is no longer feasible in a world of globally integrated financial markets. In making this claim, intervention opponents point to the many instances where massive intervention has failed to sustain exchange rates. Most recently, there is the case of Turkey in 2002. Other recent cases include Brazil in 1999, Russia in 1998, and the East Asian economies in 1997. A classic example concerning developed economies is the United Kingdom in 1992. In each of these instances, market forces proved too powerful, and central banks ultimately had to accept lower exchange rates.

Missing in the discussion of dollar intervention is the fact that there is a significant difference between intervention designed to lower the value of a currency and intervention designed to support a currency's value. Turkey, Brazil, Russia, East Asia, and the United Kingdom were all instances where national central banks were pitted against market participants in an attempt to defend exchange rates. The resources available to these banks were restricted to limited holdings of foreign reserves, and given the huge leverage possessed by market participants, they were inevitably defeated. However, intervention by a strong currency bank is a different matter, since it is selling its own currency, of which it has unlimited supplies.

Evidence for the success of intervention is provided by the Plaza Exchange Rate Accord of September 1985, when the G-7 finance ministers agreed to bring down the value of the dollar, and there followed a smooth depreciation that lasted 18 months. On a more systematic level, research by Dominguez and Frankel (1993) reports evidence that exchange rate intervention was successful in the 1980s. Their conclusions are reaffirmed in a recent state-of-the-art survey of the literature on exchange rate intervention by Sarno and Taylor (2001) and in a recent intervention event study by Fatum and Hutchison (2001). Ito (2002) also provides implicit support for the effectiveness of intervention by reporting how the Bank of Japan made systematic profits on its interventions during the 1990s. Currency markets appear to be significantly driven by psychology, momentum trading, and herd behavior, which explains why econometric models do so poorly in attempts to predict the exchange rate. That said, this also explains why robust coordinated central bank market interventions accompanied by coordinated central bank "open-mouth operations" can change market psychology and the direction in which the herd is moving.

If successful exchange rate intervention is feasible, that still leaves the question of when intervention is warranted. When it comes to exchange rate settings, policymakers can be guided by real exchange rate measures that track the real value of currencies and take account of differences in country inflation rates. A theoretical framework for analyzing this issue is provided by Williamson (1985) through his concept of fundamental

Table 7.2 Total reserves excluding gold (end-of-period, in billions of US dollars)

Country	1990	1995	2001
Japan	78	183	395
China	30	76	216
Hong Kong	24	55	111

Source: Blecker (2002).

equilibrium exchange rates. In arriving at decisions, the policy process should also ensure that those who are economically affected are consulted. In this connection, it is noteworthy that the National Association of Manufacturers, the AFL-CIO, and the American Farm Bureau Federation are all currently calling for a weaker dollar.

Economic policymaking involves judgments. Adjusting interest rates results in changes in asset prices. Central banks willingly engage in interest rate management because they recognize the pervasive effect of interest rates on economic activity. The same holds for the exchange rate. Just as interest rate policy is set on the basis of sensibly informed judgments about the economy, so, too, exchange rate policy should be conducted in similar fashion.

China and Japan: Two Special Policy Concerns

The value of the dollar needs to be brought down against the broad index of currencies. However, the Japanese yen and the Chinese renminbi are especially problematic. In the case of the yen, the Japanese government has repeatedly engaged in strategic interventions to gain competitive trade advantage. In the case of the renminbi, China has run persistent large trade surpluses, yet capital controls prevent the renminbi from appreciating. In both cases, these policies have resulted in large accumulations of foreign reserves that have blocked the yen and the renminbi from appreciating. The scale of accumulations is shown in table 7.2.

With regard to the yen, Japanese government policy appears driven by the hope that a weak yen will sufficiently stimulate exports to pull the economy out of recession. However, the reality is that Japan is a relatively closed economy, with exports constituting only 11 percent of GDP, while a significant portion of imports are nonsubstitutable primary products. Therefore the base on which depreciation operates is too small for yen depreciation to solve Japan's domestic economic problems. Instead, yen depreciation risks exporting Japan's problems to the United States and to other East Asian trading rivals. This risks triggering financial instability and a cycle of competitive devaluation in the East Asia region. The clear

policy implication is that Japan must abandon its attempt to depreciate its way out of recession.

With regard to the renminbi, the problem is that China is using an artificially undervalued currency to spur export-led growth. According to the International Monetary Fund's *Direction of Trade Statistics Yearbook* (2000), in 1999 (the latest available data) China had a trade surplus of \$68.7 billion with the United States and of \$28.7 billion with the European Union. China is also a massive recipient of foreign direct investment (FDI) and the dominant destination of such investment in the developing world. In a free market, China's exchange rate should appreciate under these conditions. However, China has pursued an aggressive interventionist and mercantilist exchange rate strategy that has prevented its currency from appreciating. The result has been continuing trade surpluses that threaten global deflation. Jobs are being lost in the US manufacturing sector, and China is also effectively sucking all the demand out of the global economy, leaving nothing for other developing countries. In this fashion, the developing economies are being pushed into permanent stagnation. Once again the policy implication is clear. As a member of the international economic community, China must abandon its mercantilist exchange rate policy and allow its currency to appreciate as market forces dictate.

Policy Recommendations

The recognition that currency markets can damage economic activity points to broader issues of international economic governance. The existing international policy framework treats trade and finance as separate independent arenas, yet it is clear that trade outcomes are profoundly affected by currency markets. Milton Friedman's (1953) old defense that exchange rates are determined by market fundamentals and that market speculators will inevitably pull exchange rates back to levels warranted by these fundamentals is now discredited, as the empirical literature on purchasing power parity conclusively proves.⁶ Instead, exchange rates appear to behave like asset market prices, and exchange rate bubbles driven by speculative expectations can persist for long periods. Today's dollar problem shows that exchange rate misalignment is not just a problem for developing countries.

Recommendation 1. An immediate policy recommendation is for the US Treasury to explicitly revoke its earlier "strong dollar" rhetoric. Such rhetoric has likely contributed to the dollar's appreciation by creating market expectations that the Treasury stands ready to intervene in the event of dollar weakness. When linked with the willingness of many

6. Obstfeld (2001) provides a survey of the empirical literature on purchasing power parity.

foreign governments to accept weaker currencies to gain international competitive advantage, the Treasury's rhetoric has likely fostered perceptions of a "one-way" bet that places persistent upward pressure on the dollar. Revoking this rhetoric will help erase such perceptions.

Recommendation 2. Japan must abandon its attempt to depreciate its way out of recession. This is a policy that will not work for Japan, yet risks exporting Japan's problems. China must abandon its mercantilist exchange rate policy and allow its currency to appreciate as market forces dictate.

Recommendation 3. The European Central Bank must be enjoined to lower interest rates and adopt a more progrowth monetary policy stance. There is clear evidence that the European economy is slowing dramatically, and this has had a dampening effect on investor demand for euro-denominated assets.⁷ By increasing growth, an interest rate reduction stands to appreciate the euro by making European assets more attractive.

Recommendation 4. Leaders of the G-7 should initiate a second Plaza Accord. They should publicly acknowledge that the dollar needs to be brought down smoothly from current levels and that their central banks will act to do so through coordinated market intervention. An appropriate benchmark would be 100 to 110 yen per dollar and 1.10 to 1.20 dollars per euro.

Recommendation 5. In addition to these changes in country policies, there are deeper structural failings in foreign exchange markets that point to a need for permanent coordinated exchange rate policies. Acting together, with the onus of intervention falling predominantly on central banks of stronger currencies, the international community should establish procedures to prevent future damaging currency misalignments. American workers suffered from the dollar bubble of the mid-1980s, and they are suffering again from today's dollar bubble. Exchange rates are too important and potentially disruptive to be left to unfettered speculation, and the community of central banks should establish procedures for monitoring and correcting exchange rate excesses.

Recommendation 6. There is a need to reconsider existing arrangements of unfettered capital mobility. The goal should not be to prevent capital mobility, but rather to give central banks the ability to slow inflows when they deem necessary. One possibility is application of speed bumps in the form of temporary nonremunerated reserve requirements on capital inflows. These have been used to good effect in Chile.

Recommendation 7. The fact that exchanges rates can become significantly distorted points to the need for exchange rate considerations to be addressed in trade agreements. In serial fashion across countries, exchange

7. The IMF's *World Economic Outlook*, September 2002, reports of Europe that "there are signs of core inflation starting to come down, and . . . the recovery has appeared increasingly hesitant" (27).

rate depreciations have destroyed US manufacturing jobs and capital investments without regard to underlying productive efficiency. Such depreciations swamp the benefit of tariff reductions achieved through trade negotiations, and amount to an exchange rate subsidy for US competitors. Trade policy must explicitly address this problem and can no longer be pursued as if trade and exchange rates are unrelated.

In the global trade-exchange rate game, US policymakers have persistently abdicated their responsibilities, leaving US manufacturers unprotected against the exchange rate manipulations of rival governments. Some of the major manufacturing US trading partners, such as Japan and Korea, manipulate their currencies to give their exports a competitive edge. This has been documented by Calvo and Reinhart (2000), who term developing countries' practice of managing their currencies "fear of floating." Although governments nominally commit to a floating exchange rate regime, they actually engage in systematic intervention to prevent appreciations.

The old Bretton Woods system of fixed exchange rates guarded against this type of unfair practice, but that system suffered from the need for large disruptive periodic exchange rate adjustments, and it could not withstand the powers of speculation created by liberalization of capital flows. The system that has replaced Bretton Woods encourages unfair exchange rate gaming, and it also allows exchange rates to be set by capital flows irrespective of trade deficits. There is no going back to the Bretton Woods arrangements. However, placing exchange rate provisions in trade agreements, having a coordinated G-7 exchange rate policy centered on strong-currency central banks leading interventions, and making small modifications to the rules governing capital flows so as to allow central banks to slow inflows would go a long way to making the international financial system work more fairly and productively. Implementing such an agenda will require policymakers to escape the existing efficient-financial-markets ideology that has them abdicating their powers of responsible governance. In the meantime, this ideology promotes a policy of dollar complacency that is deepening America's economic slump.

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