The Dangers of an Overvalued Dollar

John Williamson, discussing his study with William R. Cline, argues that established fundamental equilibrium exchange rates (FEERs) will help promote global financial stability.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest on Peterson Perspectives today is John Williamson, senior fellow at the Institute and author with our colleague, William R. Cline, of a new study on fundamental equilibrium exchange rates—a study that is now part of an annual series at the Institute. John talked about it at a presentation today, June third. Welcome, John, thanks for joining me.

John Williamson: Oh, it's a pleasure.

Steve Weisman: John, the headline of your study today is that the dollar continues to be substantially overvalued in relation to not just the Chinese currency, the renminbi, but many other currencies. How overvalued is it and how much should we worry about that in terms of the future of global economic stability?

John Williamson: We came out with this week with a finding of an overvaluation of about 12 percent on average against other currencies. As you say, that includes some currencies against which the US dollar is actually undervalued, the Canadian dollar in particular we see in that category and the South African rand. But there aren't many currencies in that category.

The majority of currencies are either pretty well valued in general but nevertheless undervalued against the dollar—and therefore one needs them to move up against the dollar, like the euro, for example—or are undervalued generally as well as against the US dollar. In this category are currencies like the Chinese renminbi, which I would like to see move up, that are therefore undervalued a lot against the dollar.

Steve Weisman: And some other Asian currencies as well.

John Williamson: And some others of the Asian currencies, yes.

Steve Weisman: One reason why the dollar is overvalued is the so-called safe haven phenomenon. Since the beginning of the crisis, how much of a factor has that been?

John Williamson: Well, it's a large factor. This study was based on exchange rates for March, and that factor was I think at its maximum right about then and accounted for about 10 percent on the value of the dollar that time. So it's pushed the value of the dollar up. It's come down about halfway, but it's still overvalued relative to last year.

Steve Weisman: Why has it come down in the last two or three months?

John Williamson: I think the valuation was, as you said, due in part to a safe-haven effect. People were very scared by the financial crisis and they thought it might get worse, but it proved not to get worse. It proved to get better. The world economy hit bottom and it's now showing signs of recovering. So it's a natural consequence that other currencies begin to recover and the counterpart of that is the fall in the dollar.

Steve Weisman: Is there also a factor of a fear of inflation in the United States and other things that would contribute to a decline in the dollar's value in the future?

John Williamson: If one expected the United States to have inflation greater than that in the rest of the world, the consequence would be a declining dollar secularly. That might happen gradually, it might be a slow adjustment. That's how the FEER [fundamental equilibrium exchange rate] would adjust, in a slow movement. That would clearly have to weaken gradually to offset the rising prices in the United States. I don't yet see that this is a likelihood that the United States will inflate more than the rest of the world.

I think that's a serious angle, of a fairly general inflation in the coming years, but I don't see the evidence that the United States is likely to inflate more than the average of other counties.

Steve Weisman: John, you pioneered the whole concept of establishing, based on economic fundamentals, what should be the appropriate exchange rates for a healthy equilibrium in the economy. But markets have a way of defying those norms for their own reasons. What is causing them to flout what should be the norm?

John Williamson: Well, a lot of markets nowadays like to think of that as being a trend. So the dollar is strengthening or it's weakening and it has to continue and the longer it continues, I suppose, the happier they are. So they certainly see this trend continuing until it's gone too far, until it's overshot and then corrective forces come into play.

I think the world would be much healthier if in fact people began searching for equilibrium and asking themselves the question, not whether a change was likely, a continuing change, but whether a rate is far from equilibrium, and if so began seeking a return toward it.

Steve Weisman: The reflection of the equilibrium is the exchange rate, but the underlying concern about this equilibrium is the current account deficits and surpluses that we experience occasionally and certainly have in the last several years in the United States, especially with China. Why do these big imbalances not correct themselves?

John Williamson: Well, exactly because there are too many market operators who are intent on pushing a rate according to some trend projection rather than looking at what's necessary or what would have the effect of correcting a current account imbalance. I think the world would be a lot healthier if most operators, market operators, did ask those things, but that's not what they look at.

Steve Weisman: In order to achieve the equilibrium, there would have to be much more coordinated intervention, wouldn't there?

John Williamson: One way of doing it would be by coordinating intervention. I think it would help too if one could get some agreement on what you are trying to achieve by coordinating intervention. In other words, get some agreement on the package of exchange rates that would be aimed at by intervention, because at the moment there's no intervention primarily because there's no such agreement.

It's only when rates go to really extreme levels and people on both sides of the market can see that rates have gone to such extreme levels that they are hurting both parties that there's any chance of getting joint intervention, but I think it would help. The first stage would be to get agreement on something like my fundamental equilibrium exchange rates.

Steve Weisman: But treasury secretaries and finance ministries seem terribly averse to talking about this. You pointed out at the session today that the mantra of the US Treasury is always that strong a dollar is in the United States' interest even when that's manifestly not true or it's not even the policy.

What does that tell you? I mean there's a little bit of talking out of both sides of one's mouth.

John Williamson: I think that's right. I don't really understand what they expect to be achieving. They think they're preserving confidence in some way …

Steve Weisman: This is the Treasury you mean?

John Williamson: Right, but how that preserves confidence, I don't claim to understand.

Steve Weisman: Well if the Treasury did say a strong dollar is not necessarily in our interest, wouldn't that cause a run on the dollar?

John Williamson: Well, if the dollar were overvalued at the time, it sure would. But that's what would then depreciate the dollar. Now, the question is whether it would stop at a sensible level. And all the people who are so skeptical of the power of intervention seem to think that it would have been impossible to stop a run that would be bound to overshoot and then we'll get a weaker currency instead of too-strong currency.

Therefore they stick with the devil they know. I don't really understand why you can't say what you mean and …

Steve Weisman: Mean what you say.

John Williamson: Right.

Steve Weisman: Just a final question. There has been a lot of talk about overhauling the entire international financial architecture. What component of such an overhaul would help to produce the kind of discussion or agreements that you're talking about here?

John Williamson: I think it would be to have a commitment to agree on a set of target exchange rates. If these targets came out of a discussion in the IMF Executive Board, everybody would be entitled to have a say in what went in to the analysis. And I just don't believe that you couldn't reach agreement. Of course it would be difficult; negotiations are always difficult if there are very important issues, but I don't think that you couldn't reach agreement at the end of it. The Chinese, you sit them down, you tell them that they've joined—the problem is they joined an organization where there really weren't any rules…

Steve Weisman: You mean the IMF?

John Williamson: Right. When they joined the IMF, there weren't really any rules about exchange rates, any meaningful rules.

If they in fact joined an organization with rules, the historical record is that they have been pretty good at abiding by the rules, so I think that would have happened. Now, whether you can in fact talk them into agreeing to a change in the rules that would then bind them, that's going to be more difficult, but I do think that that's the challenge we're faced with.

Steve Weisman: John Williamson, thank you very much for discussing that challenge with us today.

John Williamson: My pleasure.