The Declining Dollar: Little Cause for Concern

Joseph E. Gagnon discusses the consequences of a declining dollar and says the probability of the dollar crashing in relation to other currencies is fairly low..

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest today is Joseph Gagnon, who has recently joined the Peterson Institute as a senior fellow from the Federal Reserve where he was an economist for 22 years. Thanks for joining us, Joe.

Joseph Gagnon: Oh you're welcome, Steve.

Steve Weisman: Joe, what's happening with the dollar? There's a lot of talk that the dollar is suddenly depreciating. And there are some cries of alarm, some declarations that this is a good thing. Let's start with what is actually happening to the dollar in the world economy.

Joseph Gagnon: As you said, it has been depreciating lately against a number of currencies, but notably not the Chinese renminbi because China has pegged its currency to the dollar. It's basically unwound—going back to where it was a little over a year ago. It went up during the crisis because people saw it as a safe haven. And as people have relaxed a bit, it seems to have come back down. I think the fear is whether it might go down further.

Steve Weisman: Do people see it as less of a safe haven now, or is it just that they see other markets—currency markets—as safer than they were during the crisis?

Joseph Gagnon: I think it's more the latter. People are more willing to put their money in different places and places where they hope that there'll be higher returns. And interest rates are very low in the United States, so it's less attractive for them right now.

Steve Weisman: Explain to our readers and listeners what the effect is of the dollar declining against the currencies of our trading partners.

Joseph Gagnon: The effects on the economy are to increase US exports—to help US exporters sell their products overseas and to reduce the attractiveness of the US market to foreign exporters. So it should help our trade balance over time. That's probably the biggest one and perhaps the one reason why some foreigners are concerned especially in Europe, where the euro is returning to high levels.

Steve Weisman: And are we beginning to hear concern in Europe, especially the big exporters like Germany, about this trend?

Joseph Gagnon: Yes, I believe so and especially in the rest of Europe. And you hear it more, or at least I've seen a bit more of it, talked about in France and Italy, than even Germany.

Steve Weisman: Let's talk about China for a second. China, after letting the dollar or letting the Chinese currency appreciate for a while, has pretty much stayed at that current ratio for the last year. And there're other Asian countries that have followed that lead or that are also pegged to the dollar like China. How many other countries are we talking about?

Joseph Gagnon: To a greater or lesser extent, I think most of the countries in Asia, with of course the major exception of Japan, but mostly the emerging countries of Asia have been resisting their currencies appreciating against the dollar. So it's not an all or nothing thing but it's a widespread phenomenon.

Steve Weisman: Americans have heard their Treasury secretary, under both Republican and Democratic administrations, say that a strong dollar is in the United States's interest. And we've even heard that reiterated by Treasury Secretary Geithner, as we did from Treasury Secretary Paulson before him. Is it?

Joseph Gagnon: You know, that's a tough question. I think the way they've traditionally formulated it, it is true in the sense that they often embellish it with the type of sound, fundamental policies, leading to a strong dollar and that's all in the US interest. A strong dollar is to the extent that it means we can borrow more cheaply from abroad, interest rates are lower in the United States, that a strong dollar is associated with stable prices in the United States. And it makes it easier for us to buy things from abroad. So in all that sense, it's good. But I think it's only good in the sense that it's the result of good policies in the long run. It's not that at any point in time it would be better to have a stronger dollar. And they've been clear; they haven't said that. In fact, they shy away from saying, "We want a stronger dollar."

Steve Weisman: Right now.

Joseph Gagnon: Yes. Even now. Right. And even now and in general, they've really tried to distinguish between indicating whether going up or down will be good from here, versus just in more a vague, generic sense whether just having a strong dollar is good. I think a better way of interpreting a strong dollar would be to talk about stable prices and low inflation in the United States. And a strong currency is one that has low inflation. In that sense, clearly a strong dollar is in our interest, in the sense of a dollar with lower inflation.

Steve Weisman: Are there any potential dangers to a dollar depreciating?

Joseph Gagnon: You know there can be. I've studied this in my research. Typically, bad outcomes associated with depreciation are almost always a result of monetary and fiscal policies but mostly monetary policies that were too inflationary; that basically tried to overstimulate the economy, pushed unemployment too low and wound up depreciating the currency and getting inflation and then having a boom-bust cycle. And I don't see that as a risk right now. Unemployment is not too low and inflation is currently not a worry and I think it will be a long way before it becomes a worry. So in this juncture, it seems depreciation wouldn't have the dire consequences that it sometimes has in the past. In fact, I haven't—in studying 40 years of exchange rates of the major countries, industrial countries, I can't think of a single episode where there was a sharp depreciation when a country had very low and falling inflation and very high unemployment and there were any bad results.

Steve Weisman: Politically though, I think there is a concern in some quarters that in the next couple of years countries might lose faith in the politicization of the monetary policy. Congress, in its regulatory reforms, may be making our central bank more accountable to congressional wishes. Explain to me how that might lead to a dangerous scenario.

Joseph Gagnon: I think you put your finger on probably the one way in which that could be associated with a dollar crash—could spark a dollar crash. Again, I don't want to be on record as saying, "I think a dollar crash is likely." I think it's unlikely but these things cannot be ruled out. And the one spark that might cause such a scenario that would have bad consequences would be something that would call in question the credibility of future monetary policy. Something that would prevent the Federal Reserve from being able to head off any future inflation as it needs to. If that were to happen—and even as soon as markets begin to believe it might happen—then you could begin to have a dollar crash and you might get some of the bad inflationary effects, you might get some of the bad outcomes that we did see in the past. And I think that would be the one case to worry about.

Steve Weisman: And that would be the one case in which holders of dollars in other countries might go into some kind of selling frenzy?

Joseph Gagnon: That's a little tricky because one of the puzzles of international finance is we don't understand quite why the preferences of international investors across currencies do shift; and they do shift. And when they shift, they don't always have harmful consequences. But as I said: When they do have harmful consequences they tend to be associated with these losses of inflationary credibility and inflationary episodes in countries. When those go together with currency crashes then you have problems. But if you have a loss of investor desire for a certain currency that isn't associated with these other factors, then it's not so bad. And if you're in a recession and that happens, it's a good thing. It has been a good thing in the past. I mean, I'm speaking from past episodes—my study of past episodes. But of course, I can't guarantee you that the future might not hold something different.

Steve Weisman: Right. But for now, you see the relationship of the dollar to other currencies. I mean, that it might depreciate some more but it's basically—you don't see any major further declines in the offing?

Joseph Gagnon: It's hard to predict these things. We can't predict things so I don't see—I certainly don't see any reason.

Steve Weisman: I wouldn't hold you to it …

Joseph Gagnon: Yes. I don't see any reason for it. But I think the one thing that people are talking about, which I agree with, is I think China would be better off in the long run letting its currency float, which would almost certainly mean an appreciation. And a lot of Asian countries might go with it. So I think one of the things people here at the Peterson Institute, including Fred Bergsten, our director, has been saying and I agree with is that the dollar in the long run does need to depreciate. And I mean, the other countries need to depreciate against the Asian currencies and if the Asian currencies are undervalued in the long-run sense it would be better if you got that adjustment sooner, I would think, rather than later. But as far as the dollar versus other currencies, it doesn't seem like there's any obvious need for further readjustment.

Steve Weisman: Joseph Gagnon, thank you very much for joining us in your debut on Peterson Perspectives.

Joseph Gagnon: Oh you're welcome, Steve. It was a pleasure.