The Dollar Situation in May 2004

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The U.S. dollar, after rising sharply against other currencies for several years, has been falling for about two years now. This has led many people to consider the dollar as being "weak." The truth, however, is that despite the downward movement of the dollar vis-à-vis other currencies since the first quarter of 2002, the dollar's necessary correction is only about half-completed.

In no sense is the dollar "weak." To the contrary, it is still too strong. In fact, the dollar today is stronger than it was when Robert Rubin, President Clinton's Treasury Secretary and author of the "strong dollar policy" was still in office. Individuals who consider the dollar "weak" are looking only at the last 2-3 years rather than considering a more valid perspective. One cannot select the dollar's peak or trough value, pronounce that to be normal, and than use that value as the basis by which to judge strength or weakness.

The best measure of the dollars value relative to other currencies is the Federal Reserve Board's price-adjusted broad currency index. That index, after being relatively stable for a decade, began to soar in 1997 -- rising 25 percent until it peaked in February 2002. Since then the dollar has begun to return to more normal levels, but only about half-way. Today the index is still 14 percent over its early 1997 level.

Moreover, it is instructive to recognize that the index today is stronger than it was in May 1999, when then-Secretary of the Treasury Rubin felt compelled to explain almost daily that he favored a strong dollar policy. The dollar was too strong then, and is still too strong now.

Now, there may be differences of view as to whether the dollar's relative value at the beginning of 1997 was at a level approximating equilibrium. This level, though was neither a peak nor a trough and was also at a point in time when the current account balance was relatively stable. Before anyone challenges this they should undertake an examination of the dollar's performance in the entire post-Smithsonian era that started in the early 1970's. Any such examination will quickly reveal the dollar was badly overvalued in the early 1980's and in the current period. For example, just taking the average value for the index, excluding the overvaluation of the early 1980's, shows the dollar today is about 10 percent higher than its 30-year average!

The consequences of the dollar's excessive strength have been severe. For one thing, the U.S. merchandise trade deficit soared from $180 billion in 1997 to $535 billion last year. With the European Union, the U.S. deficit went from $15 billion to nearly $100 billion. Estimates indicate that about three-quarters of the deficit increase is attributable to the excessive value of the dollar.

The U.S. trade and current account deficits are not caused by capacity restraints in the United States that are forcing excess demand to be satisfied by imports. To the contrary, both U.S. employment in the goods sectors and industrial capacity utilization are both very low. The basic cause of the deficit was the dollar.

The consequences are serious for the world as a whole, not just for the U.S. economy. The U.S. current account deficits cannot be sustained. They are distorting world capital and economic flows, and Adam Smith's invisible hand will bring about a correction.

His hand has already been trying, but governments -- principally in Asia -- have been resisting. If they persist, the dollar's correction is likely to be severe and abrupt at some point, rather than the manageable adjustment that has been taking place to date.

Why did the dollar get so overvalued, and why did it begin a correction? Certainly the Asian financial crisis of 1997 played a significant role in capital flight into the United States. The rapid growth of the U.S. economy also pulled in huge amounts of portfolio and fixed investment capital. But those developments really ended by 1999-2000, yet the value of the dollar kept rising even after interest rate and growth differentials had notably shifted away from the United States.

The answer, according to foreign exchange traders, was the belief that the U.S. government's "strong dollar" policy meant the Treasury would intervene if the dollar began to decline from its lofty level. The Treasury never said so and never even hinted so, but traders said that if the "strong dollar" policy didn't mean the Treasury would intervene -- then what did it mean?

In early 2002, the Administration made a major change in rhetoric. It began to explain that while it favored a strong dollar, the dollar's strength should reflect economic developments and the actual value of the dollar should be set by the marketplace free of government intervention. Let me emphasize that -- ***free of government intervention***.

Foreign exchange traders, all of whom knew the dollar was excessively strong, began moving almost immediately to lessen their dollar positions, and the dollar began its correction -- at least vis-à-vis currencies that were free to adjust in the marketplace.

The euro, for example, went from a low of about $.87 to as high as $1.28 and is about $1.18 today. But $.87 was not an equilibrium rate for the euro by any stretch of the imagination. That rate reflected a huge drop in the value of the euro without any underlying economic developments behind it. While many Europeans may look at the euro as excessively strong today, it is important to remember that the euro is only barely back to the initial level it had when it was first traded.

Moreover, if you look at the European Central Bank's monthly publication for January 1999, it is quite clear that the bank viewed the euro as undervalued at that time. Additionally, the vast bulk of the economic literature of the day predicted a significant upward movement was in the cards. It is also important to remember that European currencies had an average value of $1.21 for the decade prior to 1997 -- and at times reached as high as $1.40!

Thus it is difficult to conclude that the euro is excessively strong today or that the dollar is weak against the euro. What is important though, is not my personal view regarding the appropriate level for currencies, but that the markets set the exchange rate free of government financial or verbal intervention. While markets will oscillate, if left free of intervention, they will generally tend to reflect underlying economic fundamentals.

The problem with interference is not with the euro or the Canadian dollar, both of which have exhibited no signs of government intervention in the currency markets. No, the problem is with the Asian currencies -- most particularly the Chinese yuan, which is pegged at its 1994 level despite the huge increases in productivity, output, investment, and quality in Chinese production.

China maintains its peg by purchasing about $10 billion of U.S. dollars every month, or about $120 billion in the last year -- just about the same size as its trade surplus with the United States. China is now sitting on $440 billion of dollar reserves -- about 40 percent of its entire GDP!

Other Asian countries are intervening in markets as well. Japan, for example, poured even more into buying U.S. dollars than did China -- building its reserves up by about $150 billion in the first three months of this year. But at the end of that period, the yen had actually strengthened somewhat. Korea and Taiwan are also intervening heavily. Together, China, Japan, Korea, and Taiwan built up their reserves by $540 billion in the last 12 months -- and now sit on over $1.6 trillion dollars of reserves as a result of their policies to keep their currencies below market value.

Global disequilibrium cannot be obtained as long as intervention is tolerated to this degree. It is not only the United States that faces economic distortions as a result, but also Europe -- and in the longer run, Asia as well. Economic disequilibrium is never a good thing, whether it is on the surplus or the deficit side.

We all have much to gain by insisting that currency markets should be free of government intervention. That is what the International Monetary Fund is supposed to do, and that is what the G-8 is supposed to do. It is high time that they start doing it.