

The Dollar's Fall: Time for a Grand Bargain?
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The dollar's fall is not abating. To the contrary, it is rapidly reaching the point where it poses a serious problem. Growth in Europe, especially in Germany, is already slow, and the further loss of export competitiveness now threatens to derail the continent's feeble expansion. Japan is still trying to crawl out of its deflationary hole. The decline in the dollar and resulting fall in import prices are the last things it needs.

Only in the United States has the falling dollar been regarded benignly. And this may be about to change. So far, the weaker dollar has helped to sustain the U.S. expansion. It has not produced significantly higher inflation and interest rates. But the lower the dollar sinks, the larger the losses that foreign central banks take on their reserves of U.S. treasury bonds. There are signs that they are growing reluctant to add to their holdings of U.S. securities and shifting some of their existing reserves into euros and yen. If a large-scale shift occurs, U.S. Treasury bond yields would rise and the dollar would plunge. The U.S. housing-price bubble would burst. All this would wreak havoc with financial markets.

These facts have led to predictable calls for coordinated intervention in foreign exchange markets. Pundits call for a "New Plaza Accord," harking back to the 1985 crisis meeting at the Plaza Hotel in New York. To be sure, the context then was different. The problem in 1985 was an excessively strong dollar, not a weak one. But observers recall how the dollar adjusted back to more normal levels after finance ministers announced their commitment to produce "some further orderly appreciation of the main non-dollar currencies against the dollar."

What is attractive about the Plaza precedent is that it makes it seem that the dollar can be stabilized without significant changes in national economic policies. In 1985 the U.S. didn't agree to significant reductions in its gaping budget deficit. The Asians didn't undertake a major fiscal expansion. There was no discussion at the Plaza of monetary policy, and no one actually adjusted their central bank interest rates. No one had to agree to changes in policy with domestic costs, in other words. As Paul Volcker put it, "To the best of my knowledge, no budget, trade, or structural policy was changed as a result of the Plaza." He could have said the same of monetary policy. All that happened was that governments intervened in foreign exchange markets.

The truth is that nothing is achieved for free, not even in currency markets. In fact, the dollar had already stopped rising and started to fall fully half a year before the Plaza meeting, reflecting the growing reluctance of foreigners to finance the U.S. current account deficit. The problem of an over-strong dollar was already solving itself, in other words. The Plaza Accord allowed the politicians to claim credit for this, where in reality they bore little responsibility.

If the idea that a bit of foreign exchange market intervention could steer financial markets was implausible in 1985, it is even less plausible today. International financial markets were liquid then, but they are immensely more liquid now. The swaps and credits that central banks and governments can mobilize for purposes of intervention are dwarfed by the resources of market participants. If the markets think that the prices of U.S. treasury securities and the dollar are going to fall, there is nothing that concerted intervention, by itself, can do about this.

This is also the lesson of the other famous episode of large-scale intervention, the Louvre Agreement. After 1985 the dollar fell steadily. By 1987 the concern had become that a further fall would be destabilizing. Again there were calls for intervention, and again high government officials assembled, this time in the Louvre wing of the offices of the French Finance Ministry. They agreed to reference ranges for the dollar against the deutschmark and the yen and committed to intervention to defend them.

Again, there was little in the way of changes in national economic policies. The Bank of Japan cut its discount rate by a mere 50 basis points and the Bundesbank refused to do anything despite much goading by the Americans. U.S. Treasury Secretary Baker pledged to cut the U.S. budget deficit over time, much as the Bush Administration pledges to do today. But since there was neither the political will nor the Congressional support for doing so, the U.S. deficit drastically exceeded the target in Baker's pledge. Germany and Japan had agreed to increase their deficits to support global growth, but both governments faced political resistance at home. With the United States unwilling to do its part, they had no grand bargain to point to in order overcome domestic political objections. Germany managed to push through only token fiscal stimulus. The Japanese did only a little better.

Moreover, this time the dollar had not cooperated by conveniently reversing direction just prior to the meeting. With little in the way of significant changes in economic policies, there was no reason for exchange rates to stabilize, much less to reverse course.

Within two months of the Louvre meeting, the yen had busted out of its target range and resumed its appreciation. Despite massive amounts of foreign exchange market intervention, the dollar resumed its fall. Only later in the summer when the Fed raised the discount rate for purely domestic reasons – that is, only when there was a real change in U.S. policy – did the greenback finally stabilize.

This second episode thus points to the only thing that would stabilize the dollar now: changes in U.S. economic policies. The dollar is weak because U.S. savings, both household savings and government savings, are inadequate, and because foreigners are increasingly reluctant to make up the difference. It would be nice if household savings rates could be magically raised, but there are no convenient policy instruments for fine tuning them, especially in the short run. This means that the dollar's weakness can be addressed only by reducing government dissaving – in other words, by cutting the budget deficit.

And herein lies the second lesson of the Louvre Agreement. U.S. tax increases or spending reductions would slow the growth of global demand. That would be bad for profitability and could lead to a sharp downward correction of highly valued global stock markets. This is just what happened in 1987 when the Fed raised interest rates and the stock market crashed.

This in turn suggests if the U.S. takes steps to address its budget deficit, the rest of the world needs to support global demand. In Europe, where the ever-higher euro will soon be putting downward pressure on inflation, there is room for the ECB to cut interest rates. In Asian countries with low debts and deficits, there is room for cutting taxes. Korea's deficit, for example, is only 1 per cent of GDP. Its government has already committed to applying a small dose of fiscal stimulus, but it could go further. Japan, with much larger debts and deficits, is preparing to raising taxes. While it will have to undertake fiscal consolidation eventually, it should put those measures on hold for now. Asia can also take some of the pressure off Europe by allowing its currencies to rise against the dollar, but doing so will slow its economies, making strong fiscal expansion all the more important.

So here we have the outlines of a grand bargain: fiscal consolidation in the U.S., fiscal expansion in Asia, and monetary stimulus in Europe. Everyone will be better off with this adjustment in the policy mix. Budgetary adjustment in the U.S. will strengthen the dollar and put the U.S. back on a sustainable fiscal path. Monetary stimulus by the ECB will cap the rise in the euro and encourage the investment that Europe needs. And looser fiscal policy in Asia will sustain global growth and help the continent to recover from its tsunami.

Unfortunately, none of the three regions seems ready to do its part. The ECB is still preoccupied by the nonexistent specter of inflation when the real risk in Europe is deflation due to the falling prices of imports not just from China but now from America as well. It is engaged in a death struggle with national governments, refusing to cut interest rates until the latter first rein in their excessive deficits. And with the collapse of the Stability and Growth Pact and the breakdown of fiscal discipline in France and Germany, no end to this gridlock is in sight.

In Asia, governments remain reluctant to run deficits because of memories of the last time they did so, in 1997-8. Those were the years of the Asian financial crisis, when foreign exchange markets descended into chaos and economic growth collapsed. In fact, Asian policy makers have the cause and effect backwards: the crisis caused the deficits, not the other way around. Now, after the tsunami, countries like Indonesia, Thailand and Malaysia will have no choice but to run larger deficits to reconstruct the devastated regions. But their increased public spending will at best neutralize the reduction in spending by distressed households unless they are joined in fiscal expansion by larger economies like Korea and Japan.

Worst of all, the United States is still unwilling to address its fiscal problem. Mr. Bush's so-called plan for halving the budget deficit by 2009 rests on the wishful assumption of a significant jump in revenues, starting with a record surge of \$200 billion this year. We shall see. If the dollar's accelerating fall causes the stock market to weaken, there is no way that such forecasts will prove even remotely correct. The administration's budget proposal contains no significant cuts in spending. The costs of the Iraq War are not even included in the budget request. Neither are the costs of "reforming" Social Security by letting people divert part of their payroll taxes to private accounts while making unchanged payments to current retirees, which will require borrowing perhaps \$2 trillion over the next decade. It is hard to imagine that the markets will see this as a serious effort to bring the U.S. deficit under control.

Nor will foreign governments see it that way. With the United States contributing only words, there is no prospect for a grand bargain. Europe and Asia will not take steps to support global demand unless they see that the United States is putting its fiscal house in order. Since there is no sign of this happening, the only realistic expectation is for the dollar continuing to fall. If that fall accelerates, spooking financial markets, global economic prospects could become dire indeed.

We can then expect another summit of finance ministers where they announce "concerted intervention" to halt the decline of the greenback and invoke the spirit of the Plaza and Louvre. But if those spirits could speak, they would remind the assembled ministers that their words are empty. Only real action – actual adjustments in monetary and fiscal policies – can put exchange rates and the world economy back on a stable footing. Unfortunately, domestic politics in each of the world's three principal regions make such action unlikely at the present time.

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