

## **Dollar Adjustment – Hard Landing or Global Slowdown?**

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The acceleration in the depreciation of the US dollar against the currencies of its major trading partners, and in particular against the Euro, in the last quarter of 2004 has elicited fears of a possible “hard landing” for the dollar, similar to that experienced after the attempt in the failed 1985 Plaza Accord to use international policy coordination to produce adjustment to international imbalances via an orderly dollar depreciation. This expectation finds support in the strong similarities between the large external and fiscal account imbalances and those produced by the Reagan administration’s supply-side policies in the early 1980s. At that time rapid reductions in tax rates led to a rising fiscal deficit, while the rapid expansion of the economy brought rising external deficits and speculative capital flows that produced rapid dollar appreciation. While the appreciation was reversed by a precipitous depreciation, this had little impact on the external imbalance that was only reversed by the first Gulf war and the fiscal deficit was only reversed by the Clinton administration policies of increased taxation and historically high sustained rates of growth of productivity and output.

The fact that the US external balance has continued to deteriorate even in the presence of substantial dollar depreciation and the absence of political support for effective measures to reduce the growing US fiscal deficit such as those introduced by the Clinton administration has led many to the conclusion that international financial markets will impose a solution in the form of further, possibly disruptive, dollar depreciation. This view is further supported by suggestions that many of the world’s central banks have started to diversify their reserve holdings away from US dollar assets. The result has been an increase in speculative financial flows towards

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<sup>1</sup> This article represents only the author’s personal opinions and should not be interpreted as those of the United Nations.

currencies as diverse as the Euro and the Chinese RMB that are expected to appreciate, and a rapid narrowing of yield spreads in international capital markets to historically low levels that in all probability no longer reflect the real risks involved in investments in emerging market financial assets.

However, if the causes of the US imbalances are primarily due international differences in relative growth rates rather than imbalances in relative prices of traded goods, then exchange market led adjustment of the US imbalances may simply produce greater financial market instability. If the anticipated changes in exchange rates increase the competitiveness of US producers they will provide a further stimulus to domestic growth, while decreasing competitiveness in those economies that rely on export demand to sustain positive growth, leaving the global growth differentials unchanged. The collapse of the dollar would then be accompanied by ever increasing dependence on the US, now increasingly accompanied by the large Asian economies, for global expansion.

On the optimistic side Federal Reserve Chairman Alan Greenspan has suggested that markets should not rely on historical comparisons of the magnitude of the imbalances since financial engineering innovations have made it possible for financial markets to accommodate much larger internal and external deficits than in the earlier period. He cites a Federal Reserve staff study noting that “current account deficits that emerged among developed countries since 1980 have risen as high as double-digit percentages of GDP before markets enforced a reversal. The median high has been about 5 percent of GDP” suggesting that the US position is not yet in the danger zone. He further notes that in “the aforementioned Federal Reserve study of current account corrections in developed countries, although the large majority of episodes were

characterized by some significant slowing of economic growth, most economies managed the adjustment without crisis.”<sup>2</sup>

In assessing the probable reaction of foreign exchange markets, it is important to note that the imbalances that characterize the global economy today are quite different from those of the 1980s. While the increased sophistication of international capital markets is certainly an important difference, more important are the increase in the magnitude and pattern of global trade and capital flows that they have allowed to take place. As a result, it is likely that an understanding of the current situation requires a reversal of the importance of those factors considered to be of importance in determining external imbalances and exchange rates in international markets.

Under conditions of fixed exchange rates with limited private capital flows such as characterized the post-Bretton Woods world through the early 1970s, economists were used to consider international differences in productivity and inflation as the major determinants of relative competitiveness of internationally traded goods and services. Exchange rate adjustments were viewed as offsetting these differences. However, after the breakdown of the stability of the Bretton Woods system in the 1970s, the development of sophisticated global capital markets in the 1980s and the liberalization of trade through the completion of the Uruguay round in the 1990s brought increasing importance to international capital flows determined by interest rate differentials, anticipated exchange rate movements, and relative growth and profitability. Instead of imbalances in trade in goods and services being offset by changes in international reserve

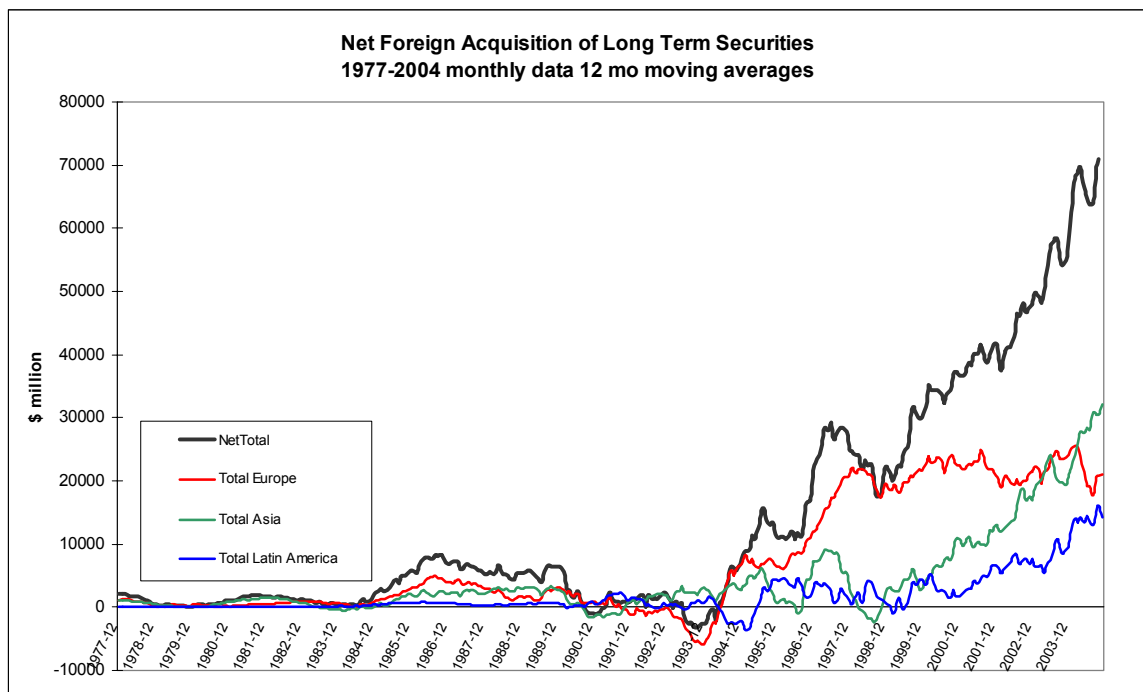
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<sup>2</sup> See Remarks by Chairman Alan Greenspan, Before the Bundesbank Lecture 2004, Berlin, Germany, January 13, 2004 (<http://www.federalreserve.gov/boarddocs/speeches/2004/20040113/default.htm>). Similar views are expressed in Remarks by Chairman Greenspan, “Current account”, Economic Club of New York, March 2, 2004 (<http://www.federalreserve.gov/boarddocs/speeches/2004/20040302/default.htm>) and Remarks by Chairman Alan Greenspan, At the European Banking Congress 2004, Frankfurt, Germany November 19, 2004, Panel discussion: “Euro in Wider Circles”, (<http://www.federalreserve.gov/boarddocs/speeches/2004/20041119/default.htm>).

balances and then exchange rate adjustments, trade in goods and services adapted to international capital flows and exchange rate adjustments.

The evidence of this rapid change in the importance of international capital flows for the US economy can be seen in Chart 1<sup>3</sup> showing the sharp increase in net non-resident acquisitions of US long-term securities as global recovery got under way in the 1990s.

Chart 1.



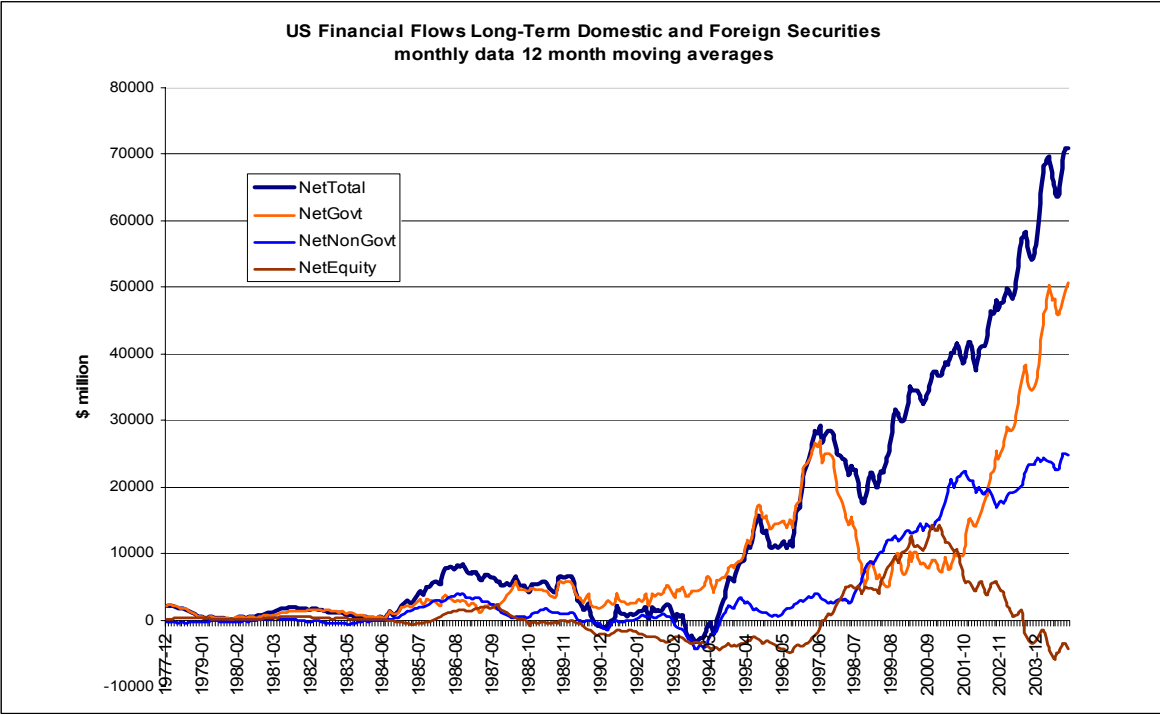
Not only was there an increase in the magnitude of the flows, their sources also underwent substantial change. The regional breakdown of the sources of these net inflows in the Chart shows that although Europe was the most important source of net inflows in the 1980s, the situation was more complex in the 1990s. Although inflows from Europe were relatively more important in the early 1980s, accounting for a majority of the net foreign acquisitions of US securities in the period 1994 to 1998, subsequently Asian countries undergoing rapid recovery in

<sup>3</sup> Data on US long term securities flows are elaborations of statistics reported to the US Treasury International Capital System ([http://www.treasury.gov/tic/s1\\_globl.csv](http://www.treasury.gov/tic/s1_globl.csv))

their external accounts after the 1997 financial crisis replaced Europe as the major investor in US assets. At around the same time inflows from Latin America and the Caribbean also started to increase rapidly, mainly from offshore financial centers.

The changing regional composition of inflows was also accompanied by a changing pattern of asset composition for foreign investors as can be seen in Chart 2<sup>4</sup>. In the first half of the 1990s US government securities dominated all other assets, only to be displaced by equity and private bonds as the stock market boom accelerated in the last half of the decade. By the end of the decade government securities had once again become dominant as Asian holders concentrated their purchases in these securities.

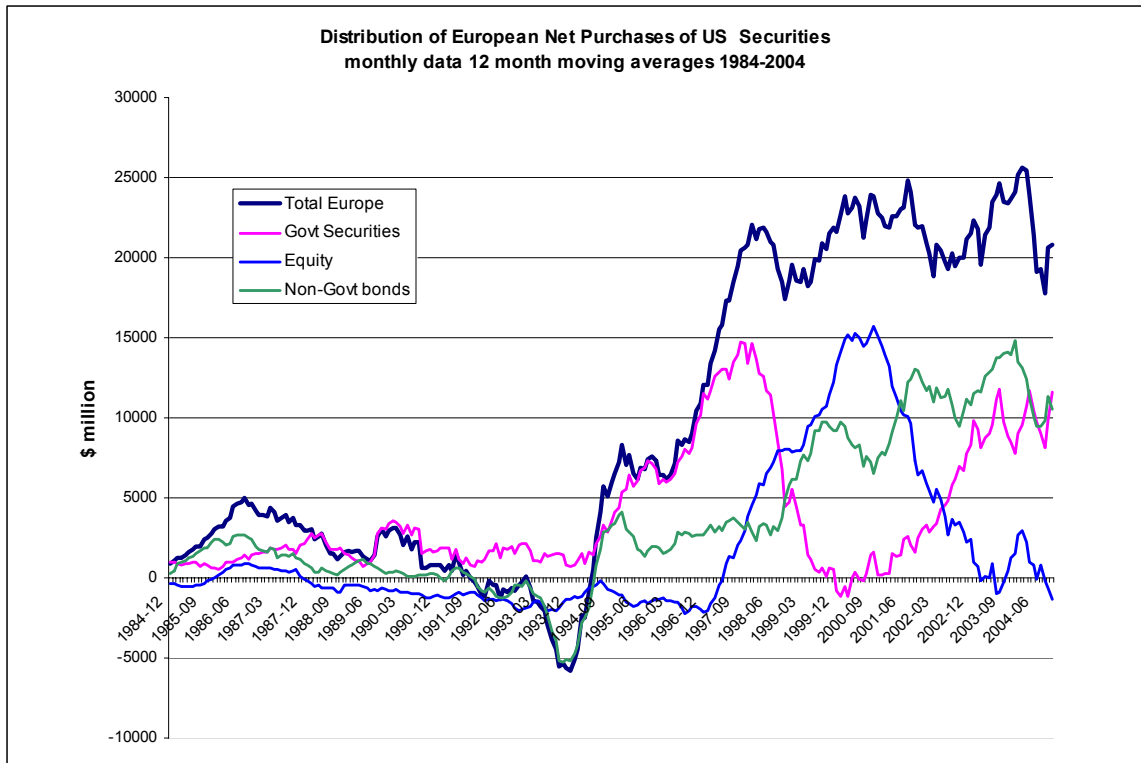
Chart 2



<sup>4</sup> Data on US government securities are columns (1 +2)less (3+ 4), private bonds columns (4+6) less (11+13) and equities columns (5+7) less (12 +14) of the statistics reported to the US Treasury International Capital System ([http://www.treasury.gov/tic/s1\\_globl.csv](http://www.treasury.gov/tic/s1_globl.csv))

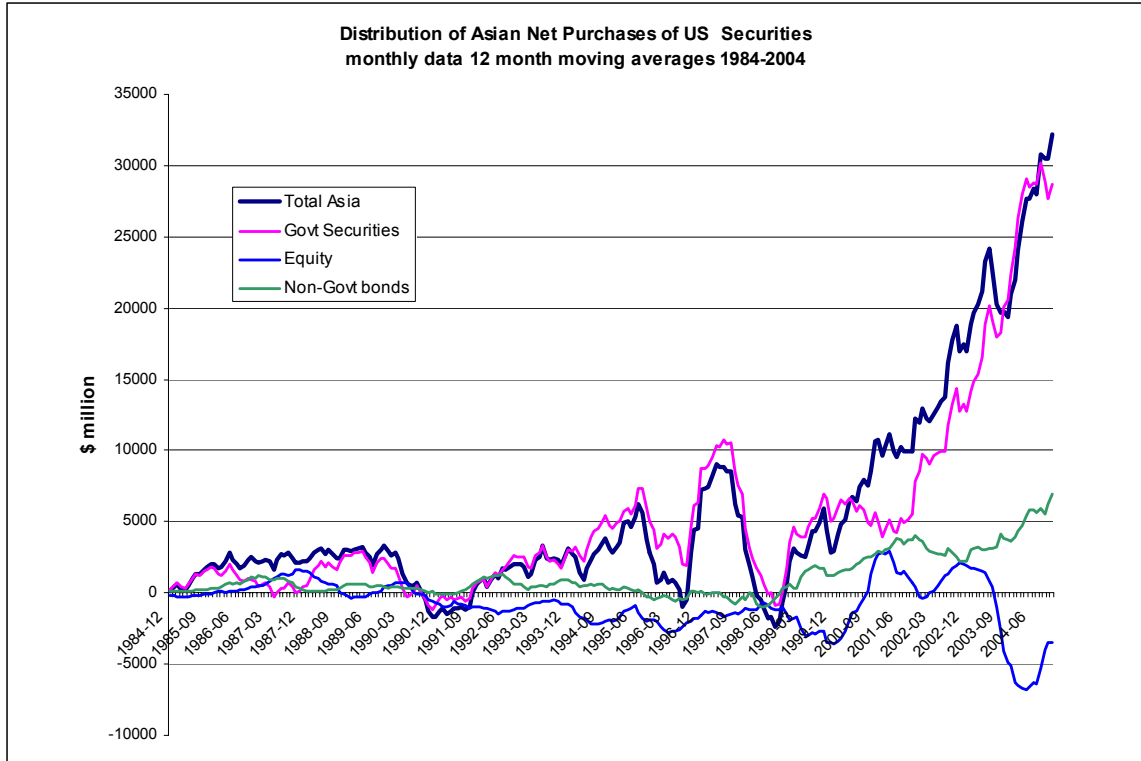
The change in the composition of flows of the Asian and European Regions can be seen in Chart 3. While the stability of European flows is generated by a substitution of government bonds for equity in the mid-1990s, the attractiveness of US government securities returns as the stock market bubble breaks.

Chart 3

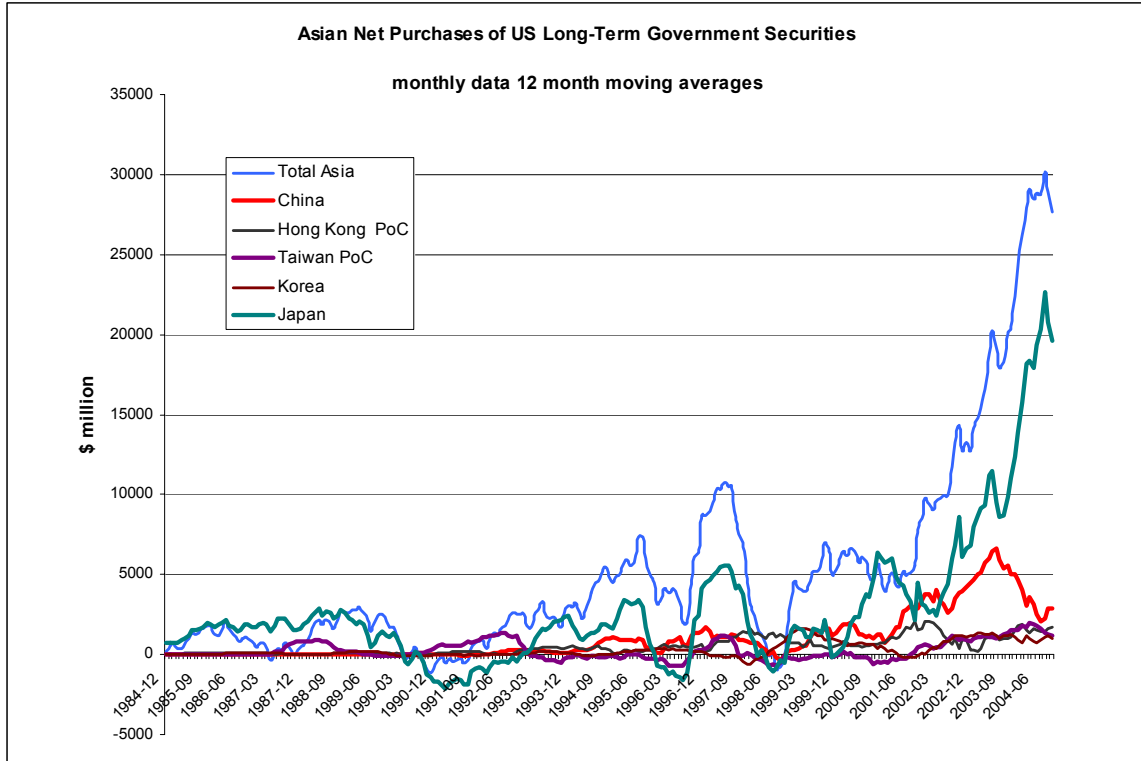


On the other hand, for Asian equity purchases have never been important and government securities, largely held as foreign exchange reserves dominate.

Chart 4



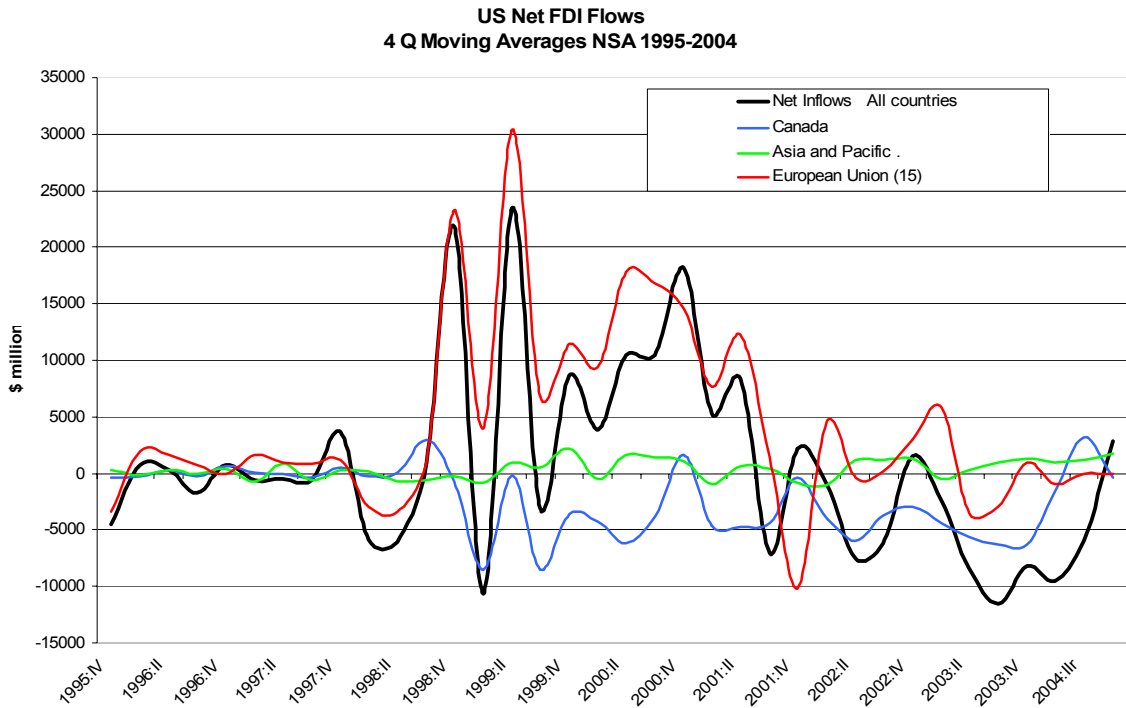
Although a great deal is made of the build up of reserves by the emerging market economies in Asia, by t far the largest share still accrues to Japan as can be seen in Chart 5.



Another change in international financial conditions has been the rapid rise of foreign direct investment flows. These flows have also been an important part of the appreciation of the dollar in the late 1990s. As European investors' acquisition of securities was falling off Europe became the major source of direct investment in the United States as can be seen in Chart 6<sup>5</sup>. This European FDI bubble was probably linked to the equity bubble and it is interesting that the sharp decline mirrors the depreciation of the dollar relative to the Euro.<sup>6</sup>

<sup>5</sup> The data for US net foreign direct investment are elaborations of data from the US Department of Commerce, Bureau of Economic Analysis, International Economic Accounts, Direct Investment, (<http://www.bea.gov/bea/di1.htm>).

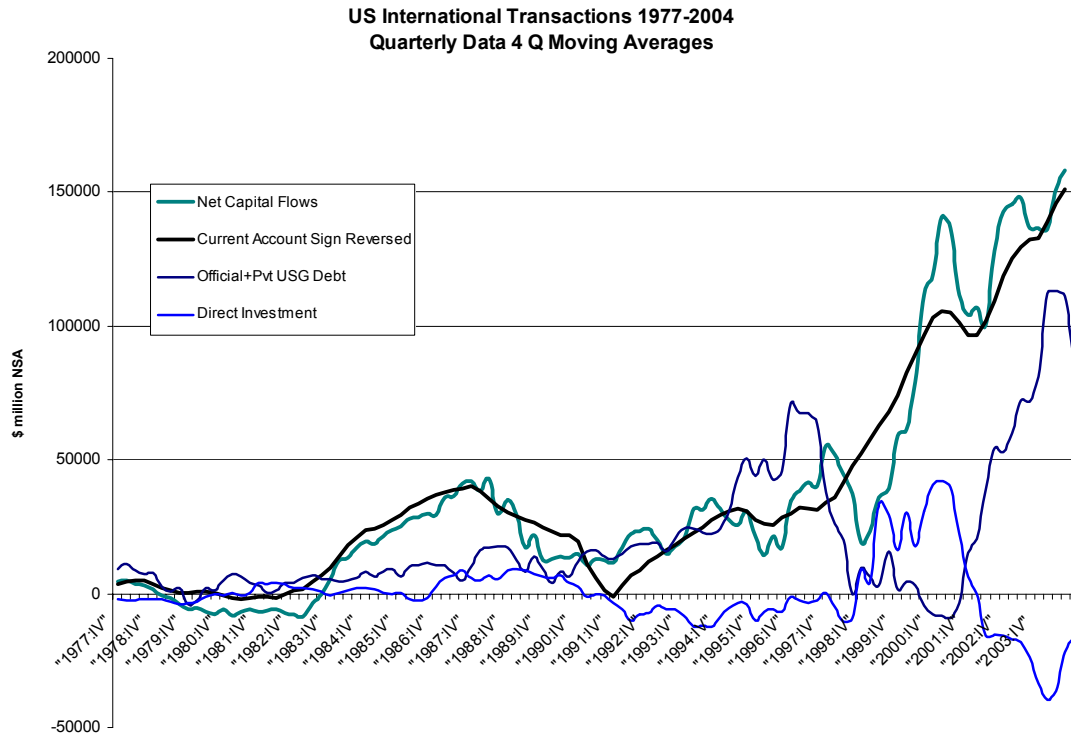
<sup>6</sup> Strictly, foreign direct investment cannot be considered as an independent source of demand for dollar assets for it includes the purchase and/or swap of equity or other securities to finance mergers as well as reinvested profits arising from previous FDI.



The broad picture then is that the dollar appreciation of the 1990s was largely driven by the rapid increase in the magnitude of capital flows, and the sustained nature of these flows, despite changes in regional sources and in the type of assets involved. Comparing net capital inflows relative to current account financing requirements in the 1980s with those of the 1990s, Chart 6 shows that while inflows lagged behind the current account deficit in the earlier period capital inflows frequently exceeded the current account financing requirement as the dollar appreciated in the 1990s. (The current account deficit is shown with sign reversed in order to make comparison with inflows more visible)<sup>7</sup>.

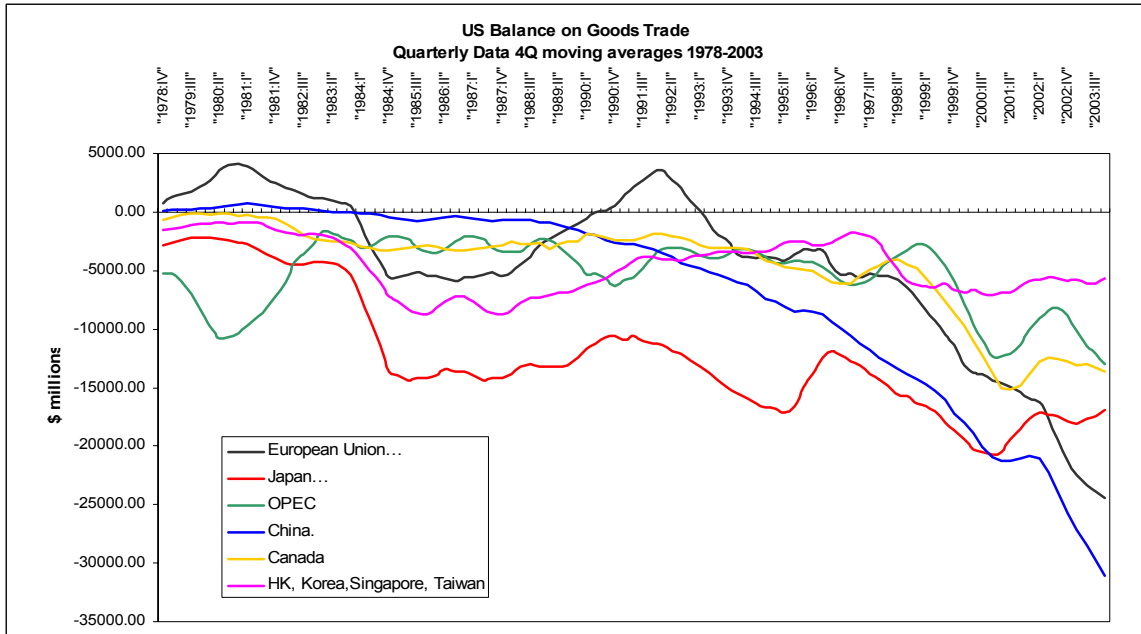
Chart 6

<sup>7</sup> The data for US international transactions come from elaborations of the US Department of Commerce, Bureau of Economic Analysis, International Economic Accounts, Balance of Payments (International Transactions) (<http://www.bea.gov/bea/di1.htm>).



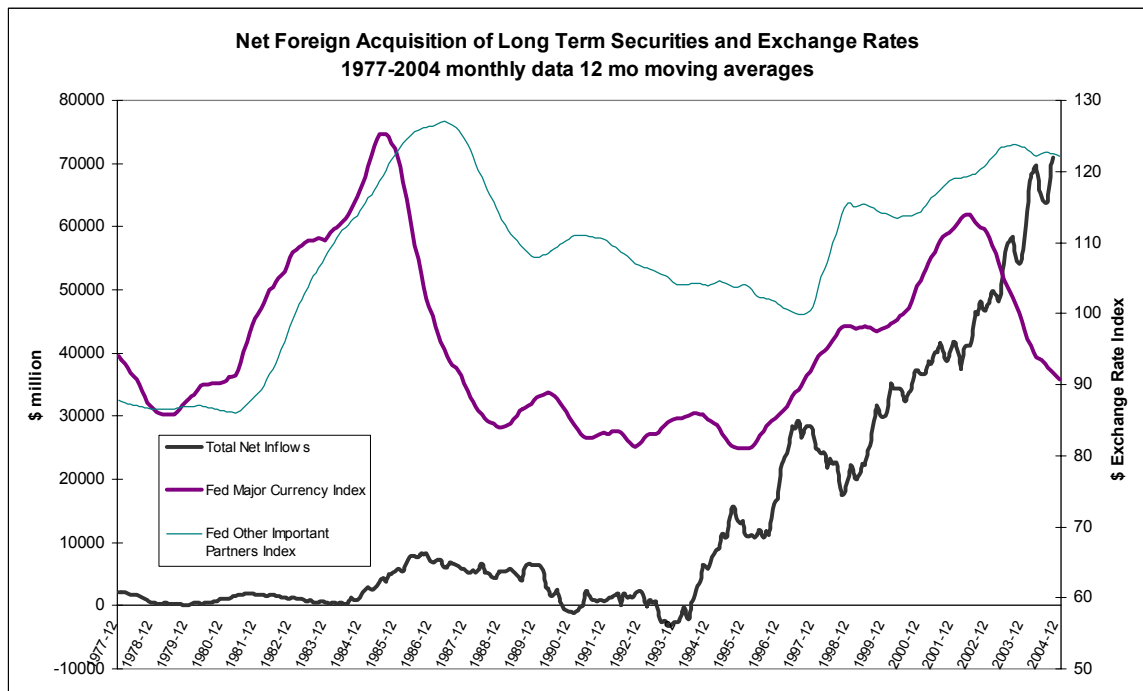
In addition to the change in the magnitude and distribution of capital flows across regions and assets, US bi-lateral trade flows are also very different from those of the 1980s when they were largely accounted for by Japan and OPEC. Chart 7 shows that during the 1990s the US has large bi-lateral deficits on goods trade with a larger number of countries, and in particular China, the EU and Canada have joined OPEC and Japan whose relative importance has declined substantially. This shift is in large part due to the recent liberalization of trade and the pattern of foreign direct investment noted above. US direct investments in China have provided increased capacity to produce exports to the US, while the same is true for Canada and after NAFTA for imports from Mexico. European direct investments in the US, on the other hand, have increased the import of European intermediate goods for sales in the rapidly growing US market in the 1990s. Both of these factors have had a negative impact on the US external position.

Chart 7



The broad conclusion then is that the role of global capital flows is much more important in understanding the origin and resolution of the current global imbalances than they were in the 1980s. Chart 8 exemplifies this difference by plotting net inflows against the movements in the Federal Reserve's price adjusted index of the exchange value of the dollar against the major world currencies and against its other important trading partners.

Chart 8



The Chart illustrates two important points. The first is that the recent depreciation of the dollar has not been accompanied by any sharp reversals in net capital inflows. The second is that this fact may be accounted for by the asymmetric nature of the exchange rate adjustment process. Although the dollar depreciation has not been as large in either absolute or percentage terms as that in the 1980s, its absolute level is now very near the low levels experienced in the 1980s as measured by the Federal Reserve’s price adjusted Major Currencies Index.<sup>8</sup> However, over this same period it has marginally appreciated against the currencies in the Federal Reserves’ “other important trading partners” price adjusted exchange rate index<sup>9</sup> and this despite the fact that some countries such as Korea and some countries in South America included in the index, such as Brazil and Chile, have allowed their currencies to appreciate relative to the US dollar. This

<sup>8</sup> The index includes a trade weighted average of the Euro, the Australia and Canadian Dollars, Japanese Yen, Swedish Kroner, Swiss Franc, and the United Kingdom pound sterling.

<sup>9</sup> The index includes the currencies of Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand ; Israel, Saudi Arabia and Russia.

means that dollar depreciation has occurred against only a few of the economies that account for the external imbalance, while it has appreciated against the mainly Asian economies that account for largest share of the imbalances. Many of these countries have chosen to keep their exchange rates stable against the dollar though active policies of market intervention. The dollar reserves thus acquired are largely held in dollar assets which has supported the sustained inflows shown in the Chart. As a result not only has most of the dollar depreciation been relative to the Euro which has the next largest bilateral deficit after China, but accounts for only around 12 per cent as a share of the overall US deficit, it has also brought sharply increased speculative flows to China and other Asian economies in the anticipation of decision to abandon policies of exchange rate stability.

Given the relative magnitude of the flows involved, it is clear that if the adjustment is solely in dollar-Euro exchange rate the depreciation that would be required to bring improvement in the US external imbalance in the absence of other adjustments would involve massive overshooting and involve increased international financial instability, even if it were politically acceptable.

However, there are other aspects of the changing pattern of international trade and capital flows that suggest that the problem could not be resolved even if there were exchange adjustment elsewhere. The impact of increased international financial flows, and in particular of foreign direct investment, on trade flows has been to increase the geographical distribution of production. Thus an increasing share of any globalised economy's domestic production is undertaken by the affiliates of foreign companies created through direct investment. On the one hand this is visible in a growing divergence between measures of domestic production and national production measuring the impact of non-resident factors of production on net facto

incomes. Thus an increasing portion of a country's external deficit may simply represent the existence of large foreign direct investments by domestic companies who are using low cost foreign production sites to manufacture goods that were previously made at home and now count as imports. Or it may represent the imports of foreign affiliates operating and selling in the domestic market. Part of the deficit thus represent the net foreign profits of domestic corporations. Exchange adjustment may thus have a positive impact on the return flow of profits from domestic corporations' international operations that offsets any improvement in the import balance due to increasing the costs of imports.

In addition, the geographical dispersion of various stages of the production process has made the impact of the growth in international trade on an economy more difficult to interpret since an increasing share of trade is in the form of primary inputs and semi-finished goods that are imported imports that are assembled into goods for export to final markets abroad. Thus there is a growing divergence between growth in a country's manufactured goods exports and growth in domestic value added from exports. Again, the impact of exchange adjustment is attenuated since it will have an opposite impact on imports and exports.

The US Department of Commerce provides estimates of the US external balance corrected for the impact of foreign corporations operations in the US and US corporations operations abroad<sup>10</sup>. They show that on average for the years 2000-2002, the last year for which data are available, around one quarter of the US deficit is accounted for by the export sales of US companies' foreign affiliates into the US market. As direct investment continues to grow and outsourcing continues to increase, it is to be expected that this distortion in the external accounts will increase and that exchange adjustment will be slow to reverse it.

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<sup>10</sup> The figures quoted are elaboration of data available in Ownership-Based Framework of the U.S. Current Account, 1982-2003 (XLS) (<http://www.bea.gov/bea/di/home/more.htm>)

For European companies operating affiliates in the United States, the figures show that for countries such as the UK, Netherlands and Germany, the sales of their US affiliates are from 4 to 12 times the value of their direct goods and services exports to the US market. Thus, direct exports of European goods for sale in the US have been increasingly displaced by the production and sale of goods produced by affiliates of European companies operating in the US. The initial impact of exchange rates is thus primarily on the translation of dollar profit remittances, and thus on the bottom line of the parent company's balance sheet, rather than on the flow of imports of goods and services.

However, the problem is made more difficult by the fact that on average foreign affiliates operating in the US import semi-finished inputs for use in production. In 2002 figures show that for all countries affiliated company imports in value terms were over double the value of their exports. For Europe it was around 1.8times and for Asian companies the ratio was well over three to one. Since it takes much more time and it is much more costly to close a foreign production operation than to divert exports from one market to another, it is unlikely that these foreign affiliates will be closed even if dollar depreciation induces large increases the costs of their imported inputs. Depreciation is thus unlikely to have much impact on the European share of the US bi-lateral deficit accounted for by these operations.

A similar argument can be made for the Asian bilateral imbalance with the US. First, a large proportion of Asian imports represent the products of US international corporations operating abroad. As many have pointed out, the wage differential between Asian labour and US labour is larger than any possible devaluation of the dollar and, as was the case in Japan in the 1980s, is likely to be met with increased productivity or falling wages. But, more importantly, wage costs are only a very small fraction of Asian production costs, which are made up primarily

of imported raw materials and semi-finished goods. Any appreciation of Asian currencies would reduce the costs of imported inputs and largely offsetting the impact on export prices leaving competitive conditions unchanged. Analysts do well to remember the minimal affect that frequent and large appreciations of the Yen in the 1970s and 1980s had on its bi-lateral trade balance with the US.

Finally, the recent increase in petroleum prices has meant the return of the oil producing countries as a major component of the US bi-lateral deficit. But, since their exports are priced in dollars, there is little that exchange rate adjustment can do to bring a reduction in the imbalances.

All this suggests that the increase in international capital flows and the globalisation of international production have substantially reduced the impact of exchange rate adjustments in remedying international trade imbalances. It seems unlikely that any conceivable dollar appreciation would be capable of reducing the US deficit without changes in other areas, even if there is appreciation in Asian currencies. However, if foreign exchange markets fail to perceive this new reality in trade and financial flows, and believe that adjustment can only be achieved by dollar appreciation then the likely failure of depreciation to bring rapid improvements in the US external accounts may lead to a belief that more depreciation is necessary and substantial overshooting against major currencies along with increased speculative flows to Asia. The former will simply make it more difficult for Europe to recover a steady growth path, while the latter will increase the risks of another Asian financial crisis. The more likely result is a slowing of growth in the rest of the world and a reduction in US exports growth, rather than a reduction in imports, leading to an even larger US deficit. Indeed, recent figures show that US export declines have been more important than import growth in their impact on the deficit. The risks of

leaving the adjustment of international imbalances to foreign exchange markets thus lie more on the side of a global recession than the damage caused by a hard landing for the dollar.

In the discussions leading up to the creation of the Bretton Woods System Keynes was concerned that countries running trade surpluses should not impose restrictive policies on their creditors that would jeopardize global growth. He recommended an automatic mechanism that would insure that surpluses were made available to finance continued growth in the debtor economies while longer term measures were introduced symmetrically both surplus and deficit economies. The financially sophisticated international financial system praised by Chairman Greenspan, along with the role of the US dollar as the international reserve currency, is currently fulfilling much the same role Keynes proposed.

From this point of view the fear that the dollar will collapse because international investors will no longer finance the US deficit is in fact a threat to global expansion if no other economy replaces the US in leading global recovery. In this respect the international adjustment problem is not China's surplus with the US and its policy to stabilize the RMB. China supports global growth by recycling its surplus with the US to purchase imports from other Asian economies with the result of a nearly balanced external position and an extremely rapid growth rate. The problem lies in those economies in Europe and Japan that currently run large surpluses that are used to finance growth in the US that they are unable to achieve at home. In this respect the problem is quite similar to that of the 1980s and the risk remains, as Chairman Greenspan has noted, not in financial crisis, but in the slowdown in growth that is required to bring adjustment.