THE DOLLAR, INTERNATIONAL TRADE, AND MONETARY POLICY
Remarks by Thomas C. Melzer
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I would like to thank you for the opportunity to discuss developments in international markets and their relation to monetary policy. The sharp increase in the value of the dollar from 1980 to the first few months of this year and the ever-expanding current account deficit have become issues of serious concern for everyone, especially policymakers. This concern has sparked calls for trade policy and monetary policy responses that, I think, are wholly inappropriate. Moreover, the sources of recent international developments are not well understood and, thus, are likely to add even more confusion to public discussions. I would like, therefore, to offer an alternative perspective on the source of the dollar appreciation over the past five years. I would also like to correct what I regard to be mistaken policy conclusions that many observers have drawn from the recent experience.

Perhaps the biggest mistake that many people make is to view the increase in the value of the dollar as the cause of a multitude of economic problems. These problems run the gamut from the demise of import-competing and export industries in the United States to increased national unemployment, and from rapidly rising U.S. indebtedness to foreign countries to greater burdens on less developed countries that have to buy dollars to repay their debts. As you know, there are many people who believe that a multitude of domestic and international problems would simply disappear if only we could bring down the value of the dollar.

Of course, like all great myths, there is some "truth" underlying that view. The high value of the dollar makes foreign goods and services cheaper than those produced at home; this induces us to purchase more foreign goods and buy fewer similar domestically-produced items. Consequently, import-competing industries shrink and lay off workers. Exports, in terms of foreign currencies, become more expensive; consequently, foreigners buy less of our products, thus shrinking export industries and reducing employment in these industries as well. Record imports, combined with decreased exports, produce a deficit in the balance of goods and services. In order to pay for this deficit, we must issue debt or give up equity in various assets, thereby increasing our debt to foreigners. One day, of course, we will have to repay the larger debt. Less developed countries, whose debts are denominated in dollars, must pay larger and larger amounts to service their debts to their U.S. and foreign creditors. The increased value of the dollar makes them even poorer, ultimately jeopardizing their ability to ever repay.

What's wrong with blaming all these woes on a higher dollar? Simply that such an assessment assumes that the value of the dollar has risen in a vacuum, that it has produced these dire results without regard to other economic forces. This view thus leads to the conclusion that any action to decrease the dollar would produce salutary results with no bad side effects. I happen to disagree with this view; we cannot afford to use just any means to reduce the value of the dollar.

To see why this is so, we must recognize that the dollar exchange rate is simply a price of the dollar in terms of other currencies. Like all other prices, it is determined by fundamental forces of supply and demand. The price of the dollar can rise only if there is an increase in demand or a decrease in supply. The value of the dollar cannot be the <u>cause</u> of any economic malaise. Instead, it is merely a <u>symptom</u> of the other fundamental underlying events that produce these shifts in demand or supply. What have these events been?

We know that there has been an increase in the demand for dollars to purchase U.S. stocks, bonds and other assets. Foreign purchases of U.S. assets have increased from about $58 billion in 1980 to about $79 billion at an annual rate in the first half of 1985. We also know that there has been a decrease in the supply of dollars arising out of U.S. purchases of foreign stocks, bonds, and other assets: U.S. purchases of foreign assets has declined from $86 billion in 1980 to only a $6.5 billion annual rate in the first half of 1985. It is not surprising that the dollar rose. The net capital inflow--foreign purchases of our assets plus the decline in our purchases of foreign assets--has been simply enormous. Interestingly, this has been largely attributable to a decline in our purchases of foreign assets, not an increase in foreign purchases of U.S. assets.

From an accounting point of view, net capital inflows must always be offset by net inflows of goods and services. Thus, the other side of this net capital inflow coin is our deficit in the balance of trade. Whenever capital flows in, we end up holding large balances of foreign currencies which have to be spent either on foreign assets or on foreign goods and services. Clearly, we were not buying foreign assets; we were liquidating them. Instead, we bought goods and services, producing record deficits in the balance of trade.

Now, while the accounting perspective is helpful, it doesn't provide us with the cause of the net capital inflow and resulting trade deficit. For that we need a more general economic perspective.

This distinction between whether we induced the capital inflow or foreigners desired to invest in the U.S. is very important to determine what steps might be necessary, and in fact how important it is, to turn the international picture around. Perhaps the easiest way to see why is to compare a country's behavior with that of an individual.

I am sure that all of us at one time or another have been net debtors, that is, we have borrowed money to buy goods or assets. If we borrowed solely to increase our consumption, then our income did not increase and, at repayment time, we had to tighten our belts and consume less. If, on the other hand, we borrowed to buy assets that increased our income, there was no need to tighten our belts at repayment time. The same principle applies to countries. For example, many LDCs have borrowed to increase their consumption; now, they are having a hard time servicing their debt. On the other hand, the United States was a net debtor for most of the 19th century and never had major repayment problems because this debt was used to finance investment projects. I think that our current indebtedness has also been channelled into investment; thus, the assertion that we are impoverishing future generations through foreign debt is largely erroneous.

Of course, even though the capital inflow is adding to U.S. investment, it still produces a trade deficit which, it is alleged, has detrimental effects on our output and employment. There is no doubt that import-competing and export industries are negatively affected. It is not that easy, however, to unravel these effects from other underlying influences that result from changing comparative advantage among countries and industries. Suppose, however, that the trade deficit is the lone culprit. Can this deficit be a cause of general unemployment in the United States? The answer, of course, is "No!"

When we buy a dollar's worth of foreign goods, the foreigner must spend that dollar in the United States. He can buy goods or services or he can buy assets, but unless he keeps dollars in his mattress, buy something he must! In the past five years, foreigners clearly were not buying our goods and services; they were buying assets. The sellers of these assets, whether the government or private sector, were then spending the proceeds on goods and services, generating increases in output and employment. Even if some of that spending were on imports, the big bulk of it was on domestic products. Thus, while unemployment rose to new highs in some industries, employment rose to new highs in some other industries. Total unemployment is at the same level today that it was in 1980--before the dollar and trade deficits commenced their upward climb. Employment, as percent of working age population today, is the highest it has been since World War II.

Even if we agree, after some reflection, that neither the value of the dollar nor the trade deficit are as pernicious as many describe, we still haven't explained what caused this huge net capital inflow into the United States.

Capital flows are induced by a few fundamental factors. One of these is changes in the rate of return on investment in our country relative to another. This rate of return has to be defined very specifically: it is the rate of return after inflation, after taxes, and after what we loosely call "risk."

There are good reasons to suspect that this rate of return rose in the U.S. relative to other countries in the early eighties:

> The 1981 tax act changed U.S. investment incentives. Liberalized depreciation accounting, expensing of small capital expenditures, extension of investment tax credit, and reduced corporate and business taxes substantially raised after tax real rates of return.
>
> Increased demand for credit by the federal government raised the real interest rate.
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> Declining U.S. inflation reduced the risk of loss in future purchasing power.
>
> Financing uncertainties abroad, some associated with LDC debt, some with general political instability, some with perceived long-term anemic economic growth in the European community, reduced risks and increased potential returns in the U.S. relative to other countries.

Whether one agrees with <u>all</u> of these "causes" or not, they pretty well describe the potential candidates for "causes" of capital inflow. Therefore, accelerating the decline in the dollar means reversing one or more of these factors.

I would like only to talk about proposals which seek action from monetary authorities to lower the value of the dollar. One of these proposals is to "intervene" in the exchange markets by supplying more dollars to these markets. With a constant demand for dollars and an increased supply, the price of the dollar should certainly fall.

Unfortunately, it is not as simple as that. Consider what such an accelerated growth in the U.S. money supply might mean. At first, U.S. economic activity would be stimulated by the increase in money growth; the associated increase in the demand for credit would cause the real interest rate to rise and put upward pressure on the value of the dollar. The second impact would be to increase inflation and inflationary expectations which, by increasing the risk associated with U.S. investments, would reduce the inflow of capital. Perhaps, the net effect of these actions would be to reduce the value of the dollar in the long run. Certainly, however, it would reduce economic growth and employment in the U.S. relative to the rest of the world. Even if the value of the dollar should fall, making our exports cheaper to foreigners, domestic prices will rise due to higher inflation. As a result, foreigners may be faced with the same foreign currency prices as before, and exports may not rise.

Moreover, while a lower value of the dollar will make imports more expensive, increased prices of domestic goods due to inflation make foreign goods more attractive; on net, therefore, imports may not fall. Thus, a decrease in the value of the dollar, induced by monetary expansion, will not necessarily produce the desired result of reducing the trade deficit. Meanwhile, the accelerated inflation in the U.S. will not add anything to our economic stability or growth. As a matter of fact, it will surely reduce our efficiency and our productivity--a high cost to pay for a temporary benefit, at best, for exporters and producers of import-competing goods.

This is why I believe that the current trade deficit, when viewed from the point of view of the total economy, is not as pernicious as it is often described. It arose because investment opportunities in the U.S. were better than those abroad. Policies, particularly monetary policy, designed to lower the value of the dollar as a solution to the trade deficit, necessarily must reduce these investment opportunities and, even then, may not achieve the desired results. Instead, we would incur a substantial cost with no assured benefits in return.

Yet, this is what is likely to occur if we base our policy actions on public "myths" instead of simple economic "truths." I hope that I have convinced you that we should opt for the latter, not the former.