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Dollar Stability and International Recovery

Fairly rapidly the US dollar has recovered from its alltime low. Indeed, its return to levels roughly in line with past standards is giving support to the view held by most monetary authorities in Europe that the sharp depreciation was nothing else than an "erratic" movement as defined under the Rambouillet and other agreements. However, the usefulness of official exchange market intervention to tackle such distortions is now even more in doubt than previously. The Bundesbank, already stuck with an abundance of Greenbacks (most of which probably carrying a zero or even negative rate of real interest) has increased its holdings by another \$ 7.5 bn since fall 1977. On balance, the effects of this activity appear to have been harmful rather than beneficial. The Bank has lost credibility both on the internal and external fronts. Domestically, its announced money growth target for 1978 is now greatly endangered. In the short run this will not jeopardize the German economy's good inflation record. However, as this is not the first time the target will be missed, entrepreneurs and unions when making their future wage and price decisions may well ask themselves how much credit should be given to a target which the bank itself so easily negates. On the external front it has become manifest that the authorities' control over the exchange rate is close to nil: until March 1 the dollar had been falling despite massive intervention — thereafter it has recovered without central bank assistance.

What brought about the dollar appreciation was not a change in the fundamentals either. In fact, there is but little chance that the US trade and current account deficits or the German, Swiss and — most important — Japanese surpluses will substantially narrow in the near future. In the United States, inflation is accelerating. The recent fall in oil imports was apparently due to transitory factors rather than to a change in trend. The German growth rate in 1978 is likely not to exceed a meager 2.5 % — the same as last year and one percentage point less than was envisaged by the earlier Government forecast. And Japanese officials are cautiously dampening over-optimistic expectations as to their country's payments approaching better balance.

Rather than the fundamentals proper it is the perception of fundamentals which seems to have improved. This holds especially with regard to the United States. Last fall the sudden realisation of the massive swing in the US trade account — from a \$ 9 bn surplus in 1975 to a \$ 31 bn deficit only two years later — and the recognition that President Carter and Congress were reacting to this development with "malign neglect" had shocked both US and foreign market participants and had seriously eroded confidence in the US currency. Since the turn of the year it is felt that the authorities have adopted a more responsible approach (even though their policy measures until now appear more symbolic than effective).

It is a number of elements which have contributed to gradually changing the picture: Firstly, the shift in political priorities from further economic stimulation to stabilisation. This shift was publicly announced by President Carter in his programmatic speech on inflation on April 11. The postponement of the proposed tax cut by three months to January 1, 1979, reducing its budgetary impact from \$ 24 to 19 bn and the House and Senate resolutions to limit the Federal Budget deficit to \$ 56–58 bn — or 3 % of GNP in Fiscal 1978/79 — are indications of the administration's and legislators' growing concern with inflation. Secondly, Mr G. William Miller, the new Fed Chairman, has rather quickly demonstrated that he is by no means Carter's marionette. In fact the recent raising of the discount rate from 6.5 to 7 % apparently did not get the President's whole-hearted applause.

It was however hailed by the financial markets. Thirdly, on the energy front after a monthslong stalemate things have started to move. On the National Gas Bill a compromise seems to have been reached the effect of which will be to gradually increase supplies of domestic gas by an equivalent of 1 mn barrels of oil a day. The most controversial part of Carter's energy plan, a tax on domestic oil, raising its price to the level at the world market, is still pending — if not dead. However, the President seems now prepared to impose import fees if Congress does not act. As oil is an important determinant of the deterioration of the US external accounts — with import costs rising from \$ 4 bn in 1972 to \$ 41 bn last year — early action is indeed required if stabilisation of the trade and current deficits (not to speak of their reduction) is to be achieved. — The Treasury's announcement of regular gold auctions is but one minor element of the American "strategy" which however made great impression on bankers.

Whether the dollar will remain strong, i.e. resistant against renewed attacks of faintness, will heavily depend on the success of US and other industrialised countries' adjustment policies. Indeed, a settling down of the US current account deficit at or around the level now realised would probably be sufficient to stabilise the dollar rate for some time to come. It would also be in line with the need of matching the OPEC's expected \$ 25 bn surplus internationally. The United States, the only country able to finance its external deficits by its own currency, and an economy whose small foreign sector makes for a low impact of such deficits on total employment, appears best fitted to take a major portion of that burden.

As to Germany, foreign critics of the Government's economic policy are frequently overlooking the implications of the large foreign sector for the effectiveness of demand management. In the present unstable international setting a high degree of openness is likely to be a deterrent to private corporate investment and thus to a satisfactory, sustainable rate of economic expansion. This is true, firstly, for purely "mechanical" reasons: the higher the (marginal) propensity to import the lower is the Keynesian income multiplier. Therefore, a given stimulatory injection will produce a much smaller expansion of income in Germany ($\text{import/GNP} = .25$) than in the United States ($.09$). Or, to put it differently, for any projected percentage point of additional income and output Germany (and other European economies) have to give a larger stimulus than their American partner.

The external constraint to investment and growth makes itself felt in a second, more fundamental sense, too. This can again be shown by comparison with the United States. The average American entrepreneur is basically inward looking. If he is exporting at all, foreign sales will usually account for a tiny fraction of total sales only. Therefore, he is typically neither upset by exchange rate gyrations nor by the prospect of growing protectionism abroad. His investment decisions will be based upon expectations on the domestic market which in a closed economy can be effectively influenced by Government action. As opposed to this, German manufacturing enterprises are often highly dependent on (direct or indirect) exports. Given this dependence many businessmen will currently not be much impressed by tax cuts, expansionary budgets (the public sector deficit now reaches 5 % of GNP) or cheap and abundant bank credit, as exchange risks, continued slow growth abroad and rising protectionism endanger their sales and profit potential. If firms are at all induced to invest they will often decide to do so in the large and undivided US market rather than at home. The same is more or less true for enterprises in other European countries.

Roy Jenkins, the President of the EC Commission, has rightly drawn the attention to this interrelation between market size, stability of expectations and investment when he made his forceful case for economic and monetary union in Europe. In the absence of union it will be the task of policymakers at the forthcoming EC and international economic summits to work out a concerted programme for recovery which is consistent with reasonable exchange rate stability and stops the trend to worldwide protectionism. Only in such a climate will open economies like Germany be able to make a significant contribution to international economic expansion and equilibrium.

Hans-Eckart Scharrer