

Scharrer, Hans-Eckart

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Disquieting Dollar Strength

The renewed surge of the dollar since the beginning of this year and the Reagan administration's benign neglect of what is generally considered the main underlying cause of the dollar strength – persistently high US interest rates owing to the \$ 200 bn federal budget deficit – have once again provoked angry European reactions and motions demanding a “de-coupling” from the US currency. However, anger is usually not the best adviser. Let us ask, therefore, to what extent the arguments are well founded and whether the policy measures recommended by some political quarters – the imposition of (tighter) capital controls and/or the taxation of capital flows – are indeed an appropriate answer to the challenges posed by the strong dollar.

The first argument concerns inflation. A rising dollar, it is claimed, raises the costs of imports and thereby fuels domestic price and wage inflation. In principle, this argument is of course valid. Yet, for a variety of reasons it is of but limited practical relevance. Firstly, only part of the imports of EC member countries are contracted on a dollar basis. The greater portion is denominated in non-dollar currencies, among them in particular currencies participating in the “shock-proof” EMS regime of fixed exchange rates. Secondly, as far as industrial goods imports from the dollar area are concerned – including, for this purpose, imports from Japan – the inflationary impact of higher import prices must be balanced against the improvement in the competitive position of European producers brought about by the exchange-rate change. Thirdly, changes in import prices of primary commodities are, as a rule, greatly mitigated while being passed through to final products, oil and gas prices being the only major exceptions. Moreover, the dollar prices of primary commodities are themselves not independent of the relative strength of the dollar: at any given level of world demand they tend to be depressed when the dollar is strong and vice versa. On the whole, therefore, the inflationary impact of a rising dollar should not be overestimated. Indeed, during 1983, when the dollar strengthened by 15 percent against the D-Mark, German wholesale prices remained virtually stable.

Another important argument concerns the alleged drain on European liquidity and savings caused by the high US interest rates (in conjunction with the strong dollar), and the supposed check on recovery and growth in Europe resulting therefrom. Andreas Papandreou, the Greek Prime Minister and until recently President of the European Council, gave word to these widespread feelings insisting that “it is up to us to defend against further losses of liquidity which is very much needed for our recovery. . . (To) put an end to this unproductive capital flow and to facilitate the return of European capital to Europe . . . is fundamental for re-establishing European prosperity. . .”. Yet, there appear to be major misconceptions. Under floating exchange rates a “loss of liquidity” simply cannot take place, except for – voluntary and non-sterilized – exchange-market interventions by the monetary authorities (sales of dollars against domestic currency). Indeed, the level of domestic liquidity, however defined, is for all practical purposes under the control of the central bank; this is the very essence of monetary targeting. As to the alleged outflow of “capital” (as opposed to “liquidity”) it must be pointed out that the European Community has in fact been a net importer – rather than exporter – of capital over the past five years (since 1979). But far from being happy about a situation which – according to the above reasoning – should strengthen the European capital basis and thereby enhance recovery and growth, all member countries have been striving

hard to reverse the trend and generate a net outflow of capital. Strangely enough this policy is also strongly advocated by those politicians who otherwise praise the virtues of capital export controls. The apparent paradox can easily be explained: (net) capital imports are nothing else than the balancing item to a deficit on current account and, as every (European) politician certainly knows, current account deficits are bad and need to be corrected.

In bilateral relations between Europe and the US this correction has in fact taken place – thanks not least to the upward revaluation of the dollar. From an \$ 8 bn deficit in 1981 the EC has moved into a considerable surplus, estimated at \$ 5-6 bn in 1983; a surplus which is generally regarded as being stimulatory. The inevitable “price” is a capital flow of equivalent size from Europe to the US – a flow which allegedly “does not serve the interest of trade, nor does it help to stimulate European activity” (Papandreou). One thing is obvious: policy-makers and their advisers should make up their minds what they really want: a current-account surplus or a capital inflow. One simply cannot have both, as proponents of capital outflow restrictions try to make us believe (and seem to believe themselves).

This is not to argue that a continuation of the dollar's upward movement is without problems and should be welcomed. On the contrary, the ensuing deterioration of Europe's terms-of-trade vis-à-vis the dollar area is tantamount to a wealth transfer to that region: Americans need to pay less to acquire European products while Europeans have to pay more to buy US or Japanese goods. No European can be glad about that. Moreover, high US interest rates coupled with a strong dollar, by greatly aggravating the debt burden of developing (and CMEA) countries, have increased the fragility of the international financial system while depressing economic activity in the debtor countries. The spill-over effects have been felt in Europe, too. Also, the strong dollar is promoting protectionist tendencies in the US which, in conjunction with the countermeasures they invite, threaten to undermine the very foundations of the international trading system. Finally, inasmuch as the current dollar strength is a temporary phenomenon (“overshooting”), the future fall of the dollar is likely to be all the steeper the higher it is quoted now; many an investment in plant and equipment could then well be rendered obsolete.

Yet, capital restrictions are not an appropriate answer to the problem as they address the symptoms – the capital flows – rather than their underlying causes and motivations. In this connection the “conventional wisdom” that the current dollar strength is primarily a matter of US interest rates and budget deficits needs to be challenged. Indeed, the interest rate differential between the US and Europe has not changed much since the '70s when the dollar was inherently weak. What has changed is the basic thrust of US monetary and economic policy and the economic prospects – both in absolute terms and relative to Europe. The US inflation rate has been curbed dramatically from 13 percent in 1980 to 3 percent today; progress in Europe has been much slower: from 11 percent the rate declined to its present 6 percent. At the same time, the US economy has exhibited a higher degree of resiliency and, more recently, a stronger recovery than the EC economy. What appears more important than these cyclical phenomena is the fact that the US has regained the lead in advanced technologies whereas Europe conspicuously lags behind both the US and Japan. The loss of market shares in the international markets for investment goods is an alarming indication of a lack of economic and social dynamism. Finally, increasing tensions in East-West relations have raised doubts as to the security of investments in Europe.

It is these basic issues that the Community will have to address if a “de-coupling” from the dollar is to succeed. Determined efforts, both on the national and the Community levels, to maintain and “deepen” the common market are at the centre of a strategy of sustained economic revival which can also be expected to support the exchange rate. The dismantling of the host of non-tariff barriers to trade in goods and services among EC member countries, new emphasis on a European competition policy, a curbing of the ever increasing flow of subsidies to ailing industries (including agriculture) and the deregulation of economic activity are major elements of such a forward-looking strategy. The dollar strength is a signal that something is wrong – not in the US but in Europe.

Hans-Eckart Scharrer