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MONETARY POLICY

The US Dollar – Scenario of a World Currency

by Hans E. Büschgen, Cologne*

The exchange rate of the US dollar fell sharply last year. What part was played by the adverse “fundamentals” of the US economy, the large current account deficit, the country’s heavy foreign indebtedness and the substantial budget deficit? How will the dollar behave in future?

An analysis of the behaviour of the US dollar is particularly interesting, since it is assumed that the dollar exchange rate reflects significant changes in global economic relationships while at the same time having a decisive influence on the economic expectations and decisions of firms and individuals throughout the world, and hence on world economic developments. The key role of the dollar exchange rate stems from the pre-eminent position of the USA in the world economy and its virtual hegemony over the western industrialised countries. An awareness of this role is clearly discernible in the utterances and behaviour of representatives of the US Administration in recent months, particularly Treasury Secretary Baker.

The dollar’s important role in the global network of relationships is also clear from its functions in the world economy. The dollar is a transaction currency; the bulk of world trade in goods and services is invoiced in dollars and the dollar is often used as a “vehicle currency” in the foreign exchange markets. It is also a reserve currency, held by the central banks of the world. Thirdly, it serves as a key currency; numerous countries have tied the parity of their currencies to the dollar. Finally, it is the premier currency for borrowing and lending in the international financial markets, even if the share of Euro-currency transactions in non-dollar currencies has risen to around 50 % recently on account of the weakness of the dollar.

Chronicling the exchange rate of the dollar against the Deutsche Mark from Bretton Woods in 1944 to the present day shows that there was a long period of

stability until 1969, when there began a series of dollar devaluations culminating in the transition to floating exchange rates in place of the system of fixed but adjustable rates. The dollar was weak for many years after the decision to float, reaching a low of DM 1.7358 on 25th July 1980. The subsequent appreciation took it to a peak of DM 3.4690 on 26th February 1985; since then, the exchange rate has slipped back to well below DM 2.

Throughout this period there were frequent and heated debates about the “right” exchange rate for the dollar and attempts to achieve what was considered a correct target rate by means of government action or central-bank intervention in the foreign exchange markets; sometimes they were successful, but most of the time they were not. Depending on one’s standpoint, a given rate was reckoned to be too high or too low and the dollar to be overvalued or undervalued, which meant that countries and economic interests with different objectives could take a different view of the same exchange rate. Both high and low dollar rates were regarded as possible causes of impending disaster in the economic and monetary system.

The discussions between the economic policymakers of the USA, the Federal Republic of Germany and Japan in recent months, and especially in advance of the last Annual Meeting of the International Monetary Fund, provide a prime example of differences in assessing the behaviour of the dollar; whereas the Deutsche Bundesbank, the Federal German Government and the Japanese Government considered a dollar exchange rate of around DM 2 to be low enough, the US Administration wanted the dollar to depreciate still further. The Americans are not of one accord, however;

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Paul Volcker, the Chairman of the Federal Reserve Board, fears the risk of inflation if the dollar continues to slide, while James Baker, the Treasury Secretary, advocates a cheaper dollar as the means of restoring American competitiveness.

The change in the US Administration's attitude towards the external value of its own currency, as expressed in the so-called Plaza Agreement of 1985 among the representatives of the five leading industrialised countries (the Group of Five), is a new element in the monetary equation. The sudden willingness of the US Administration to heed and to influence the dollar exchange rate followed a long period of almost complete indifference. Ronald Reagan had raised the dollar question in the election campaign against President Carter, but primarily for electoral and nationalistic reasons. He was elected partly because he promised an economic programme in which the dollar would again become a stable currency held in high regard throughout the world, after having steadily depreciated to DM 1.73 in 1980 as a result of a loss of confidence caused by years of massive capital movements.

Reaganomics and the Dollar Exchange Rate

At first, Reagan's economic policy produced good results for a number of macro-economic objectives; growth, employment and inflation rate improved considerably. However, what was not noticed in the initial euphoria about "Reaganomics" was that success on these fronts was accompanied by an extraordinary deterioration in public finance and in the balance of payments; the results of Reaganomics were achieved at the price of an exorbitant indebtedness. Reducing taxes without cutting government expenditure in the hope that economic growth would generate the needed higher revenue – the so-called Laffer curve – did not pay off. Ardent adherents of Reaganomics, who were at the same time speaking disparagingly of "Eurosclerosis" with regard to the economy of Europe, overlooked the fact that the unbridled expansion in US government debt and the rapidly growing current account deficit in the USA were creating a highly dangerous situation that has developed a momentum of its own and now threatens not just the USA but the whole world economy.

Despite the large and growing current account deficit and the rapid increase in government debt, however, the dollar exchange rate climbed from DM 1.73 in July 1980 to DM 3.47 in February 1985. One of the reasons put forward to explain this development in contradiction to two negative circumstances that are normally regarded

as important fundamentals was that "a strong country has a strong currency". The USA was therefore seen as the "safe haven" in which the monetary wealth of the world took refuge.

In fact, the true reasons are far more prosaic. With the Federal Reserve pursuing a restrictive monetary policy, US interest rates were pushed up by the steady rise in government debt and the associated demand for capital; interest rate differentials in favour of the United States triggered the substantial inflow of capital into the USA and the sharp reduction in capital outflows. The negative "fundamentals" were therefore largely offset by the massive capital inflows, in other words the increasing indebtedness of the USA towards the rest of the world. It was not primarily the acquisition of equities or direct investments in view of the supposedly superior earning power of US business, as was often argued, but simply interest-rate-induced capital movements that financed the US current account deficit. In other words, the capital inflows into the USA that kept the dollar strong can be explained satisfactorily in terms of the positive interest rate differential and the scant heed that was initially paid to exchange rate risks.

In February 1985, however, the dollar stood at almost DM 3.50, a level that forced foreign investors to pay urgent heed to the exchange risks, alerted businesses in the USA to the economic consequences of the high dollar exchange rate and aroused the Administration from its long indifference towards the macro-economic implications of a strong dollar. The growing dollar balances held by foreign investors, in other words the United States' external debt, reached such proportions in 1985-86 that they began to be perceived by investors as a problem from the point of view of yield and risk. Combined with the negative fundamentals of the government debt, the external debt and the current account deficit, this caused the dollar to depreciate in the autumn of 1985, despite the continued favourable interest rate differential.

The fall in the dollar exchange rate induced by economic factors was reinforced by the concerted intervention agreed in September 1985 by the "Big Five" (Plaza Agreement) which was based expressly on the premise that the exchange rate of the dollar against the Deutsche Mark and the yen did not adequately reflect fundamental economic conditions and needed to be corrected. Massive exchange market intervention by the central banks, and especially those of the USA, Japan and the Federal Republic of Germany, intensified and accelerated a depreciation of the dollar that had already begun on the basis of economic data.

Monetary intervention has long been accompanied and supported by verbal intervention, particularly by American politicians, in an attempt to influence the behaviour of exchange market operators by announcing desirable exchange rate targets. This causes market uncertainty and hence does nothing to help stabilise the dollar exchange rate; it makes an objective exchange rate analysis extremely difficult, particularly as the purpose of such a policy of "moral suasion" is itself hard to assess. The reasons for this are the following:

☐ A host of influential but often uncoordinated bodies have a hand in determining US economic policy.

☐ American economic policy is not based on a stable, long-term concept shaped by an economic philosophy or ideology. Decisions tend to be pragmatic and to differ from case to case. Attitudes towards management of the economy change rapidly, depending on the country's interests at the time; today a high dollar exchange rate is hailed as proof of American strength, tomorrow it may be condemned as the cause of the United States' weak export performance. Exchange rate policy of any kind was long dismissed as unnecessary interference in the markets; however, it has been pursued with a vengeance since it became plain that US interests were being permanently affected. Although earlier French proposals for stabilising exchange rates by means of a target zone concept had been rejected, the number of advocates of a return to more stable exchange relationships is now increasing even in the USA. The entire behaviour of the United States towards the external value of its own currency appears short-sighted and to lack an underlying concept. It is doubtful whether an exchange rate policy geared strongly towards defending national economic interests is compatible with the role of the dollar as a key currency.

☐ To outsiders, the political intentions of the US Administration are apparent only in expressions of opinion and intent. It is often uncertain whether these reflect tangible political planning or are a public relations exercise to deflect or influence demands from particular lobbies, such as those calling for protectionist measures.

Now that the dollar has sunk to around DM 2, the exchange rate experts are debating whether it has reached an acceptable equilibrium level or a further dollar depreciation is necessary from the point of view of the world economy and justified by the fundamental economic data. This demonstrates clearly the problem of seeking to achieve the "right" exchange rate outside the market by agreement and by exercising political judgement; what is actually being sought is not the

"right" exchange rate but the one that best serves the interests of the various countries. With an eye to their own competitiveness, the Federal Republic of Germany and Japan consider the dollar exchange rate to be low enough already, but the Reagan Administration believes that the dollar must decline still further.

The optimum dollar exchange rate would be one that simultaneously

☐ reduced external imbalances between the industrialised countries;

☐ prevented protectionism;

☐ promoted growth in the industrialised countries; and

☐ made low inflation rates in the USA possible.

This is a "magic polygon" that defies construction in present circumstances since these objectives are not compatible.

Dominance of Capital Flows

The "right" dollar exchange rate is always the one produced in the foreign exchange market as a result of the considered decisions of market participants; it is the outcome of the payments stemming from international flows of goods and services and short and long-term capital transactions. There is much evidence to suggest that exchange rates are determined primarily by short-term capital flows induced by interest rate, risk and speculative considerations. The international financial markets are now more or less global and hence largely unregulated by national governments, so that the increasingly convenient and rapid communications technology enables large amounts of short-term money to be moved around the world in accordance with investors' objectives and their interest rate and exchange rate expectations.

Changes in flows of goods and services and the exchange rate shifts they induce take place relatively slowly. By contrast, large capital sums can be switched from one currency to another very quickly, with correspondingly swift exchange rate implications. Given the predominance of these monetary factors, frequent and sometimes substantial exchange rate fluctuations are both possible and probable, since it can be assumed that the factors influencing financial investment decisions – such as economic and political facts, but also attitudes, rumours, hunches, and so forth – change rapidly.

Let us therefore inquire into the factors that should be relevant to an evaluation of the dollar by the international financial markets.

The main weak points in the fundamentals of the dollar exchange rate are the United States' excessive private and public debt and its large current account deficit. The extent to which this double deficit has undermined the country's international credit standing is evident from the latest credit ratings published by the "Institutional Investor"; for the first time since the banking journal began to publish country ratings the USA ranks only second behind Japan, ahead of Switzerland and the Federal Republic of Germany. In 1986 public and private debt in the USA rose to around \$9,000 billion. This debt has increased by 75 % since President Reagan took office, whereas gross national product has risen by only 46 %.

The extraordinarily high government indebtedness gives particular cause for concern. The fiscal year 1985/86 closed at the end of September with a budget deficit of around \$230 billion. A combination of increases in

expenditure and cuts in taxes has led to a dangerous development that is difficult to reverse: high government indebtedness, high interest rates, high capital inflows, an initially high dollar and a high current account deficit. In reality, of course, the causal link is rather more complex than this rough sketch implies, but it is clear that the United States has brought many of its present economic difficulties upon itself by pursuing the wrong fiscal and foreign trade policies over a period of years.

Before he was elected, Ronald Reagan promised to eliminate the budget deficit of \$60 billion inherited from President Carter; today it stands at \$230 billion, or 5.5 % of GNP. Spending cuts had been planned for the budget period from 1981 to 1986; instead, government expenditure grew tremendously. Just the interest on the public debt would have exceeded new borrowing in 1987 if interest rates had not been lowered substantially. By the end of this year, federal debt will have risen to

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Alexander Brunckhorst

INTERNATIONALE FINANZMÄRKTE UND DIE VERSCHULDUNG VON ENTWICKLUNGSLÄNDERN

Der Beitrag der internationalen Finanzmärkte im Rahmen alternativer Ansätze zur Bewältigung der Verschuldungsproblematik von Entwicklungsländern

(INTERNATIONAL FINANCIAL MARKETS AND THE DEBTS OF DEVELOPING COUNTRIES)

The Contribution of the International Financial Markets within the Framework of Alternative Approaches to Overcoming the Debt Problems of Developing Countries

Not only businessmen, academics and politicians are presently concerned with the indebtedness of the developing countries. The increasingly pressing debt service bills and the belief that important debtors are about to become bankrupt lead repeatedly to headlines in the daily press, making the importance of this problem clear to a broader public. This study by Alexander Brunckhorst is a doctoral thesis written at the chair of Professor Dr. Jens Lübbert, University of Hamburg. It is concerned with the potential contribution of the international financial markets to overcoming the critical debt situation of developing countries. (In German)

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more than \$2,000 billion; Reagan has therefore accumulated higher debt than all his predecessors over the past 200 years and more. Over the last five years the debt has more than doubled. The legal borrowing limit has had to be raised twelve times during Reagan's incumbency. The debts of state and local authorities have also heavily risen; at present they amount to \$540 billion.

What is dangerous about the Reagan Administration's debt policy is not so much the level of debt as the fact that the funds have been used not for investment but to finance state consumption, especially in the fields of armament and social programmes. The borrowed funds have not been used profitably, and hence their servicing is a problem.

The US Tax Reform

The prospects for a reduction in the budget deficit are not good. The Gramm-Rudman-Hollings Act of 1985 does provide for a planned reduction in new borrowing to nil by 1991, but it is highly unlikely that this objective will be achieved. The Budget Office of the White House has recently published a budget proposal for fiscal year 1987/88 providing for total spending of more than \$1,000 billion for the first time and a projected deficit of only \$107 billion, but it is doubtful whether this figure can be met. In the current fiscal year 1986/87, which began in October 1986, experts expect an actual deficit of \$170-180 billion, despite the fact that under the Act it should not exceed \$144 billion. Cuts in the defence budget, the fall in interest rates, and also the use of overoptimistic estimates of income and "creative" accounting have enabled the Administration to adhere to the letter of the law, but the actual deficit will be in excess of \$170 billion. Moreover, the tax reform that has now been passed is expected to produce increased receipts of around \$10 billion initially, but in later years it will reduce revenue by between \$30 and 40 billion, which will make it much more difficult to comply with the Act.

The implications of the so-called "tax revolution" are important for assessing the future trend in the dollar exchange rate. Conceptually, the tax reform comes under the heading "deregulation", in other words freeing economic activity from government influence; the reduction in tax rates to a maximum of 28% for individuals and 34% for corporations while at the same time clearing away most of the thicket of tax allowances means that in future economic decisions should be based more on business criteria than on tax considerations. The sources of tax revenue totalling around \$500 billion will change. In the long run, the new system is probably simpler, kinder to families and offers individuals performance incentives, and it may improve

the allocation function of the markets. In addition, it can be expected that American multinational corporations will invest more heavily in the USA in the long run, since higher foreign taxes cannot be offset in full against lower US taxes.

Two aspects present problems, however. In view of the need for the reform to be neutral in its effect on revenue, the reduction in the industrial tax burden will be financed by greatly increasing the incidence on certain firms, in particular capital-intensive ones, by removing many previous tax allowances and lengthening depreciation periods. It remains to be seen whether easing the burden on consumption and increasing that on investment in this way will stimulate growth or curb it.

Fragile State of the US Economy

The assumption that consumption can continue to bolster economic activity in the USA, as it has since 1981, poses problems, since private households in the United States are also very heavily in debt.

The savings ratio is extremely low – below 4% – and the debt mountain of \$2,500 billion is now equal to 20% of income. Moreover, interest on consumer credit is no longer tax deductible under the new tax arrangements, so that the interest burden has increased dramatically for those with consumer loans. If confidence in the business prospects of industry is also dented, it is quite feasible that consumption will hesitate and a recession will set in. The tax reform may have a beneficial long-term effect on the efficiency with which market forces determine the course of the American economy and will make the United States more attractive for achievement-motivated individuals and innovative firms on account of the lower tax rates, but its timing is unfortunate because of the additional tax burden it will impose on firms at a time of weak growth.

There is also a corporate side to the debt problem in the USA, businesses are heavily in debt to the tune of around \$2,500 billion, mostly at short term. The massive debt accumulated by all the major industries has made US businesses highly fragile and vulnerable to even short-term friction. They have become highly susceptible to recessionary tendencies.

The shaky state of the US banking system is also important for foreign investors. The annual number of bank failures has never been as high as in the last two years; in 1985 around 100 banks closed their doors and in 1986 as many as 138 became insolvent. Provision for risks is inadequate by comparison with the practice of, say, German banks, the percentage of profits written to reserves is low and loan default risks are not reflected in

the profit and loss account until very late; as a result, the US banking system is vulnerable to the kind of risks that have materialised in lending to Latin America and sectors such as agriculture, the oil and machine tool industries and real estate. It is estimated that around one-third of the present total of 14,300 US banks will have ceased to exist by 1990.

The balance of payments on current account is another serious weak point in the American economic scenario. The current account deficit rose from \$9 billion in 1982 to \$150 billion in 1985 and is estimated at around \$170 billion in 1986. A deficit of \$300 billion is forecast for 1990 unless there is a marked turnaround in the current account.

The dramatic deterioration in the US current account between 1981 and 1986 was the result of a massive rise in imports; real imports rose by around 50 % over the period, whereas exports declined by 10 %, despite the expansion of around 10 % in total world trade. The current account deficits are offset by equally high imports of capital. Economic policy mistakes have led to high government indebtedness, a monetary policy geared towards stability, high interest rates and an initially high exchange rate, a combination that has rapidly turned what is potentially the richest country in the world from being the largest creditor to being the largest external debtor. US external debt totalled \$110 billion at the end of 1985; it will have almost doubled in the course of 1986. According to calculations by the OECD, net US external debt will amount to between \$700 and 800 billion in 1990 if the present trend continues.

In the face of this dramatic scenario, an economic policy debate began in the autumn of 1985 to find ways out of the dilemma that had now finally been recognised. This produced a series of proposed solutions, the suitability of which will be assessed briefly below.

As the current account deficit grows, so too do the number, insistence and influence of those calling for imports to be curbed by protectionist measures and exports to be promoted by government subsidies. More than 300 proposals for protection and subsidies are now before Congress. Every fresh batch of foreign trade statistics and every news item about possible rises in US interest rates seems to swell the ranks of the protectionists.

One positive aspect is that the Reagan Administration has managed to block most of the protectionist initiatives so far. Many of the official exhortations, demands and threats regarding foreign trade addressed to the outside world are actually for internal

consumption and intended to weaken the case of the protectionists. The individual Congressman scarcely looks beyond the interests of his own state, but US economic policymakers are fully aware that protectionist measures will provoke retaliation by trading partners, raising the spectre of worldwide protectionist processes that would nullify the beneficial welfare effects of the international division of labour. However, it seems that the US Administration has had to yield to protectionist pressure of late. Significant signs of this can be seen in the planned restrictions on imports of agricultural products from the European Community and machine tools from the Federal Republic of Germany and in the proposals from influential Congressmen for the introduction of massive import duties. The possibility of a trade war between the USA and the EC and strains between the USA and Japan symbolise the dangerous state of international trade policy.

Regrettably, the trend towards protecting economies with non-tariff trade barriers of various kinds is increasing worldwide. The EC is setting a particularly bad example with its policy towards developing and newly industrialising countries. The USA and Japan have also erected many non-tariff hurdles to imports, however. The most recent American measure of this kind, which probably also violates the GATT rules, is the imposition of an import charge, albeit at a rate of only 0.22 %. The Democrats' victory in the Congressional elections is likely to strengthen the trend towards greater protectionism in the USA.

Dollar Devaluation and the Current Account

The official economic policy of the leading industrialised countries relied initially on the fall in the dollar exchange rate to ease the current account imbalances. No improvement is yet discernible, however, even though the dollar has depreciated by around 45 % against the Deutsche Mark and the yen since 1985. Over the short term, this is due partly to the "J curve effect". With the dollar declining, import prices rise, export prices fall and for the same volume of trade the balance of payments initially deteriorates. However, the J curve effect cannot fully explain why the US balance of payments has failed to react in the desired fashion, for the fall in the dollar exchange rate has lasted almost two years already.

One possible reason is hardly paid sufficient regard in the discussion; the dollar has indeed depreciated considerably against the DM and the yen, but not against the Canadian dollar and the currencies of the South-East Asian and South American NICs and Australia. Measured against the currencies of the United

States' seventeen most important trading partners, which account for 80 % of America's foreign trade, the dollar has lost only about 4 %. If one looks only at the seven most important countries with 60 % of US foreign trade, the external value of the dollar has actually risen. The problem becomes even more obvious if one considers the regional structure of US foreign trade. Canada takes 25 % of US exports, the EC 21 %, Japan and the East Asian NICs 18 %, Latin America 14 % and other countries 22 %. Japan and the Federal Republic of Germany account for only 14 % together. Added to this is the fact that cyclical developments in partner countries differ widely, with correspondingly different effects on US export prospects; whereas the upturn in economic activity is continuing in Western Europe, import demand in Japan, Canada and Latin America is noticeably weak for a variety of reasons.

Countries whose currencies are tied to the dollar, such as those in South-East Asia, have devalued in line with the dollar, with the result that their already cheap goods have become even more competitive. The US Administration must therefore recognise that the depreciation of the dollar benefits the newly industrialising countries of the Far East and Latin America more than the United States. In the foreseeable future these countries will become more active not only as competitive suppliers to European markets but also as low-cost producers worldwide, so that the export opportunities of US businesses will not show the desired improvement. Nor will the depreciation against the Deutsche Mark and the yen automatically correct the flows of goods, since exporters in Germany and Japan will seek to defend their market positions, even at the expense of narrower profit margins.

Apart from the time required for the US current account to show the desired response, observers have serious reservations about the assumption that a lower dollar exchange rate can produce an adequate reduction in the deficit. The more deep-rooted reason for the United States' difficulties in foreign trade lies in the serious lack of efficiency, and hence competitiveness, of US business by international standards.

In the consumer goods field, the ability of American companies to compete with foreign suppliers in the home market is undermined by serious weaknesses in product quality and service and by poor marketing in general. Qualitative preferences safeguard the market shares of foreign competitors. The "Buy American" campaign, which is problematical in any case, seems a farce when comparable products are no longer produced by firms in the USA because the market has been completely taken over by products from the Far

East (Japan, Korea, Taiwan and Singapore) or Brazil, as in the case of many electronic goods.

The depreciation of the dollar will not much help US firms in export markets either, as in many sectors their products are not particularly competitive and their marketing strategies are totally inadequate. American product, process and marketing development has largely ignored the particular characteristics of overseas markets. This applies to traditional products such as steel, textiles, food, drink and tobacco as well as to electronic and optical goods. The mechanical engineering, automobile and chemical industries are also in a weak competitive position. Even many of the "high-tech" products that are initially developed in the USA are taken up by other countries, which develop them further, produce them more efficiently and then sell them in the United States. The trade balance in electronic goods swung from a surplus of \$7 billion to a deficit of \$8.6 billion in 1985. Even the Pentagon must import electronic equipment from Japan. In addition, American industry falls far short when it comes to investment in modernisation and rationalisation.

The structure of US trade with Japan is typical. Whereas the USA exports aircraft and agricultural products, Japan supplies cars, leisure electronics, computers, robots, and so on. The lack of confidence of US business in its ability to compete becomes evident when an agreement between the USA and Japan has to limit sales of microchips; instead of structural changes, a switch to new markets and a change in business policy, there are calls for protection through embargoes, import quotas, customs tariffs and other restraints to trade. Even with a lower dollar exchange rate, the United States' manufacturing base is still not sufficiently competitive to bring about a lasting improvement in the country's foreign trade position.

Further Depreciation?

There is also the question whether the reallocation of resources necessary to reduce the US trade deficit can be achieved quickly enough in the context of an inflation-free economic process. A rise in exports and a fall in imports depends upon capital formation in the USA through saving. Positive net exports of an economy presuppose abstinence from consumption. It might be hoped that removing the tax deductibility of interest on consumer credit might modify consumer behaviour; the question, however, is whether consumers cut back on imports or domestic products.

In view of developments so far, there are also frequent official demands for a further reduction in the dollar

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exchange rate. It has already been shown that there is something to be said for such a demand, if one considers the external value of the dollar against all other currencies. However, it is primarily a further change in the dollar/DM and dollar/yen rates that is being publicly advocated or threatened. This harbours macro-economic dangers for the USA on the price front; rising import prices and falling export prices would push up the domestic price level. A further depreciation of the dollar would therefore arouse fears of inflation and the danger of a rise in interest rates, which in turn would jeopardise the already weak growth.

A further sharp fall in the dollar would also cause interest rates to rise by inducing reactions in the capital account. Expectations of dollar exchange rate changes and high negative swap rates in the forward exchange market could make dollar investments appear even less attractive. The Government would then have difficulty financing its budget deficit by means of capital imports; the only remedy would seem to lie in a restrictive fiscal policy and a higher savings ratio.

These implications of a further reduction in the dollar exchange rate are probably the reason for the hesitant stance of the US Administration. On the one hand Treasury Secretary Baker threatens a further dollar devaluation, while on the other hand the Chairman of the Federal Reserve Board, Paul Volcker, warns of the inflationary consequences of such a move. The propaganda in favour of a lower dollar exchange rate therefore comes over as half-hearted and hesitant, and often as a threat unconvincingly presented as an objective. Instead of being the Government's true intent, the threat is used to solve America's dilemma by forcing its trading partners to adopt an expansionary economic policy.

The Locomotive Theory

American notions of the "locomotive" function of Japan and Germany are mistaken in several respects. To begin with, it is wrong to equate the two countries as regards their current economic situation, their interests and their importance for the US balance of payments. Japan supplies 20 % of US imports, Germany only 6 %; the United States' trade deficit with Japan came to \$ 43 billion in 1985, that with Germany to \$ 10 billion. In actual fact, the Japanese economy is showing clear signs of recession. For that reason, the Japanese Government has adopted additional counter-cyclical expenditure of about ¥ 50 billion, with the emphasis on public investment; however, this is expected to provide only very slight stimulus to economic growth. Moreover, it is unlikely to have a positive impact on US exports because of its

emphasis on infrastructure and the strong preference Japanese consumers have for Japanese products. The 1987 budget does not promise to boost growth either.

Other important trading partners of the United States, such as Canada, South-East Asia and the OPEC countries, are also showing weaker growth. Calls for an expansionary policy would therefore be better addressed here than to Germany, which can currently be expected to follow a stable growth path, since a slackening in exports will be offset by an acceleration in the rate of growth of domestic demand. It also seems rather inept to expect an expansionary policy in Germany and Japan to make a decisive difference to the US current account; according to calculations by the International Monetary Fund, an acceleration in growth in Japan and Germany would produce an improvement of \$ 10 billion at best in the US current account.

It is true that a further cut in the tax burden, a reduction in the public sector share of GNP and an easing of government regulation would be desirable over the long term in order to sustain growth in Germany. However, the US Administration's assumption as to the scope for deregulation in Germany is completely wrong, as it is clearly based on an unrealistic assessment of the extent to which economic activity is regulated by the state. Finally, one argument against US demands to boost economic activity in Germany is that a rise in German imports would primarily benefit the EC states and countries in South-East Asia, but not the USA. Demand pull in the relatively small German market cannot significantly stimulate the US economy.

The burden of adjustment must be distributed by means of economic policy co-ordination between Europe, Asia and the United States, although only the USA can ultimately correct the misdevelopments at home. But how would such a policy look?

A further managed dollar depreciation would require exchange market intervention instead of the verbal attacks meted out by the US Administration. However, this would run counter to the declared wishes of the other industrialised countries, as amply illustrated by the concerted action of the European central banks in October 1986 to support the dollar at around DM 2.

The joint intervention was probably also intended to demonstrate that the governments and central banks of Europe were tired of hearing what they should do to make the US Administration's mistakes in economic and fiscal policy bearable for the United States. However, this clearly raises the danger of a currency war and competitive devaluations, a world trade policy that had disastrous consequences for all countries in the thirties.

The efficiency of a policy of permanent intervention is also doubtful. It is impossible to identify an "objective" equilibrium rate as a guide for intervention, since there is no workable theory for doing this. It is a fundamental error to attempt to use exchange market intervention as a substitute for a policy of real economic adjustment to iron out underlying imbalances. Solutions have to be sought in the fields of economic and fiscal policy. The highly nervous uncertainty currently displayed by governments, banks and exporters as to the desirable "right" dollar exchange rate demonstrates that notions of an officially set "equilibrium" rate are wrong-headed.

Thoughts of returning to an intervention system of the Bretton Woods type are to be treated with great caution. For one thing, the rate adjustment mechanisms would have to be more flexible and immune to problems of political prestige. Not even governments can find the "right" dollar exchange rate. Exchange market intervention can be used in an attempt to dampen exchange rate fluctuations, reinforce existing trends and temporarily attenuate the urgency of a fundamental adjustment policy, but it cannot remove the need for such a policy. If currency convertibility is maintained, the financial markets will probably always be stronger than the interveners and thus able to impose their assessment of a currency's worth.

The idea of using a system of indicators for co-ordinating and shaping national economic policies, such as the USA has put up for discussion, also has little to offer. In such a system, corrective government action is automatically triggered if the economy's performance falls below or exceeds the chosen macro-economic indicators. The inherent problems in such an arrangement stem from the necessarily arbitrary choice of indicators and our imperfect knowledge about the relationship between the indicators, economic policy measures and economic performance.

We do not have a closed, proven theoretical model from which a workable rule-bound economic policy can be deduced. In practice, it would probably be impossible to reach agreement on such a system because of the serious infringement of national sovereignty and the widely differing interests involved. If a system that prescribed binding economic, fiscal and monetary measures for certain combinations of indicators were used to manage the world economy and its adjustment needs, the world monetary system governed by market forces would be replaced by an administrative system of control that would be doomed to failure.

A reduction in the US current account deficit, and hence in the balance on capital account, necessitates a

radical reduction in the budget deficit. Economic models therefore suggest that a restrictive monetary and fiscal policy, in other words abstinence from consumption, is urgently required in the USA to improve the current account. Curbing economic activity in the USA would also stem the flood of imports, which is the prime cause of the imbalance in the development of the current account.

Difficult Dilemma

A severe austerity programme is the typical remedy that the International Monetary Fund prescribes for countries with heavy foreign indebtedness and a high current account deficit. In the case of the United States, however, such a policy should be dosed so that a downturn in the USA did not plunge the entire world economy into the whirlpool of a cumulative recessionary process. If government spending behaviour remained unchanged and growth slowed down, the reduction in tax receipts would cause the budget deficit to increase further, necessitating continued high net capital inflows and hence a current account deficit. Encouraging growth by monetary measures such as reductions in interest rates stimulates imports and makes adjustment of the trade balance more difficult. If the dollar depreciates further as a result, this policy of easy money contains the danger of rekindling inflation. To look to expansionary policies abroad for salvation runs up against conflicting objectives in partner countries and fails to recognise that the underlying causes must be combatted in the USA itself.

The United States is therefore facing a difficult dilemma. The Administration must tread a narrow path between inflation on one side and recession on the other. The US current account deficit can be eliminated only if the government pursues a sounder budget policy and a monetary policy that continues to pay heed to the need for stability, if partner countries have some success with expansionary growth policies, if American business makes strenuous efforts in export marketing and if the dollar undergoes a limited further depreciation.

It would be wrong to expect immediate results, however. The present dilemma is the outcome of a complicated mix of contrasting economic strategies in the industrialised countries in question over a period of five or six years. The fear now must be that the USA will lack the necessary patience; if that were the case, the dollar would probably decline further, fiscal policy would continue to be undisciplined, monetary policy would become more lax and there would be a danger of rising protectionism and accelerating inflation.