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The Decline and Fall of the Dollar: Some Policy Issues

IN *Dollars and Deficits: The World Economy at Risk*,¹ I have set out the empirical analysis that has led me to conclude not only that a decline in the dollar is inevitable, but also that, absent major changes in policy by both the United States and its allies, the dollar will fall over a period of perhaps two to four years to a level below its previous trough in 1980. As measured by the International Monetary Fund Multilateral Exchange Rate Model (MERM) index, it would fall, in a hard landing, by more than 40 percent by 1989, and the deutsche mark would appreciate against the dollar by over 90 percent. This paper considers the policy issues that would face the United States and its major allies if such a hard landing were to materialize.

The figures cited here come from simulations of a model developed for my book. It is a relatively simple model of how growth rates and relative price changes influence the U.S. current account balance on goods and nonfactor services, and how the latter generates changes in the U.S. net investment position and net investment income. It also incorporates feedback from the exchange rate on domestic prices, and from net exports on GNP and domestic demand, in both the United States and the rest of the world. The properties of the model with respect to a decline in the dollar are in broad terms similar to those of the Federal Reserve Board's Multicountry Model and the Organization for Economic Cooperation and Development's interlink model, and to the widely used rule of thumb that a 1 percent decline in the dollar, as measured by the MERM index, leads to a \$3 billion improvement in the current account balance.

An important feature of the model is that it makes no attempt to

1. Institute for International Economics, forthcoming.

endogenize the two key financial variables, the exchange rate and interest rates. Models that purport to do so have performed badly and are unlikely to be able to track the unraveling of an exchange rate disequilibrium of the magnitude we are now experiencing. Instead, the exchange rate and interest rates have been projected exogenously on the basis of an empirical examination of how they behaved in the past at times of financial stress and marked changes in exchange rate expectations.

The Implausibility of Soft Landing Scenarios

The basic reason for the implausibility of the various soft landing scenarios that have been suggested is less a matter of analysis than of simple arithmetic. It lies in the magnitude of the initial disequilibrium, and hence in the size of the shifts in both the U.S. domestic investment-saving balance and current account balance needed to restore sustainable equilibrium.

In one version of the soft landing scenario—appealing particularly to academic economists—the dollar declines no faster than could be covered by a “reasonable” interest rate differential. But if, for example, the dollar were to decline at 3 percent a year, it would take twenty-two years to eliminate the U.S. current account deficit, by which time U.S. external indebtedness would have risen to over \$5.5 trillion. With a dollar decline of 5 percent a year, the corresponding figures would be fourteen years and \$2.3 trillion. Apart from the intrinsic implausibility of these debt figures, these scenarios imply that, over a decade or more, either real U.S. interest rates would have to be at least 5 percent above the potential U.S. growth rate, in which case achieving such a growth rate becomes highly unlikely; or real interest rates in other countries would have to be at least 5 percent below their growth rates, in which case these countries would suffer from virulent inflation; or some combination of both, which would not be much less implausible.

In a second version of the soft landing scenario, it is assumed that, while it is unlikely that capital inflows will go on rising indefinitely, there is no reason why they should not still be running at, say, 1 to 2 percent of GNP in 1990. With the U.S. economy growing as in the Congressional Budget Office (CBO) baseline, however, it would take a drop in the dollar of around 35 percent to hold the current account deficit down to

this level. And, in the meanwhile, U.S. net external indebtedness would have risen to \$700–800 billion. In other words, some asset holders, somewhere, would have to be induced to increase their exposure in dollars by \$800 billion at a time when, for example, the deutsche mark would be appreciating against the dollar by something like 75 percent.

Once these orders of magnitude have been taken into account, it becomes evident that once the dollar's decline gathers momentum, there is bound to be a significant period of time, perhaps twelve to eighteen months, when people's willingness to increase their exposure in dollars will be declining, *ex ante*, faster than the U.S. economy's need for capital inflows to make up for its deficiency of domestic saving. There will thus be a "crunch" in the financial markets, and, as a fairly conservative estimate, U.S. interest rates will rise 5 percentage points above what they would otherwise have been.

The Hard Landing Scenario

In my hard landing scenario, the U.S. economy suffers a recession of about the same magnitude as that incorporated in the CBO's low-growth medium-term projection. In other respects the recession is, however, quite different from that depicted by the CBO, because it is associated with a steep decline in the dollar. The projection of how much U.S. interest rates are pushed up in this scenario by efforts to sell off dollar-denominated assets is based, in part, on an estimate that interest rates were held down by at least 5 percentage points by capital inflows in the period 1983–84, when the dollar was appreciating strongly. Despite this rise in interest rates, the dollar "overshoots"; present and prospective holders of dollar-denominated assets experience exchange rate losses estimated at \$400 billion in terms of a MERM-weighted basket of foreign currencies (a good deal more in terms of deutsche marks or yen); and by 1990 the *ex ante* desire to get out of dollars has produced an *ex post* capital outflow equivalent to 1.5 percent of GNP.

In this scenario, interest rates in other OECD countries decline by 2–3 percentage points because of the *ex ante* reflux of capital from the United States. In other respects, however, these countries follow their present policies, in particular their restrictive fiscal policies. With a reversal of the positive stimulus to demand that they have been enjoying

from the United States, they find themselves pushed into a growth recession, with GNP growth averaging under 1 percent in the period 1987–88. The model also incorporates a negative feedback on growth in the less developed countries (LDCs) resulting from low OECD growth:

Policy Options Facing the United States

In this hard landing scenario, the United States will be facing a prospect quite unique in its postwar history: a recession generated by the pressures of the external adjustment mechanism. The unusual and unpleasant feature will be an incipient recession accompanied by high interest rates and accelerating inflation, which, after twelve to eighteen months, might roughly double to the 6 to 7 percent range. In terms simply of the market forces at work, a recession might not be inevitable: with the dollar falling sharply, the negative impact on demand coming from high interest rates might fairly soon be offset by a stimulus from rising net exports. But this arithmetic does not take into account the likelihood that the necessary policy response to the evolving situation would make a recession unavoidable.

One possibility is that the dollar falls so fast and so far that it quickly reaches a level at which expectations stabilize and U.S. interest rates fall back to normal levels. But, again, the numbers and past experience suggest that it could fall 40–50 percent before reaching this point. And this would pose a high risk of an inflationary explosion.

What about fiscal policy? What few seem to realize is that at some point in the near future, people's *ex ante* willingness to increase their exposure in dollars is going to fall to zero and, indeed, turn negative. At that point, crowding out in U.S. financial markets will become inevitable unless, by then, the structural budget deficit has been reduced to around zero. Since this point may not be more than a year or so away, this is clearly impossible. In other words, there is now no way in which the United States can get its fiscal sums right because they have become so heavily dependent on what has become the most fickle of economic variables: exchange rate expectations.

If, contrary to all the political signs, strong action were taken quite quickly to reduce the deficit, the day of reckoning might be postponed—

but not for long. Still, there is a powerful case for taking such action, especially if it could be taken before the crunch came, because it would give the Federal Reserve Board (FRB) more room to maneuver and thus make the dollar's decline more manageable.

What about monetary policy? One school of thought argues that if action were taken to cut the budget deficit and if, then, the economy seemed to be slipping into recession, the FRB should ease up. But this argument completely ignores the unique features of an externally generated recession: strong upward pressure on interest rates, accelerating inflation, and a rapidly falling dollar. The FRB will face an impossible choice. If it strictly pursues its monetary targets, high interest rates will push the economy into recession and entail serious risks of a major financial crisis as debtors are sharply squeezed in the United States and the developing world. If, on the other hand, the FRB eases up in order to keep interest rates from rising too much, the perception that it is prepared to monetize both the budget deficit—which would be rising toward the \$400 billion mark—and the external deficit would greatly alarm both the financial markets and the foreign exchange market. There would be a clear danger of a self-feeding spiral of eroding confidence between the two markets, adding greatly to the upward pressure on interest rates and the downward pressure on the dollar.

Once again, because of the magnitudes involved, there will, in the event, be no way for the Federal Reserve to square this circle. All that can be said is that from the point of view of the longer-run interests of the United States and the world economy as a whole, it would probably be best if it errs on the anti-inflationary side.

A Cooperative Scenario

The upshot of this analysis is that there is now nothing that U.S. authorities can do to prevent a hard landing. Still, such an outcome is not inevitable. In theory, at any rate, it could be avoided if both the United States and its major allies were to undertake a prompt and simultaneous change of policies.

Analysis of a "cooperative" scenario, in which the rest of the OECD area takes sufficient expansionary action to offset the negative impact

of declining net exports and achieve a 4.5 percent growth rate in the period 1987–89, shows that—at least using any sensible utility function—the gains from cooperation would be very substantial. To achieve that growth rate, countries in the rest of the OECD would need to take expansionary action sufficient to produce a growth of domestic demand averaging 5.2 percent in the period 1987–89, compared with under 3 percent on present policies. In contrast to the hard landing scenario, some part of the improvement in the U.S. current account balance would be taken up by larger current account deficits in the LDCs, since under these relatively favorable conditions it is assumed that they would be able to obtain additional financing.

In this cooperative scenario, the monetary authorities are able to prevent the dollar from overshooting and manage to stabilize it at a level consistent with rough balance in the U.S. current account by 1990. The benefits to the United States from faster growth abroad come partly in the form of a smaller decline in the dollar, and hence less inflation, and partly in the form of a more moderate slowdown. The benefits to the other OECD countries come particularly in the form of lower unemployment; their inflation gains from the lower dollar are somewhat less, because the dollar depreciates less. Significant benefits also accrue to the developing countries, which are able to grow faster and run larger current account deficits.

THE GAINS FROM COOPERATION

Following is a listing of the differences between the cooperative and hard landing scenarios, 1990 levels, in percentages:²

	<i>United States</i>	<i>Rest of OECD</i>
Nominal dollar exchange rate	+ 23	...
GNP	+ 5	+ 13
Unemployment (percentage points)	– 1.9	– 5.3
Price level	– 2.6	+ 2.4

2. For details, see *Dollars and Deficits*. Note that in these simulations, in which the dollar declines sharply, attention is concentrated solely on the impact of exchange rate changes on the price level, while the latter is assumed to be invariant with respect to the level of activity. This simplification can be justified on the grounds that the slope of the “external” Phillips curve linking inflation and output when the exchange rate changes appears to be more than five times steeper than the traditional “domestic” Phillips curve.

Policy Options Facing the Other OECD Countries

There is at present absolutely no sign that Japan, West Germany, or the United Kingdom would be prepared to take expansionary action of the required order of magnitude, despite the fact that, after two years of world recovery, unemployment in Europe is distressingly high and still rising.

This is indeed eloquent testimony to the strength of the belief of authorities in these countries that they face a situation where expansionary demand management policies either do not work or would do more harm than good. The basis for this belief lies both in the experience of the 1970s and in the resultant major changes in conventional economic wisdom.³ Oversimplifying, the arguments are as follows. First, these economies have become so inflation prone that any acceleration in aggregate monetary demand would soon lead to an equivalent acceleration in inflation, leaving only a small temporary boost to real output and employment. Second, because of the strength of inflationary expectations—and because of the overhang of accumulated public debt—larger budget deficits would push up interest rates by so much as to nullify the positive impact on money incomes and demand from larger budget deficits. Third, faster rates of monetary expansion could raise inflationary expectations and lead to higher rather than lower interest rates—this risk being heightened at present because, with high U.S. interest rates and a strong dollar, monetary expansion could lead directly to more inflation by depressing the country's currency still further.

Whatever the strength of these arguments as applied to the past, and to each country in isolation, they will, to an important extent, cease to be valid once the dollar begins its inevitable decline. For so long as the dollar remains strong, the highly unbalanced U.S. fiscal-monetary policy mix provides an external demand stimulus to other OECD countries, but at the same time holds up both interest rates and—through currency depreciation—inflation. Once a sharp shift out of the dollar begins, the sign on all three of these terms will be reversed; there will be downward pressure on interest rates in the rest of the OECD area, and currency

3. Stephen Marris, *Managing the World Economy: Will We Ever Learn?*, Essays in International Finance 155 (Princeton University, 1984).

appreciation will reduce inflation; but by the same token, there will, after a lag, also be a negative external impact on demand. In other words, a quite new situation will develop that will both increase the need for more expansionary—or less restrictive—fiscal and monetary policies and make it more likely that such policies will increase domestic demand and employment rather than inflation and interest rates.

Thus, paradoxically, Reaganomics has, by now, created the potential for a “Reagan miracle” in Europe and Japan of the kind enjoyed by the United States in the period 1983–84. These nations could give themselves a fairly large dose of fiscal expansion and set off a strong rise in domestic demand, while inflation would be held down because their currencies would be appreciating, and budget deficits would not crowd out investment because their savings would (*ex ante*) be flowing back from the United States.

In practice it seems unlikely that either the United States or its major allies will make the necessary policy changes in time to prevent a hard landing. This need not necessarily be a pessimistic conclusion. History shows that genuine reform—or simply change—in the untidy and amorphous entity that constitutes “the international monetary system” has generally taken place only as the result of a crisis, and has then sometimes happened surprisingly quickly. The last chapter of my book contains some suggestions as to how constructive use might be made of the oncoming crisis.