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All Eyes on the Dollar

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On Wall Street these days there is an obvious sense of urgency to the macro conundrum. As I see it, a US-centric global economy is feeling the full force of America's postbubble shakeout. Lacking in autonomous sources of domestic demand, anemic growth in the non-US world awaits a jump-start from the once powerful American growth engine. And that just isn't happening. The impacts of America's summer flirtation with a double-dip recession have been magnified in the rest of the world. Europe is floundering, Japan is veering back toward another crisis, and an inventory-led rebound in global trade is leading to a peaking of the cyclical upturn elsewhere in Asia. All this and only a double-dip scare! Can you imagine what would have happened had there actually been a recessionary relapse in the US economy?

This is hardly idle conjecture. I would currently place a probability of greater than 50 percent on a US double-dip at some point in the next 6 to 9 months. In that context, the task ahead for global stabilization policy is hardly simple. As I see it, the authorities are confronted with a triangulation of trade-offs. First, there is the need for the United States to purge its postbubble excesses—the root cause of a Japanese-like tendency for periodic recessionary relapses over the next several years. Second, there is the imperative for the rest of the world to wean itself from excessive dependence on the US economy. And, third, there is the urgent need for global policymakers to do everything in their power to avoid deflation. Achieving any of these objectives is tough enough. Pulling it all off simultaneously is a different matter altogether.

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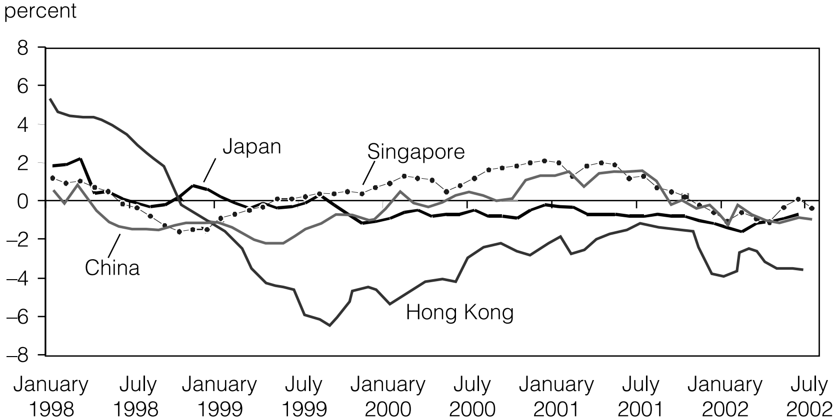
It's not all that difficult to come up with policy prescriptions that might resolve each of these objectives in isolation from one another. Slow growth is the antidote for the purging of America's postbubble excesses. A dip or two—however painful—would accelerate the process, presumably leading to a slowdown in domestic demand that would be required to boost saving, pay down debt, and facilitate a long overdue current account adjustment. A return to policy austerity—both fiscal and monetary—by US policymakers would be required to achieve such an outcome, in my view. As for the growth-starved rest of the world, the policy prescription is precisely the opposite—progrowth fiscal and monetary policies that would jump-start domestic demand overseas and break the unhealthy and excessive dependence of other nations on the United States. Nor is there much debate about deflationary remedies—aggressive monetary and fiscal stimulus, and the sooner the better on both counts. The risk of being late in countering deflationary pressures is especially worrisome for postbubble economies like Japan and the United States. The trick is to move early enough while there is still policy traction.

The problems, of course, arise when you put the package together. That's because these remedies work at cross-purposes with one another. The conflict is most acute in the United States. The demand shortfall required to purge postbubble excesses clashes with the restoration of demand vigor needed to avoid deflation. The more successful any antideflationary measures are, the more likely it is that excesses will only intensify in a "revitalized" US economy—taking America further down the treacherous road of reduced saving, higher debt, and an import-led widening of already massive trade and current account deficits. In that critical respect, the policy stimulus required to avoid deflation will only exacerbate America's lingering postbubble excesses. Maybe the perils of deflation are so serious that it's worth taking just such a risk. That is basically my stance on the matter. At the same time, I would be the first to concede that in today's climate, the trade-off between avoiding deflation and the purging of postbubble excesses seems just about intractable. But those are precisely the tough choices that the authorities must now make.

The Perils of Deflation

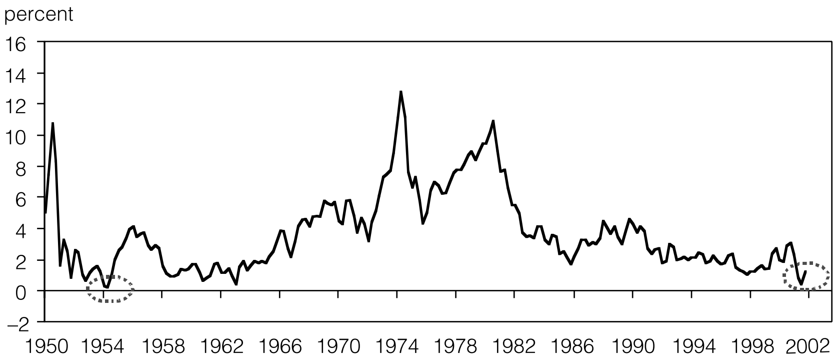
In my opinion, two priorities should be uppermost in weighing the policy options that confront us today. The first is the avoidance of global deflation. This could well be the most serious issue we have faced in the world policy arena since the 1930s. Starting in Japan, deflation has spread throughout most of Asia, whose economies collectively account for about 30 percent of world GDP (figure 8.1). Of the major economies in the region, only Korea has managed to avoid deflation. Meanwhile in the United States, the GDP price index was increasing at a rate of just 0.8

Figure 8.1 Asian deflation at work (consumer price index, year on year)



Source: Bloomberg.

Figure 8.2 Heading toward deflation? (US GDP chain-weighted price index, two-quarter moving average)



Source: US Department of Commerce.

percent in the third quarter of 2002—its slowest rate of rise in 48 years (see figure 8.2). Prices of goods and structures, combined—items that make up 47 percent of real GDP—are already contracting at an annual rate of −0.7 percent. Only in services, where price measurement is notoriously unreliable, is US inflation holding in positive territory. And deflationary concerns are mounting in Europe, where stabilization policies have suddenly become procyclical. Germany seems especially vulnerable in that regard.

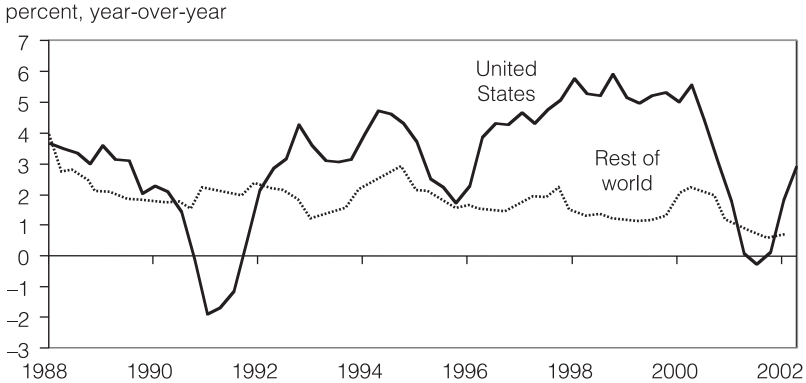
For over 22 years disinflation has been the predominant macro theme shaping the global economy and world financial markets. From its peak of around 13 percent in 1980, industrial-world inflation has eased off to an estimated 1.6 percent in 2002. Yet the road to price stability has proved to be surprisingly treacherous. Most importantly, it has led to asset bubbles that now threaten to transform disinflation into deflation.

Two key complications may have biased the endgame toward deflation—the IT revolution and globalization. Both occurred in the latter half of the 1990s, after the regime shift in stabilization policies. The advent of the Internet gave rise to an extraordinary surge in the demand for information technology that led to a disproportionate expansion of aggregate supply. It also gave rise to a cyclical surge in productivity and the associated "new economy" mania that led to ever-greater monetary accommodation and the mother of all equity bubbles. At the same time, globalization took off, with the annualized expansion of world trade averaging 8.2 percent in the latter half of the 1990s—fully 50 percent faster than average gains of 5.5 percent in 1984-93. This reflected an equally important macro transformation—an IT-based integration of the global supply chain. The combination of the IT revolution and globalization tilted the balance toward deflation. Suddenly, toward the end of the 1990s—at the height of massive asset bubbles—the world was awash in excess supply, a classic setup for price destruction.

Then the music stopped. The equity bubble popped in early 2000, and a US-centric global economy slipped into mild recession in 2001. In retrospect, that may have been all it took to tip the scales toward deflation, in part because these shocks hit the world economy when it was operating at an exceedingly low inflation rate—a 0.8 percent increase in the industrialized world's GDP deflator in 1999. Initial conditions matter. If the world had been hit with a negative shock when the inflation rate was hovering around 3 to 4 percent, it would have been easier to absorb the jolt without unleashing deflation. But with inflation all but squeezed out of the system at the height of the mania, the popping of the bubble may well have been the straw that broke the back of price stability. At very low rates of inflation, there is little to cushion the world in the event of a shock. For that reason alone, the risk of deflation cannot be taken lightly. In retrospect, maybe we simply went too far down the road to price stability—eliminating the margin of error that surely would come in handy today.

In its ideal state, price stability represents perfect balance between aggregate supply and demand. The task for policymakers is to manage both sides of the macro equation in order to achieve this equilibrium. The so-called policy mix—trade-offs between monetary and fiscal actions—became central to the outcome. Not surprisingly, America led the way in using its policy mix in attempting to adhere to inflation targets. The first decade of US disinflation was characterized by tight money and easy fiscal policy. This mix was reversed in the 1990s, as a shift to fiscal austerity was countered by a more accommodative monetary policy. In my view, the problems arose from this shift in the policy mix. The transition from tight to easy money unleashed a massive asset bubble and concomitant

Figure 8.3 Domestic demand disparities



Note: All data are for January of the year indicated.

Source: International Monetary Fund.

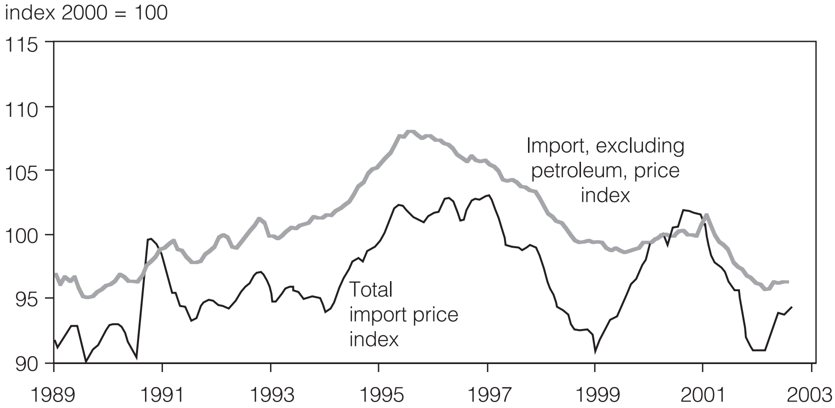
excesses in the real economy. Without a purging of these excesses, sustainable recovery in the US economy and in a US-centric global economy will be most difficult to achieve.

Global Rebalancing and the Dollar

The second priority for global policy is what I would call a rebalancing of a lopsided world economy (figure 8.3). In essence, this is all about shifting the mix of global demand away from the United States and toward the rest of the world. It is the imperative of global rebalancing that brings the dollar into play. Such a transformation boils down to a shift in relative prices. And the dollar is by far the world's most important relative price. As I see it, the time is now ripe for the United Sates to welcome a sharp decline in the dollar—a drop of 15 to 20 percent on a trade-weighted basis. It would serve three important purposes: First, it would be inflationary—putting an end to the unrelenting fall in import prices and thereby arresting the strain of ''imported deflation'' that is currently afflicting the United States (figure 8.4). Second, a weaker dollar is key to America's long overdue current account adjustment. It would shift purchases from foreign-produced to domestically produced products, but it would also reduce the growth of domestic demand; this latter development would stem from the higher real interest rates that typically accompany sharp currency corrections. Saving would probably increase as a result, also tempering the excesses of debt that weighs on consumer balance sheets.

Third, a weaker dollar, of course, also has important consequences for the rest of the world. Obviously, it would imply a strengthening of other major currencies—especially the euro and the yen—which would undoubtedly cause great consternation and angst overseas. Yet that might

Figure 8.4 Falling US import prices



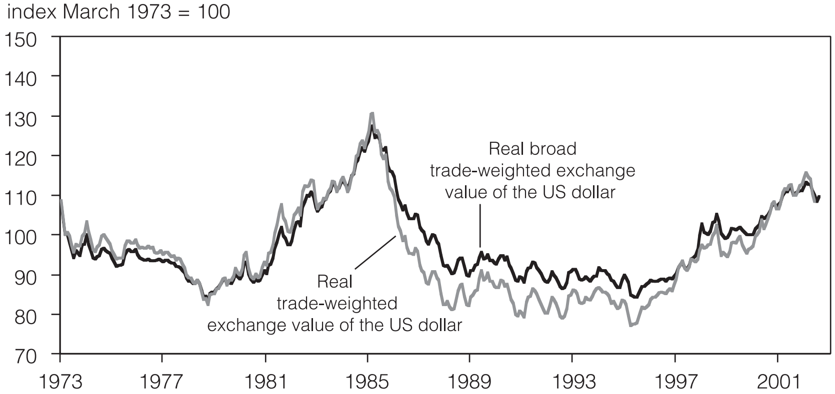
Note: All data are for January of the year indicated.

Source: US Department of Commerce.

be exactly the kick the rest of the world needs in order to embrace long overdue progrowth policy reforms. As a result, a weaker dollar could well intensify pressure on foreign authorities to shift the mix of their growth objectives away from relying on US-led external demand and toward stimulating long-deficient domestic demand. A failure of the rest of the world to embrace progrowth policy stimulus remains a major impediment to sustained global economic recovery, in my view. Japan, of course, has taken major steps in that direction. But they came too late—after the Japanese economy had already tumbled into a deflationary trap. To say that Europe is dragging its feet on this score would be a serious understatement. With fiscal policy stimulus closed off by the strictures of the Stability and Growth Pact, and with monetary easing occurring only reluctantly by a central bank still fighting inflation in a deflationary world, the very concept of progrowth policies has become an oxymoron in Europe.

A depreciation of the dollar would put considerable pressure on the rest of the world to see stabilization policy in a very different light. A strengthening of the yen may well be the final straw for a long-battered Japanese economy, forcing politicians and policymakers finally to come to grips with the imperatives of reform. A strengthening of the euro might have a comparable effect on European authorities, forcing a rethinking of procyclical fiscal policies and pushing the European Central Bank to rethink its battle against a long-vanquished inflation. Most importantly, a weaker dollar would go a long way toward putting the world on notice that it can no longer avoid the imperatives of global rebalancing. US-centric global growth can only work for so long. There comes a time when the rest of the world has to carry its own weight. Given the ominous buildup of America's postbubble excesses, that time is at hand.

Figure 8.5 Dollar risk



Note: Data for January of each year indicated.

Source: Federal Reserve.

What if the Dollar Doesn't Fall?

The Teflon-like US dollar, of course, seems largely unsympathetic to the urgency of the world's dilemma. After falling by about 6 percent in the first six months of 2002, the dollar retraced more than half its descent, as measured on a trade-weighted basis against the broadest possible basket of US trading partners (figure 8.5). The dollar currently (mid-December 2002) is only 3 percent below its late January highs, hardly enough to spur the global rebalancing that the world so desperately needs. (It has, however, weakened in the early days of 2003.) While a fundamentally overvalued dollar remains vulnerable to a sharp correction, trading action over the past year makes it abundantly clear that heightened global angst has the potential to put any such depreciation on hold. Needless to say, that's hardly a trivial consideration in light of intensified concerns over the possibility of a US double-dip recession and a war in Iraq. In a US-centric global economy, there is no ''growth premium'' for the rest of the world in the event of an American recessionary relapse. And a war in the Middle East and its concomitant threat to world oil supplies appears to have ''safe haven'' written all over it. For those reasons alone, the dollar may prove to be stubbornly resistant on the downside—thereby closing off the last option for an unbalanced global economy to find a new equilibrium.

Should the US dollar fail to correct, the noose can only tighten on a shaky global economy. Global rebalancing will then have to be vented by sharp corrections in other US assets, notably stocks and/or bonds. America will then find itself stuck between deflation and the unrelenting pressures of its postbubble excesses, and the rest of the world will find itself unduly dependent on the whims of an ever-fickle US growth dynamic. Nor will there be any realistic options for global policymakers to find a benign solution to this unrelenting buildup of global tensions. In the end, a long overdue rebalancing of a US-centric global economy is really the only way out. I continue to believe that a significant depreciation of the dollar offers the most realistic and least painful avenue for resolution. I remain convinced that, one way or another, the current disequilibrium in the global economy will eventually force a new equilibrium.

Gauging the Impacts

Martin Baily's paper in this volume confirms many of the conceptual points I have made above as far as the macro impact of a weaker dollar in concerned. I have to confess that I've never been too sympathetic to soft landings. Instead, I prefer the ''fast dollar decline'' scenario he describes as a more realistic assessment of what lies ahead. In that simulation, Baily finds that a 20 percent drop in the value of the dollar would reduce the level of real GDP by 1.2 percent by 2007, with personal consumption down over 5 percent and capital spending down nearly 12 percent over the same period. Higher interest rates would be the precipitating factor in this demand adjustment, with the federal funds rate going back to 10 percent over the next five years. One of his most important findings is that a sharp decline in the value of the dollar raises the CPI-based inflation rate by one full percentage point over each of the next five years. Such an outcome could well make a real difference in staving off deflationary pressures currently bearing down on the United States.

The one surprise in Baily's analysis is that the rest of the world doesn't do any better than the United States. However, a key assumption in this aspect of his research is that no meaningful policy actions are taken by foreign economies in order to stimulate their domestic demand. I remain hopeful that such actions will occur, as a dollar correction triggers the progrowth reforms noted above—in effect, sparking a global rebalancing that leads to a delinking of the rest of the world from the US economy. The good news is that, even if that's not the case, Baily estimates that the US current account deficit would be cut in half, thereby returning to 2.5 percent of GDP over the next five years. Needless to say, if I'm right and dollar weakness triggers progrowth policies elsewhere in the world, the US external deficit would undoubtedly shrink a good deal more.

Other Policy Actions

Of course I do not believe a weaker dollar is a panacea for all that ails the US or the global economies. Nor do I believe in competitive currency devaluation as a means toward any end. Yet an unbalanced world needs a realignment of relative prices, and a weaker dollar is the most sensible way to achieve this, in my opinion. It also happens to be the one option with the greatest potential to stave off America's deflationary endgame. But the dollar certainly can't do the job alone. Additional Fed policy stimulus may well be required to trigger this adjustment in the dollar. Such easing would reinforce the dollar-correction scenario I have in mind, but it would also be helpful in putting a floor on US domestic demand—yet another remedy to contain deflation. Nor would I shy away from another dose of fiscal stimulus in this climate, especially tax cuts aimed at middle-income workers.

The odds of outright deflation are now high enough, in my view, for policymakers to take extraordinary actions to prevent it. As the Fed's own research staff has duly noted, that's a key lesson from the Japanese experience that should not be lost on the United States or, for that matter, on any industrial economy.[1] There's always a risk that these actions might come too late to make a real difference for a postbubble economy. But at this point in time, the bigger risk comes from doing nothing. The time to act is now.

A lopsided world economy on the brink of deflation needs a major policy fix. Tensions on this order arise rarely. And they require a radical rethinking of policy options. In my view, a rethinking of America's strong-dollar policy is at the top of the list. The questions we ponder not only have academic interest: they could well hold the key to some of the most vexing problems the world has faced in 70 years.

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1. See Alan Ahearne, Joseph Gagnon, Jane Haltmaier, Steve Kamin, et al., ''Preventing Deflation: Lessons from Japan's Experience in the 1990s,'' Board of Governors of the Federal Reserve, International Finance Discussion Paper No. 729, Washington, June 2002.