

A Case for Action to Lower the U.S. Dollar

By

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June 1, 2006

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Summary and Conclusions

Foreign governments—particularly in East Asia and in the oil exporting countries—have made large purchases of U.S. dollars during the last five years to keep their exports growing rapidly and to keep the U.S. dollar's value artificially high. This foreign currency manipulation has benefited U.S. households (through cheaper imports and lower mortgage rates), but has caused hard times for wheat farmers and other U.S. exporters. The dramatic increase in foreign dollar reserves and the resulting “high” value of the U.S. dollar is causing major changes in the structure of the U.S. economy—e.g., a rapid increase in the U.S. trade deficit, a decline in the relative size of the U.S. manufacturing and trade sectors, and the boom in housing prices and construction.

The case for U.S. government action to end foreign currency manipulation has strengthened recently. The imbalances caused by this foreign manipulation have become unsustainable and the threat of a severe crisis is increasing. The paper examines two plausible scenarios.

First, the U.S. imported \$724 billion more goods and services than it exported in 2005. In order to purchase these extra goods (and also all the goods and services produced by the U.S. economy), spending in the U.S. economy was 6.3% greater than U.S. production. The deficit spending of the U.S. household and government sectors was 4.0% and 3.8% of GDP, respectively. These large deficits kept the U.S. economy growing. However, the negative savings of the U.S. household sector is highly unusual and was financed by borrowing against rising home equity. When the housing bubble slows and U.S. household savings returns to more normal levels, household expenditure will decline by 4% of GDP or more. Unless the U.S. dollar declines to slow import growth and expand the U.S. export sector, spending in the U.S. economy will not be sufficient to prevent a rise in unemployment.

Second, the currency reserves of developing countries around the world have increased dramatically in the last five years and greatly exceed reasonable estimates of the amount needed to prevent financial crises. More than 70% of these reserves are invested in U.S. dollar assets—mostly U.S. bonds. The return on these U.S. assets has been low and, when the inevitable depreciation in the U.S. dollar occurs, foreign governments will incur large capital losses. Foreign governments have an increasing incentive to be the first to sell U.S. dollar assets and to diversify their foreign currency reserves. When this happens, U.S. long-term interest rates will rise and an abrupt increase in U.S. mortgage rates could cause a recession.

After discussing several other longer-run dangers of the current situation and the strong link between low U.S. savings rates and the decline of the U.S. trade sector, I conclude the paper by proposing that the U.S. government call an international conference, preferably through the IMF, to define and prohibit currency manipulation by large developing countries and to coordinate the required depreciation in the U.S. dollar.

A Case for Action to Lower the U.S. Dollar

Tom McCoy*
June 1, 2006

I've been a wheat farmer for more than thirty years. For the first 25 of those years, I paid little attention to exchange rates. I knew almost all my wheat was exported and that our foreign customers used world currency markets to purchase the U.S. dollars they needed to buy my wheat. However, because U.S. wheat (and also the wheat of our competitors) is priced in U.S. dollars, I never dealt with foreign currencies myself. The effects of fluctuations in the value of the dollar were easy to ignore.

Between 1997 and 2001, U.S. wheat farmers faced an extended period of low prices and declining exports. The five-year average of U.S. wheat prices ending in 2001 was \$2.78 per bushel—lower than any five-year period since the early 1970's. When adjusted for inflation, wheat prices have been trending downward for a long time. However, between 1973 and 1996, actual wheat prices fluctuated around an average of \$3.39 per bushel and showed little trend either up or down. The long period of much lower wheat prices in the late 1990's was unusual and I wanted an explanation.

As part of my investigation, I checked the excellent USDA web site dealing with exchange rates. The USDA calculates an index showing how changes in the value of the U.S. dollar affect the cost of U.S. wheat in the currencies of our customers. The USDA also calculates an index showing how exchange rate fluctuations affect the returns of our competitors when they convert the U.S. dollars they earn from wheat sales back into their domestic currency. Both indices showed a dramatic increase in the late 1990's. Between 1997 and 2002, the U.S. dollar rose 29% relative to the currencies of our wheat customers and 42% relative to the currencies of our competitors.¹ The higher U.S. dollar increased the price of wheat in both our customers' and competitors' currencies—reducing U.S. wheat sales and increasing wheat production in the countries we sell to as well as those we compete with for export sales.² Since 2002, the U.S. dollar has partially reversed its rise. However, the value of the dollar is still 26% higher relative to our wheat customers' currencies than it was in 1997 and 12% higher relative to our competitors' currencies. Wheat prices and exports are now closer to normal levels, but are still below their levels in the 1980's and early 1990's.

I concluded that the high value of the U.S. dollar during the last decade is an important cause of our low wheat prices. Along with other U.S. exporters, my bottom line will improve greatly if I can persuade the U.S. government to take action to stabilize the value of the dollar at a lower level. However, since many parts of the U.S. economy are

* Before taking over my family's farm in 1975, I received a Ph.D. in economics from Stanford University and taught economics for several years. I wish to thank C. Fred Bergsten and the Institute for International Economics for inviting me to attend their conference, "Dollar Adjustment: How Far? Against What?" in May of 2004—at a time when I first realized how critical these issues are for my industry. I also appreciate the helpful comments from the participants in the seminar I presented at Oregon State University in May of 2006.

benefiting from the “high” dollar, a case for such action requires convincing policymakers that: 1) the current situation poses a significant danger to the U.S. economy as a whole and 2) effective actions exist to lower the U.S. dollar and reduce the likelihood of a future crisis in the U.S. economy. Both parts of the argument are controversial and complicated. However, I believe a strong case can be made that action is urgently needed now and that this action would benefit the U.S. economy as a whole.

The remainder of this paper is divided into five sections. In the first section, the reasons for the U.S. dollar’s rise are briefly discussed and some background is provided about the current situation. The second section presents two plausible scenarios under which the large and growing U.S. trade deficit will cause a crisis—and possibly a severe recession—in the U.S and the world. The third section deals with other ways the current situation is damaging the U.S. and world economies. The fourth section discusses why government deficits and low household savings rates in the U.S. are a primary reason for the declining fortunes of U.S. export industries. In the last section, I urge the U.S. government to stop the massive purchases of U.S. dollars by foreign governments. The sole aim of these purchases is now to prevent foreign currencies from appreciating (and the U.S. dollar from depreciating). This currency manipulation is responsible for growing imbalances in both the U.S. and world economies. Action by the U.S. government is more likely to be successful if the U.S. works through an international conference, preferably convened through the auspices of the International Monetary Fund (IMF), to develop a more usable definition of “currency manipulation” and to coordinate the adjustment in world currency values

I. Background

In the middle of 1997, both the value of the U.S. dollar and the U.S. trade deficit began to increase rapidly.³

Chart 1

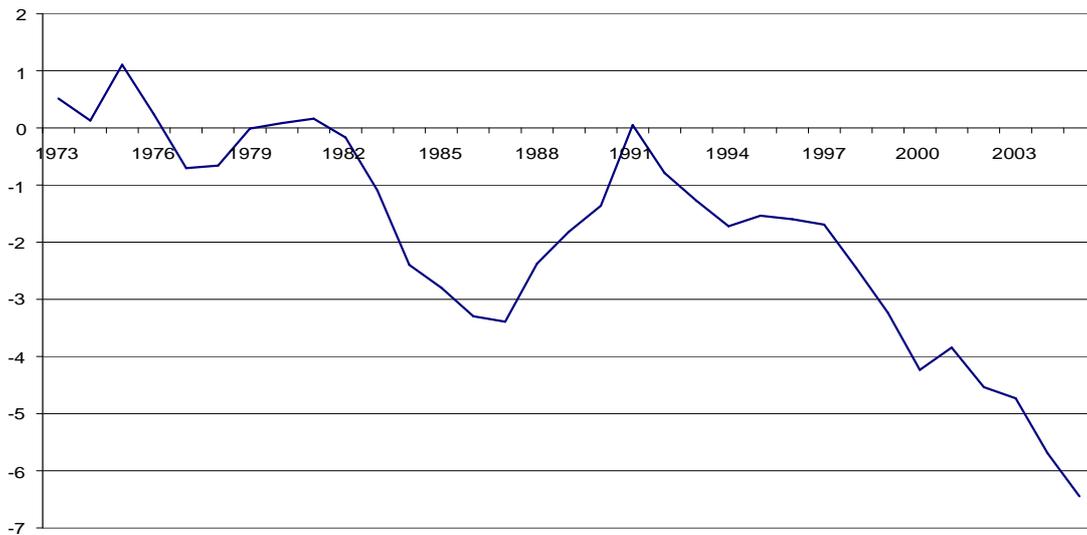
Federal Reserve Broad Dollar Index
Inflation adjusted



This sharp increase in the value of the U.S. dollar coincided with the “Asian financial crisis,” which started in Thailand in 1997 and continued for several more years as it spread around the world (e.g., to Thailand, Indonesia, Korea, Russia, and Brazil). During the early 1990’s, many low- and middle-income countries had financed trade deficits by borrowing U.S. dollars on world financial markets. As the crisis spread in 1997, lenders abruptly cut off further international lending and many countries found they could not

Chart 2

U.S. Current Account Deficit as a Percent of GDP



repay their U.S. dollar denominated debts. Most turned to the International Monetary Fund (IMF) for help. The IMF recommended raising interest rates and allowing the exchange rates to depreciate. This often produced a severe domestic recession and a rapidly expanding trade surplus (as imports fell and exports increased).

The extra dollars earned by the trade surpluses were initially used to repay debt and rebuild currency reserves. The countries most affected by the crisis learned a painful lesson about the fickleness of international lenders. They came out of the crisis strongly motivated to build currency reserves so that they never again would be at the mercy of the international lenders.⁴ As the years went by and the recovery continued, many countries became accustomed to the rapid expansion of their export industries. The aftermath of the Asian financial crisis produced a happy accident—an export led development strategy that seemed to work. Although China was not directly involved in the “Asian financial crisis” and was not forced to depreciate its currency, it also ended the 1990’s with an undervalued exchange rate and rapid growth through expanding exports.

Between 1996 and 2005, the annual trade surpluses to China, India, Japan, Korea, Taiwan, Singapore, Hong Kong, and the other developing Asian countries increased from \$25.7 billion to \$404.9.⁵ If Asian currency markets had been free to function without government intervention, a high percentage of the extra dollars earned by surging exports

would have been converted by Asian exporters into their domestic currency. This would have caused the U.S. dollar to depreciate and the Asian currencies to appreciate in value. To prevent this appreciation in their currencies and keep their exports growing rapidly, Asian governments bought the extra dollars from their exporters. Between 1996 and 2005, reserves in developing Asia and Japan increased by over \$2 trillion. Recently, the rise in oil prices has caused a similar increase in the reserves of oil exporting countries.

The sum total of trade surpluses in the world must equal the total of trade deficits. As Asian countries expanded their exports and trade surpluses after 1997, they found a more than willing partner in the U.S. economy. The strong U.S. economy in the late 1990's and the stock market "bubble" caused U.S. residents to feel richer, increase their consumption spending, and reduce their savings rate. Much of this extra spending flowed into imports and caused a rapidly expanding U.S. trade deficit (see Chart 2). When the stock market crashed and the economy slowed in 2001, the U.S. Federal Reserve lowered U.S. interest rates. Lower mortgage rates helped fuel a boom in construction and a dramatic rise in U.S. housing prices. Higher personal wealth caused by the housing boom encouraged U.S. consumers to keep spending. Between 1997 and 2004, the U.S. economy grew at an average annual rate of 4.9%. Imports into the U.S. from foreign countries grew at an annual rate of 7.4%. Most goods now seem to have a "made in China" sticker. Because of the rising value of the dollar, U.S. exports cost more on world markets and U.S. export industries grew at an annual rate of only 2.9%. The relatively slow growth of U.S. exports and the rapid growth of imports caused the U.S. trade deficit to explode—rising from \$110 billion in 1997 to \$722 billion in 2005. The trade deficit is now at the unprecedented level of 6% of GDP.

Recently, the world has achieved a seemingly stable balance with an unprecedented U.S. trade deficit matching expanding trade surpluses in Asia and the oil exporting nations. Without the expanding U.S. trade deficit, developing countries would not have a market for their exports and export growth is the basis of their recent rapid development. The governments of these developing countries are buying dollars on a massive scale to keep their currencies from appreciating and investing the dollars in the U.S. bond markets. Their action provides financing for the U.S. trade deficit and also helps keep U.S. interest rates low so the housing boom can continue. Without financing from foreign governments, the U.S. could not continue spending more than it produces.

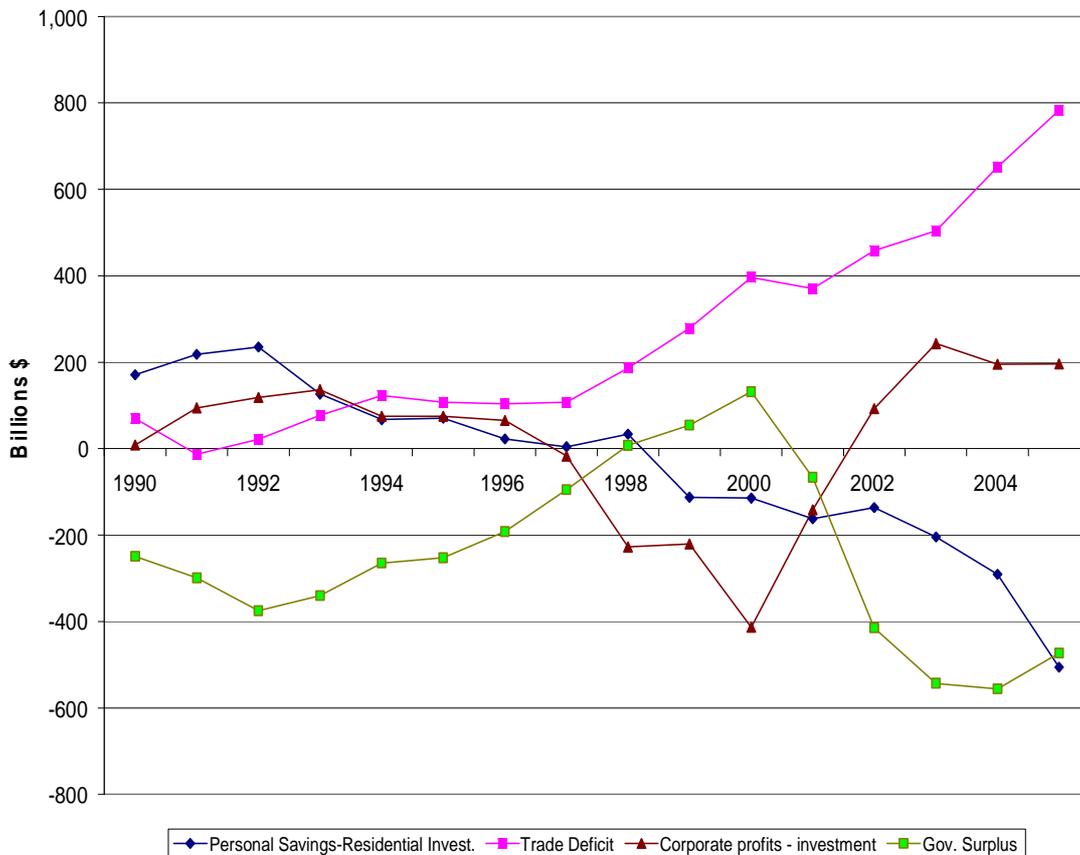
II. The Danger to the U.S. Economy from the Growing Trade Deficit

The recent "high" value of the U.S. dollar has benefited the U.S. economy by providing an abundant supply of low-priced imports. However, the current situation depends on a continuation of two trends that look more and more difficult to maintain: 1) increased debt-financed spending by U.S. consumers and 2) the continued rapid increase in U.S. dollar reserves by foreign governments. If U.S. consumers slow their spending or foreign governments stop financing the U.S. trade deficit, a crisis in the U.S. economy is likely.

Deficits in the U.S. Household and Government Sectors

In 2005, spending in the U.S. economy was 6% more than production. The extra goods came from the excess of imports over exports. Demand in the U.S. economy was sufficient to purchase these imported goods and still purchase the goods and services produced in the U.S. because two of the three main sectors of the economy—the government sector and the personal sector—ran large deficits in 2005. Personal outlays on consumer goods and services were \$33.5 billion more than disposable income in 2005 and households spent an additional \$472.2 billion on housing investment—so total consumer spending was \$505.7 billion more than disposable income in 2005. Combining all levels of government, government spending exceeded tax revenue by \$473.0 billion in 2005. The deficits in the personal and government sectors were partially offset by a surplus in the third sector—the business sector. The profits in the business sector of \$459.6 billion exceeded business investment of \$263.2 billion—so the business sector had a surplus of \$196.4. However, even with the surplus in the business sector, the deficits in the other two sectors were so large that the U.S. could purchase the goods and services produced in the U.S. and also the \$782.3 billion of goods imported from other countries (see Chart 3).⁶

Chart 3



(source: Bureau of Economic Analysis web site)

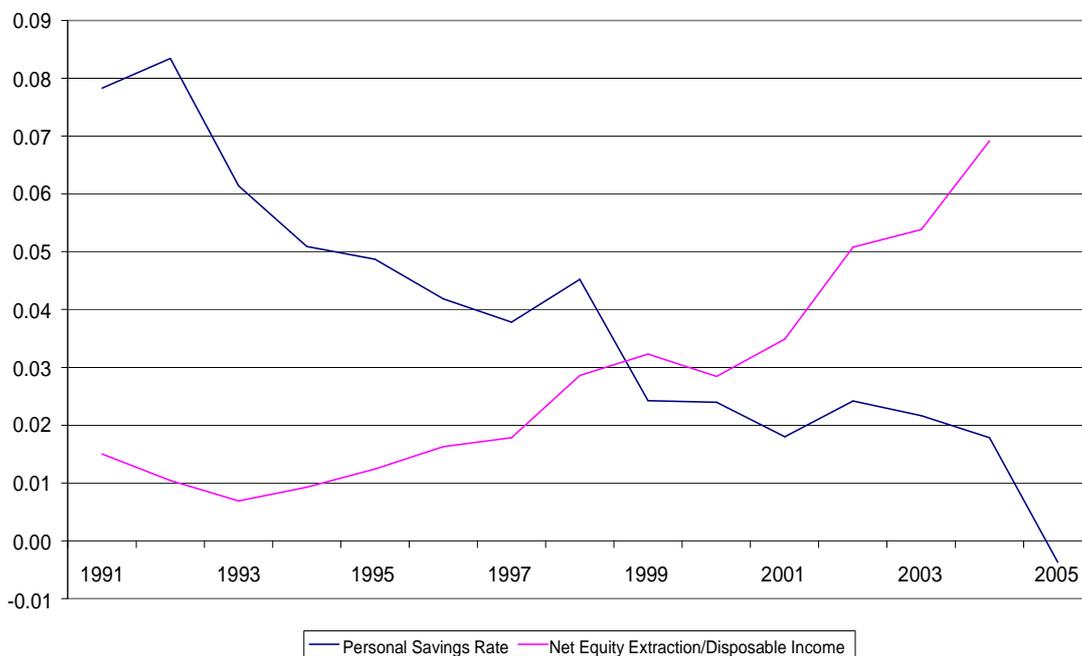
Since 1990, the changes in the deficits and surpluses of the U.S. business and government sectors have roughly offset each other. The most remarkable feature of the U.S. economy has been the growing deficit in the personal sector caused by the declining personal savings rate and increased borrowing to finance investments in housing.

The personal savings rate was 7.8% in 1991 and has declined so personal savings is now slightly negative, i.e., household spending is now more than disposable income (see Chart 4). Households have increasingly financed their additional spending by borrowing against the rising value of their homes. As Martin Feldstein points out in a recent article, “net mortgage borrowing not used for the purchase of new homes that year amounted to nearly \$600 billion [in 2004], or almost seven percent of disposable income.”⁷

When the housing boom ends (or even slows down), spending by U.S. households will slow and household savings should increase. If the U.S. trade deficit does not decline, any significant reduction in U.S. household spending will cause a recession in the U.S. Spending in the U.S. will be insufficient to purchase all the goods produced in the U.S. plus net imports in excess of 6% of GDP.⁸

Chart 4

Personal Savings Rate and Household Spending Financed by Mortgage Borrowing



(source: Greenspan and Kennedy, 2005 and Council of Economic Advisors, 2006)

Increasing Foreign Reserves of U.S. Dollar Assets

Foreign governments have been rapidly increasing their currency reserves—adding an estimated \$670 billion to their reserves in 2005 alone.⁹ The majority of these reserves have been invested in U.S. bonds. During the stock market bubble of the late 1990's, foreign private investors provided most of the financing for the U.S. trade deficit. Private investors have recently cut back their purchases of U.S. stocks and bonds and this has forced foreign governments to buy more of the excess dollars earned by their exporters. The reserves of developing countries increased from \$700.6 billion in 1998 to \$2,396.4 billion in 2005.¹⁰ If Japan is included with developing countries, the increase in reserves between 1998 and 2005 is over \$2.3 trillion dollars. Although most countries don't reveal the currency mix of their reserves, it is estimated that at least 70% are invested in U.S. dollar assets.

The countries affected by the Asian financial crisis in 1997-98 learned the importance of maintaining adequate reserves to protect themselves from the caprice of foreign lenders. However, as Lawrence Summers argues in a recent speech, the current level of reserve accumulations vastly exceed the amounts needed for financial protection. Summers uses "one familiar criteria, the so-called Guidotti-Greenspan rule that reserves should equal 1 year's short term debt to demonstrate the spectacular increase in ... excess reserves in emerging markets." Using the "Guidotti-Greenspan rule," developing countries had over \$2 trillion in excess reserves in 2005. If excess reserves are defined as reserves in excess of *two* times short term debt, the developing countries still had excess reserves totaling \$1.5 trillion in 2005.¹¹

Additional reserve accumulations are not needed to protect developing countries against a sudden withdrawal of foreign funds. In addition, reserves currently offer poor investment returns. Interest rates on U.S. dollar bonds have been low and foreign governments will suffer large capital losses on their bonds when the dollar depreciates. Consequently, foreign governments have good reasons to want to diversify their reserve holdings by selling U.S. dollar assets and shifting to another reserve currency such as the Euro. One or more countries may start selling their U.S. dollar reserves in the near future. Their action could start a stampede out of U.S. dollar assets—producing a large-scale selloff of U.S. bonds and sharply higher U.S. interest rates. Higher U.S. interest rates could cause an abrupt end to the U.S. housing boom and a recession.

III. Longer-run Dangers from the U.S. Trade Deficit

There are at least three other good reasons to worry about the current "high" value of the U.S. dollar and the resulting trade deficit:

- 1. Growing debt payments to foreigners** – Financing the trade deficit requires selling debt and U.S. assets to foreigners. U.S. net foreign debt was \$2.5 trillion in 2004 and is growing rapidly. Although the U.S. has paid remarkably little to service its debt to foreigners, payments will grow in the future. Increasing debt payments will reduce future living standards in the U.S.

Much of U.S. foreign debt is now held by countries that are not close allies of the U.S. These countries now have the power to influence U.S. foreign policy by threatening to sell their U.S. dollar assets and raise interest rates in the U.S. The threat of such action could limit the ability of the U.S. to pursue its foreign policy goals.¹²

- 2. Growing Protectionism in the U.S.** – The rapid increase in imports has accelerated the decline of manufacturing in the U.S. and the other parts of the U.S. economy that compete with imports. The affected U.S. industries have increased the pressure for higher tariffs, quotas, and other actions to reduce imports. In the past, U.S. export industries have helped resist protectionism and have strongly supported efforts—both at the WTO and through bilateral agreements—to liberalize trade. However, U.S. export industries have had difficulty selling their products on world markets at existing exchange rates and this has reduced the relative size of the U.S. export sector in the last decade. In 1996, U.S. exports were 91% of imports. In 2005, exports were only 65% of U.S. imports. With the U.S. export industries atrophying, passing legislation to liberalize trade in the U.S. Congress will become more and more difficult.
- 3. Poor Countries Are Financing the U.S.** – Until the Asian financial crisis, most developing countries ran trade deficits and received financing from the richer countries. This flow of capital from rich countries to poorer countries fit well with the conventional wisdom about economic development. Most experts believed 1) countries were poor because they lacked adequate capital and that capital would earn a higher return in poor countries (where capital is scarce) than in rich countries and 2) although expanding export industries is a key part of almost all successful development strategies, countries would use their export earnings to finance increased imports and investment.

One of the most amazing developments of the last decade is that the standard development model has been turned upside-down. The exports of developing countries are expanding rapidly. However, a substantial part of the growth in export earnings is being added to reserves and is not being spent on additional imports. Growing reserves are being invested in the U.S. bond markets. This situation might be justified if the returns from investing in the U.S. were better than the returns from investments in poor countries. However, developing countries are likely to receive poor returns on their investments in U.S. bonds.¹³

Economic development around the world should be more rapid if the financing now going to U.S. consumption is diverted to increase investments in developing countries. A way must be found to make developing countries comfortable again with trade deficits financed by foreign lending.¹⁴

IV. The Link between Declining U.S. Savings and the Decline of the U.S. Trade Sector

If the economy is near full employment and U.S. savings decline, expenditures will exceed U.S. production.¹⁵ To prevent inflation from increasing, 1) the trade deficit must increase so the additional goods and services are available from foreign countries and 2) the U.S. dollar must appreciate to make foreign goods less expensive and make U.S. citizens want to switch more of their expenditures to imported goods.¹⁶ An increase in the value of the dollar also makes U.S. exports more expensive on world markets and reduces the size of the U.S. export industries. As the U.S. trade sector—exporters and U.S. companies that produce goods that compete with imports—shrinks, its laid-off workers will be absorbed into other sectors of the U.S. economy (e.g., construction and services). Hence, a fall in U.S. savings will be associated with a decline in the relative size of the U.S. trade sector.¹⁷

Conversely, an increase in U.S. savings—through a reduction in the government budget deficit or a bursting of the housing bubble—would benefit the U.S. trade sector, at least in the long run. An increase in U.S. savings would mean that part of the excess of U.S. expenditure over income is eliminated. Demand in the U.S. economy would decline. To maintain full employment, imports must fall, the U.S. trade sector must expand, and U.S. expenditure must be shifted from imports to domestically produced goods. This would require a fall in the value of the U.S. dollar.

V. U.S. Government Actions

... it is the Chinese government, not our political process or the independent determination of markets, that is determining [the structure of the U.S. economy]. We are buying more tee shirts, shoes, and appliances and living in larger homes than we otherwise would because of a Chinese government decision. We are producing fewer appliances and less agricultural output than the market would have us make as well, thanks to a decision by the Chinese government. It does no good to tell American politicians that if the Chinese want to subsidize us we should let them, because the very fact of their subsidy changes our behavior in a way determined by them, not by us. --- Larry Lindsey¹⁸

As discussed in Section II, the governments of many countries around the world—particularly the emerging-market countries in Asia and the oil exporters—are making massive purchases of U.S. dollars. Additions to currency reserves by foreign governments have exceeded \$600 billion during each of the last three years.¹⁹ Since currency reserves are more than adequate in all these countries, the purpose is to prevent the value of their currencies from appreciating and to keep exports growing rapidly. Developing countries are clearly manipulating their currency values to gain a competitive advantage in world export markets.

China and other emerging-market countries argue they have the right to accumulate reserves—as “a matter of national sovereignty”—and to peg their currencies to the U.S. dollar at whatever exchange rate **they** choose. History supports their claim. The IMF is the international organization with the primary responsibility for determining when a country is “manipulating” its exchange rate. Article IV of the IMF’s Articles of Agreement states “each member shall: ...

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members...”

However, the IMF has never applied its rules against “currency manipulation” to developing countries. These countries have been allowed (and sometimes encouraged) to peg the value of their currencies to the U.S. dollar.²⁰

Ignoring currency manipulation by developing countries made sense when their exports and trade surpluses were a small part of world trade. Rapid export growth has been an important part of all successful development efforts and fostering the development of poor countries is an important international goal. The problem now is that exports from developing countries are no longer “small.” Between 1998 and 2005, developing countries increased their share of world exports from 21% to 31% and went from an aggregate trade deficit of \$49 billion to a trade surplus of over \$500 billion.²¹ Exports from developing Asian countries were 53% of U.S. exports in 1996 and are now more than 102% of U.S. exports.²²

In the last five years, currency manipulation by developing countries (and Japan) has led to a dramatic change in the structure of the U.S. economy. The massive foreign purchases of U.S. dollars is keeping the dollar from depreciating on world currency markets and is causing a steady decline in the relative size of the U.S. manufacturing and trade sectors. The purchase of U.S. bonds by foreign governments has kept U.S. interest rates artificially low and produced a bubble in housing prices and construction. Purchasing all of U.S. production **and** the extra goods provided by the U.S. trade deficit has been possible only because the U.S. household and government sectors are spending much more than their income. The current situation is unsustainable and stopping foreign currency manipulation is necessary to get the U.S. economy back on a sustainable path.²³ As a matter of national sovereignty, the U.S. can not allow the deliberate actions of foreign governments to dictate such large (and unhealthy) changes in the U.S. economy.

The U.S. government should act now to convene an international conference—preferably through the IMF—with two purposes. First, the conference should clarify the definition of currency manipulation—particularly as it applies to large developing countries. At a minimum, the conference should agree that countries with adequate currency reserves should not add to their reserves. Second, the conference should agree on joint, simultaneous action to reduce the value of the U.S. dollar. Reducing the U.S. trade deficit to a sustainable level—probably in the neighborhood of 3% of GDP—will require a large decline in the trade-weighted value of the U.S. dollar. However, if the trading

partners of the U.S. appreciate their currencies at the same time, the necessary trade-weighted appreciation in each of their exchange rates will be much smaller (since most of their trade is with each other) and the effects of the declining U.S. dollar will be less disruptive.²⁴

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¹ See (USDA/ERS, 2006). If monthly data are used, the increases are even more dramatic. Between August of 1996 and March of 2003, the inflation-adjusted value of the U.S. dollar rose 39% relative to the currencies of our wheat customers. Between November of 1996 and March of 2002, the U.S. dollar rose 64% relative to our foreign competitors.

² See (McCoy, 2004).

³ To simplify the presentation in this paper, I have used the term “trade deficit” when usually the technically correct term is the “current account deficit.” The current account deficit is the trade deficit (the excess of imports of goods and services over exports of goods and services) plus “net unilateral transfers” and “net capital account transactions.” In recent years, the “trade deficit” has accounted for the vast majority of the “current account deficit” and the two have increased in parallel. In 2005, the “trade deficit” was \$722.0 billion and the “current account deficit” was \$804.9 billion. The exchange rate data used in this paper have been adjusted to account for the effects of different rates of price inflation between the countries.

⁴ This point is made strongly by Martin Wolf in an excellent set of three recent lectures. The lectures are available in both audio and video versions on the web. See (Wolf, 2006)

⁵ See (IMF, 2006).

⁶ The series in Chart 3 are defined so they sum to zero, i.e., the sum of (personal savings – residential investment) plus (corporate profits – business investment)) plus (government surplus) equals the current account surplus.

⁷ See (Greenspan and Kennedy, 2005) page 20-21 and (Feldstein, 2006b) page 89.

⁸ See (Feldstein, 2006a) and (Feldstein, 2006b).

⁹ See (Summers, 2006) page 2.

¹⁰ See (IMF, 2006) Table 35, page 235.

¹¹ See (Summers, 2006).

¹² Summers notes that the U.S. successfully used the threat of reserve sales to force the British and French to withdraw from the Suez Canal in the 1950's. See (Summers, 2006) p.2.

¹³ Summers notes: As currently invested, developing country reserves will earn “what is likely to be a zero real return measured in domestic terms. This represents a substantial cost. If the wealth tied up in reserves were invested either domestically in infrastructure or in a fully diversified long-term way in global markets, 6 percent would not be an ambitious estimate of what could be earned. The resulting gain would be close to \$100 billion a year. ... As Dani Rodrik has pointed out, this is comparable to the gains thought to be achievable from the next round of trade liberalization, to global foreign aid, or to spending on key social sectors in a number of countries.” See (Summers, 2006) page 4.

¹⁴ Some experts in economic development argue that an undervalued exchange rate has and is likely to continue to be a key part of any successful development strategy. An undervalued exchange rate stimulates the trade sector and this stimulation more than compensates for the capital exports caused by the resulting trade surplus. See (Bruton, 1997) Chapter 8. I am indebted to Bill Jaeger for raising this point during a seminar I presented at Oregon State University. The problem now is that too many large countries are using an undervalued exchange rate to develop and this has created an unsustainable U.S. trade deficit.

¹⁵ I am assuming that investment expenditure does not fall with savings. If investment expenditure fell along with savings, total expenditure would not change.

¹⁶ For example, assume U.S. citizens spend 16% of their income on imports and 84% on domestically produced goods and household spending increases by \$100 billion. Without an appreciation in the dollar, expenditure on domestically produced goods would increase by \$84 billion and expenditure would exceed domestic production. The dollar must appreciate to shift \$100 billion of U.S. spending to imports. If imports are initially \$200 billion and GDP is \$1,200,

the percentage of income spent on imports would rise from 16% to 25%. The needed increase in imports would actually be less since the dollar appreciation would also cause a decline in the U.S. export industries and a shift of their capital and workers to the production of more goods for the U.S. market.

¹⁷ This paragraph is one way to describe the changes in U.S. economy over the last decade.

¹⁸ See (Lindsey, 2006)

¹⁹ See (Setser, 2006)

²⁰ Until recently, the IMF's focus has been dealing with financial crises (such as the Asian financial crisis starting in 1997) caused by over-valued exchange rates and trade deficits. The current situation is the mirror image of past crises and the IMF has so far been unwilling to step up and confront the huge global imbalances created by under-valued exchange rates and growing trade surpluses almost everywhere outside of the U.S.

²¹ See (IMF, 2006) pages 206, 213, and 219.

²² See (IMF, 2006) page 220 and the Bureau of Economic Analysis web site for U.S. export data.

²³ The U.S. is currently consuming 6% more than it produces and this extra consumption is partly responsible for the U.S. trade deficit. Many experts have argued that moving the U.S. economy back to a sustainable path will also require a reduction in U.S. expenditure and an increase in savings—mostly likely through a reduction in the U.S. government budget deficit. They may be correct. Without an increase in savings, a dramatic decline in the U.S. dollar would cause inflation in the U.S. However, I believe the negative savings rate of U.S. household sector is unsustainable and, when the housing bubble ends, U.S. household savings will increase enough to allow for the decline in the U.S. trade deficit, even if the government deficit stays at its current level (see Feldstein, 2006b). When the housing bubble ends, the problem for the U.S. economy is more likely to be too little spending and too much savings.

²⁴ See (Cline 2006b). In (Cline, 2006a) page 280, Cline proposes an additional action if the U.S. dollar does not decline by enough to reduce the current account deficit to 3% or less. He proposes a tax on the U.S. earnings of foreign investors.