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Lombard

How the dollar has fallen

By Samuel Brittan

THE SENSE of restlessness so clearly being felt by Mr James Baker, US Treasury Secretary, at the slowness of the US trade balance to respond to dollar depreciation will strike a chord with those who have long memories.

For it is all terribly reminiscent of the period after the devaluation of sterling in November 1967 — so long resisted by the then Mr Harold Wilson with an emotional obstinacy reminiscent of Mrs Thatcher's present attitude to the European Monetary System.

When devaluation occurred, there was a seemingly endless wait before any effects were seen on the UK balance of payments; and during this wait all those who believe that all elasticities are zero—and that in any case devaluation is immoral —were delighted to say: "I told you so." It was not until the summer of 1969 that decisive evidence appeared of a turnround in the British overseas trading account.

The devaluation of the dollar has been followed by a similar train of events. In spite of a single good month on which President Reagan went to town, the OECD expects both the trade and current deficits to be this year in the $130bn to $140bn range—higher than in 1985—with only a small improvement expected next year.

Part of this sluggishness reflects valuation lags known as the J-curve. After a devaluation, import prices tend to increase straight away in dollar terms thus boosting the import bill, while exports take time to strengthen. The OECD projections do show US export volume rising in the course of 1987 by 11 per cent, compared with only 6 per cent for imports.

Nevertheless, many people— not least an Administration worried by protectionist pressures from US producers—would like faster progress. One scapegoat that has recently emerged is the dollar's exchange rate against developing countries, which account for 36 per cent of all US imports. In many cases, this rate has actually risen, especially against Latin American countries.

This scapegoat has been slain by Salomon Brothers, which published in its May 30 Comments on Credit the table updated here. The "broad coverage" dollar index which includes developing as well as industrial countries, has indeed depreciated much less than the usually quoted indices against industrial countries. But nearly all of the differences reflect more rapid inflation in the LDCs. Allowing for this, the real fall in the dollar has been pretty similar, on whatever index it is measured.

The OECD "competitiveness" indicators show, for what they are worth, an improvement in US labour costs, relative to Japan, after adjustments for dollar devaluation of more than 40 per cent compared to 1982. In export prices the gain is less, but still 8 per cent. In the case of West Germany, the deterioration in competitiveness, between 1982 and 1985, has at least been eliminated.

Secretary Baker keeps saying that either other countries must expand demand or they must let the dollar depreciate still further. But the problem may lie not in any inadequacy of either dollar devaluation or world demand, but in the gap between US domestic savings and investment, of which the structural Budget deficit is but an aspect.

The probability is that Gramm-Rudman and other changes will gradually reduce the savings deficiency. This, with the unwinding of the J-curve, will gradually reduce the US payments deficit, both absolutely and still more as a proportion of GDP. The danger both to the US and the world is no longer the US payments deficit but misguided attempts to cure it faster.

CHANGES IN US DOLLAR TRADE-WEIGHTED INDEX
February 1985-May 1986

	Nominal %	Inflation adjusted %
Industrial countries Morgan Guaranty Index	−22.5	−25.3
Broad coverage Morgan Guaranty Index	−11.2	−20.6

Sources: Morgan Guaranty, Salomon Bros