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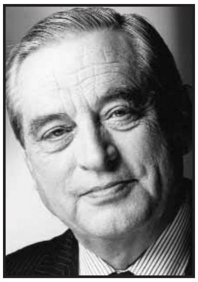
A SYMPOSIUM OF VIEWS

Will the fallen U.S. dollar set the stage for a global economic boom a year or two from now?

Background: *The conventional view is that the weakening of the U.S. dollar is the result in large part of global market concern with the negative effects from growing twin U.S. deficits. Yet could the fallen dollar, particularly if it continues a weakening pattern, set the conditions that force the world's other central banks to cut short-term interest rates further? Could such a development set the stage for a competitive monetary reflation and expansion? In other words, could a weaker dollar represent a "way out" for a global system plagued by disinflationary pressures?*



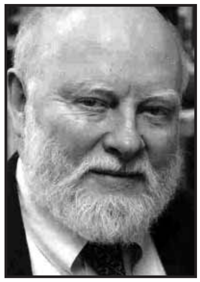
Dollar devaluation is unavoidable, but it brings a mixed blessing.

KARL OTTO PÖHL
Chairman and Managing Partner, Sal. Oppenheim jr. & Cie.; and former President, Deutsche Bundesbank

The depreciation of the dollar against a number of currencies is useful and unavoidable in light of the huge current account deficit of the United States. It is certainly a stimulus for American exporters and will support expansionary fiscal and monetary policies to get the U.S. economy to faster growth.

However, from a European point of view the devaluation of the dollar is not without problems: it is somehow unbalanced. In other words, Europe has to carry most of the burden in the adjustment process. On a trade-weighted basis, the dollar has lost less than 10 percent of its value at the end of May 2003 compared to February 2002, but 36 percent against the euro. This is two-thirds of the total depreciation. Canada, which is the second biggest trading partner of the United States after Europe (17 percent versus 17.4 percent), has contributed only one-third, Japan (share of trade 12 percent) even less. China, which has a rapidly rising trade surplus with the United States, has pegged its currency to the dollar. Its share of foreign trade with the United States has increased dramatically to 9 percent.

So far the devaluation of the dollar against the euro is rather a normalization. Markets have, however, a tendency to exaggerate, as we have seen again and again in the past. A devaluation which goes too far cannot be excluded because of the bandwagon effect, a loss of confidence in the markets as a consequence of the "twin deficit," a diversification of financial investments, etc. This could have very unwanted consequences in the United States, in Europe, and for the world economy. In Europe it would aggravate deflationary pressures and prolong the stagnation. Finally, political tensions which already exist could be intensified. So, a devaluation of the dollar is unavoidable, but it may be a mixed blessing.



The problem is the fundamental symmetry in the world's money machine.

RONALD MCKINNON
William D. Eberley Professor of International Economics, Stanford University

The emerging macroeconomic threat to the world economy is generalized deflation. The fall of the dollar (mainly against the euro) will, as everybody notes, make American producers in world markets more competitive, and thus have some short-term buoying effect on the American economy. And low American interest rates with large fiscal deficits may provide further stimulus. However, because of a fundamental asymmetry in the world's money machine, coping with deflation in other industrial economies is much more difficult.

In a deflationary world, each foreign government is paranoid about having its currency appreciate against the dollar with a consequent loss of mercantile competitiveness against its neighbors. So its central bank intervenes to buy the "excess" dollars from private holders. For example, the Bank of Japan has intervened quite massively in 2003 and earlier to sell yen for dollars in a desperate attempt to prevent the yen from appreciating—buying US$34.4 billion in May 2003 alone. Japan's official foreign exchange reserves now total an amazing half trillion dollars. The People's Bank of China has been selling yuan for dollars so that the recent run-up in its exchange reserves, which are now more than $300 billion, has been proportionately faster. And each central bank is more or less forced to cut interest rates to stem the conversion of private dollar assets into yen or yuan. The Bank of Japan has cut the short-term interest rate in Japan's money market to virtually zero. However, if either of these intervention efforts were to break down, with a sharp appreciation of the yen or the yuan, the deflationary impact would be substantial in Japan or China.

The other major player, Western Europe with its new euro, is a huge economy somewhat better—but not completely—insulated from the dollar standard. Its foreign trade and international lending is denominated in its home currency, the euro. Traditionally, the European Central Bank does not intervene to keep the euro stable against the dollar and has been more sanguine, and probably too willing to ignore, the deflationary impact of the rise in the euro over the past two years from about US$.85 to US$1.17. True, on June 5, it cut its interbank rate sharply down to 2 percent partly in response to the euro's rise. But that might be too little and too late—given the weak state of the German and French economies.

My guess is that further significant ratcheting up of the euro will eventually elicit official intervention in the foreign exchanges by European governments, and more interest rate cuts by the ECB, to prevent further appreciation. But, of course, once interest rates approach zero, this avenue will no longer work. Then, Western Europe will be in the same financial trap as its neighbors in East Asia: massively intervening to keep their domestic currency from appreciating while not being able to do much to stimulate their internal economies.

So everybody will be "waiting for Godot," waiting for the huge U.S. economy to recover and once again start attracting private capital from the rest of the world. Only then may foreign governments withdraw from intervening to keep their currencies from rising, and make use of a more buoyant world economy to expand their exports and recover.

Notice that in either of these scenarios, the United States has no problem in covering its own massive current-account deficits. If the American economy recovers, it will again attract private capital inflows. But if the American economy continues to languish, then official capital inflows—the result of foreign governments intervening to prevent their currencies from appreciating—provide the finance for America's external trade deficits.

Yes, the policy will probably set the stage for a global revival. But it's also dangerous if the decline gets out of hand.

BARTON M. BIGGS
Managing Partner, Traxis Partners

My intuition is that the weakening of the dollar is bullish for the global economy, reflation, and for equity markets. Since the bubble burst, the world has been sick, afflicted by an increasingly vicious spiral of sluggish growth mixed with whiffs of deflation and desultory policy responses. The U.S. economy is still the main engine of world growth, and the strong dollar and the huge and widening trade deficit was sapping the incipient recovery. At the same time, the European Central Bank was so obsessed with the weakness of the euro that it procrastinated on the rate cuts Europe so desperately needed, and the authorities in Japan wallowed in indecision. Stock markets, sensing the paralysis and the danger, traced out a pattern of failed rallies and new lows.

Suddenly the equation changed. As the decline of the dollar began to gain momentum, intended and unintended consequences began to set in motion what could be a virtuous circle. Here are my assumptions in short hand as there is not space for detail. First, the weaker dollar combined with massive fiscal and monetary stimulus will shortly begin to revive the faltering U.S. economy. Second, the resurgence of the euro with its positive psychic but deflationary effects will embolden and compel the ECB at long last to aggressively cut rates which eventually will revive the Euroland economy. Third, there will be a whole series of unintended consequences as the decline in the dollar shocks central banks into action. An example is the huge buying of long-term government bonds to brake the decline of the dollar. This should trigger another spurt of refinancing and a revival of capital spending.

It all this healthy? Yes for now, but probably not in the long run. Is it dangerous? Certainly, if the decline in the dollar gets out of hand and triggers competitive devaluations. But will it set the stage for competitive monetary reflation and expansion? I think so.

The answer is "no."

ALLAN H. MELTZER
Professor of Political Economy, Carnegie Mellon University, and Visiting Scholar, American Enterprise Institute

Few topics in economics are more subject to nonsense than discussions of exchange rates. The dollar has been floating, more or less freely, for years. A floating dollar can appreciate—be "strong"—when underlying conditions dictate or be "weak" when those conditions change.

Floating *is* a policy. But a country cannot have a policy of floating and a strong or weak dollar policy. Either it intervenes to strengthen or weaken the exchange rate, or it doesn't. Whatever U.S. Treasury Secretaries Rubin and Summers said to bamboozle reporters about their policy, they had the same policy—floating—that we have now. The economic conditions, not the policy, changed.

The effect of dollar depreciation against the euro is a change relating to 20 or 25 percent of our trade. Much of the rest is done at managed or fixed exchange rates. Leading trading partners such as Japan, China, Mexico, Canada, Taiwan, and others in Southeast Asia either don't let their dollar exchange rate change, or they don't let it change much. This limits the effect on the U.S. economy of reported exchange rate movements.

Five principal reasons suggest that the right answer to this question is "no." First, every change in the exchange rate has two effects—expansive for some, contractive for others. No chance of a *global* monetary reflation from that.

Second, Bretton Woods ended long ago. Countries on floating rates can control money growth. It's up to the Federal Reserve, the European Central Bank, and their counterparts in countries with floating currencies to manage domestic policy and prevent inflation or deflation. The fact that Japan chose not to do much about its deflation gives no reason to think it cannot be done. Even in Japan, monetary expansion last year helped to generate lower long-term interest rates and 2.8 percent real growth.

Third, countries that fix their exchange rates to the dollar get a boost to exports from the appreciation of the euro, but they pay more for what they buy from euro-area countries. Both work against deflation in different ways.

Fourth, to the extent that real depreciation reduces the United States' current account deficit, the United States will supply fewer dollars to the rest of the world. This reduces inflationary impulses in countries that fix their exchange rates to the dollar. By raising import costs, including inputs to production, depreciation raises prices in the United States.

Fifth, the United States has a large and growing budget deficit and a depreciating currency. Can anyone think of an example where that combination brought deflation? The combination may result from deflation and recession, but it does not cause deflation.

A dollar-related global economic boom is doubtful.

EDWIN M. TRUMAN
Senior Fellow, Institute for International Economics

I doubt the decline or a further decline of the dollar will result in a global economic boom. It may boost the U.S. economy, though the effects are more likely to be felt two to three years from now than one to two years. However, the notion that the dollar's fall will lead policymakers in other countries to take prompt action to more than offset the drag on their domestic economies from weakness in their foreign sectors is difficult to support. First, policy tends to lag, so that even if foreign authorities take compensating actions (monetary, fiscal, structural), the impacts will be delayed. Second, policymakers are generally less inclined to take dramatic action when their economies are under stress; their most likely behavior will be to blame the weakness on the rest of the world and say that they cannot do anything about it. I wish it were not so, but that is how I read policy behavior over the past thirty years.

Be careful. A disorderly dollar decline could bring new problems for the United States.

DAVID C. MULFORD
Chairman International, Credit Suisse First Boston

President Bush's tax reduction plan will provide an effective stimulus to U.S. recovery, but sustained U.S. growth will require stronger domestic demand growth in the economies of our major trading partners. The decline of the dollar could bring some pressure to bear on the European Central Bank to cut rates, which could help revive growth in Europe, but much more needs to be done in the way of structural reform for Europe to restore significant growth. In Japan there is little room for cutting rates and no sign of significant reform or recovery. In the United Kingdom, the Bank of England will remain constrained as long as there is continued sterling weakness against the euro. Meanwhile, a sharp and disorderly decline of the dollar could bring new problems for the United States—such as a decline in foreign confidence in the United States and higher interest rates—both of which would damage U.S. markets which in turn would undercut U.S. economic recovery.

What strong dollar policy? Today's weaker dollar is merely reflecting the Fed's concerns with deflation.

RICHARD CLARIDA
Professor of Economics and International Affairs, Columbia University, and former Assistant U.S. Treasury Secretary for Economic Policy

Apart from rhetoric, the United States does not have—and has not for a number of years had—a policy aimed at keeping the dollar strong in the foreign exchange markets. U.S. intervention in the foreign exchange market has been rare, and is unlikely to have a sustained effect on the exchange rate. A meaningful exchange rate policy requires that monetary policy be set with the aim of keeping the foreign exchange value of the currency at or within range of some desired level. In the 1990s, U.S. monetary policy aimed at bringing down and then maintaining low inflation in an environment of rapid productivity-led growth and falling unemployment. But statements by Federal Reserve officials and empirical academic research confirm that the strong dollar in the 1990s was a *result* of monetary policy aimed at low inflation and sustainable growth, not in itself the *goal* of monetary policy.

Certainly since early 2001, U.S. monetary policy has not been directed at the goal of maintaining a strong dollar in the foreign exchange markets. The Fed has cut rates more than most other central banks and driven short-term U.S. interest rates below those in Europe and Canada, while long-term U.S. government bond yields have also hit record lows. A shift in global portfolio preference during those years away from a more risky to a less risky asset allocation tended to provide support for the dollar for a while.

Much of the rebound in the euro from its record lows below $.85 to somewhat north of parity with the dollar has simply corrected a previous episode of overshooting. The big news this year for the dollar has been the public recognition of a deflation risk by the Fed. While the risk of deflation may be 'minor', the likelihood of a significant monetary policy response to counter possible deflation is substantial. All the conventional and 'unconventional' tools that the Fed might deploy to reflate the U.S. economy will tend, if anything, to weaken not strengthen the dollar in foreign exchange markets.

The recent dollar weakening is welcomed. But structural reforms remain the key to further growth.

KLAUS REGLING
Director General, Economic and Financial Affairs, European Commission

The return of the major currencies to levels more in line with their historical averages is welcomed. A weakening of the U.S. dollar was unavoidable given the United States' record current account deficit. It can help to rebalance growth between domestic and external sources. In the euro area, the stronger euro will boost domestic demand by reducing inflation and supporting purchasing power. Terms of trade gains will also strengthen profits and income. With less imported inflation, a stronger euro allows the European Central Bank to achieve its price stability objective with lower interest rates. All this can compensate the negative impact of the euro appreciation on the tradable sector.

Fears that the appreciation of the single currency could push the euro area into deflation are far-fetched. The euro area did not experience over-investment, nor land and housing price bubbles like in Japan in the late 1980s, and wage settlements continue at a rate close to 3 percent per year. Deflation is also incompatible with the price stability objective defined by the ECB and inflation expectations have been very stable at a healthy 1 percent. In Europe, we do not feel "plagued in recent years by disinflationary pressures." We are happy that inflation is falling now below 2 percent for the first time in almost four years.

Whilst the normalization of exchange rates is welcome, overshooting is not as it would give wrong signals for trade and cross-border investment. Sound economic policies can help to limit the tendency of markets to exaggerate currency movements. For the United States, this would imply policies to raise national savings and reduce domestic absorption. In the euro area, structural reforms remain the key priority to raise the growth potential. This, and not "competitive monetary reflation," should be the policy response to sluggish growth. Empirical evidence shows the limits of macroeconomic stimulus attempts.

The falling dollar helps the United States, but it won't set the stage for a global boom.

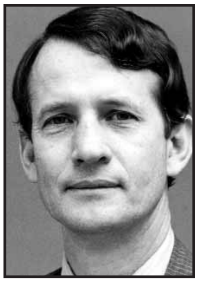
WILHELM HEMETSBERGER
Member of the Managing Board, Bank Austria Creditanstalt

The falling U.S. dollar is an important part of a more general loosening of financial conditions in the United States. This tendency should underpin the U.S. economy, while helping to combat disinflation or even deflation risks. Mid-term it helps to limit global imbalances stemming from the huge U.S. current account deficit.

In contrast, financial conditions in the euro area are too tight, with the rising euro keeping monetary conditions rather neutral. While there is certainly not a mechanistic relationship between monetary policy and the euro, we acknowledge that the stronger the euro becomes versus the U.S. dollar, the larger the possible extent of rate cuts by the European Central Bank. In fact, as we expect the euro/dollar ratio to strengthen to €1.30 by the end of the second quarter of 2004, the ECB is assumed to pare the refi rate by 100 basis points to 1.5 percent by the first quarter of 2004. Unfortunately, we doubt that rate cuts alone will be enough to jump-start the economy, as fiscal and importantly demographic developments will lead to slow growth in Euroland and Euroland's long-term overall problem. At best, a recession can be avoided, but subpar economic expansion lies ahead.

In Japan, the traditional tool kit for economic policy is nearly exhausted. The pressure for a weaker U.S. dollar prevents the last possible "exit" for the Japanese economy, namely the exchange rate channel (weaker yen). Thereby, the need for structural reforms in Japan has increased. If seriously implemented—a capital "if"—it will, by definition, take a long time before a positive effect on economic growth can be experienced.

Conclusion: The falling U.S. dollar helps the U.S. economy and increases the pressure on officials to cut interest rates (where possible, i.e. Euroland and the United Kingdom). However, the monetary stimulus will not be sufficient to set the stage for a global economic boom a year or two from now.



If Europe and Japan do the right thing, the world economy will look a lot better.

GARY CLYDE HUFBAUER
Reginald Jones Senior Fellow,
Institute for International Economics

As a railroad man, U.S. Treasury Secretary John Snow knows how to jump between rolling freight trains. When he was confirmed in January, Wall Street had already decided that the dollar should decline against the euro. Snow could have mindlessly repeated the "strong dollar" mantra concocted during the Rubin/Summers era. Whatever value it had in the 1990s, "strong dollar" talk is utterly inappropriate today, when the trade deficit hovers at $500 billion and the U.S. manufacturing sector is bleeding profits and jobs. Snow didn't make that mistake. One freight train avoided.

The more dangerous freight train is the weak world economy. A faltering U.S. economy could easily snatch victory from President Bush in 2004, and weakness abroad doesn't exactly promote prosperity at home. Everyone knows what needs to be done: in Japan, bank bailouts and quantitative monetary expansion; in Europe, 150 basis points slashed from the ECB rate. But the idea that finance ministers and central bankers are going to take sensible steps on their own volition is pure fantasy. Conservative forces maintaining the status quo in Japan and Europe are stronger than common sense.

Snow took a calculated gamble. After transatlantic acrimony over Iraq, and years of ineffective government in Japan, jaw-jaw wasn't going to inspire expansionary policies. Just possibly, however, the prospect of the yen reaching ¥110 to the dollar, and the Euro soaring to $1.25, will bring economic reform and monetary sense to Tokyo and Frankfurt. To carry out his gamble, Snow had to borrow from Alice in Wonderland. He still loves a "strong dollar," but "strong" has a strange new meaning, with no reference to exchange rates. White House Press Secretary Ari Fleischer could not have done better. Snow took a predictable whipping from the editorial pages of the *Wall Street Journal*. So what? If Europe and Japan do the right thing, the world economy will look a whole lot brighter in 2004 and 2005 than it looks now. Even if the Europe and Japan stay stuck in the mud, U.S. firms will get a nice lift.

Postscript: At the G-8 Summit in June, President Bush reclaimed the classic "strong dollar" rhetoric. Good politics and, even better, it won't change the economics.

The depreciating dollar will reallocate demand away from the rest of the world and toward the United States.

JEFFREY FRANKEL
Harpel Professor, Kennedy School of Government; Member, Business Cycle Dating Committee, National Bureau of Economic Research, Harvard University; and former Member, President's Council of Economic Advisers (1997–99)

The recent weakening of the dollar has two sources, one of a relatively short-term nature, the other of a longer-term nature. The shorter-term factor is the sharp easing of U.S. monetary policy that has taken place over the preceding two years, which in turn had its origin in the recession of 2001. Low interest rates in the United States have diminished the appeal of U.S. assets to European investors, in particular, contributing to the sharp depreciation of the dollar against the euro. This development could indeed help set the stage for reflation in Europe and elsewhere during the coming year: The European Central Bank is reacting to the appreciation of the euro by cutting its own interest rates. Thus is U.S. monetary easing transmitted to the rest of the world.

The longer-term factor, however, will operate quite differently. Twenty years of U.S. current account deficits have long since converted the world's biggest net creditor nation into the world's biggest net debtor, and the current outlook is for ever-higher record levels for the U.S. trade deficit in the future. Eventually there will have to be an adjustment. It is impossible to say when and how, and it is worth recalling that past worries of this sort have not been borne out. Nevertheless, there will probably be a substantial real depreciation of the dollar over the decade. This kind of depreciation will not be a "way out" for the disinflationary pressures of the global system. It will, rather, be a channel to reallocate demand away from the rest of the world, and toward the United States. Don't look for the depreciating dollar to score popularity points abroad.

But what happens if there's a "run" on the dollar?

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

A depreciating dollar, by making exports more competitive and imports less competitive, will by itself stimulate economic activity in the United States, and in the many other countries whose currencies are effectively tied to the U.S. dollar. By the same token, it will have a depressing effect on those economies whose currencies are appreciating against the dollar, most notably the European countries and Japan. American goods will find it easier to compete against European and Japanese products in third markets such as China or Brazil, as well as directly in Europe and Japan. Continental Europe and Japan are not in good economic shape at present, and they rely excessively on exports as a source of demand, so a depreciating dollar will weaken further already-fragile economies, and by itself that will depress U.S. exports to those areas, cutting against U.S. export growth due to improved price competitiveness. Strong growth in Europe and Japan is good for American producers, but apart from Britain they have been stagnant since 2001.

An appreciating euro should relieve whatever inflationary pressures may be present in Europe, for example by lowering local currency prices of oil and other products priced in dollars. That in turn would permit the European Central Bank to reduce interest rates, thus providing some domestic stimulus to European economies. While that would be desirable, and would somewhat offset the depressing impact of an appreciating euro, it would hardly generate an economic boom; the economic problems of Europe, as of Japan, are deeper than that.

A country with a depreciating currency potentially faces the opposite problem: increased inflationary pressures, which in turn could lead to tighter monetary policy, which could partially or even fully offset the stimulative effect of the currency depreciation. But in today's world environment, with low growth and much excess capacity, such inflationary pressures will be limited. Indeed, European and Japanese firms might squeeze their margins to remain competitive at home, in third countries, and especially in the U.S. market.

Another, darker, possibility should be mentioned: depreciation of the dollar (appreciation of the euro) could take on a self-reinforcing momentum. Investors are not highly confident in their judgements about what exchange rates should be, and traders have notorious herd behavior in the short run. Thus a "run" could begin, in which the dollar starts to drop sharply against the euro, with no obvious stopping point in view of the large U.S. current account deficit. The Federal Reserve might then tighten money sharply to stop the run, thereby thwarting the stimulative effect on the U.S. economy. Such a turn of events would, however, provide an occasion for central banks cooperatively to brake exchange rate movements that go too rapidly and too far, as they have done from time to time in the past, for example to brake the depreciating euro in the fall of 2000.

Don't forget the Japanese lesson of the 1980s.

HORST SIEBERT
President Emeritus, Kiel Institute of World Economics

Under normal conditions, a policy of lowering the foreign value of a currency will imply a disturbance for the world economy such as we experienced in the devaluation spirals of the 1930s. Over-expanding the money supply or allowing macroeconomic absorption to exceed production markedly and thus drive down the external value of one's currency means projecting one's own internal disturbance abroad and disintegrating the world economy. What is really different today from the 1930s so that a national disturbance is suddenly hailed as the solution to a global problem? With respect to absorption exceeding production, the European countries would not be well advised to follow the American road of excessive public deficits. They have already accumulated enormous public debts, not only Germany due to unification, but the other countries as well due to their welfare states. Moreover, the implicit debt of their social security systems hidden at the moment is an extreme burden on the public budgets. It will become even more acute due to the aging of population. Expanding absorption will not solve their structural and institutional problems. So there is a clear "no" to the option of increasing absorption above production in European countries.

What else could be done? The European Central Bank could expand the money supply further. Although the ECB has some room to maneuver, this is a risky business. First, the money supply is already increasing at a higher rate than the production potential plus the change in the income velocity of money plus the allowable level of the increase in the price level. Second, although there is quite a bit of talk about deflation, there is no deflation. Third, the euro is a young currency and the monetary authority faces twelve independent nation states with their own national political decisions in making budget policy. The ECB' s position is quite different from that of the Fed. To sum up, we should not forget the Japanese lesson. Japan was pressured by the United States in the 1980s to play the demand locomotive for the World Economy. It then got into the bubble and into a decade-long stagnation when the bubble burst. Is today's talk about reflation the same mistake all over again? And we should not forget the experience of a competitive devaluation of the 1930s.

Yes, one of the world's biggest problems has been an overvalued dollar.

JIM O'NEILL
Global Head of Economic Research, Goldman Sachs

My answer is largely, yes, it gives the potential if not the definitiveness of such an outcome. Certainly, a lower U.S. dollar is good news for the world economy, largely linked to the question you pose. We have long believed that one of the world's biggest problems has been an overvalued dollar. It has contributed to a undesirable build-up in the U.S. trade and current account deficit, made the United States vulnerable to excessive optimism from international investors, allowed other countries to survive on old export economies and as a result of all these factors contributed to the era of subtrend growth that has characterized the post-bubble environment.

To improve the outlook for the world economy, it is necessary for the decline in the dollar to continue and not be opposed. At the time of writing, the broad trade-weighted dollar has declined by just over 9 percent from its early 2002 peaks. Another 10 percent or so decline is to be highly welcome, contributing directly to improving U.S. financial conditions and adding significant pressure for easier monetary policies elsewhere, and hopefully more effective fiscal stimulus and micro economic reforms.

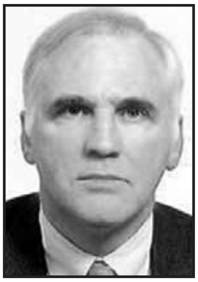
For the United States in particular, a 10 percent decline in the trade-weighted dollar improves financial conditions by around 50 basis points, helping to make past easings of policy more effective. Until February of this year, the Fed's 525 basis point interest rate cuts since January 2001 had been largely ineffective, being offset by a steepening yield curve, wide credit spreads, a weak stock market, and an unjustified and undesirable strengthening of the dollar. This is now starting to reverse and should be encouraged.

I would also tend to disagree with the consensus that the speed of the decline is key. If anything, the quicker another 10 percent decline in the dollar occurs, the better.

The key for the net impact on the world economy is the aggregate policy response, and in this regard, a quickening decline in the dollar is likely exert more pressure on other countries to change. A euro/dollar threatening 1.30 soon would be more likely to get a large monetary response from the ECB than one that declines modestly. It would also be more likely to encourage Chancellor Schröder to persist with his necessary but unpopular reforms.

For Asia, China's response is key. If their presence at the G8 this June is a foreshadowing of their true appearance into the world economy, then the Chinese renminbi should appreciate, allowing the Japanese yen to modestly rally also. For all Asian countries, this would place more emphasis on domestic demand than U.S.-oriented exports.

All in all, a 20 percent decline in the trade-weighted dollar could result in an aggregate improvement in global financial conditions that helps boost the 2004–05 GDP outlook globally by 1 to 1.5 percent of GDP. It will require many nations to play their part.



The policy responses to the dollar will likely be only modestly positive.

DANIEL TARULLO
Professor of Law, Georgetown University, and former Assistant for International Economic Policy to President Clinton

In recent years, the chief strategy of economic policymakers in the rest of the world seems to have been reliance on robust U.S. economic growth. The U.S. slowdown and dollar depreciation will surely force some response. Will the result be cascading global reflation and an economic boom? Maybe, but a quartet of factors suggest not.

First, lethargic policies are unlikely to give way to boldness. The European Central Bank has room to cut interest rates again, and may well do so. But even if the ECB cuts aggressively, the structural hurdle to European growth created by Germany will not disappear anytime soon. In Japan, creative monetary expansion is much less certain; it may lose out to currency intervention. Political paralysis seems still to foreclose the necessary step of dealing with non-performing loans.

Second, although the tax cut and increased federal spending will provide election-year stimulus that is good for U.S. growth, the longer-term negative effects of huge budget deficits may be felt within a few years. Even if the productivity optimists are proven completely right, the unprecedented size of the twin deficits will be problematic. If they are less than correct, and trend growth is lower than expected, any recovery would be stopped in its tracks.

Third, the world is not poised for robust growth. The aftermath of the equity bubble and investment overhang persist. Geopolitical uncertainty will continue to cast a pall over much global economic activity. Structural fiscal deficits loom everywhere.

Fourth, risks abound. The absence of serious economic discussion and cooperation among the major economies, along with the erratic U.S. approach to currency policies, leave less room for error than might otherwise be the case.

In sum, it seems more probable that responses to dollar decline will be only modestly positive. Without a mutually reinforcing commitment to major, necessary adjustments in each of the three major economies, the "way out" hypothesized in the question may be only from the fire into the frying pan.

Yes, but a mere monetary response from Europe and Japan won't be sufficient.

MICHAEL J. BOSKIN
T.M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University; and former Chairman, President's Council of Economic Advisors

The dollar fall was from quite high levels. The United States, Japan, and Europe are unlikely to experience strong growth or inflationary pressures any time soon. The risks are clearly more on the downside and, in the extreme, deflation. Monetary and fiscal policies need to be geared to preventing that from happening and to promoting recovery. The weakening dollar (appreciating yen and euro) puts greater pressure on the European Central Bank to get on with overdue lower interest rates, and the Bank of Japan to expand more aggressively. But that won't be sufficient. Fiscal policy is constrained by the growth and stability pact in Europe and risks turning procyclical. Europe needs lower taxes badly. And both Europe and Japan need serious movement on structural reforms, on labor market rigidities and pensions in the former and first cleaning up and then reliquifying the banking system in the latter. If it prods these governments and central banks to act more responsibly, the recently weaker dollar will ultimately help them, not just U.S. exporters.

All the dollar's drop does is shift the deflationary risk to Europe.

BARRY EICHENGREEN
George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley

The dollar's depreciation against the euro neither aggravates nor solves the problem of deflation. What it does is shift that risk to Europe from the United States. In this sense the sharp change in exchange rates is quite worrisome, since deflation risk was already greater in Europe. The European Central Bank is less nimble than the Fed. Expansionary fiscal policy, the classic remedy for deflation, is constrained by Europe's Stability Pact. And Europe is a less flexible economy, which means that it is less capable of rapidly redeploying resources from the production of traded to nontraded goods, which is what is needed to keep an economy expanding when the exchange rate appreciates.

The silver lining is that the ECB has moved to a more symmetrical inflation target, which will allow it to pay as much attention to deflation risk as inflation risk. It has revised its monetary policy operating strategy to put more weight on changes in the price level and less weight on the monetary stock, which will better enable it to keep its eye on the ball. The European Commission and the Council have agreed to a more flexible interpretation of the Stability Pact, one which pays more attention to the cyclically adjusted fiscal position and the presence or absence of structural pressures on the budget.

The remaining danger is of a war of attrition between Europe's fiscal and monetary authorities. The ECB may refuse to display more monetary flexibility until governments first fix their fiscal problems. And governments may refuse to address the underlying structural problems of their budgets unless the ECB first applies some stimulus and their economies begin to expand. If there is a war of attrition, everyone will suffer, not just in Europe but around the world.

The weakening dollar will produce no quick panacea given Europe's unsolved structural problems.

GERHARD FELS
Director, Institut der Deutschen Wirtschaft

Weakening the U.S. dollar transfers American problems to other parts of the industrialized world. However, the rising value of the euro has increased the scope for European interest rate cuts in order to foster economic activities in Euroland. But this is no panacea for the European economies. The region suffers because of unsolved structural problems. High taxes, inflexible labor markets, and too-strict regulations for private business are just the most prominent examples. Lower interest rates are helpful but cannot resolve these structural problems. Structural reform policies that have to face massive protest of trade unions in Austria, France, Italy, and Germany are the main challenge of Europe. When the necessary reforms are on the way, when for example the Agenda 2010 legislation in Germany has passed, then further interest cuts could be possible.

A weaker dollar could be a "way out"—but not an easy one.

LORENZO CODOGNO
Co-Head of European Economics, Bank of America, London

A weaker U.S. dollar could turn out to be part of a "way out" for a global economy plagued by imbalances and three years in a row of poor performance. But it will not be an easy way out, especially in Europe and in Japan. If the global re-balancing of growth relies exclusively on a weaker U.S. dollar, there is a potential for financial market turmoil.

Exchange rates are relative prices, and the global problem of slow aggregate demand growth cannot be solved on a sustainable basis by mean of currency movements. Still, the ongoing depreciation of the U.S. dollar could trigger policy responses and affect other financial market sectors, and this could be conducive to stronger growth, but also generate potential problems. A weaker U.S. dollar favors a recovery in U.S. corporate profits and eventually a positive net export contribution to U.S. GDP growth, while helping the Fed's attempt to reflate the economy. Indirectly, this will also help the rest of the world over time, and especially Europe. In the near term, a weaker U.S. dollar will likely hurt European profits, affect export performance, and depress overall GDP growth. Because Japan is resisting currency appreciation (and China's exchange rate is fixed), the bulk of the adjustment must necessarily come from the European side. If Europe has apparently accepted the economic costs of a huge euro appreciation for the sake of re-balancing the world, there is no other policy tool than lower interest rates to offset the euro shock on European inflation and economic growth. Thus the European Central Bank will be forced to ease monetary conditions further. Moreover and more importantly, by blaming the strong euro for the poor economic performance, European politicians may even take the currency appreciation as an argument to explain to their voters why Europe has to change. If this will be the political expedient to make deep structural reforms more palatable to Europeans, it would set the stage for stronger domestic demand and better economic growth in the future.

Still, this process is likely to take time and be painful. A scenario of booming economy one or two years from now appears optimistic as demand is still rather weak and excess capacity has not been fully worked out. Global risks of deflation are probably overstated, but the output gap remains wide and reflation seems unlikely to gather substantial speed a year or two from now. Nevertheless, by the end of next year world attention will likely shift back to future inflation risks again, and away from deflation. By that time, the bulk of the U.S. dollar depreciation should be behind us.

But it would be dangerous to "push" the dollar down further.

PHILIPPA MALMGREN
President, Canonbury Group, and former Special Assistant to President George W. Bush for Economic Policy

Did the victim fall off the cliff, or was the victim pushed? Sadly, U.S. Treasury Secretary John Snow is now being blamed for pushing the dollar down when it was already gently falling in a very soft landing. After his comments, the markets believe that the Administration wants to push it lower, in spite of the President's reaffirmation of the strong dollar policy. Therein lies the problem. A weaker dollar allows the United States to regain some competitiveness at a time of weakness. Some say this is good for the President's campaign politics because it will secure more votes for him from manufacturing states. However, no one should expect exports to be a powerful engine of growth when there is so little global demand. U.S. manufacturers, already suffering from the thinnest of margins, are likely to pocket any such windfall rather than create new jobs or make significant new investments.

A dollar that is deliberately pushed down by the Administration brings many dangers. Americans have long spent far more than they earn. To make ends meet, the United States must import capital. But why would foreigners with savings want to buy American bonds, stocks, property, or factories for a potentially small return when any gain they make could be easily wiped out by a big currency loss? If foreigners fear U.S. politicians seek currency weakening in order to win votes in manufacturing states, then they will hesitate to invest. If the bond and stock markets then follow the dollar down, look out. Inability to fund the current account has the potential to create far greater political problems for the President in his re-election bid than a weaker dollar can ever solve. Also, this scenario could derail the recovery.

So, what is the solution? Keep the strong dollar policy, let the market decide where to push the currency, and let the Europeans do the heavy lifting. Given the lack of demand abroad and domestic weakness on the continent, the European ministries of finance will soon be forced to intervene. They will work to hold up the dollar on America's behalf. The European Central Bank might not be as helpful. The board remains recalcitrant, insisting that the real problem lies on the structural side in Europe, which is probably true. So rate cuts, or sufficient rate cuts, may not ensue.

Thus, be content with a falling dollar because it reflects a healthy market-driven readjustment to America's imbalances. But be wary of a "pushed" dollar because it can derail the recovery altogether.

There can be too much of a good thing!

NORBERT WALTER
Managing Director, Deutsche Bank Research

There can be too much of a good thing! There is not much disagreement on what could be considered fair value for the euro-dollar exchange rate: USD 1.10 for one euro looks reasonable. It is very questionable whether exchange rates should fluctuate around this level with a band of ±30 percent, though. This, however, is the reality in the system of floating exchange rates that has been so fundamentalistically supported by the last two generations of economics students.

Spirited co-operation among the G3, including exchange rates being managed closer to fair value, monetary and fiscal policies geared toward trend growth, plus government and labor policies designed to foster trend growth, would be much better than present unilateralist policies that are mutually distortive. If governments and central banks do not coordinate their efforts, little but the market is left to enforce consistency. It is important to realize, however, that this solution is only third best. While a weak dollar will push European Central Bank money market rates down in Europe, little can be done in Japan.

Japan is in a liquidity and debt trap. If anything, the Japanese need a weak currency at least as badly as the United States (not because of the current account, but because of weak growth and the effective exhaustion of macro policy instruments).

While some monetary stimulation by the ECB is welcome and effective, Japan's action cannot be supportive for G3 macro co-ordination, and fiscal policy in Japan and Europe will hardly come to the rescue of the cycle. Thus, it may be overly optimistic to see future recovery hinging on just a few downticks in ECB money market rates which result from a coercively powerful euro. To get the world economy going again, a reasonably reduced oil price, containment of terrorism, and a deep economic policy reform in Asia and Europe are a must. Anything short of such conditions and recovery will fail to materialize.

The dollar will decline further but there will be no resulting global panacea.

ALLEN SINAI
Chief Global Economist and President, Decision Economics, Inc.

The U.S. dollar is very vulnerable to further weakness on a number of counts: 1) a high, and rising, current account deficit; 2) a high, and rising, federal budget deficit, of uncertain size; 3) stagnant U.S. economic growth and deflation risk; 4) low, and uncertain, returns on investments in U.S. assets, especially given downside risk to the U.S. currency; and 5) ongoing geopolitical risks and issues with respect to U.S. relationships, or the lack thereof, to other countries.

While a falling dollar holds promise for increasing U.S. exports, lessening imports, and limiting deflationary risk, it cannot alone offset inadequate U.S. and global aggregate private-sector demands, should chronically weak spending persist for whatever reason(s). A weakening dollar, if accompanied by continuing weak U.S. consumption, soft business fixed investment, and lower interest rates, would not represent a way out for the global economy in a situation of chronically low economic growth. Indeed, if accompanied by a turning away by countries from U.S. assets and loans to U.S. businesses and to the U.S. government, a falling dollar could provide the catalyst for a global recession and global deflation.

Stimulative monetary and fiscal policies and stimulus from improved financial markets, along with continuing low—and lower—interest rates across G-8 countries, are necessary as soon as possible to lift U.S. and global aggregate demand and to prevent global deflation risk from taking hold in an entrenched way.

Dollar declines are no panacea for lifting the U.S. and global economies out of their doldrums!

The problem is that a global attempt at competitive devaluation could send the world economy back to the 1930s.

RICHARD C. KOO
Chief Economist, Nomura Research Institute

The world is now entering balance sheet recession, where a large number of companies in an economy are no longer maximizing profits but instead are trying to strengthen their balance sheets after facing a major fall in asset (share) prices. With the household sector still saving money while the corporate sector is no longer borrowing money even at very low interest rates, a fallacy of composition problem is created which pushes the economy ever deeper into recession. Japan entered this recession ten years ago, but now others are following after the bursting of the information technology bubble. With so few companies willing to borrow money, monetary policy becomes largely ineffective in this type of recession, while fiscal policy becomes absolutely essential in both keeping the aggregate demand levels up as well as keeping the money supply from shrinking as a result of the disappearance of private sector borrowers.

The temptation in this type of recession, however, is to use the beggar-thy-neighbor policy by devaluing the currency. Although it may be the convenient thing to do for a country, when every country tries to do it at the same time, an international fallacy of composition is created, and the resultant competitive devaluation will bring the world economy right back to the 1930s, the last great balance sheet recession, in no time. Indeed, Keynes created the International Monetary Fund in 1945 precisely to avoid this outcome in the absence of a world government. Now that we are back facing the same danger, I would very much like to see individual countries committing themselves to a pact where any deficiency in demand inside a country as a result of balance sheet problems is countered within the country through a prompt fiscal action by the government and not allowed to spill out. When everybody has the same problem, any attempt by the United States to export its way out will only make the situation highly unstable if not totally devastating for the world economy.

Turmoil in foreign exchange markets is hardly a recipe for global prosperity.

ULRICH RAMM
Chief Economist, Commerzbank AG

The huge imbalances between domestic saving and domestic investment are indeed a main characteristic of the triade (North America, Europe and Japan) for many years. Most observers would agree that balances of this magnitude—e.g., a deficit of roughly $600 billion in the United States—are unsustainable, especially if they are structural in nature and persist for many years.

The dollar's recent slide can alleviate the adjustment but in itself it will neither directly stimulate domestic saving in the United States nor reduce investment there. In other words, to have a sizeable impact on one of these variables, the dollar will probably have to undershoot massively and this would be unwarranted for the U.S. economy and for the rest of the world.

Central banks outside the United States will probably respond to a sudden depreciation of the dollar—which means for them importing price stability and exporting jobs—by easing domestic monetary policies. The concept of monetary conditions indices is summarizing this idea by calculating the interest rate equivalent of a given change in the real external value of the currency. For the euro, most estimates assume a ratio of 1:7.5, i.e., a 1 percentage point lower money-market rate compensates a real effective appreciation of the euro by 7.5 percent. (However, the European Central Bank has indicated its doubts of the validity of the concept on several occasions.)

Therefore, a global monetary reflation as response to the dollar's fall would only result if central banks outside the United States overreact by lowering short-term rates more than necessary to compensate for the currency shock. In the case of the ECB, this is not very likely. Furthermore, it should not be overlooked that a more drastic fall of the dollar—much above $1.20 to the euro which is only slightly higher than purchasing power parity—could force the Federal Reserve to tighten earlier and more aggressively than otherwise. Consequently, as in the past, turmoil in foreign exchange markets is hardly a recipe for global economic prosperity.

Rather, it will take strong domestic demand growth in all major countries combined to make substantial inroads into the excess capacity around the world that is the major source of deflationary pressures. So, in Europe and Japan, where the potential for growth seems great, structural reforms that will unleash this potential need to be accelerated. Moreover, additional pro-active fiscal policies (fiscal restrictions in Europe have been demonstrably misconceived and fiscal stimulus in Japan not so well applied) might also be required—and, in the short- and intermediate-term accommodated by a commensurate monetary expansion.

To provide ample room for monetary expansion, major central banks would be well advised to be reasonably flexible in their inflation targeting, whether it is explicit or implicit. Recent experience also suggests that a quite low target rate may well unduly limit the ability of central banks to resist emerging disinflationary pressures, and through delayed central bank action may even stimulate such pressures.

The dollar's contribution will be marginal at best.

STEPHEN AXILROD
Global Economic Consultant

A weak dollar that encourages more monetary expansion in Europe (through lower interest rates) and also Japan (through unsterilized exchange market intervention) may be an aspect of any coming global monetary reflation, but its contribution will only be marginal at best. Monetary actions abroad to fend off a stronger currency are not, basically, the "way out" of disinflationary dangers. That will depend much more on fundamental shifts in policy attitudes more broadly, especially in Europe and Japan.

In the late 1990s, shortsighted policies in major foreign countries had placed a tremendous burden on the United States to be the "locomotive" and importer of last resort for a faltering world economy and to help support fragile financial markets—indirectly exerting pressure on the Fed to adopt a monetary policy that was, in my judgment (hindsight is wonderful), less tight on balance than it should have been. Now, in the aftermath of the stock market bubble, the United States is no longer in a position to be the main locomotive.

This is not a time to be gloomy.

TIM CONGDON
Chief Economist, Lombard Street Research

In most industrial countries the inflation rate in early 2004 will be the lowest since the 1960s, while Japan will be facing its sixth year of falling prices. Policymakers will therefore be doing their utmost to stimulate faster growth of demand. Despite the current strains in the Japanese and German banking systems, a sensible forecast has to be that the world economy will enjoy above-trend growth in both 2004 and 2005. The key theoretical issue is whether monetary policy will become ineffective as short-term interest rates approach zero.

In somewhat similar circumstances in the 1930s, the American government bought massive amounts of gold and silver from the private sector. The purchases were financed by bank borrowing and led to a sharp increase in the quantity of money, and this formed part of the explanation for a boom in equity prices in 1934. (1934 was the best year for the American stock market in the 20th century!) Conditions are not identical today, but analysts need to look at those events and to take comfort from the revival achieved by the Roosevelt administration in those years. This is not a time to be gloomy about the international economic prospect.

The ability of financial institutions to react correctly is critical.

EUGENE R. DATTEL
Veteran Wall Street professional and author, **The Sun That Never Rose: The Inside Story of Japan's Failed Attempt at Global Financial Dominance**

It is striking that the perception of one isolated event—dollar weakness—could create a chain of events that would yield economic expansion without any reference to the structure of financial institutions in nations—Japan, China, America, etc. In addition, this pivotal currency event is within the control of government officials.

A lot of ink has been used to describe the necessity of "structural reform" in the financial sector as a prerequisite to global recovery. As such, I would ask what impact dollar weakness would have on a nation's private-sector financial institutions and their behavioral characteristics.

Are the implications of a weak dollar so significant that "structural change" in the financial sector becomes of secondary consideration? Is reflation and expansion the necessary precursor to structural change and would growth obviate the need for "structural change"? How drastically does the dollar have to fall before other central banks act? Will the adjustment mechanism of each country operate uniformly or will some countries adjust more satisfactorily than others?

Over the last decade, numerous recommendations have been offered for the ailments of America in the 1980s, Japan, Asia, and Europe in the 1990s, and now all of the above. At some point, simplified isolated solutions have included lowering interest rates, currency manipulation, monetary expansion, and "structural reform." American financial missionaries—investment banks, money managers, and financial restructuring firms—were even considered to be harbingers of a new era.

In reality, dollar weakness is obviously an important factor, but the reactive capacity of a nation's financial institutions would also be a determinate in the both short- and long-term growth potential. ◆