Foreign Exchange by David Goldman

Again: What will Mr. Baker do now?

Analysts believe Washington will go back to talking down the dollar.

On Friday, Aug. 21, the dollar traded at slightly over 1.82 German marks and 143 yen, against more than 1.89 marks and 151 yen a week earlier—apparently the consequence of the nearly $200 billion p.a. trade deficit for the month of June announced Aug. 14. The prospect, if not the fact, of a renewed plunge in the dollar's value, is back for the first time in three months.

In fact, there are two factors at work in the dollar's weakness, which has wiped out half of its late spring recovery. The trade deficit is one. Another is the pronounced monetary tightening by the Japanese, West German, and British central banks (see page 4).

Among the best-known dollar bears, few are willing to predict the dollar's short-term course. Stephen Marris of the Institute for International Economics in Washington has just re-published his "hard landing" prediction, but says that he is skeptical about whether the "latest blip" represents a fundamental turn.

It appears most likely that Washington will, as customary, make a bad situation worse, by reacting with the worst of possible policy-responses. That is the view of Dr. Mieczlaw Karczmar, a Deutsche Bank economist based in the United States.

A cheaper dollar will not reverse the U.S. trade deficit, Karczmar argues, for the simple reason that the most important categories of U.S. imports are not "price sensitive," i.e., must be purchased even at much higher prices—capital goods being a principal case in point.

However, the Treasury will return to talking down the dollar, he predicts, for the simple reason that it has nothing else to offer a Congress bent on protectionist legislation. The $16.3 billion June trade deficit convinced many analysts that the Democratic-controlled Congress can pass protectionist legislation over a presidential veto. "The overwhelming view in Congress is that this is the only action short of protection that could correct the trade decline," Karczmar argues.

Ironically, he adds, this view unites both "liberal" and "conservative" economists across the political spectrum, from ex-Carter official C. Fred Bergsten on the left, to Harvard's Martin Feldstein, Reagan's former economic adviser, on the right.

Some sections of the financial community offer the same advice. The July 27 *Amex Bank Review* argued, for example, "For the U.S. trade deficit to be closed within a reasonable period of time, the U.S. must generate a fast growth in exports, of at least 10% p.a. in value terms. Anything less than double-digit growth will mean either a major cut in imports in volume terms, and/or a rise in U.S. foreign debts to unacceptable levels. . . . In the past, U.S. exports and imports have responded to dollar declines though, as in the 1970s, undervaluation is probably required and would certainly speed up the process of adjustment. The rest of the world of course must expand their own markets fast enough to absorb a 10% growth in U.S. sales."

But the U.S. imports, net, one-fifth of its physical-goods consumption. Nothing but steep economic decline, or a fundamental recovery of basic industry, can change this. Short of either, any decline in the dollar will raise import costs much faster than it raises export income.

In principle, either a sharp increase in the growth rate of America's biggest trading partners, or a re-opening of the Ibero-American market, might improve the trade deficit. Neither is to be expected.

So the administration appears ready to adopt a wrong solution which, ultimately, may lead to a correction of the deficit—but not the way the administration wants, the Deutsche Bank economist concludes. Further attempts by the administration to talk down the dollar might provoke a negative reaction from the foreign investors who lend this country $150 billion a year. "Interest rates will rise, and the economy will finally stall," Dr. Karczmar warns. "A recession, of course, could correct the trade deficit. But it is not a viable policy solution. But it is the one we might stumble into."

As reported in this space last issue, Baker hoped that a big rise in exports under trade-policy pressure from Washington, might help the economy limp past the 1988 elections. Enthusiastic predictions concerning the trade-related boost the economy might receive, foundered on the June trade data. Now, in order to head off a trade war instigated by congressional Democrats, the administration may adopt a course of action which will guarantee big trouble long before November 1988.

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