Book Review: Dollar Adjustment: How Far? Against What?

Edited by C. Fred Bersgten and John Williamson

Reviewer: Gita Gopinath, Harvard University and NBER

In today's times, the single most debated question in international policy circles is the fate of the U.S. dollar and the U.S current account. This book is a collection of essays on this debate. The papers were presented at a conference in Washington D.C. on May 25th 2004, organized by the Institute for International Economics. The main questions that were asked at the time of the conference were the following: (i) How much further does the dollar need to depreciate? (ii) Against which currencies does it need to depreciate? The general consensus among the authors is that there is a serious misalignment of key national currencies in the world. The main conclusion is that the dollar needs to decline by an additional 15% or so and most of this adjustment needs to take place against Asian currencies. This will require China to revalue its exchange rate against the dollar by around 20%.

Chapter's 2-4 deal with the question of the size of the dollar adjustment needed. To provide a precise answer to this question is clearly impossible. This is more so given that there is very little guidance from theory about what it means to have a misaligned exchange rate. There are two approaches taken here, which are common in the literature. The first is to define a 'sustainable' current account. Next, the idea is to calculate bilateral exchange rates that are consistent with exogenous measures of a 'sustainable' current account. A second approach is to empirically estimate a relation between the real exchange rate and its fundamentals using historical data. The misalignment is then the difference between the actual exchange rate and the exchange rate provided by the permanent part of the model.

Since, there is no agreed upon number for the sustainable level of the US current account deficit, the authors consider several possible target values for the current account. The numbers involve reducing US current account deficits from over 4.6% of GDP to 3%, 2.5%, 2% and 1% of GDP. The next question of how much should the dollar depreciate by, bilaterally, depends on one's conjectures of which countries should face the brunt of the current account adjustment and convert their surplus positions into smaller surpluses or even deficits. Again this calculation involves considering several possible scenarios for adjustment. The point that is made here is that the adjustment should be spread across several countries and should not be borne solely by Europe. Moreover, China and other countries in Asia, especially the Newly Industrialized countries, need to play a central role in this adjustment.

The second set of essays deals with the impact of a large dollar adjustment on the US and its trading partners. Once again, there are several back of the envelope calculations made and suggestions that the U.S. deficit be brought down to around 2% of GDP. This would require fiscal consolidation in the U.S. and an effort to raise demand growth in Japan and Europe. There are several case studies of countries. Chapter 7 discusses the consequences for Canada of a US current account and currency realignment. Chapter 8 discusses the

Japanese macro economy and its exchange rate policy and monetary policy in the period 2003-04. Japan's motivations for intervening in its currency markets are highlighted including the need to prevent a premature appreciation of the yen in the midst of a weak economy. A nice effort is made to calculate the effect of an appreciation in the yen's real effective exchange rate on Japan's trade. They arrive at the following estimate: a 10% appreciation in REER in the medium run will cause a decline of 0.1% in the export/GDP ratio.

In Chapter 9, there is a discussion of China and the Renminbi exchange rate. The Renminbi is found to be significantly undervalued, by around 15 to 25%. An argument is made for the need to allow the currency to appreciate, not just to benefit the rest of the world, but also China. This is so as to prevent the economy from overheating and to hasten the much needed banking reform in China. The last set of essays discusses the use of sterilized intervention to achieve desired currency values. There is some positive evidence in this regard for yen interventions.

The essays are a valuable source for students and researchers interested in policy level discussions of currency and current account misalignments. There are several tables and back of the envelope calculations that provide a useful understanding of these issues. The country studies of Canada, China and Japan are useful for those seeking quick and easy facts on the exchange rate and current account policies of these economies.

The essays clearly are not meant to break new theoretical ground on our understanding of these issues. Also, it is not the place to look to for a compelling study of what a ‘sustainable’ current account is or what its means to have a ‘misaligned’ currency. To this extent, the methodologies used in the various chapters are idiosyncratic and vary depending on the authors’ persuasion. In the absence of a theoretical framework to discuss the estimates generated, there is room for some skepticism regarding the conclusions.