The Economy in Perspective

Appreciating the dollar…The U.S. dollar has been in the news often lately, and some financial journalists have announced that it is finally getting its comeuppance. After all, they have considered the dollar overvalued for some time and have scratched their heads over its apparent ability to defy gravity. They have declared that the dollar had nowhere to go but down because the United States has been living beyond its means. Undeniably, the United States has run a current account deficit for the better part of 20 years; most recently, that deficit has grown very large. Arriving at this point has required foreigners to invest their excess savings in dollar-denominated assets, whether in the form of land, corporate stock, or U.S. Treasury securities, and to do so at an increasing rate. Although many analysts have concluded that dollar depreciation must be part of adjusting to a new equilibrium, they differ widely over the magnitude, timing, and currency pairs associated with any movement in the dollar. Experience shows that exchange rate changes cannot be forecast with much accuracy.

So, without making specific predictions about the dollar, let's consider a few of the arguments being leveled against that old reprobate. Americans, it is said, consume too much and save too little. Household debt has risen to record levels, both in absolute terms and as a percent of disposable income. And the personal saving rate, for goodness' sake, has dwindled to next to nothing. All true, but are these signs of gluttonous behavior?

Just as corporations have restructured their balance sheets by paying off high-interest debt, households have refinanced their debts at lower rates and improved their cash flow. This has allowed them to purchase durable assets such as automobiles and houses at relatively low interest rates and made their debt burden lighter than it might first appear. As far as the personal saving rate is concerned, research conducted by the Federal Reserve Board staff indicates that the consumption boom and saving rate decline of the 1990s can be attributed almost entirely to the behavior of the wealthiest 20 percent of households. In other words, the economywide decline in the personal saving rate occurred because the wealthiest families—whose net worth surged during the stock market boom—were spending more than they earned, while the remaining 80 percent of families saved at rates that were the same or higher than before. One could argue that most households' responses to prices and interest rates have been eminently sensible all along.

Other rational actors are also involved. The dollar has depreciated by anywhere from one-fourth to one-third of its value against some major currencies since early 2002. But its exchange value has changed little during this period against the currencies of a number of other important trading partners. Some foreign governments have seen merit in trying to control their currencies' value against the dollar, reasoning that it is better to accumulate large holdings of U.S. financial assets than to export less and import more than they otherwise might have done. In these countries, the prevailing exchange rates have also made it rational for households to save more and consume less than they probably would have done had their domestic currencies strengthened, or strengthened further, against the dollar.

Households, businesses, and governments around the world have been doing what they always do: acting in their perceived self-interest, subject to the constraints they face. The U.S. current account deficit has been expanding in an environment where households and firms could borrow funds at relatively low real interest rates and purchase foreign goods at relatively low prices; in our trading partners' economies, private decisions have been made in an environment that has promoted saving and exporting.

The essence of market systems is that people respond to incentives. If their collective choices lead them down an unsustainable path, interest rates, exchange rates, and relative prices will adjust and guide decisions toward a different set of outcomes. If the U.S. current account becomes unsustainably large, it cannot do so solely through Americans' decisions. And if forces are set in motion that eventually shrink our deficit, people everywhere are likely to face a new set of interest rates, exchange rates, and relative prices.