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Foreign Exchange by David Goldman

'Strong dollar' is really overvalued

It was rising even before Nov. 4—in disregard of the trade fundamentals.

The dollar's rise the day after Ronald Reagan's victory simply confirmed for many the perception that the dollar is the hot currency for the near term, a formula making the rounds weeks before the election as the dollar gained 7 percent against the deutschemark in little more than a month. Currency traders claim that the dollar will appreciate further in the next few months.

This view was summarized in the Nov. 1 issue of the London *Economist*, which stated that the moment the British government releases the Minimum Lending Rate from its artificially imposed level of 16 percent, the move into the dollar will be further enhanced.

"American, Arab and other foreign investors who made juicy profits by investing in sterling via British equities and gilts are said to be thirsty for more," states the *Economist*, "but can they really expect to go higher still? . . . If interest rates in America remain high when British rates eventually fall, much of the hot foreign money now coming into London could leave for Wall Street."

This thinking has helped push the dollar up against the mark, as well as to a 4.40 French franc rate and a 1.74 Swiss franc rate. However, in making these heady assessments, most of the currency traders have overlooked for the time being the fact that America's crossrates are linked to its trade performance. And the U.S. is becoming increasingly dependent on manufactured imports. No economy so dependent is viable.

America's increasing import dependence became strongly apparent during the first six months of this year.

Adjusted for inflation, U.S. imports in the first six months of 1980 actually fell by 5.9 percent on an inflation-adjusted basis. Yet two items stand out: U.S. capital-goods imports rose by 10.5 percent on a real basis, and U.S. consumer goods rose by 9.6 percent.

A relevant comparison is the behavior of American capital goods imports during the 1974-75 recession years, when under comparable economic conditions, American capital goods imports fell by 7 percent. The difference between the two periods is accounted for by a shift in the American economy.

In short, the United States, particularly in the Northeast, where much industrial plant and equipment is increasingly obsolete if not decrepit, finds that it can no longer efficiently produce capital goods and consumer durables with a high value-added component. This is the crisis dodged by those who want to phase out basic industry under the rubric of the "sunset" industries. Unable to compete with West European or Japanese imports, or to produce large enough volumes of capital goods for American consumption needs, the United States has been forced to import these capital-intensive goods.

Hence the future difficulties for the dollar. If the conditions leading to high levels of U.S. exports are removed, one cannot assume that the United States will be able to lower, as compensation, its level of imports.

The level of import dependence means that even as the U.S. enters a second-dip recession, it cannot dispense with its imports. This means a widening U.S. trade deficit.

The third-quarter improvement in the merchandise trade gap announced Nov. 6 reflected the recession and the decline in oil imports, but for the first three quarters, non-oil imports rose 12 percent, with capital goods showing the biggest increase. Led by a spectacular increase of exports to Europe of 43.4 percent for the first half of 1980, overall U.S. exports rose by 28.1 percent—17 percent on an inflation-adjusted basis. The conditions leading to this export boom included a low dollar rate, a recession that forced U.S. industries to push for export sales, and a European economic expansion that opened Europe's markets wider to American goods.

Those conditions began evaporating as Europe began to move toward recession and the dollar was artificially appreciated as of August by the Fed's rising interest rates.

In August, the U.S. export level was flat on a real basis; and in September, exports fell by 2.1 percent from last year's levels. After adjustment for inflation, not yet available from the Commerce Department, the September range of decline will be 12 percent.

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