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PROSPEROUS AMERICA

WORKING PAPER

# The Threat of U.S. Dollar Overvaluation:

## How to Calculate True Exchange Rate Misalignment & How to Fix It

**by Michael Stumo (CEO)**
**Jeff Ferry (Research Director)**
**and John Hansen (Advisory Board)**

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*This memo explains (1) the dollar overvaluation problem, (2) how to accurately calculate the dollar's misalignment against trading partner currencies, and (3) how the Market Access Charge (MAC) that CPA and others favor would fix this serious threat to America's future.*

The foreign exchange value of the national currency should play the pivotal role in bringing excessive trade deficits (or surpluses) back into balance. Unfortunately, however, exchange rates have lost their link with trade balancing equilibrium pricing. The graph below shows very problematic over and undervaluation of major US trading partner currencies calculated in the manner shown in section 2.

We propose a new policy tool, the Market Access Charge, to move the dollar back to a competitive, trade-balancing exchange rate.

### 1. CURRENCY MISALIGNMENT/DOLLAR OVERVALUATION CAUSES

In past centuries, the only reason that people would choose to hold a foreign currency would be to trade with it. For example, an Englishman might hold dollars to buy a car from Ford or some other U.S.-based exporter who insists on being paid in dollars. But in the last few decades, and especially since the early 1990s, international speculators and traders have invested in dollars, including stocks,

***Figure 1: Major Currencies Under/Overvaluation May 2017***

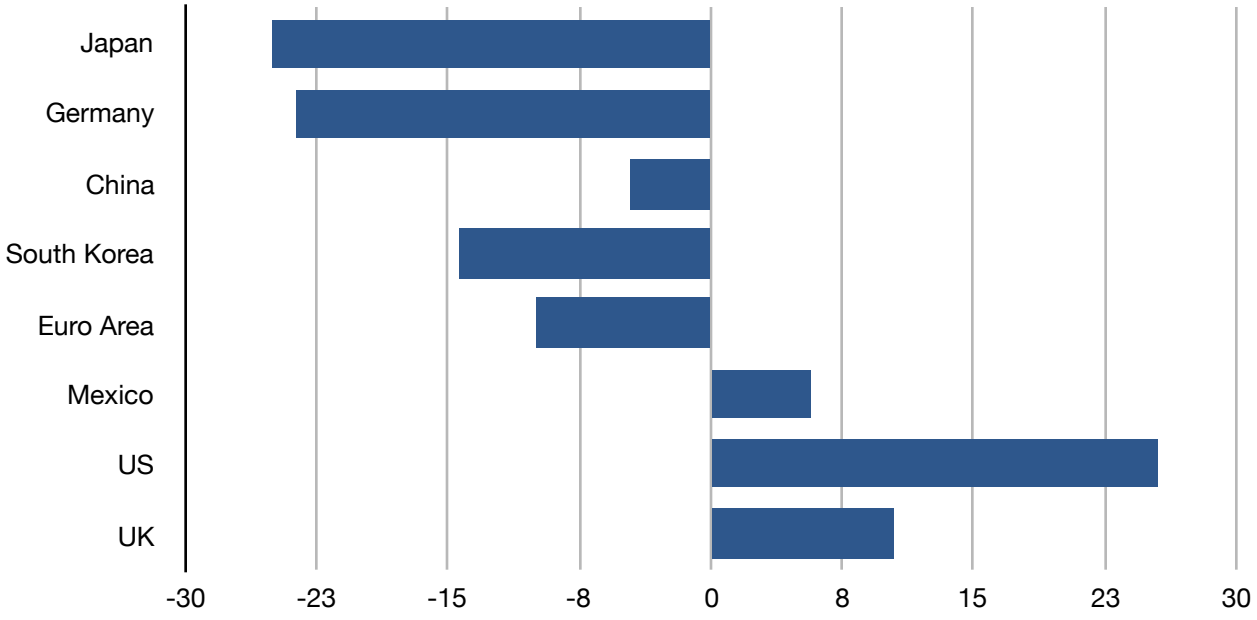


**Figure 2: Private Investments in Dollar Assets Outweigh Government Purchases**

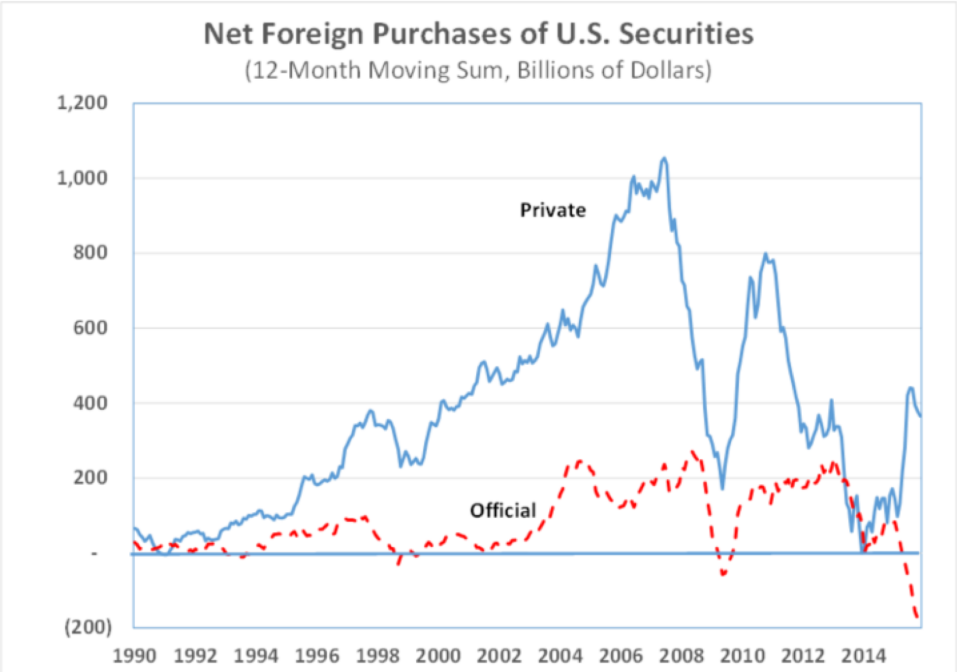
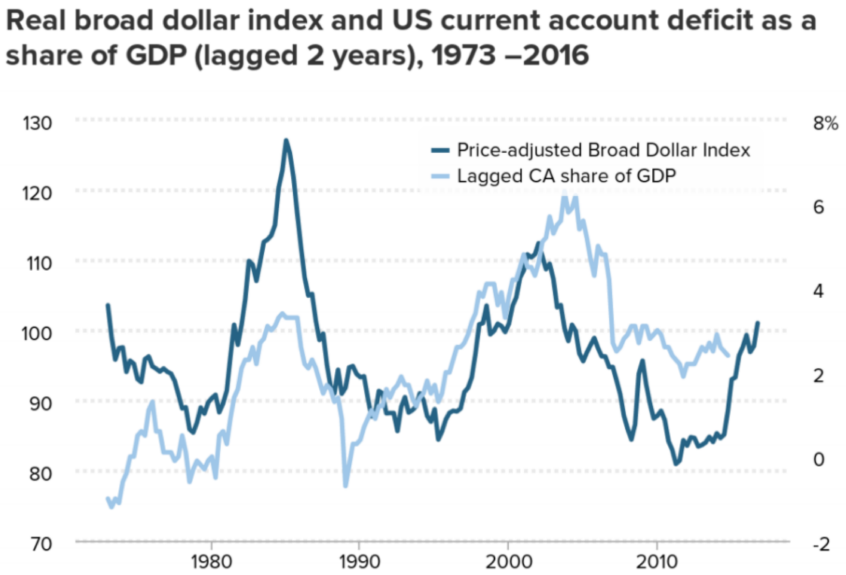



**Figure 3: Dollar Exchange Rate (dark blue line) drives Current Account Deficit (light blue line, inverted scale and lagged two years)**




bonds, and cash, at the rate of hundreds of billions of dollars a year.

The dollar investments of private investors now far outweigh the investments of government investors. Figure 2 shows that private investment flows into dollar securities peaked at a rate of $1 trillion a year in 2007, fell in the Great Recession, and have since recovered to some $400 billion a year. At all times, these levels were well above the levels of government purchases of dollars.

Not shown in Figure 2 is the estimated $5 trillion of daily turnover in currency trading by

banks and traders, most of it very short-term, that takes place in the money markets of New York, London, Tokyo, and other financial centers. Private investors in foreign currencies buy dollars for many reasons, including to purchase goods that are priced in dollars (many major commodities such as oil are priced in dollars), as a hedge
against depreciation of their own local currencies, to invest in the U.S. economy, as a speculative investment, and in many cases simply because in an uncertain world, the U.S. dollar is viewed as a rock of reliability and stability.

Figure 3[1] shows the value of the dollar as compared to the U.S. current account deficit (the trade deficit with overseas remittances and other small items added in). In this graph, the current account deficit is lagged two years and inverted, to show a correlation with dollar currency movements. When the dollar rises, the current account deficit worsens (larger negative figure as a percent of GDP), and when the dollar falls, the current account improves. The self-correcting trade relationship expected by economic theory by which a larger current account deficit drives the dollar down is not in evidence.

Because the dollar changes precede the trade deficit changes by two years, clearly causality appears to run from dollar exchange rate movements to current account balance movements. The current account deficit has been strongly negative throughout the last ten years, yet the dollar has not fallen to bring trade back into balance. On the contrary, in mid-2014, despite a trade balance close to -3% of GDP, the dollar suddenly rose more than 15%, and stabilized in 2016, only to rise yet again after the November election.

These exchange rate increases are likely to *worsen* the trade deficit in the next two to four years. The ability of the U.S. dollar to defy gravity despite huge and persistent trade deficits has played an important role in the persistence of those deficits.

A dollar that is too high keeps our exports too expensive and makes imports too cheap, prompting Americans to consume more imports and to export less. The impact of an overvalued dollar is hard to overstate. According to Fred Bergsten and William Cline, both of the Peterson Institute, "every 10 percent rise in the dollar adds about $350 billion to the trade deficit and reduces the level of U.S. economic activity by about 1.65%, with a corresponding loss of about 1.5 million jobs."[2]

## 2. FUNDAMENTAL EQUILIBRIUM EXCHANGE RATE – THE ESTABLISHED MEASURE OF CURRENCY OVER AND UNDER VALUATION

The fair or equilibrium value of a currency is the value that will enable a country's trade to balance (i.e. exports and imports equal) in a reasonably short timeframe. Beginning in 2008, Fred Bergsten and his Peterson Institute for International Economics colleagues developed a methodology for calculating a Fundamental Equilibrium Exchange Rate (FEER), the exchange rate that will enable a nation's trade to balance.[3]

The traditional FEER methodology generally targets getting a nation's current account to within plus or minus 3 percent of balance. That is a broad target range. For example, the U.S. is today running a current account deficit very close to -3% with negative impacts on output and employment.

In 2015, Peterson suggested targeting absolute, true-zero trade balances and recalculated FEER levels based on targets of balanced trade. Moving from a target of +/-3% of GDP to a true-zero balance is very important for the United States. Our present current account deficits equal to 3% of GDP cost us the needless unemployment of about three million American workers, according to most estimates of the job cost of imports. There is absolutely no reason that America should accept that as "normal." Furthermore, unless GDP grows by at least 3% per year on average in nominal terms, the burden of outstanding debt will continue to rise.

The Peterson Institute issued new global FEER estimates in May using the traditional +/- 3% balance target methodology. John Hansen, a former World Bank economist now serving on the CPA Advisory Board, has converted these FEER estimates into true-zero FEER estimates using a methodology agreed with Peterson. The key result of this analysis is startling:

[1] / Source: Robert Scott, 2017

[2] Bergsten, C. Fred, 2016.04, "Time for a Plaza II?" Chapter 14 in International Monetary Cooperation: Lessons from the Plaza Accord After Thirty Years, C. Fred Bergsten and Russell A. Green (eds). Washington: Peterson Institute.

[3] Fred Bergsten, a respected International financial economist and founder of the highly-regarded Peterson Institute for International Economics, was one of the architects of the Plaza and Louvre Accords of the 1980s, the only international agreements that successfully engineered a decline in the value of the dollar.

**The U.S. dollar is currently 25.5% overvalued compared to its FEER.**

As can be seen in Column 5 of Figure 4, the U.S. dollar is more seriously misaligned than the currency of any other major trading partner country. In a sense this is not surprising, as more speculative foreign exchange investing goes into dollars than any other currency. But of equal concern is the fact that the other most seriously misaligned currencies of major partners in Column 5-- namely Germany and Japan – are misaligned in the opposite direction. They are undervalued while the U.S. dollar is overvalued.

The dollar's gross overvaluation imposes a tax on the selling price of all U.S. products that can be traded internationally – even if they are not actually traded. It is a tax on U.S. producers trying to export. On U.S. producers competing with imported goods. And it is even a tax on U.S. producers who face the threat of imports. For example, the threat of imported shirts from China can force a New England shirt manufacturer to sell his shirt for 25 percent less than he would otherwise be able to charge if the dollar were not so overvalued.

Note well that this tax on U.S. producers, which is also a subsidy for foreign producers, is a tax on the selling price, not on profits. The current 35% headline corporate tax rate applies only to profits,

**Figure 4: Exchange Rate Under- and Overvaluations**

True-Zero Current Account Balance Targets

| 0 | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| Country | Cline/IMF Targeted Change in Current Account (% of GDP) | Cline Change in REER Required to meet Current Account Target (%of currency value) | Additional Change in Current Account Required for True-Zero (% of GDP) | Additional REER Adjustment formTrue-Zero CA Balance (% of currency value) | Total Adjustment for True Balance (% of currency value) |
| Canada | 0.1 | (0.5) | 0.20 | 1.0 | **0.5** |
| China | 0.3 | (1.4) | 1.30 | 6.1 | **4.7** |
| Euro area | 0.4 | (1.6) | 2.90 | 11.6 | **10.0** |
| Germany /a | (2.9) | 11.6 | 3.00 | 12.0 | **23.6** |
| India | 0.3 | (1.3) | (2.30) | (10.0) | **(11.3)** |
| Indonesia | 0.3 | (1.3) | (2.00) | (8.7) | **(10.0)** |
| Japan | (1.1) | 6.7 | 3.00 | 18.3 | **25.0** |
| Korea | (2.7) | 6.8 | 3.00 | 7.6 | **14.4** |
| Malaysia | 0.6 | (1.3) | 2.20 | 4.8 | **3.5** |
| Mexico | 0.2 | (0.6) | (1.70) | (5.1) | **(5.7)** |
| Switzerland | (3.1) | 7.0 | 3.00 | 6.8 | **13.8** |
| Thailand | 0.5 | (1.0) | 3.00 | 6.0 | **5.0** |
| United States | 1.3 | (7.7) | (3.00) | (17.8) | **(25.5)** |

Source: Cline, 2017, op. cit., and Hansen's calculations.

a/ Germany estimated based on 2016 IMF data for Germany and for eurozone (Germany needs 10% more revaluation than EZ per IMF); Cline's 2017 eurozone.data used for German estimate here.

Note well that this tax on U.S. producers, which is also a subsidy for foreign producers, is a tax on the selling price, not on profits. The current 35% headline corporate tax rate applies only to profits,

and if profits are zero, so are taxes. The "overvalued dollar tax," however, applies to the selling price. Consider, for example, a producer who could sell a shirt for $40 and make a five-dollar profit if the dollar were not overvalued. However, because the dollar is overvalued by 25%, the producer will have to sell his shirt for $30 ($40 * (1-0.25)). This leaves him with a loss of five dollars. Although the overvalued dollar tax is "only" 25% instead of 35% like the corporate income tax, the overvalued dollar tax works out to be a 200 percent tax on profits – 100% on the $5 of original profit, plus another $5 loss!

> ***This is why the dollar's overvaluation is such a serious threat to the survival of manufacturing and farming in the United States. The dollar's overvaluation threatens not only the existence of these two critical sectors. It also threatens the entire economy because these two sectors are by far the most important sources of the exports we need to pay for our imports.***

The dollar's misalignment is primarily caused by the buying and selling decisions of private traders, not by government currency manipulation. As Bergsten and others have noted, official currency manipulation has been "in remission" since about 2014. In fact, as shown in Figure 2, except for a relatively few years, official currency manipulation has played a minor role in the dollar's massive misalignment. Rather, the dollar is overvalued because private investor decisions are unrelated to the fundamental performance of trade or production in the U.S. or any other economy, and the global monetary system no longer has a mechanism to bring exchange rates back to levels consistent with balanced trade.

## 3. RECONNECTING THE DOLLAR WITH TRADE BALANCING EQUILIBRIUM PRIC-ING: MARKET ACCESS CHARGE (MAC)

> *"If the dollar is brought back to a fully competitive exchange rate by the MAC, more workers will find well-paying jobs - and just as important, wage rates will rise thanks to a tighter job market, giving working Americans a significant real wage increase for the first time in nearly forty years." -John Hansen*

Dr. John Hansen, a 30-year veteran of the World Bank, developed the MAC as a system to discourage overseas private investors and return-sensitive official investors such as sovereign wealth fund managers from excessive speculation and trading in U.S. dollar assets. By reducing the incentive for foreigners to invest in dollars, we can gradually and safely reduce its overvaluation, benefiting the U.S. economy and restoring control over our own currency. Hansen's proposal is to launch the MAC with a 50 basis point (0.5%) charge on any purchase of U.S. dollar financial assets by a foreign entity or individual. (See post on Hansen's website *Americans Backing a Competitive Dollar* for more details.) As a one-time charge, the MAC will discourage would-be short-term investors, many of whom hold dollars or dollar-denominated securities overnight or even for minutes for the sake of a tiny profit.

The MAC rate would operate on a sliding scale, geared to the value of the trade deficit as a percentage of GDP. The MAC tax would rise if the trade deficit rose, and fall as the trade deficit falls. Although the charge itself is small, Hansen and the CPA believe it would be sufficient to discourage foreign inflows of hot money, with no material impact on foreign direct investment in factories and other directly productive activities.

Most importantly, the MAC would have a substantial impact on the dollar's value, moving it gradually and safely to a trade-balancing exchange rate and keeping it there, regardless of what other countries do. If the trade deficit goes to zero, so would the MAC. We agree with Hansen that, if properly implemented, the MAC could eliminate the full 25% overvaluation of the dollar, and this could lead to the complete elimination of the trade deficit over the subsequent three to four years.

### 3.1 IMPLEMENTATION, ADMINISTRATION, AND REVENUE

Many nations have used capital flow management policies to reduce excessive buying or selling pressure on their currency. Like other capital flow tools, the MAC can be implemented unilaterally by the U.S. federal government. It does not violate IMF rules, which explicitly allow member nations to implement policies needed to rectify international financial imbalances. It does not violate WTO rules either. We recommend a period of international consultation with G20 members to reduce the risk of misunderstandings and, hopefully, to get them to implement their own versions of the MAC. Faced with a U.S. government determined to take action on its capital account to improve its trade account, other nations may make complementary MAC-like proposals, and this would benefit the U.S. and the world by

restoring a stable foundation for balanced, sustainable global growth.[4]

The MAC would be a self-financing system since it would generate revenue. We expect the MAC would generate at least $1 billion in annual revenues, and probably more, depending largely upon how much foreign exchange trading in the dollar declines due to increased transaction costs from the MAC. MAC revenue would be temporary, not permanent, because the explicit goal of the MAC is to reduce and ultimately eliminate the trade deficit, at which point the MAC would go to zero. It is therefore proposed that MAC revenue be earmarked for a "U.S. Competitiveness Fund" supporting short-term spending projects such as infrastructure investment. It is important to note that no Americans would pay the MAC charge. Only foreign-based individuals and entities are liable to pay the MAC. It should also be noted that, as the MAC attains its goal of balanced trade and MAC revenues gradually fall to zero, the Government will enjoy increased tax revenue because the MAC will greatly stimulate U.S. competitiveness and thus overall output, profits, wages – and thus the tax base.

### 3.2 COMPLEMENTARY TO OTHER TRADE POLICIES

Although we believe the MAC could eliminate the trade deficit entirely over a period of several years, there is still a clear need for other U.S. trade policies focused on eliminating unfair trade practices and non-tariff barriers. The MAC should be seen as complementary to, not competitive with, such trade policies. Though in remission now, currency intervention and manipulation by governments is likely to resume, and the U.S. government should not hesitate to act to stop or counteract such activities. The CPA favors actions to strengthen the monitoring, definition, and enforcement of remedies to counteract currency manipulation, dumping, and other unfair trading practices.

## 4. CONCLUSION

Persistent overvaluation of the U.S. dollar is a leading cause of the U.S. trade deficit, and the resultant industrial decline, manufacturing employment decline, and disappointing GDP growth. The introduction of a Market Access Charge can reduce dollar overvaluation, discourage unwanted investment in the dollar, bring down the dollar's value, significantly reduce America's trade deficit and stimulate economic growth, employment and personal income. The U.S. government can implement a MAC unilaterally.

[4] In the best of all worlds, all countries would have a MAC in place. For example, if the countries of the eurozone had had MACs in place, in the past decade, this would have slowed the flow of excess German savings into the southern periphery countries, possibly preventing the Euro crisis. If a MAC had been in place in the East Asian countries in the 1990s, this may have prevented the East Asian crisis, which was caused by excessive foreign capital inflows, followed by a "sudden stop." And returning to the U.S., if a MAC had been in place in the 1970s and early 1980s, this could have reduced the reflow of petro-dollars to the United States, preventing the overvaluation of the dollar and the domestic inflation that led to excessive imports from Germany and Japan.