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The Deficit and the Dollar

The dramatic increase in the exchange value of the dollar was probably the most important economic event between 1980 and 1984. On a trade-weighted basis, the real (or inflation-adjusted) value of the dollar soared 70 percent between 1980 and the first quarter of 1985. The strong dollar led to an unprecedented trade deficit that reached 3 percent of GNP in 1985, hurting a wide range of U.S. manufacturers and creating the greatest political enthusiasm for protectionist measures since the 1930s. The sharp rise in the dollar not only increased the real incomes of Americans but also contributed significantly to the drop in inflation.

Economists have offered many explanations for the dollar's surge, and the subject remains one of great contention. In **The Budget Deficit and the Dollar** (*NBER Working Paper No. 1898*), NBER President **Martin Feldstein** argues that the rise in expected future U.S. government budget deficits has been the primary cause of changes in the value of the dollar.

Increases in expected future deficits raise real long-term interest rates in the United States and the higher rates attract funds from abroad. The dollar's rise is necessary to create the trade deficit and associated current account deficit that permit the desired net inflow of foreign capital. Moreover, since the world capital markets will not allow differentials in expected asset returns to persist, the dollar must rise high enough so that its expected future fall just offsets the nominal interest rate differential between dollar securities and foreign assets.

Feldstein also argues that the budget deficit's effect on the dollar was reinforced by the change in monetary policy that began in October 1979. The Federal Reserve's shift to a contractionary policy caused a short-term spike in real interest rates that temporarily increased the attractiveness of the dollar. More fundamentally, the new Fed policy also made investors worldwide more confident that the value of the dollar would not soon be eroded by a return to rising inflation. The reduction in the perceived risk of dollar investments added to the attractiveness caused by the deficit-induced rise in expected real interest rates.

Other economists have offered very different explanations of the strong dollar. The 1985 *Economic Report of the President,* for instance, argues that the principal factor behind the dollar's rise was an increase in the aftertax return on new business investment caused by lower inflation and the 1981 tax act. The *Report*'s authors note that the differential between real three-month interest rates in the United States and abroad narrowed to zero and occasionally was negative after 1982, which they interpret as evidence that interest rate differentials had little to do with the dollar's continuing rise.

Another commonly expressed opinion is that the rise in the dollar reflected growing confidence in the United States as a "safe haven" for foreign investors. Some have argued that the strong dollar merely indicates that U.S. monetary policy has been too tight. Finally, economists who believe that budget deficits

do not raise real interest rates because they induce offsetting increases in private saving must reject any role for the budget deficit in the dollar's rise.

Feldstein begins his analysis by noting flaws in the alternative explanations. He argues that the evidence that there has been little or no difference in real short-term interest rates since 1982 is essentially irrelevant since it is differentials in long-term real rates that matter, and long-term real rates have remained higher in the United States after 1982.

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The United States does offer a politically safe environment, but Feldstein argues that it is hard to see why the United States would have seemed particularly safer relative to, say, Switzerland, in the early 1980s than it was in the 1970s. Moreover, a shift in worldwide demand in favor of U.S. assets would have driven U.S. interest rates down. The sharp rise in real rates suggests that any safe-haven effect on the demand for dollar assets was overwhelmed by the increased supply of those assets. Feldstein also questions whether the sharp decline in the value of the dollar since February 1985 can sensibly be attributed to deterioration in the relative political stability and security of the United States. Further, the improved tax climate for investment in the United States should have raised the value of the dollar, but Feldstein's evidence indicates that this effect was very weak.

In his analysis, Feldstein presents statistical evidence on the relationship between the dollar and the German mark. He examines the effects of a number of variables on the mark-dollar exchange rate adjusted for inflation in both countries, from 1973 through 1984. He finds that an increase in expected future five-year U.S. budget deficits equal to 1 percent of GNP causes the real value of the dollar to rise about 30 percentage points relative to the mark. Changes in the growth of the monetary base also affect the exchange rate. But changes in tax rules, and in the interaction of inflation and taxes, have not had any discernible effect on the exchange rate. Feldstein concludes that his new evidence shifts the burden of proof to those who claim that deficits do not matter or that tax, monetary, or "confidence" variables were the real reasons for the strong dollar. He also notes that the decline of more than 20 percent in the real dollar-mark exchange rate since mid-1984 is in line with what would have been expected on the basis of the fall in expected future budget deficits.

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The Feminization of Poverty?

Contrary to popular belief, the percentage of poor adults who are women has not increased in recent years. Although there was considerable "feminization of poverty" in the 1960s, the percentage of women among the (adult) poor was relatively stable in the 1970s. Moreover, between 1979 and 1984, women's share of poverty actually decreased, according to NBER Research Associate **Victor Fuchs.**

In **The Feminization of Poverty?** (*NBER Working Paper No. 1934*), Fuchs also reports that black women fared less well relative to black men than white women relative to white men throughout 1959–84. Based on these findings, he concludes that "... the feminization of poverty that did occur was *not* the result of worsening labor market conditions for women," but rather was caused by the increased share of women in households without men.

Fuchs's data come from the federal government's Census of Population (1960, 1970, and 1980) and the Current Population Survey (March 1980 and March 1985). He defines feminization of poverty as the increase in the percentage of adult poor who are women, or the increased probability of a woman being poor relative to the probability of a man being poor. He also applies two standards to the measurement of poverty: a *fixed* level, adjusted only for changes in the cost of living; and a *changing* standard that also rises with average income per capita.

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He finds that for both blacks and whites, the percentage of the poor who were women rose by about five percentage points during the 1960s. In 1984, however, the feminization of poverty was greater among blacks than whites. Although some racial differentials existed in 1959 and in 1969, most of this divergence occurred during the 1970s. Between 1969 and 1970 among whites aged 18 and over, the percentage of the poor who were women was virtually unchanged; for whites aged 25–64 the percentage actually declined. During that same decade, black women (in both age groups and by either standard) continued to lose ground relative to black men. After 1979, women's share of poverty decreased for both races, both age groups, and by both measures.

Nonetheless, by 1984 over 68 percent of black adult poor were women, compared to just over 62 percent for whites. This was primarily because the share of black women with children in households without men (as a proportion of the black adult population) rose from about 6 percent in 1959 to almost 13 percent in 1984; the comparable increase for white women was much smaller. It has been shown that the incidence of poverty is much higher in households with a female head than in male-headed or male-female households. In 1984, nearly 13 percent of white women and almost 24 percent of black women lived in such female-headed households.

Finally, Fuchs finds that the incidence of poverty increased relatively more rapidly for men than for women, both black and white, between 1979 and 1984. For women over 18 with children in households without men, the poverty rate declined from about 24 percent to about 21 percent. The comparable rate for men during that period rose from 12.5 to 12.8 percent. Fuchs concludes that this probably reflects changes in the labor market at that time: the ratio of female-to-male average hourly earnings rose five percentage points, and the unemployment rate for men over 20 rose from 4.2 percent to 6.6 percent, while the rate for women increased by only half as much, from 5.7 percent to 6.8 percent.

While Fuchs focuses solely on the *feminization* of poverty in this paper, he observes that absolute poverty rates for both men and women fell during the 1960s and 1970s and began to rise again in the 1980s. The share of women who were poor declined from 21 percent in 1959 to 15 percent in 1969 and to 12 percent in 1979, but rose slightly to 13 percent in 1984. Male poverty rates declined from 18 percent in 1959 to 10 percent in 1969 and 8 percent in 1979, but then rose to 9 percent in 1984. The same trend held for blacks, although they had much higher poverty rates than whites. In 1959, 48 percent of black women and 41 percent of black men were poor. In 1984, the poverty rates were 31 percent for black women and 20 percent for black men.

Exchange Rates, Productivity, and Competitiveness in the United States and Japan

The sharp drop in the dollar relative to the Japanese yen over the past year may not be nearly enough to restore the competitiveness of many U.S. manufacturers, according to NBER Research Associate **Richard Marston**. In **Real Exchange Rates and Productivity Growth in the United States and Japan** (*NBER Working Paper No. 1922*), Marston argues that the misalignment of the dollar in the early 1980s obscured the effects of higher productivity growth in Japan on the relative competitiveness of the two economies.

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Ordinarily, differing rates of productivity growth in two economies would not affect the real exchange rate (that is, the exchange rate adjusted for relative changes in the overall price levels), as long as the productivity growth was reflected in growing real wage rates. However, productivity growth is concentrated in manufacturing in both the United States and Japan. As a result, increases in the prices of manufactured goods will be lower than the overall rate of inflation in both countries. If productivity grows much faster in Japanese manufacturing than in the United States, which has been the case, then the prices of U.S. manufactured goods will rise relative to the prices of Japanese manufactured goods even if the real exchange rate adjusted for changes in the overall inflation rate remains constant. That is, even if the real exchange rate based on the overall price level is unchanged over the years so that the dollar never appears "overvalued," U.S. manufacturers will become continually less competitive with Japanese rivals.

That apparently is what has occurred. Marston assesses the effects of productivity differentials between the United States and Japan by comparing the movements of overall price indexes with indexes based on traded goods (that is, goods that can be imported and exported). Using data for 1973–83, he finds a widening gap between real exchange rates computed on the basis of the overall price indexes and exchange rates based on indexes of traded goods alone. Thus, the inflation-adjusted value of the dollar would have had to fall continually relative to the yen for U.S. companies to remain as competitive as they were in 1973.

In fact, the real exchange value of the dollar based on the price deflators for gross domestic product declined very slightly between 1973 and 1983, indi-

cating that the United States became a bit more competitive. However, based on the prices of manufactured goods alone, the value of the dollar rose 35 percent. Thus, the competitiveness of U.S. manufacturers declined substantially.

What's more, the productivity differentials between the United States and Japan vary enormously from one industry to another. As a result, the effects of productivity and exchange rates on competitiveness also vary from industry to industry. This represents a shift in the comparative advantages of the United States and Japan, with some U.S. industries becoming more competitive and others becoming much less competitive. One subsector of manufacturing—fabricated metal products, machinery, and equipment—represents 44 percent of manufacturing in the United States and 50 percent in Japan. The real exchange value of the dollar for goods in that subsector rose 67 percent over the ten-year period, meaning that the competitiveness of U.S. companies in those industries has declined much more than the competitiveness of manufacturers in general. AE

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