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Will a Fall in the Dollar Boost U.S. Production?

One of the most widely accepted propositions influencing economic policy is that a country can boost its output, especially internationally traded goods, by lowering the foreign exchange value of its currency. This view gained prominence recently because of the perception that the Clinton Administration desires to lower the value of the dollar as part of its efforts to reduce the trade deficit with Japan. Whether this perception is correct or not, resulting concerns about the relative rate of return on U.S. investment have contributed to a rise in interest rates and a fall in the dollar's value. A lower dollar is not likely to boost U.S. output, however. Indeed, there is a positive relationship between the dollar's value and output largely because changes in incentives that, for example, lower U.S. investment, productivity and output also reallocate international investment and contribute to a lower value of the dollar. Conversely, efforts to push the dollar down are likely to lower U.S. output because they would require actions —such as boosting inflation, raising tax rates or adopting protectionist trade policies—that unintentionally lower domestic investment and productivity. The evidence in the table below supports this positive relationship.

The table shows four periods when the value of the dollar showed different trends, along with the associated growth rates of various components of U.S. output, including a key traded-goods sector, the capital goods industry. The value of the dollar is measured by the Federal Reserve Board's trade-weighted, nominal exchange rate index. During the 1980-85 period, a 10.4 percent average annual rate that accumulated to a 63.9 percent rise in the value of the dollar led some analysts to conclude that the country was losing its industrial base to foreign competition. As the table shows, however, manufacturing and real gross domestic product (GDP) growth, led by the capital goods industry, accelerated from their 1973-80 pace as the dollar rose. In 1985 to 1991, the value of the dollar almost completely retraced its 1980-85 rise. Many analysts urged this decline, expecting it to boost U.S. output, but the three output measures slowed, led again by the capital goods industry. In the latest period, the dollar rose and output growth improved markedly.

— John A. Tatom

CHANGES IN THE DOLLAR'S VALUE AND U.S. OUTPUT MEASURES
(compound annual rates)

Period	Value of the dollar	Capital goods[1]	Manufacturing[2]	Real GDP
1973-80	-1.8%	2.7%	1.9%	2.1%
1980-85	10.4	5.7	3.1	2.5
1985-91	-7.5	3.1	2.1	2.2
1991-93	1.9	6.7	3.8	2.7

[1] Industrial production components: industrial machinery and equipment, electrical machinery and transportation equipment
[2] Manufacturing component of industrial production

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