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Statement by

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before the

Subcommittee on Domestic Monetary Policy

Committee on Banking, Finance, and Urban Affairs

House of Representatives

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Thank you, Mr. Chairman, it is my pleasure to appear before this Subcommittee to discuss the problems of the strong dollar.

The strength of the dollar over the past three years has been truly impressive. The dollar appreciated by 46 percent from the fourth quarter of 1980 to September 1983 against a weighted average of the currencies of the other major industrial countries. Against the German mark the appreciation amounted to 40 percent; against the yen, 13 percent; against sterling, 59 percent, and against the French franc, 83 percent.

Making allowance for inflation differentials the rise is somewhat smaller, since inflation in the United States over this period was less than abroad. But even on an inflation adjusted ("real") basis the dollar's appreciation was still a very substantial 40 percent. Its real value is currently some 27 percent above its average value over the entire floating rate period, since March 1973. This type of calculation is sometimes used to measure the degree of "overvaluation" of the dollar on current purchasing power parity grounds. Of course, a different base period would lead to a different degree of overvaluation.

How, then, do we explain this extraordinary strength of the dollar? There does not appear to be any single, simple explanation. Broadly speaking, the economic factors that influence exchange rates can be grouped under three categories: (1) inflation, (2) interest rates and rates of return, and (3) current-account deficits and surpluses.

High inflation works against a currency, and probably much more forcefully than in proportion to changes in relative purchasing power. By the same token, the sharp drop in inflation, and inflation expectations, that

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has occurred in the United States can be assumed to have contributed substantially to the strength of the dollar. The extent to which this has occurred is not measurable, but I do not doubt that an important change has occurred in international perceptions of the dollar as an asset worth holding.

As regards interest-rate differentials, it is important to distinguish between nominal and real interest rates. Using real rates implies making allowance, as already noted, for the effect of inflation on the relative purchasing power of currencies. To the extent that currencies are expected to move in proportion to purchasing power changes, it is real interest rates, which already embody these expectations, that are relevant to analyzing exchange rate movements. As the chart attached to my testimony shows, there has been a broad association of the real interest differential between dollar and foreign-currency assets and the dollar's real exchange value over the floating rate period. (I should note that any measurement of real interest rates is necessarily only an approximation, since the concept of real interest rates involves expectations of future inflation, which expectations cannot be measured directly. The chart uses 3-month interest rates and year-over-year inflation rates.)

The real interest differential moved from nearly 1 percent against the dollar in October 1980 to over 4 percent in favor of the dollar in August 1983. Unless such a shift were offset by a shift in exchange rate expectations it would result in an attempt by asset holders to reallocate their existing portfolios toward dollar assets and away from foreign currency assets. Similarly, new world savings would be allocated more toward dollar investments.

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It seems quite plausible that a large shift in real interest differentials in favor of the dollar should result in a large appreciation of the dollar. And it is quite plausible that the present high level of real interest rates in the United States, and thus the high interest rate differential, is mainly due to (actual and expected) massive budget deficits in the United States.

There may be a contributing factor tending to push up U.S. real interest rates, namely, an increase in the prospective profitability of real investment in the United States. There are some indications that this may have occurred. Changes in tax laws have helped to raise the return on capital. The discounted value of future profits of U.S. corporations, as represented in stock prices, has surged by some 60 percent (S & P 425 industrials) since August 1982. Indeed, over the past year or so the profit outlook, reflected in relative movements of stock and bond prices, appears to have improved more in the United States than in any other industrial country with the exception of Canada. Other evidence lending support to the increased profitability of real investment in the United States is the reported 1/3 increase in profits from current production (economic profits) in the GNP accounts from the fourth quarter of 1982 to the second quarter of this year. And business fixed investment is significantly higher in this recovery than had been predicted, given the level of real interest rates and the degree of capacity utilization. This profit picture stands against the background of the decline in profitability from the late 1960's through the 1970's.

This apparent increase in the profitability of real investment may reflect the effects of new technology, e.g., the computer revolution, in

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which the United States is in the lead. I believe that it also reflects the beneficial effects, despite the painful transition, of moving from high inflation to low inflation. In any event, it appears plausible that foreigners should demand the currency of a country with increased profitability of real investment. This is not to downplay, however, the role of U.S. budget deficits in raising real U.S. interest rates. In my view they are by far the main factor.

Recent current account developments seem to have played little role in the behavior of the dollar. It was only in small surplus in 1980-81 and has deteriorated sharply since mid-1982. The factors of strength in the exchange rate picture seem to have predominated over this factor of weakness.

There are also more special reasons for the dollar's strength over the past three years, however. The presence of actual and threatened political instability in many parts of the world, both in industrial and developing countries, has undoubtedly been a significant factor in foreign demand for dollars. And the United States is the "preferred habitat" of flight capital from Latin America. A final factor which should be mentioned is the international debt problem, which also, at least initially, tended to strengthen the dollar.

Given the presence of conflicting forces, predicting the future exchange value of the dollar is bound to be a hazardous undertaking. Some observers have thought that the dollar would decline with the development this year of massive U.S. balance of payments deficits on current account, especially since the 1984 deficit is expected to be even greater. Certainly these deficits would tend to cause the dollar to depreciate. But the exchange market, so far, has shrugged off the already large decline and the

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prospects, as of today, of further widening of the current account deficit. So long as investor demand for net dollar assets at existing exchange rates continues to be strong, the negative effect of the current account may be offset. The key question then is, when are those factors which have led to such a great demand for dollar assets -- real interest differentials, political uncertainties, and the international debt situation -- going to change? I am afraid that I do not possess any special powers of prognostication on these points. Clearly, action by the Congress and the Administration significantly to reduce the budget deficit could have a substantial impact on real interest rates and a decline in these rates would be widely expected to contribute to a depreciation of the dollar. In a similar vein, the assurance of adequate availability of official financing to those developing countries willing to pursue responsible adjustment policies might also tend to reduce the demand for dollars and thus mitigate upward pressures on our currency.

The Subcommittee has asked me to address the question of the impact of the dollar's appreciation on various aspects of the domestic economy. In this connection, it is important to bear in mind that, given the major determinants of exchange rates mentioned above, changes in rates are likely to be responses to changes in those determinants, which, in turn, respond to a variety of events. These responses feed through the economic system via various channels, some of which can change very quickly, such as exchange rates and interest rates, which then affect other economic variables that change more slowly, such as GNP, employment, and the general price level.

The Board staff has simulated the impact on the domestic economy of the appreciation of the dollar. Let me stress that these estimates should be

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treated with great caution. First, they are necessarily dependent upon the particular model being employed. Second, they represent only the effects of an assumed exogenous appreciation of the dollar, not the full effects of any policy change, such as tax cuts, which may have led to this appreciation. The overall effect of the tax cuts on GNP and employment, for example, may well have been positive, even after allowing for any negative effects of the dollar appreciation.

The Board staff estimates that the effect of the dollar's real appreciation since the fourth quarter of 1980, which was near the low point for the dollar, has led, by mid-1983, to a 14 percent fall in the volume of U.S. merchandise exports and a 15 percent rise in the volume of merchandise imports. In nominal terms, the effects were a decline of $50 billion (annual rate) in exports and a decline of $10 billion in the value of U.S. imports, with decreases in the dollar prices of imports more than offsetting volume increases. The effects of the dollar's appreciation are still working themselves out, and it is estimated that the full effect on the trade balance will reach about $50 billion (annual rate) by 1985. These estimates take into account the stimulative effect of the dollar's appreciation on income and prices abroad, as well as the opposite impact at home.

In these estimates the effect on the U.S. consumer price level by mid-1983 is to lower it by about 4-1/2 percent below the level it would otherwise have reached — reducing the inflation rate by about 1-1/2 percent per year over this period. The levels of real GNP and employment are estimated to be lower by 1 percent and 1 million, respectively, at mid-1983, but these effects are transitory and would be completely reversed by early 1985. The latter occurs because the initial negative impact on GNP and the

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price level induces a decline in interest rates which stimulates business investment and housing expenditure. When these effects have fully run their course, then, the level of GNP and total employment would show little net change, but employment in the traded goods sector would be lower by about 2 million and higher by the same amount in the non-traded sector, largely services. That is, about 2 million jobs would have been shifted from the traded goods to the non-traded goods sector. The regional impacts of such adjustments could be severe.

The subcommittee has requested comment on the question of how the dollar's exchange value could be reduced or indeed whether it should be. It is in the nature of a smoothly functioning international monetary system that exchange rates should be determined by market forces. However, we must recognize also that some of the market forces that have driven up the dollar are of our own making, in particular, the large budget deficit and ensuing high real interest rates. Probably the most desirable policy action which could be taken, therefore, would be a sharp reduction in the budget deficit. This would tend to reduce real interest rates which, in turn, would tend to reduce the dollar's exchange value, improve the current account, and increase investment. This action on the budget, therefore, would have beneficial results in many directions quite aside from the exchange market including reducing inflation and expectations of inflation.

Other means of seeking to influence the exchange rate are questionable. Intervention in the exchange market, if sterilized, as U.S. intervention routinely is, would have only very limited effects, unless undertaken on an enormous scale. This was the conclusion I drew from the report of the Working Group on Exchange Market Intervention. There have, in

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fact, been significant net intervention sales by foreign central banks, amounting to $80 billion over the past three years. Intervention involving sales of dollars that was not sterlized would imply a change in our monetary policy, in an inflationary direction. Clearly it would be highly undesirable to seek to depress the dollar by regenerating inflationary expectations.

As you know, the United States has intervened in only a minimal fashion since March 1981. We have basically sought to counter only the most severe instances of short-run disorder in exchange markets. Some have suggested intervention on a somewhat greater scale. The Federal Reserve would not object to this in certain circumstances, but we would not ordinarily expect the results on the dollar's exchange value to be large nor long-lasting, in the absence of other more fundamental policy changes. The Federal Reserve routinely sterilizes the effects of U.S. and foreign dollar intervention on the reserve position of the U.S. banking system. Analytically, intervention sales of dollars may tend to put upward pressure on U.S. interest rates, when the monetary effects are sterilized, since more dollar securities would then have to be held by the public. But such operations would, in effect, offset the downward pressure on interest rates which arose from an initial excess demand for dollars that appreciated the dollar.

Selective controls on external receipts and payments are undesirable. Historically they have been ineffective, since there are usually so many alternative methods of accomplishing the same type of transactions. For a currency so widely held around the world and so widely traded in foreign markets as the dollar, controls are totally impracticable.

To conclude on this question, the present position of the U.S. balance of payments, and even more the prospective further increase in the

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current-account deficit, in my personal view, is highly undesirable. It puts the United States in the unnatural position of borrowing on an unprecedented scale from the rest of the world. It tends to drive up real interest rates abroad, hampering recovery and making the debt burden of developing countries harder to bear. By putting very large amounts of dollars in foreign hands, which may not indefinitely be willing to hold them, though now they are eager to acquire them, it creates the danger, although in no way the certainty, of a future excessive drop of the dollar.

To the extent that the abnormal strength of the dollar is the result of the budget deficit, a reduction of the budget deficit seems to be the most appropriate remedy. In my view, that is very predominantly the case. On the other hand, to the extent that foreigners' purchases of dollar assets reflect a higher profitability of real investment in the United States, and to the extent that this situation should persist, strong demand for the dollar may be perpetuated and the economy probably would have to adapt and in consequence shift resources from the export sector to production for the domestic market.

Technically, it would also be possible to conduct monetary policy with a view towards influencing the exchange rate. Some central banks follow, from time to time, this kind of policy. For the United States, however, this would have the serious drawback of having to compromise our present anti-inflation policy. For instance, in order to achieve a lower level for the dollar, it would be necessary to take domestic action to expand the money supply and so lower, temporarily, interest rates. Pursued for any length of time, such action would be inflationary and have a reverse (and perverse) effect on interest rates. That is not to say that we

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should not consider the value of the dollar, along with other variables, in setting our monetary targets. I would note that it would be unwise, of course, to seek stability of exchange rates with respect to currencies that are themselves inflating. Against such currencies the dollar should appreciate over time. It also follows that the better we do on inflation, the less we need worry about the high exchange rate.

In light of present uncertain prospects, a word on the longer run outlook for U.S. export markets seems appropriate. With the reconstruction and expansion of industrial capacity in foreign economies since World War II, the United States has shifted away from having a net export position during the late 1940s in virtually all categories of goods — agricultural products, capital goods, automotive products, consumer goods other than foods and autos. The shift has been toward developing net export positions in products that are land-intensive, skill-intensive and technologically advanced — such as agricultural products, capital goods, chemicals, and military equipment — while developing net import positions in fuels and in manufactures that can only be produced profitability at relatively lower real wage rates. This trend toward a greater degree of international specialization has on balance contributed to the growth of U.S. productivity and income.

Since the beginning of 1981 the U.S. net export position has declined in virtually all categories of goods except fuels and military equipment. Part of these declines are related to the appreciation of the dollar against the currencies of other industrial countries, part are related to the financing problems and adjustment measures of some important developing countries, and part to timing differences in the international business cycle. It is undeniable that severe costs have been imposed by

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these developments on firms and workers in export and import-competing industries. It also appears to be the case, however, that those sectors facing the greatest difficulties in competing with imports are industries that currently are paying relatively high wages. Such sectors can only profitably compete in the longer run by paying lower real wages or by receiving protection from imports in a manner that allows them to pass along their higher costs in higher prices for consumers or industrial users. Moreover, as is suggested by the table, over time the rise in net imports of products that the United States produces relatively inefficiently has been counterpart to the growth in net exports of comparatively advantageous products. Protection of inefficient industries is likely to restrict the growth of these efficient industries. The United States must continue to resist pressures for import protection and continue fighting against foreign import restrictions or export subsidies -- particularly those that impede our comparatively advantageous export sectors.

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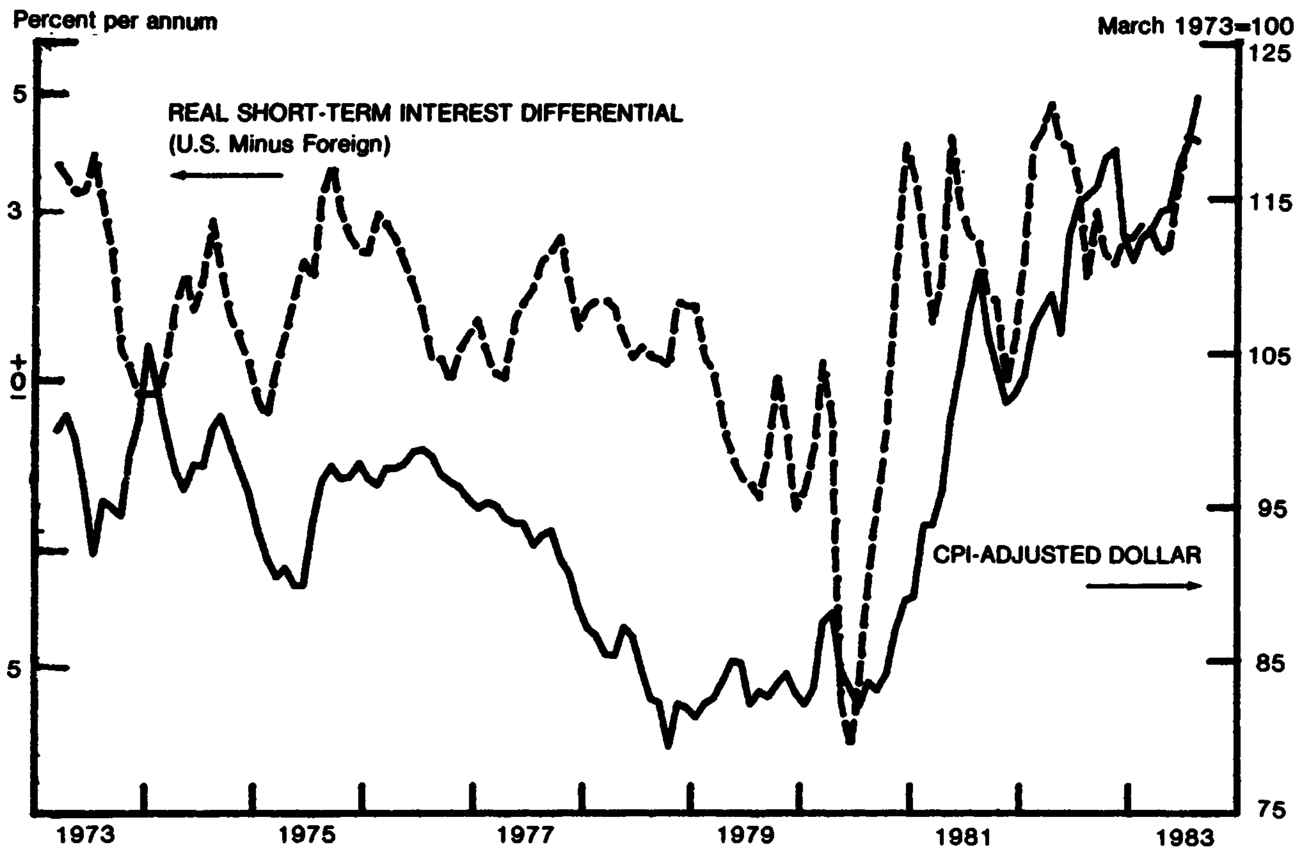

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Shifts in U.S. Commodity Trade Balances
(Billions of dollars, seasonally adjusted annual rates)

Commodity Balances[a]	1947	1973	1981-H1	1983-H1	$ Changes 1973 to 1981-H1	$ Changes 1981-H1 to 1983-H1
	(1)	(2)	(3)	(4)	(5)	(6)
Agricultural Goods	2	9	28	18	+19	-10
Capital Goods	3	14	48	31	+34	-17
Chemicals	1	3	12	9	+9	-3
Fuels	1	-7	-77	-42	-70	+35
Automotive Products	1	-4	-10	-22	-7	-11
Consumer Goods[b]	1	-8	-21	-30	-12	-9
Other[c]	1	-6	-3	-11	+3	-8
Overall Trade Balance	10	1	-24	-47	-25	-23
Current Account Balance		7	8	-27	+1	-35

a/ Commodity balances represent exports less imports.
b/ Excludes fuels, foods and automotive products.
c/ Mainly industrial supplies other than fuels and chemicals.

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