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Observations on the Dollar's Strength

Remarks by

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I am pleased to be with you today to discuss the effects of the strong U.S. dollar on the world economy. Few developments have so confounded economic forecasters as the dollar's persistent appreciation since late 1980. The associated flows of capital and the resultant redirection of trade have become a principal topic of discussion and policy debate. For private planners and makers of public policy alike, the outlook for the dollar is a major uncertainty. And in a broader sense, by giving rise to more forceful calls in the United States for protectionism, the dollar's strength has clouded the prospects for continued expansion of world trade, growth of the world economy, and resolution of the international debt problem.

Whether measured in nominal or in real terms, the dollar's appreciation over the last four years has been stunning. The dollar's rise since the fourth quarter of 1980 comes to about 75 percent on the trade-weighted index of the dollar's value against the other G-10 currencies that is used at the Federal Reserve Board. This figure somewhat overstates the gain in the dollar's relative purchasing power because inflation has proceeded more rapidly on average abroad than in the United States. In real terms -- adjusted, that is, for changes in consumer price levels here and abroad -- the trade-weighted value of the dollar has increased nearly 70 percent, still a very large figure.

While the extent of the dollar's climb has been remarkable, to be sure, perhaps the most striking feature of the dollar's rise is the fact that it has continued even as the U.S. deficits on trade and current account have expanded to unprecedented magnitudes. The persistence of this combination of developments points to a complex of causes for the dollar's appreciation.

The dollar has derived its strength in part from the historically high level of dollar interest rates relative to the recent rate of inflation in the United States. There can be little doubt that high real interest rates are at least partly attributable to enormous current and prospective deficits in the U.S. government's budget. The enhancement of tax incentives for investment by U.S. firms in the early 1980s likely contributed, as well, to increased demands for credit and upward pressure on U.S. interest rates. Technological change also may have helped boost investment demand.

According to econometric work at the Board, however, differentials between real interest rates on dollar assets and those on assets denominated in other currencies explain only a little more than half of the rise in the dollar's real exchange rate over the last four years. While any such estimate must be regarded as imprecise, it seems fair to conclude that a substantial portion of the dollar's rise is attributable to influences other than real interest-rate differentials. Investors apparently have come to desire that a larger proportion of their wealth be in dollar-denominated claims for any given differential in real interest rates.

Several factors may account for this apparent shift in investor attitudes. The vigor and dynamism of the U.S. economy have contrasted favorably with economic performance elsewhere, especially in Europe. A demonstrated U.S. commitment to improve price stability has eased concern that a resumption of rapid inflation might erode real returns on dollar assets. The political and social, as well as economic, stability of the United States has made this country a relatively secure place in which savers may want to keep their wealth. Meanwhile, instability elsewhere, particularly in debt-burdened developing countries, has discouraged further foreign lending to those nations and has prompted capital flight from which the United States has probably benefitted disproportionately.

As I turn now to the effects of the strong dollar, I think it is important to emphasize at the outset that I am really speaking of the consequences that flow from the policies and other developments both in the United States and abroad that have raised the dollar's value. The exchange rate, per se, is merely a transmission mechanism through which the U.S. economy influences the rest of the world and vice versa. Insufficient attention to this fact, I believe, has at times produced some confusion in domestic and international debate on economic policy.

In the United States, the dollar's appreciation has helped bring down inflation and keep it low during one of the strongest economic recoveries of the postwar period. The dollar's rise has held down both the cost of imported inputs and prices in industries whose products compete with imports. This effect has kept the overall pace of inflation below the rate of price increase in sectors producing nontraded goods and services. According to Board staff estimates, the increase in the exchange rate over the last four years, if not reversed, will ultimately reduce the level of prices by roughly 5 to 7 percent. This effect on the price level, which has been spread out over several years, has depressed the measured annual inflation rate by about 1-1/2 percent. If the dollar were to stay at its present value, the effects of its appreciation to date would be preserved in the U.S. price level, but the depressive effect on the inflation rate would not continue.

By holding down the observed rate of price increase, the dollar's advance has helped greatly to alter the inflationary psychology prevalent in the United States in the 1970s. The dollar's appreciation has reduced the cost in lost U.S. output and employment that might otherwise have been necessary to accomplish the dampening of inflation expectations that has occurred. In the process, it has given the Federal Reserve somewhat greater flexibility in the implementation of monetary policy, but only for a time. When the dollar's climb ends -- and it may have already -- its moderating influence on the U.S. inflation rate also will cease, with some lag. Vigilance against a pickup in inflation and a possible resurgence of inflation expectations then will be especially important, and it will be all the more crucial should the dollar depreciate, as seems likely eventually.

Abroad, the price effects of the dollar's strength generally have been adverse, though perhaps not from the point of view of producers for export. Foreign-currency prices of many traded goods have tended to rise relative to prices of other goods and have exerted upward pressure on general price levels. In order to limit increases in measured inflation rates and the potential increase in inflation expectations that might ensue, many governments, it appears, have pursued more restrictive policies than they might have otherwise. The associated slack in domestic demand has held down prices in nontraded goods sectors and to some extent also in world markets for basic commodities, thereby limiting increases in average price levels, but at the cost of lost production for domestic use, static employment, and high unemployment. This, along with other considerations, suggests that the benefits that the rest of the world derives from the United States' stimulative policies can be overstated.

It is true that the rapid growth of the U.S. economy and the appreciation of the dollar, by enlarging U.S. trade and current account deficits, have provided a major force for expansion in the rest of the world. Growth of demand in the United States represented 70 percent of the total growth of demand in the OECD area from 1982 to 1984, even though we accounted for only 40 percent of OECD GNP in 1982. This is to say, the United States accounted disproportionately for the increase in OECD demand in this recovery.

U.S. demand for the exports of developing countries, in particular, has been of critical importance to their difficult process of adjustment. U.S. imports from non-OPEC developing countries expanded nearly 40 percent from 1982 to 1984, accounting for about half of the total increase in these countries' exports. The U.S. contribution to adjustment has helped to stabilize the world financial system generally.

The United States also has provided powerful stimulus to industrial countries. U.S. imports from Western Europe, for example, rose 35 percent from 1982 to 1984. U.S. imports from Sweden, in particular, rose nearly 65 percent. In the case of our industrial trading partners, however, stimulus from the United States, while welcome, also has had some negative side-effects. As I noted earlier, the United States' expansionary fiscal policy may have induced other countries to exercise greater restraint than was otherwise desirable. Moreover, forms of stimulus other than demand from the United States might have been more beneficial to economies abroad — for example, enhancement of incentives for investment in these economies.

In addition, the shift in investor attitudes that apparently has helped boost the dollar has simultaneously exerted upward pressure on interest rates abroad, tending to discourage interest-sensitive expenditure. This reduction in domestic demand has subsequently been offset to some extent, of course, by export demand from the United States. By boosting the dollar and exports, the shift in asset demands has brought a partial cure for its ill effects on economies abroad. But the cure is only partial. While total demand for the production of foreign economies tends to be sustained by exports, investment and other interest-sensitive expenditures tend to remain depressed. It is not surprising, therefore, that foreign governments are dissatisfied with the dollar's strength despite resultant improvements in their trade and current account balances. At the same time, it seems, the proper response to the shift in investor attitudes is not for the United States to make dollar assets less attractive, but rather for other countries to make their economies more attractive by ameliorating structural rigidities, by enhancing incentives, and maybe in certain cases by stimulating their economies more directly. In this regard, Sweden's 1982 actions to trim marginal income tax rates and its recent decision to liberalize entry for foreign banks appear to be helpful steps.

The counterpart to the U.S. current account deficit, the growing net inflow of capital to the United States, has been a critically important factor in enabling the United States to finance both rising investment and its enormous federal deficit. Foreign capital has supplemented the domestic savings of individuals, businesses, and state and local governments by nearly one third and has helped keep U.S. interest rates lower than they otherwise would have been. The federal budget deficit consequently has crowded out less domestic private investment than it might have. Instead, crowding-out effects have fallen partially on investment in the rest of the world as the United States has taken a greater share of available capital.

This result has not been unambiguously beneficial to the United States. We have become increasingly dependent on funding from abroad, and were dollar assets suddenly to fall into disfavor, we would suffer a painful adjustment. In addition, the dollar's strength has imposed severe strains on the export and import-competing sectors of our economy at the same time that it has benefitted those sectors of foreign economies. While in macroeconomic terms the resultant loss of jobs in our traded-goods industries largely has been offset by the creation of new jobs in other sectors, complaints at the microeconomic level of specific industries and communities are understandable. Moreover, sectoral shifts both here and abroad are to be regretted to the extent that they represent a distortion induced by U.S. fiscal imbalance. Indeed, it is difficult to believe that the world's productive resources are being allocated efficiently when U.S. federal borrowing absorbs a flow of credit greater than the large net capital inflow to the United States, and when a consensus is lacking in the United States for the possible future sacrifice of consumption and investment that may be necessary to service a prospectively large external debt incurred at high real interest rates.

By holding down U.S. interest rates, capital inflows to the United States probably have obscured the urgency of dealing with our federal budget deficit. I am hopeful that an earnest reassessment of U.S. fiscal policy is now in train and that a substantial reduction in the budget deficit is being sought. Economic analysis and common sense tell us that budgetary and trade deficits of the magnitude we are running are not sustainable indefinitely. If left unchecked, these deficits sooner or later will impair confidence in our economy and undermine our growth and prosperity.

Correction of our fiscal imbalance is the appropriate way to alleviate strains on our export sector and on our import-competing industries. By lowering U.S. interest rates over time, reduction of the federal deficit also would tend to bring the dollar's value down and thereby make U.S. goods more competitive in world markets. Correspondingly, foreign producers of traded goods would experience pressure on their market shares and profits. But a reduction in U.S. credit demands would promote investment abroad. All in all, global welfare probably would increase through an improvement in the allocation of resources.

Protectionist measures are not the proper solution to the strains imposed by the dollar's high value. Indeed, measures that are now being proposed in the United States are likely to do serious harm. For instance, if such measures reduced U.S. imports from developing countries, they would severely impair those countries' ability to service their debt. Even if we could somehow shield developing countries by exempting them from import restraints, there are other severe economic costs to protectionism. Quotas, tariffs, or import surcharges all would act directly to raise U.S. prices. This problem might be compounded by a renewal of inflation expectations, undoing some of the progress that has been made on this front. Ironically, if the fundamental sources of the dollar's strength were not addressed, then protectionist measures that effectively reduced some imports probably would put additional upward pressures on the dollar, which in turn would further hurt U.S. exporters and unprotected industries. Moreover, protectionist action by the United States would invite retaliation by foreign countries and a breakdown of the world trading order built up through great effort since the 1930s. In this event, the world generally would suffer.

Looking ahead, a further upward move in the dollar's value would give additional impetus to expansion of the U.S. trade and current account deficits and corresponding surpluses abroad. Even if the dollar were to stabilize around recent levels, the lagged effects of its appreciation to date would include some further widening of our external deficits. In all likelihood, the cumulation of claims on the United States should eventually reduce demand for additional dollar assets, causing the dollar gradually to decline in value. Depreciation of the dollar, in turn, would tend over time to shrink the U.S. deficits on trade and current account. Action to reduce the federal budget deficit would promote external, as well as internal, balance.

A sharp depreciation of the dollar would be very disruptive both in the United States and abroad, but especially to this economy. As the dollar's fall curtailed U.S. imports, foreign exporters to the United States would find their production capacity underutilized. This possibility has engendered legitimate concern abroad that the dollar's current strength may be encouraging overexpansion of export industries. While a substantial drop in the dollar's value would reduce foreign surpluses in trade with the United States, net capital outflows from foreign economies also would diminish, by definition. This would alleviate financial strains in those countries, provided monetary policies were accommodative. For the United States, on the other hand, a sharp reversal in the dollar's value would tend to exert strong upward pressure on prices as well as interest rates. The pressures of federal credit demands, notably, instead of being vented abroad, would fall more heavily on the domestic private sector.

Let us hope that the potential for such an unpleasant scenario is not realized. Let us hope that a crisis is not needed to motivate a correction of the U.S. fiscal imbalance. By addressing this problem now, the United States can help to restore world trade and capital flows to a more reasonable pattern. Foreign governments also can help by fostering growth and efficiency in their own economies.