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Economics

3-5-1984

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Recommended Citation

Edelman, Mark A., "Understanding The Exchange Value of the Dollar" (1984). *Economics Commentator*. Paper 203.
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Economics Newsletter

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No. 207

March 5, 1984



UNDERSTANDING THE EXCHANGE VALUE OF THE DOLLAR

by
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Recently, no factor has been more important to the health and wealth of agriculture than the exchange value of the dollar in international trade. The purposes of this newsletter are to (1) review recent trends in exchange rates, (2) explore the consequences and causes of these trends, and (3) analyze the policy options for altering the exchange value of the dollar.

WHAT'S HAPPENED TO THE VALUE OF THE DOLLAR?

The Federal Reserve Board publishes a measure of the general exchange value of the U.S. dollar. This index compares the dollar to a composite of currencies representing Germany, Japan, France, England, Canada, Italy, Netherlands, Belgium, Sweden, and Switzerland. The respective exchange rates between the U.S. dollar and each foreign currency are weighted by the respective shares of global trade for a base period of 1972-1976. In Figure 1,

the monthly indices for the exchange value of the dollar are listed for the past 15 years. The March 1973 index value equals 100.0.

These data show the 1983 annual average index value to be 125.3. This means that in 1983 the dollar exchanged for 25 percent more Japanese Yen, German Marks, and other currencies than it did in March 1973. Notice that the present index value is at a 15 year high point. This means that the dollar is stronger than at any other time since 1968.

Also, we can see that the exchange rate index hit a 15 year low during July 1980. The annual average index value for 1980 was 87.4. So, from 1980 to the present peak, the value of the dollar has risen by 37 percent, according to the Federal Reserve index.

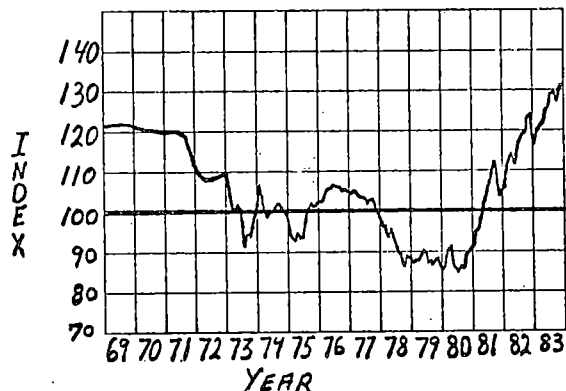
WHAT ARE THE CONSEQUENCES of a rapidly changing exchange value of the dollar?

From the figure, we see that the value of the dollar declined by about 20 percent during the early 1970's. When the dollar declined in value, our exports automatically became 20 percent cheaper for our foreign customers. Imports into the U.S. became 20 percent more expensive. As a result, U.S. consumers experienced higher prices in the short run.

The devaluation of the dollar and the warming of East-West relations were the two key factors that set the stage for rapid expansion of agricultural exports during the early 1970's. As a result, the declining value of the dollar was one of the major reasons that U.S. agriculture experienced record income during the 1970's.

Now during the 1980's, the value of the dollar has risen by more than a third. As the value of the dollar increased relative to other currencies, our exports automatically became a third more expensive for our foreign customers compared to our competition. Also, imports into the U.S. became a third

Figure 1. Index of the Trade-Weighted Exchange Value of the U.S. Dollar, 1969-83.



Source: Federal Reserve Bulletins, Board of Governors, Federal Reserve System, selected months.

cheaper for U.S. consumers compared to U.S. produced goods that compete with imports.

In view of the recent rise in the value of the dollar, it is easy to see why the bloom is off the export market. Total U.S. exports declined 13 percent from \$229 billion in 1981 to \$200 billion in 1983. During the same period, agricultural exports declined 20 percent from \$43.8 billion to \$34.8 billion. However, total U.S. imports increased 6 percent from \$254 billion to \$270 billion and agricultural imports remained about the same at \$15 to \$17 billion.

Not surprisingly, agricultural and non-agricultural exporters are calling for export expansion subsidies. Also, an increasing number of U.S. industries that compete with imports are clamoring for import protection. For example, steel, shoes, and copper have recently petitioned the International Trade Commission to restrict U.S. imports.

A rising dollar forces us to re-allocate resources and labor in the trade sectors and between the trade and non-trade sectors of our economy. These adjustments are not painless. They mean that profits, wages, and employment potential decline in export sectors and in domestic sectors that compete with imports. If the value of the dollar remains strong, agricultural exports and incomes are likely to remain soft.

WHAT CAUSES THE VALUE OF THE DOLLAR TO CHANGE? In general, three factors heavily influence exchange rates: (1) real interest rates, (2) political and economic stability around the world and (3) the balance of trade.

REAL INTEREST RATES are simply a measure of actual interest rates minus the inflation rate. If the inflation rate is greater than the interest rate, savers have no incentive to save. Savers receive an increasing incentive to save as actual interest rates rise higher and higher above the inflation rate.

Table 1 compares the real interest rates of the major trade currency nations between 1979 and the first half of 1983. The table shows that the U.S. has

shifted from negative real interest rates in 1979 to the highest real interest rates in the world since 1982.

Table 1. Estimated Real Interest Rates, 1979-83.

Country	1979	1980	1981	1982	1983 ^a
U.S.	-.10	-.14	5.98	6.06	5.48
Germany	2.59	4.04	6.21	3.58	2.07
Japan	2.65	-0.75	2.79	4.52	4.54
France	-1.32	-1.10	1.96	2.63	3.43
Canada	2.58	2.60	5.32	2.84	3.57
U.K.	.19	-1.90	1.39	2.97	5.03

^a For first half of 1983 only.

Source: Annual Report 1983 and International Financial Statistics, International Monetary Fund, August, 1983.

Very simply, the wealth around the world tends to travel to where it can receive the highest real return on investment. Since 1981, the U.S. has been that location. In order to invest in the U.S., foreign interests must acquire dollars in the international money markets. This puts upward pressure on the exchange value of the dollar.

Second, **WORLD DEBT PROBLEMS**, the **WORLD RECESSION**, and a rise in **POLITICAL INSTABILITY** around the world tend to encourage wealthy interests to locate part of their holdings in "safe havens". Foreign interests act to protect their wealth by placing it in a "safe" currency. This protects their wealth even though their home country may be going through economic and political chaos. Because the U.S. is a "safe haven" for international wealth, many foreign interests have been acquiring dollars.

Third, the U.S. experienced a record **TRADE DEFICIT** in 1983. A trade deficit means that we have been importing more than we have been exporting. During 1983, total U.S. exports were \$200 billion, total U.S. imports were \$270 billion, and so our trade deficit was \$70 billion.

To put U.S. agricultural trade in perspective, total agricultural exports

amounted to \$34.8 billion or only half of the overall trade deficit. Total agricultural imports were \$16.4 billion, so the agricultural trade balance showed an \$18.4 billion surplus. The agricultural trade surplus is important to the degree that it contributes to reducing the overall trade deficit.

Generally, large overall trade deficits put downward pressure on the exchange value of the dollar. When we import more than we export, dollars flow out of the U.S. to cover the full payment for imports. This adds to the supply of dollars in the international money markets and tends to put downward pressure on the exchange value of the dollar.

In the last four years, the rising value of the dollar indicates that the influence of our high real interest rates and the "safe haven" incentive have been stronger than the impact of the increasing trade deficit. As the trade deficit continues to grow, this picture could change and the value of the dollar could decline somewhat. Some trade experts are predicting the trade deficit to rise above \$100 billion for the current year.

Most recently, the value of the dollar has declined from a peak in January to the level experienced last fall. However, the present level is still over a third higher relative to 1980 levels. The future direction of our exchange rate depends upon developments in real interest rates, world stability and trade deficits. Any rapid changes in these factors would heavily influence the exchange value of the dollar.

WHAT ARE THE POLICY OPTIONS for coping with the rising value of the dollar? Assume for the moment that your goal is to lower the exchange value of the dollar. This is a big assumption because some special interests benefit from a rising dollar. But let's make this assumption anyway. In lowering the exchange value of the dollar, there are seven policy options to consider:

1. We could re-inflate the economy to lower our real interest rates and flood the international money markets

with dollars. Up to now, the Federal Reserve Board has vowed to continue to fight inflation in order to preserve our nation's long-term economic stability.

2. We could have the other major currency nations follow tighter monetary policies to increase their real interest rates and make their currencies stronger. This approach has already been suggested to our allies. Their initial response was for us to not meddle in their internal economic policy affairs and to cut our Federal budget deficit first.

3. We could target foreign aid and foreign policy to reduce political and economic instability around the world. This approach is sometimes easier said than done.

4. We could adopt import restrictions and export expansion subsidies to offset the rising value of the dollar. This approach may sound good to the special interest groups involved, but is not likely to survive for long. Efforts to restrict imports are bound to conflict with efforts to expand exports because potential customers will refuse our exports unless we accept their imports.

5. We could lower our real interest rates by cutting the Federal budget deficit, or cutting tax incentives for private borrowers, or increasing tax incentives for private savers. These approaches are difficult for our national political decision-makers to accomplish in an election year.

6. We could tax foreign investment in the United States to reduce the demand for dollars in the international money markets. This option would tend to put upward pressure on our interest rates in the short run because the pool of loanable funds for credit would be reduced.

7. We could do nothing and allow the increasing trade deficit and/or the risk of recession or inflation to lower our exchange rates. These market factors are likely to bring the value of the dollar down somewhat, unless interest rates climb or political instability around the world rapidly rises.

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In the final analysis, there are some tough economic trade-offs involved. The final option selected must be politically feasible in addition to economically sound. The political feasibility depends upon the political clout of special interests and the public's understanding of the consequences of each option.

It is important to recognize that all of the above options--except (#4) trade restrictions and subsidies and (#7) do nothing--involve policies that are beyond the traditional political domain and control of any one individual special interest group. If agriculture wishes to be politically successful in reducing the value of the dollar to help stimulate exports and/or reduce import incentives, then agricultural interests must go beyond the traditional scope of agriculture and food policy and look at macro-economic policies. To lower the exchange value of the dollar, agricultural interests would have to pool their political clout with other interests like steel, autos, and textiles that are also concerned about the dollar's exchange rate rise.

SDSU AGRI-BUSINESS DAY PROGRAM

TIME: 8:30 A.M. Thursday, March 29, 1984
PLACE: Stauroilite Inn, Brookings, S.D.

The Twenty-Second Annual Agri-Business Day Program will focus on "The Future of Agricultural Finance in South

Dakota". The program includes the following presentations:

"Critical Issues - Agri-Business Financial Services", John E. Thompson, Head of SDSU Economics Dept.

"The Need for Agricultural Marketing and Financial Management Services - Past, Present, and Future", C.P. "Buck" Moore, President Region VI Norwest Corp.

"Farm Management Services - Relationship to Agricultural Finance and the University", Maurice Miller, V.P. Corp. Planning, Cenex

"Credit and Farm Related Services as Viewed by a Farm Lender", James C. Heiser, Sr. V.P. PCA/OFI Operations, Fed. Intermediate Credit Bank of Omaha

"Marketing and Financial Management - Relationship to Credit Services", D.M. Hitterdal, Doane Farm Management Co.

"Independent Bankers' Point of View", Robert Fishback President Brookings First National Bank

"Farm Services Required to Effectively Use Borrowed Capital", Dennis Michael, Yankton Farmer

"Agricultural Credit: Possible Alternatives and Innovations", Brian Schmiesing, SDSU Economics Dept.

A \$10 registration fee includes a noon luncheon and the Proceedings.