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THIRTEEN MYTHS OF A STRONG DOLLAR

INTRODUCTION

The U.S. dollar continues to soar on world money markets. It has gained in relation to the once mighty trio of the West German mark, Japanese yen, and Swiss franc. It has humbled the British pound, French franc, Canadian dollar, and Italian lira. Once again, the greenback appears to be everyone's favorite currency.

For many, this popularity brings problems and is not seen as a sign of U.S. economic health. U.S. exporters see the dollar's strength as a threat, since the decrease in the value of foreign currencies against the dollar means that more foreign funds are required to purchase U.S. goods. This inhibits U.S. exports and, it is maintained, has created a U.S. trade deficit of over $100 billion for this year. Such U.S. industries as automobiles, steel, textiles, and shoes see the dollar's strength as prompting increased sales of less expensive imports at the expense of the domestic producers.

Still others view the dollar's strength as an indication of serious problems with the international monetary order. The commentators argue that the demise of the fixed exchange rates and their replacement by floating rates have caused frequent destabilizing shifts in exchange rates, greatly hindering international economic activity. They insist that a new international monetary order be established to restore tranquility to international trade.

The trouble is, the notion that the strong dollar is a problem rests on myths--a baker's dozen, at least. These myths must be demystified and rejected so that attempts to "solve" the dollar "problem" do not inflict serious damage on the U.S. economy.

MYTH 1: THE DOLLAR IS OVERVALUED.

The value of floating currency such as the dollar is determined by market forces of supply and demand. Between late 1980 and 1984, strong demand for the dollar pushed up its value by 30 percent against the Swiss franc, 40 percent against the British pound, 50 percent against the German mark, and over 100 percent against the French franc.[1] The notion that the dollar is "overvalued" suggests that some "natural" value of the dollar is lower than the market value and that its current strength is artificial. The dollar's value, in fact, reflects the underlying conditions of the U.S. economy and the degree of international confidence in U.S. political stability and long-term economic health. In this sense, the dollar exchange rate is always "correct," responding as it does to the demand for trade and the investment in dollars.

In the mid-1970s, rampant inflation, the debacle in Vietnam, the spectacle of an American president being chased from office, the sudden surge in oil prices, and other factors made the American political and economic system appear fragile. The U.S. was on the retreat on many fronts. And accordingly, the dollar seemed less attractive and less secure for investors and lenders. The Reagan years have done much to erase this pessimism. Today, a robust dollar reflects America's political stability, economic strength, productivity, and high return on direct investment that have been spurred by policies rewarding private initiative and entrepreneurship. The U.S. today is viewed by investors as a safe haven, and the dollar, as a secure store of value.

Economic and noneconomic factors thus contribute to the dollar's current strength. Far from being artificial or excessive, the strong dollar is linked directly to the strong U.S. economy and mirrors international confidence in U.S. economic and political stability, a rarity in today's world.

MYTH 2: THE U.S. BUDGET DEFICIT KEEPS THE DOLLAR HIGH.

Arguments that the budget deficit pushes up interest rates and that high interest rates account for the strength of the dollar ignore two facts:

1) There are no hard data or statistical evidence to verify what is only an instinctive feeling that budget deficits are linked to high interest rates. Explains economist Thomas M. Humbert:

> From mid-1981 to the present [January 1984], the Treasury bill rate dropped to 9 percent from a 15 percent peak.

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[1] Arthur Burns, "The American Trade Deficit in Perspective," Foreign Affairs, Summer 1984, p. 1059.

> This large drop occurred at the same time that deficits rose from $110 billion to nearly $200 billion. U.S. real interest rates (that is, adjusted for inflation) also dropped between 1981 and 1983, although erratically.[2]

In his report, Humbert cites studies finding little direct and certain correlation between budget deficits and interest rates. Interest rates, note Humbert and others, are dependent on factors much more telling than federal deficits, such as business expectations, industrial productivity, and the size of the government budget.

2) Even if there were some causal link between deficits and interest rates, high interest rates would be only a partial cause of the strength of any currency. Prospects for return on direct investment and other considerations are more important determinants of exchange rates. In fact, some countries with high interest rates have weak currencies. The prime lending rate charged by commercial banks in France, for instance, is currently about 12 percent, and in Italy, the figure is 18 percent.[3] Both are above the U.S. prime rate. Yet the franc and the lira have dropped sharply in value over the last few years. The general strength of an economy, its business climate, entrepreneurial opportunities, and similar factors evidently are more important than interest rates in determining international exchange rates.

MYTH 3: THE CURRENT STRENGTH OF THE DOLLAR IS UNPRECEDENTED.

Compared to the late 1970s, today's dollar does seem high. But there is no reason to use that period as a baseline in measuring the dollar. Indeed, despite its recent surge, the dollar barely has regained the ground lost during the 1970s. In 1970, for instance, the dollar bought 4 West German marks, 4.3 Swiss francs, and 370 Japanese yen. During the 1970s, the U.S. weakened the dollar considerably by excessive monetary expansion. Meanwhile, oil shocks, U.S. wage and price controls, and Watergate, among other factors, made the U.S. economic and business climate less attractive. The dollar began plunging, and by 1980, many believed that it would remain a "weak" currency. That year the dollar bought only 1.7 German marks, 4.2 French francs, 1.65 Swiss francs, and 225 Yen. Now the dollar buys over 3 marks, over 9 French francs, 2.50 Swiss francs, and 245 yen. However, when the exchange rate of the dollar is stated in terms of special drawing rights (SDRs), a weighted group of currencies used by the International Monetary Fund as an economic benchmark, the dollar in 1984 merely equals its 1970 strength.[4] If the value of the

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[2] Thomas M. Humbert, "Understanding the Federal Deficit. Part 3: The Unproven Impact," Heritage Foundation Backgrounder No. 330, January 27, 1984, p. 7.

[3] The Economist, November 24-30, 1984, p. 118.

[4] The Economist, October 20-26, 1984, p. 108.

dollar levels off, or even drops slightly, it will fall below its 1970 level.

MYTH 4: THE STRONG DOLLAR INDICATES A SERIOUS PROBLEM OR WEAKNESS IN THE U.S. ECONOMY.

The opposite is true. The strength of the dollar is due in large part to the robust U.S. economy. The recovery in the U.S. was solid and moved swiftly into expansion, while inflation has dipped dramatically and remains low. Unemployment has declined, the U.S. economy has created over seven million new jobs since 1980, and interest rates are below their level of the late 1970s. Even with interest rates higher than in the early 1970s, the recovery has moved ahead strongly, and faster than in most other industrialized countries. Consequently, foreigners continue to demand dollars so that they can invest in the U.S. economy. They find it very profitable to share in the strong U.S. recovery by borrowing or buying dollars, even at high exchange rates.

MYTH 5: THE STRONG DOLLAR HINDERS THE RECOVERY IN EUROPE.

This notion reverses cause and effect. It is the sluggish European recovery that has made the U.S. economy attractive to investors and thereby contributes to the dollar's strength.

Reagan Administration measures that improve the climate for business boost foreign confidence in the U.S. economy. Toyoo Gyohten of the Japanese Finance Ministry notes that "the dollar is a symbol of America's political and economic strength." Fritz Leutwiler of the Swiss National Bank adds that "The U.S. is seen by investors as young, flexible, and dynamic and Europe old, sclerotic, and much less flexible. It's not just psychological. I think the reasoning behind [the dollar's rise] is quite correct."[5]

At the London economic summit of June 1984, European leaders marveled at America's economic vitality, its ability to create jobs, and its "entrepreneurial spirit."[6] In contrast, reports the London Economist, "Young, innovative European firms labor under crippling burdens that their American and Japanese counterparts do not have."[7] The respective strengths of the economies and currencies of the U.S. and Europe reflect, in large part, the wisdom or folly of their respective domestic economic policies.

The strength of the dollar, moreover, allows Europeans to export large quantities of goods to the U.S. In this sense,

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5 "The Superdollar," Business Week, October 8, 1984, p. 167.

6 Hobart Rowen, "Jobs Issue Enhances U.S. Clout at Summit, Official Says French 'Cannot Get Over It,'" The Washington Post, June 11, 1984, p. A1.

7 "Europe's Technology Gap," The Economist, November 24-30, 1984, p. 95.

America's record imports are serving as a locomotive for Western Europe's economic recovery. On the other hand, capital flight from Europe slows its recovery. But such flight and the strong dollar are the results of unwise economic policies, not the cause of European weakness. Indeed, it would appear that West Europeans prefer to blame the U.S. for their troubles. When the dollar was falling in the late 1970s, Europeans complained bitterly that this was damaging their economies seriously.

MYTH 6: THE STRONG DOLLAR TRIGGERED THIRD WORLD DEBT.

The strong dollar harms less developed countries, it is said, since debts to U.S. banks must be paid in "expensive" dollars and interest payments on loans often are tied to U.S. interest rates. Though this argument contains some truth, it overlooks the deeper causes of the problem. Many debtor countries borrowed dollars recklessly, gambling that inflation would continue to weaken the dollar and hence reduce the value of their debts. The sharp drop in U.S. inflation means that they bet wrong and now must pay off loans in noninflated money.

The root of the problem is the nature of the borrowing and investment policies of the developing countries--not American success in controlling inflation. For example, South Korea's debt of $40 billion ranks just below the $44 billion figure for Argentina. Yet South Korea has managed its borrowing and investment carefully and constructively and is paying both interest and principal on schedule.[8] On the other hand, Argentina and many other countries used borrowed funds to finance excessive consumption, high wages for state bureaucrats, graft for corrupt politicians, and bailout money for failing state-owned or operated enterprises.[9] The strength of the dollar has only aggravated the underlying weakness of such flawed policies. A weaker dollar might ease pressures on debtor countries, but it would not solve the debt crisis. More fundamental changes must be made.

The strong dollar, of course, also offers opportunities to debtor countries. With a strong dollar, debtor countries can export goods much more readily to the U.S. and thus earn valuable foreign exchange.

MYTH 7: THE INFLUX OF FOREIGN CAPITAL ENDANGERS THE U.S. ECONOMY.

The strength of the U.S. economy has attracted considerable foreign investment. Reports Business Week,

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8 "World Debt In Crisis: Watch List," Wall Street Journal, June 23, 1984, p. 37.

9 See Edward L. Hudgins, "Four Steps to Resolve the Argentine Debt Crisis," Heritage Foundation Backgrounder No. 365, July 10, 1984.

> Total private foreign investment in the U.S. is expected to rise to $715 billion this year, up from $597 billion in 1983 and $533 billion in 1982....Foreign purchase of U.S. Treasury securities totaled $6.5 billion in the second quarter, roughly twice the previous record quarterly rate.[10]

Some economists warn that American interest rates have encouraged capital flow into the U.S., making the U.S. dependent on "footloose" foreign capital, which suddenly could be withdrawn. The general fear of foreign capital dependency is groundless economically. Most countries have relied on foreign capital at critical stages of economic expansion. Until this century, the U.S. depended on British capital to build railroads and other heavy industry. The pound sterling also funded development in Germany, Argentina, and many other countries. Later, German capital played a similarly important development role. After World War II, dollar investments throughout the world led to worldwide economic growth.

There is nothing disturbing, therefore, about overseas investors having confidence in the U.S. economy. Direct capital investment, from whatever source, is in the economic interest of the recipient. Indeed, such investment is modernizing many U.S. industries, making them much more efficient and internationally competitive.

MYTH 8: AN ABRUPT DROP IN THE DOLLAR'S STRENGTH COULD DISRUPT THE U.S. ECONOMY.

Some economists argue that, even if foreign investment is good for America, an abrupt drop in interest rates or the dollar's strength could prompt a sudden exodus of foreign capital. This could cause serious economic disruption, they claim, undermining attempts to finance the budget deficit with foreign funds and thus forcing Treasury borrowers to compete more directly than they have been with private sources of capital.

Such a drop is very unlikely. The dollar's strength and the corresponding desire to invest in America are due in large part to the strength of the U.S. economy. Unless Washington raises taxes or the Federal Reserve Board strangles the economy by restrictive monetary policy, the U.S. economy almost surely will remain sound. And since investment opportunities elsewhere in the world will develop only gradually, as other economies begin to revive, an abrupt capital flight from the U.S. is unlikely.

Other factors will stabilize the value of the dollar. The dollar is the dominant international currency, for example, used

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10 Business Week, op. cit.

as a reserve and store of value in most central banks. Oil purchases must usually be paid for in dollars, and in countries with serious monetary problems, the dollar has become an alternative currency. In Argentina, for instance, one banker estimates that enough black market dollars may be circulating to pay off the country's $44 billion national debt.[11] This reserve status of the dollar means that it enjoys considerable immunity from sudden changes in the strength of the U.S. economy.

MYTH 9: THE STRONG DOLLAR LURES CHEAP FOREIGN GOODS INTO THE U.S., HARMING THE ECONOMY.

The strong dollar indeed allows Americans to purchase foreign products more easily and at lower relative cost than if the dollar were weak. But far from harming the U.S. economy, this helps it. For one thing, it helps keep inflation down. For another, when Americans spend less money on foreign goods, they have money left over for other purchases. The dollar's strength also means that consumers receive more goods while paying out less of their income. Competition from imports, meanwhile, helps keep down the prices of domestically produced goods. U.S. industries must seek more efficient production methods and must cut costs to compete with imports. In the case of export firms, such action has made production leaner and more innovative, laying the foundations for a more efficient export sector.

MYTH 10: THE STRONG U.S. DOLLAR HARMS U.S. INDUSTRY.

Any economic condition affects various sectors of the economy differently. The dollar's strength, for example, makes it more difficult for certain U.S. industries, such as textiles and steel, to compete with foreign goods. Many export-oriented industries similarly suffer. On the other hand, those industries purchasing imported raw materials or capital goods do so at a bargain, thanks to the dollar's strength. This can lower their production costs and sale price. Example: industries using steel as a primary component of their product (such as autos, major appliances, and farm machinery) benefit from purchasing less expensive steel. All import-dependent industries benefit. Just as U.S. consumers benefit from the increased purchasing power of the dollar, so too do many U.S. industries--thereby creating jobs and wealth.

MYTH 11: THE STRONG DOLLAR LEADS TO THE "DEINDUSTRIALIZATION" OF AMERICA, BECAUSE OF CHEAP FOREIGN GOODS.

It sometimes is argued that all but a handful of U.S. industries eventually will be destroyed by cheap imports. The U.S.

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[11] Jackson Diehl, "Shopping Sprees, Speculation Help Argentines Survive Inflation," The Washington Post, September 4, 1984, p. A13.

will be left with a "service" economy, it is said, with most people working as poorly paid sales clerks. In short, the industrial base will be destroyed.

The fact is, however, that the strong purchasing power of the dollar frees capital for investment, research and development, the modernization of existing industries, and the creation of new industries. Business Week reports that the strong dollar:

> is leading to changes that will gradually improve the U.S. competitive position, even against the Japanese. Last year alone, $11.3 billion of foreign investment went directly into plant and equipment and $6.4 billion into the stock market. These billions are making an enormous contribution to rebuilding the industrial structure that will make the U.S. more competitive.[12]

The positive industrial effects of the strong dollar already are beginning to be felt. A St. Louis Federal Reserve Bank study, for instance, reports that U.S. export growth has been more rapid in this economic expansion than in the 1975-1976 and 1980-1981 upturns.[13]

MYTH 12: THE STRONG DOLLAR CREATES U.S. UNEMPLOYMENT.

The evidence is to the contrary. As the strength of the dollar in foreign exchange has increased, unemployment in the U.S. has decreased. The U.S. economy has created over seven million new jobs since 1980. Yet in Western Europe, with its lower valued currencies, from two to three million jobs have been lost in the past decade, and unemployment is viewed as a long-term problem.[14]

The stronger dollar, of course, has reduced employment in some export-oriented industries, though industries using imports have fared well. The root of the problem in many heavy industries, however, is that workers are making wages much higher than the market can handle. In these cases the strong dollar is only one cause of the problem, at most, accelerating fundamental realignment in the world economy.

MYTH 13: A WEAKER DOLLAR WILL HELP U.S. EXPORTERS.

A weaker dollar would not necessarily help U.S. exporters in the short run. Trade adjustment tends to lag behind changes in exchange rates. According to a Congressional Research Service study:

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12 Business Week, op. cit.
13 Ibid.
14 Lawrence Ingrassia, "Persistent Joblessness Still Troubles Europe in Wake of Recession," Wall Street Journal, November 13, 1984, p. 1.

> If the quantitative response to lower foreign prices is slight in the short run, the proportionate increase in the quantity of exports [by U.S. companies] will be smaller than the proportionate fall in price [of U.S. export goods], and less foreign exchange will be earned from export sales after the depreciation than before.[15]

In other words, since export sales and revenue tend to lag behind currency depreciation and export earnings at current trade levels, the chances are that export earnings would drop with currency depreciation. The CRS study suggests that this so-called "J curve" effect could last as long as two years.

It is far from certain, moreover, that a weaker dollar would aid American exporters in the long run. Explains economist A. Wilmots-Vandendaele:

> From 1976 to 1978, despite the plummeting dollar, the U.S. trade gap widened: It jumped from $17 billion to $40 billion and from then until 1982 remained in the range of $36 billion to $42 billion while the greenback lost 31 percent in value to the yen, 21 percent to the mark, and 6 percent to the pound and the franc.[16]

A weaker dollar might help particular export firms in the long run, but it is questionable whether the U.S. export sector as a whole would gain. The nature of foreign demand would determine the change in export income for each company, while some effects of the weaker dollar would affect exporters adversely. Example: When a weaker dollar makes imports more costly, pressure eases on union negotiators, leading them to push for higher wage contracts. This increases production costs. A weaker dollar's impact on trade, therefore, must be examined industry by industry.

CONCLUSION

In the past few years, the U.S. dollar has regained much of the strength that it lost during the 1970s. This is no cause for alarm. The dollar is not a "problem" requiring a government "solution." The dollar's strength reflects the strength of the U.S. economy: It reflects many economic and noneconomic factors. Not surprisingly, therefore, the strong dollar is generally good for the U.S. economy. Those who wish to weaken the dollar in order to increase U.S. exports misunderstand the causes and consequences of the strong dollar. They fail also to realize

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15 Thomas F. Dernburg, Flexible Exchange Rates: Exceptions and Reality. An Analysis, Congressional Budget Office Report No. 84-985, June 22, 1984, p. 34.

16 A. Wilmots-Vandendaele, "A Weaker Dollar Might Not Curb the Trade Deficit," Wall Street Journal, September 6, 1984, p. 28.

that the negative consequences of a weakened dollar would far outweigh any initial modest trade benefits. Rather than a cause for concern, a strong dollar is a cause for satisfaction and pride.

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