~~28433~~
124314

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C.

FOR RELEASE ON DELIVERY
EXPECTED at 11:00 a.m.
June 6, 1984

STATEMENT OF

ALLAN I. MENDELOWITZ

ASSOCIATE DIRECTOR, NATIONAL SECURITY

AND INTERNATIONAL AFFAIRS DIVISION

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND

MONETARY POLICY

SENATE COMMITTEE ON BANKING, HOUSING

AND URBAN AFFAIRS

124314

ON

FLOATING EXCHANGE RATES AND THE DOLLAR

029032
124314

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to be here this morning to discuss our report, Floating Exchange Rates in an Interdependent World: No Simple Solutions to the Problems. As you requested, we will address two principal topics: first, reasons for the dollar's continued strength on foreign exchange markets and second, actions and policies that have been advanced as solutions to the problems that the strong dollar continues to pose for American businesses.

REASONS FOR A STRONG DOLLAR

Although the dollar's continued strength may appear to be a contradiction in the presence of massive trade and current account deficits, it is not so surprising when viewed in the context of the broader economic environment. Exchange rates are determined by much more than just trade flows. They depend on differences between the economies and respective economic policies of different countries and expectations about the future. While we cannot measure the precise effect of each individual determinant of an exchange rate, we do know the general direction of causation. Briefly, those economic changes or policy developments that generate demand for a particular currency will cause the value of that currency to appreciate relative to others. Over the last several years, both underlying economic changes and specific U.S. government policies have increased the demand for dollars.

The dollar's strength against other currencies comes in large part from the attractiveness of investments in the United

States. The U.S. demand for savings, including the demands for financing the substantial budget deficit, has exceeded the domestic U.S. supply of savings. This excess demand for savings produced high real (i.e., inflation adjusted) interest rates. The excess demand for savings and resulting high rates of return on dollar investments attracted foreign capital which in turn increased the demand for dollars. Although the inflow of foreign capital has kept interest rates from going even higher, this same capital inflow has contributed to the rise in the dollar's value.

The persistence of high interest rates along with a strong dollar strongly suggest that, for fear of reigniting inflationary expectations, the Federal Reserve has not been willing to accelerate monetary growth to accommodate this excess domestic demand for credit. The dollar's strength is also a sign of widespread international expectations of low U.S. inflation, so current interest rates are high in both nominal and real terms. High interest rates and the strong dollar are, together, the reflection of both fiscal and monetary policies of the United States.

Another factor contributing to the dollar's appreciation against all other major currencies has been the general perception of the safety and stability of the investment climate in the United States. This has led to a demand for dollar investments as "safe havens."

On a bilateral basis, the exchange rate between the dollar and any particular currency reflects the differences between the respective economies and economic policies of the United States and those of the second country. Such is the case with respect to the yen-dollar exchange rate. For example, while the United States is currently a capital importer, Japan is a natural capital exporter. For a number of reasons, Japan enjoys a surplus of savings--making capital available for overseas lending and investment. Since the 1970s, moreover, the Japanese government has been gradually relaxing controls over its financial markets. As restrictions were eased, capital flowed overseas in response to economic incentives, and as a result the yen weakened.

The dollar's strength clearly has been both a benefit and a burden for the U.S. economy. Consumers have gained greater buying power, for instance, as the strong dollar decreased the the price of imports. Also, the inflow of capital probably kept interest rates lower than they would have been otherwise. At the same time, however, by increasing the price of American products relative to foreign products, the strong dollar has hampered U.S. firms' efforts to compete with foreign firms, both domestically and in foreign markets. This year's U.S. trade deficit may exceed $110 billion according to many estimates, including those of the administration. As much as half of that deficit may result from the dollar's appreciation during the past several years.

GENERAL OBSERVATIONS

What, if anything, can move the dollar off its uncomfortable pedestal? We offer the following general observations.

--First, exchange rates may not respond symmetrically to policy changes. The fact that large U.S. budget deficits and restrictive monetary policy together led to a strong dollar does not mean, for example, that a substantial cut in the budget deficit must necessarily weaken the dollar. Such a change, by increasing confidence in the stability of the U.S. economy, could attract more foreign capital and conceivably increase the dollar's value.

--Second, while a weakened dollar would improve the competitiveness of U.S. industry, it would not be an unalloyed good. Just as a rising dollar lowered the rate of inflation, a falling dollar will make inflation worse. We will be required, in a sense, to pay back the earlier reduction in inflation.

--Third, it is not possible for us to offer any simple policy changes with an assurance that they will attain specific exchange rate goals. Foreign exchange markets are too complex and difficult to predict accurately that a policy change will produce a specific value for the dollar for a sustained period of time.

--Fourth, while exchange rates may react fairly quickly to any policy changes, international trade will not react as quickly. The lag between the depreciation of a currency and any subsequent improvement in the trade balance averages 12 to 18 months. We agree with the President's Council of Economic Advisors that the die is cast as far as the dollar's impact on the 1984 trade deficit. There is little likelihood of a dramatic improvement in the trade deficit in the near term.

--Lastly, and in a somewhat more optimistic vein, not all of the U.S. trade deficit is caused by an "overvalued dollar." An economic recovery by the United States that has been stronger than that of our trading partners has also contributed to the trade deficit. Although greater growth in other economies will not wipe out the trade deficit, international economic recovery can help to cut the U.S. trade deficit by expanding the demand for U.S. exports.

POLICY ALTERNATIVES

Several measures have been suggested for lowering the value of the dollar against other currencies and helping to improve the competitiveness of U.S. industry. I will briefly discuss several of them, including

--changes in U.S. economic policies,

--government intervention in foreign exchange markets, ideally coordinated among major nations,

--imposition of capital controls in the United States, and

--greater international coordination and cooperation in setting economic policy.

Each proposal has both potential benefits and limitations.

Changes in U.S. economic policy

It should be possible to reduce the value of the dollar by changing macroeconomic policies. However, we may find that doing so would sacrifice important domestic policy goals. For example, a policy of accelerated monetary growth might lower the value of the dollar. However, if these policies were changed only to bring about a depreciation in the dollar, it is likely that any gains enjoyed by sectors of the economy that compete with foreign producers would be offset by the losses experienced by sectors of the economy due to renewed inflation. Excessive money supply growth and an ensuing dollar depreciation would both lead to increased domestic prices. We would urge that any macroeconomic policy changes be made in response to a full complement of domestic and international concerns. Policy makers must recognize the limits that the increased openness of the U.S. economy places on the range and mix of acceptable macroeconomic policies.

Greater government intervention in foreign exchange markets

Many proposals to lower the value of the dollar call for increased U.S. government intervention in foreign exchange markets, coordinated with intervention by other major nations. There is still some disagreement about precisely how effective intervention can be. Most analysts agree, however, that it cannot be a long-term force in setting exchange rates because intervention by nations, individually or jointly, is not enough to counter the market forces that determine exchange rates. However, intervention can be effective at particular times in bringing order to chaotic markets. This appears to be the case in the coordinated intervention by the United States, France, West Germany, Japan, the Netherlands, and Switzerland in late July and early August 1983, when extremely rapid depreciation of European currencies against the dollar was stabilized. Furthermore, while agreements among nations to intervene are necessary for coordinated intervention to succeed, nothing guarantees that several different nations will be able to agree that a particular intervention at a particular time is in their best interest.

Controlling international capital flows

By restricting capital movements in and out of a country, capital controls are supposed to limit exchange rate fluctuations or to influence the level of the exchange rate. Such controls are designed to lessen the transmission of economic disturbances across national borders by limiting economic interdependence. In restricting capital movements, however, a country foregoes some benefits of interdependence, such as greater access to overseas investments or to foreign sources of funds.

Capital controls can take several forms and can be established to favor inflows or outflows. Restricting capital outflows or encouraging inflows, for instance, would be strategies to strengthen a nation's currency. Possible techniques include making capital outflows less attractive by imposing special taxes on interest earned on foreign assets (as the United States did with the Interest Equalization Tax in the 1960s) or restricting bank loans to foreign borrowers. A currency could be weakened by encouraging capital outflows or discouraging capital inflows. For example, net capital flowing to the United States might be reduced if additional taxes were placed on interest payments made to foreigners.

If capital controls are successful in changing currency values, they may exact a cost elsewhere in the economy. For example, if capital inflows are restricted with no accompanying change in the domestic demand for or supply of savings, interest rates will tend to rise. Exports may be encouraged and imports discouraged, but the whole economy may bear a cost in the form of higher interest rates.

Some arguments for capital controls are noneconomic in origin, however. Nations frequently restrict or regulate direct foreign investments in several types of industries, such as defense, atomic energy, radio and television broadcasting, and mineral development. In such cases, nations decide that foreign ownership is not acceptable and that the benefits of capital controls are worth the cost.

Coordinating national economic policies

Finally, few observers believe that increased intervention or other policies that do not deal with fundamentals can resolve the difficulties frequently attributed to exchange rate behavior. Increased intervention in foreign exchange markets would only substitute a short-term solution for what many observers find to be the real problem--uncoordinated or imprudent national economic policies.

It has been known for a good number of years that nations could avoid many international economic problems by better coordinating their economic policies. However, no one has yet found a way to achieve more effective coordination. Nations pursue policies that they perceive to be designed to advance their individual national interests. Even when there is a formal structure for defining common interests and a stated commitment to coordinated policies, as in the European Economic Community, subordinating domestic concerns to achieve common objectives is exceedingly difficult for a national government.

Nations do exchange information on current economic conditions and policies. This shared information can be the basis for recognizing the constraints on policies in an interdependent world economy. In the final analysis, however, each nation must define its own long-term political and economic interests and adopt policies designed to satisfy those interests, recognizing that every other nation has the same responsibility for the welfare of its own citizens. Interdependence among national economies, however, constrains the range of policies that a nation may successfully adopt. Implementing economic policy without recognizing how interdependence influences the outcome of that policy can disrupt foreign exchange markets and, in turn, prove costly to the economy.

CONCLUSIONS

Simply put, there are no quick fixes or simple solutions to the problem of the dollar. We have been taught a painful lesson as to the limits of our ability to adopt macroeconomic policies without regard to their international consequences. A solution to the exchange rate problem requires a careful balancing of fiscal and monetary policies designed to attain simultaneously domestic and international goals.

Mr. Chairman, this concludes my prepared statement. I will be happy to try to answer any questions you may have.