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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT
AND MONETARY POLICY

AND THE
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE

HOUSE COMMITTEE ON BANKING AND URBAN AFFAIRS

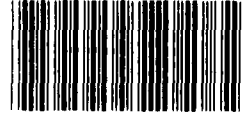
ON

FLOATING EXCHANGE RATES AFTER TEN YEARS

Mr. Chairmen and Members of the Subcommittees:

We are happy to be here today at your request to testify on the importance of exchange rates to the American economy and the lessons of our 10 years' experience with floating exchange rates. Our testimony is an interim report on our on-going work on exchange rates.

The consequences of the high value of the American dollar on foreign exchange markets over the past several years demonstrate how important exchange rates have become for the United States. Although the strong dollar has helped to reduce inflation by lowering the prices of imported goods, it has made American products more expensive than competing foreign goods--



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reducing the demand for them both at home and abroad. Reduced demand, in turn, is believed to have contributed to the depth and duration of the recent recession. If the dollar remains strong and exports remain below potential levels, economic activity will be lower than might otherwise be the case.

The concern over the effects of exchange rates should not end with the economic recovery. The American economy is becoming more closely linked with other nations' economies as U.S. and foreign businesses increasingly compete in domestic and international markets and as U.S. and foreign investors continue to seek out worldwide investment opportunities. With this greater interdependence of national economies, exchange rates between the dollar and other currencies will remain a matter of great importance to the American economy.

Furthermore, this linkage among economies means that countries cannot pursue independent economic policies without international consequences. Domestic economic policy affects exchange rates and, at the same time, changes in exchange rates affect the policy's success in reaching goals, such as high employment or low inflation. No exchange rate regime--whether fixed or floating--can enable a country with open trade and capital markets to avoid the international consequences of domestic economic policy. Many problems that are commonly attributed to misaligned exchange rates are in fact problems that arise as nations conduct divergent economic policies in an interdependent world.

Our testimony this morning examines the problems of floating exchange rates in a world where economies are open to international trade and capital movements. We begin with an examination of how exchange rates affected the recent recession.

COSTS AND BENEFITS OF
THE STRONG DOLLAR

Between 1979 and 1983, the dollar rose in value against the currencies of all U.S. major trading partners. The increase in the value of the dollar against several other currencies between January 1979 and (1) October 1982, when the dollar peaked against the Japanese yen, and (2) July 1983, immediately before the United States joined with other nations to try to reverse the dollar's rapid appreciation against European currencies, is shown in the attached table. It should be noted that this appreciation relative to other currencies was not uniform in either size or timing. For example, between January 1979 and October 1982 the dollar's appreciation against the yen was nearly the same as its gain in value against the mark and greater than its gain against the pound. Over the January 1979 to July 1983 period, however, the dollar's appreciation against the pound and the mark exceeded its appreciation against the yen.

The consequences of the overall appreciation may have been substantial. Estimates by Data Resources, Incorporated (DRI) suggest that appreciation of the dollar against other major currencies from the summer of 1980 to the summer of 1983 has had a

healthy impact on inflation by lowering consumer and wholesale price indices by 2.9 and 1.3 percent, respectively. At the same time, however, DRI estimates that the recession was much more severe than it might have been if the dollar were not so strong. In the DRI simulations, first quarter of 1983 GNP was 2.4 percent lower than it might have been and employment was one million jobs less because of the strong dollar.

The costs associated with the strong dollar have not been borne equally by all sectors of the economy. Manufacturing in general was hardest hit by the dollar's strength; DRI estimates suggest that total manufacturing output fell by 5.8 percent and nearly 800,000 jobs were lost. For example, Ford Motor Company estimated that changes in the yen-dollar rate gave its Japanese competitors a \$900 per car price advantage, weakening the competitive position of the U.S. automobile industry as it confronted a wide assortment of problems. The exchange rate of the dollar is probably one reason why automobile imports grew 17 percent between January and September 1982 while domestic sales were sluggish. The import growth occurred in spite of a voluntary export restraint that limited the number of cars imported from Japan.

The strong dollar and U.S. economic policy reinforced each other during 1981 and 1982. As suggested earlier, the strong dollar helped to accomplish one goal of macroeconomic policy-- lowering the domestic inflation rate. At the same time, the tight U.S. monetary policy of the early 1980s combined with

high fiscal deficits resulted in high real and nominal interest rates. These, in turn, attracted capital flows to the United States and strengthened the dollar. Lower U.S. inflation also contributed to the dollar's strength.

HOW WELL HAVE FLOATING EXCHANGE RATES WORKED?

The United States began to rely on market-determined exchange rates in 1973 when the Bretton Woods system of fixed rates collapsed. This major institutional change was unavoidable and there was widespread support for shifting to a more flexible system. However, floating exchange rates have not worked exactly as anticipated.

Most importantly, flexible exchange rates do not permit nations to pursue domestic economic policies without regard to the international consequences. When the floating exchange rate period began, there was an expectation that national economic policy would be freed from exchange rate concerns. By automatically adjusting exchange rates to the proper levels, the market would remove the need for governments to defend a fixed exchange rate, as was often the case under the Bretton Woods system. Thus, nations would have greater freedom to adopt macroeconomic policies in pursuit of domestic targets such as price or employment stabilization or economic growth. However, flexible exchange rates do not remove constraints on economic policy. Domestic considerations may outweigh the costs of the international effects of a chosen policy, but the costs cannot be

avoided. These costs can include reduced employment and reduced real economic growth, as the recent recession demonstrated.

The increased integration of the U.S. economy with the rest of the world, furthermore, has changed the domestic effectiveness of monetary and fiscal policies. Monetary policy will have a stronger impact on an open economy than on a closed economy. A tight monetary policy, for instance, can contribute to the dollar's appreciation, which can have the same deflationary consequences as the restrictive monetary policy.

The effect on fiscal policy, on the other hand, is more ambiguous. An expansionary fiscal policy could lead to dollar appreciation, if government demand for funds is large enough. Appreciation, if it did occur, would tend to diminish the effectiveness of the fiscal stimulus.

A second lesson of the floating exchange rate experience is that a market-determined rate can adversely affect firms that engage in international trade or compete with imported products in the domestic market. When floating exchange rates were first adopted in 1973, sustained exchange rate "misalignment" was not anticipated. However, exchange rates react to many variables in addition to exports, imports, and relative inflation rates; variables such as interest rates and the risk of investing in different nations can affect exchange rates.

Furthermore, exchange rates are sensitive to expectations and can react quickly to changes that may have important future

consequences. As a result, the market-determined rate can diverge from a hypothetical exchange rate that depends only on relative trade flows and national inflation rates.

The problem of "misalignment" is in reality the consequence of the multiple determinants of exchange rates. An exchange rate may diverge, for a time, from a rate that would balance trade if investment decisions and expectations dominate foreign exchange markets. An extreme divergence, often referred to as "overshooting," is a partial explanation for some of the exchange rate fluctuations seen in the past year. The dollar may have "overshot" against the yen in late October and early November 1982 when the exchange rate of the yen slumped to Y 278 to the dollar. The current rate is around Y 230 to Y 235 to the dollar.

NO CONSENSUS FOR A CHANGE
IN EXCHANGE RATE POLICY

While the severity of the recession has demonstrated how economic disruptions as well as benefits spread in an interdependent world, international trade and investments are too vital to our economy to entertain suggestions to isolate the U.S. economy from the rest of the world. At the same time, the extent of the recession made clear the need to examine the floating exchange rate system and to consider whether improvements are possible.

Despite the problems of floating exchange rates and the calls for changes in government exchange rate management policies, including the revival of fixed rates, there is little agreement on what, if any, changes would improve the system. Many international economic problems that are popularly attributed to flaws of the floating exchange rate system are more the result of greater interdependence among the major industrial economies than any particular exchange rate system. Regardless of the exchange rate regime in place, differences in economic policies between nations will influence international trade and capital flows. "Fixed" exchange rates that diverge from the market level would be impossible to sustain for any but a short period of time. Furthermore, our experience in defending fixed exchange rates under the Bretton Woods system includes a number of examples in which macroeconomic policy was used to lower economic performance because of exchange rate considerations. The fixed system was not without its costs.

The unavoidable complications of interdependence and the limits of economists' current understanding of exchange rate behavior prevent a consensus on changing the current system. For example, a number of analysts point to the potential benefits of coordinated intervention, such as reduced exchange rate volatility or misalignment. Others, however, point to the fact that intervention does not change market fundamentals and contend that such intervention is unlikely to succeed.

It is clear, however, that greater interdependence of national economies constrain the range of domestic economic policies that the United States or other nations can adopt without paying a high price. To our knowledge, no alteration to the current system--or any new system--will allow us to escape these constraints.

Mr. Chairmen, this concludes my prepared statement. I will be happy to answer any questions you or your Subcommittees may have.

The Dollar's Appreciation Against
Selected Currencies

	<u>1/79-10/82</u>	<u>1/79-7/83</u>
	(percent)	
British Pound	22.8	31.1
Canadian Dollar	3.3	3.5
French Franc	68.5	83.2
German Mark	37.0	40.0
Japanese Yen	37.3	21.3