

Foreign Exchange by David Goldman

IMF annual report: dollar in trouble

The Fund's new report warns that the strength of the dollar is not likely to be maintained, and "swings" in exchange rates can be expected.

The International Monetary Fund's 1984 Annual Report was issued on Sept. 12, warning of troubles ahead for the U.S. dollar. We excerpt here the discussion of "Exchange Rate Issues in Industrial Countries."

Concerns about the levels of exchange rates among the major currencies intensified during 1983 and the first few months of 1984, in particular because of the continued strength of the U.S. dollar. Except for the Japanese yen, which appreciated sharply against the U.S. dollar toward the end of 1982 and then maintained a relatively stable dollar value during 1983, the pattern of an appreciating dollar generally persisted throughout 1983.

The dollar then depreciated somewhat in nominal effective terms during the first quarter of 1984, but rose again in the second quarter, approaching the level reached in January. These exchange rate movements raised the real value of the dollar to about 15 percent above its average value for the decade 1973-82 in relation to the Japanese yen and the pound sterling, some 40 percent in relation to the deutsche mark, and nearly 50 percent in relation to the French franc.

A country's average real exchange rate over the past decade is, of course, not necessarily sustainable and appropriate under present circumstances. Changes in underlying economic and financial conditions often call for changes in real exchange rates.

For example, the very sharp real

appreciation of the pound sterling from 1978 through the first quarter of 1981 can be explained in part by the development of North Sea oil at a time of rapidly rising oil prices, while the subsequent reversal was aided by the softening oil market in 1982 and 1983. Also, shifts in private saving and investment patterns or in market confidence may induce changes in real exchange rates in order to generate a balance between the current and capital accounts.

The demand for U.S. dollars, in particular, has occasionally been stimulated by the traditional role of the United States as a haven for financial investments during periods of turmoil in other countries. During the past year and a half, this demand may also have been stimulated by the positive effects of the strong economic recovery and the 1981 tax package on after-tax corporate profits and the expected rate of return on investment.

In a narrow sense, one can even say that, in the absence of intervention by the authorities in foreign exchange markets, exchange rates are always at equilibrium levels, since they are simply a reflection of the preferences and expectations of market participants engaged in free and open trading based on information available to them. But that observation does not imply that serious misalignments cannot occur in terms of the relative prices at which international trade takes place.

Whenever stable domestic economic and financial conditions are ab-

sent, developments in financial markets can lead to swings in exchange rates that, while reflecting the free play of forces in the foreign exchange market, may not be consistent with the proper functioning of the adjustment process in the goods markets. This does not mean that the movements in exchange rates per se are unjustified but that the international interest would be well served if both unstable domestic conditions and the accompanying movements in exchange rates were eliminated. For example, a lack of balance between monetary and fiscal policies may lead to a rise in real interest rates, and an appreciation of the exchange rate to the point of jeopardizing a country's international competitive position. Such a development would be detrimental not only to that country but also to its trading partners because it would have to be reversed sooner or later, with all countries obliged to bear the cost of moving factors of production first in and then out of certain sectors. Moreover, in the interim it may result in the introduction of protectionist measures that may be difficult to remove later.

The main reason for the current concern about exchange rates is that they appear to have exerted strong pressure on trading patterns and current account positions of the major industrial countries. For example, the rise in the exchange value of the U.S. dollar during the past several years has contributed to a sharp weakening in the U.S. current account balance (including official transfers) from a surplus of \$5 billion in 1981 to a deficit of \$39 billion in 1983, which, if continued, could have disquieting implications for the international allocation of world private saving. On the other hand, the U.S. current account deficit has had beneficial effects on economic recovery in other countries. . . .