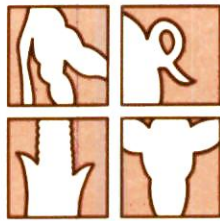




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WEEKLY OUTLOOK

Department of Agricultural Economics
College of Agriculture
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March 6, 1985

THE STRONG DOLLAR CONTINUES

THE STRENGTH OF THE U.S. DOLLAR relative to other major currencies has been receiving considerable attention lately. The impact of the dollar's strength on U.S. trade has been of special concern to the agricultural industry.

This week's letter is the first of a two-part series on exchange rates. In the first part we look at the magnitude of recent changes in exchange rates and the reasons for these changes. Next week we will examine some of the effects of the strong dollar and prospects for the future direction of exchange rates.

In describing changes in the value of the dollar, one must choose a starting point and currencies for comparison. The United States changed from a policy of fixed exchange rates to one of floating exchange rates in March 1973. That seems to be a reasonable place to begin in examining rates. Currencies of other major industrial nations should be used for comparison--the Japanese yen, the Deutsche (German) mark, and the British pound. Of these comparisons, the Deutsche mark is probably the most important.

The Deutsche mark was variable in the range of about 38 to 44 cents in the early to mid 1970s. The value increased to the 58-cent level in 1979 and 1980. Since 1980 the mark has declined almost steadily. The value of March futures closed just under 30 cents on March 1. The decline has totaled nearly 50 percent. An index of currency futures based on the British pound, Canadian dollar, Deutsche mark, Japanese yen, and Swiss franc shows a similar decline, although not as dramatic. That index has declined about one-third since 1981.

The reasons for the strength of the dollar since 1980 are many and have not always been well understood. The explanations have often seemed circular in nature. Following is an attempt to describe those factors contributing to the strength of the U.S. dollar.

The magnitude of the increase in the value of the dollar since 1980 is partly a function of the fact that the decline in the value of the dollar up to that point was overdone. Large budget deficits, relatively high inflation rates, and low or negative real interest rates in the U.S. contributed to the dollar's weakness.

Part of the dollar's strength over the past four years has been a correction of that weakness. That is, the weak dollar made the prices of import goods very

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high and the prices of our exports quite low. The foreign demand for the dollar to buy U.S. goods increased and the U.S. demand for foreign currencies to purchase imports declined. The shifts in currency demands resulted in an adjustment in exchange rates.

A second factor contributing to the dollar's strength has been the shift in real interest rates in the U.S. since 1979. The real rate of interest is defined as the nominal rate of interest minus the expected rate of inflation. This rate moved from negative levels in the early 1970s to very large positive levels by 1982. Those real rates remain high today. The change has been a function of the rapid economic growth in the U.S., the stance on tighter money supply since 1979, the decline in the inflation rate, and increased government borrowing to finance the deficit. Higher real rates of return along with the changes included in the Economic Recovery and Tax Act of 1981 raised the after-tax return on new business investment. This favorable climate increased the level of foreign demand for dollar assets, putting upward pressure on the value of the dollar.

A third reason for the strong dollar is the "safe-haven" concept. Capital tends to flow out of areas of social and economic instability to areas of stability such as the United States. This activity increases the demand for dollar assets.

A fourth and less often cited reason for the most recent strength in the dollar is a speculative one. As people expect the dollar to increase in value, they purchase the dollar, driving prices higher. This activity is important in the short run.

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