The dollar may be falling at just the right time

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The dollar's recent decline to a yen-dollar rate of 100 triggered numerous calls for exchange rate intervention. Advocates noted that the yen-dollar rate had not been so low since 1995 and that the dollar has fallen more than 20 per cent since 2002. But intervention proposals misunderstand the significance of the 100 yen-dollar rate, the recent dollar declines, the need for the increased US competitiveness and the potential adverse effects of intervention.

Comparing the current exchange rate with the 100 yen per dollar in 1995 is misleading because of differences in US and Japanese inflation. Between 1995 and 2007, consumer prices rose 37 per cent in the US but remained virtually unchanged in Japan (a decline of less than 1 per cent). A dollar buys substantially less in the US today than it did in 1995 while 100 yen buys the same amount in Japan as it did then. Since it takes $1.37 in the US today to buy what a dollar bought in 1995, the yen would have to strengthen to 73 yen per dollar (1 divided by 1.37) to cause a dollar to buy the same amount in Japan as it did in 1995.

It is wrong, moreover, to read much into the dollar's recent rapid decline. The value of the dollar, like other asset prices, fluctuates substantially from year to year. But over long periods the dollar's real value has changed very little. The real, inflation-adjusted value of the dollar against a broad basket of currencies, has declined only 7 per cent over the past 20 years (i.e. less than 0.5 per cent per year).

The recent decline of the dollar has led many people to talk about the current "weakness" of the dollar, encouraging intervention to stop the dollar's further decline. This confuses recent declines with fundamental weakness. The very large US trade deficit shows that the value of the dollar is not weak but is actually very strong. Because of the dollar's strength, prices of US goods in global markets make them inadequately competitive.

The dollar's decline over the past five years stimulated exports and helped to shrink the trade deficit. Real US exports are up 17 per cent in the past two years and the trade deficit has come down 11 per cent from its peak in 2006. But the trade deficit last year was still more than $700bn (£350bn) or 5.1 per cent of gross domestic product. Since US imports are still nearly twice as large as US exports, it takes a very large fall of the dollar to shrink the net deficit.

Despite the recent dollar decline, America's trading partners still have large trade surpluses. Japan's trade surplus exceeds $100bn. In the eurozone it is nearly $40bn, in China it is $250bn, in Russia it is $140bn and in Saudi Arabia it

exceeds $140bn. So the more competitive dollar is not causing fundamental trade problems for America's trading partners.

The falling dollar reflects an unwillingness of private and public portfolio investors around the world to hold the current amounts of dollar securities at the existing interest rate and exchange rate. To induce them to do so, and to increase their holdings by the roughly $700bn needed to fund this year's US current account deficit, requires either a lower value of the dollar (so there is less risk of further dollar decline) or a higher rate of interest (to compensate them for any further fall of the dollar). A lower dollar has the favourable ef-fect of stimulating US net exports and therefore of raising the US growth rate at a time of general economic weak-ness. In contrast, higher interest rates would reduce aggregate investment and other aspects of aggregate de-mand. The US has therefore been for-tunate that the adjustment to the fall in world demand for US securities has taken the form of a lower dollar rather than of a rise in the level of US interest rates.

Exchange rate intervention to strengthen the dollar would be doubly counterproductive. If it succeeded, it would cause the dollar to rise when the US economy needs a more competitive dollar. Moreover, co-ordinated intervention with Japan would encourage and legitimise Japan's action to depress the yen. The progress of the past few years in getting the big countries to allow the market to determine the value of their currencies would be lost.

Investors and policy officials should recognise that the dollar's current decline is part of a natural process for reducing the US trade deficit. Because of the potential weakness of the US economy in the coming months, the dollar decline and the resulting reduction in the trade deficit have actually come at a good time.

The writer is professor of economics at Harvard. He chaired the Council of Economic Advisers under President Ronald Reagan