JOINT ECONOMIC COMMITTEE

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The U.S. Dollar in Historical Perspective

Recent headlines reporting that the U.S. dollar fell to an all-time low against the euro prompted fears about the economic consequences of the declining value of the U.S. dollar in terms of foreign currencies. A review of the facts shows that fluctuations in the value of the U.S. dollar are not unusual and its current value is well within historical norms.

An exchange rate is the price of one currency in term of another currency. This report uses the Federal Reserve Board's real broad trade-weighted index of the foreign exchange value of the U.S. dollar to measure the real value of the U.S. dollar since the current system of flexible exchange rates began in March 1973. This index has two major advantages over looking at specific exchange rates over time:

- It uses a broad base of major and minor currencies weighted by the proportion of total U.S. two-way trade with the country or monetary union that issues each currency. An individual exchange rate may fluctuate because of country-specific factors that do not indicate a general movement in the foreign exchange value of the U.S. dollar.
- It adjusts exchange rates for the inflation rate in each currency to distinguish real changes in the foreign exchange value of the U.S. dollar from nominal changes that merely reflect differences in inflation rates.

After the initial adjustment to flexible exchange rates, the real value of the U.S. dollar in terms of foreign currencies has followed a definite pattern. First, the real value of the U.S. dollar has a period of relative stability. Then an exchange rate cycle begins. The real value of U.S. dollar rises rapidly for a number of years to a peak substantially above its long-run equilibrium value.[1] After peaking, the real value of the U.S. dollar declines rapidly for a number of years and returns approximately to its pre-cycle level, followed by another prolonged period of stability.

Adjustment to flexible exchange rates: March 1973 to September 1980. After the United States and other developed countries launched a new system of floating exchange rates in March 1973, the real value of the U.S. dollar fell sharply. However, between July 1973 and December 1976, the value of the U.S. dollar stabilized, as measured by the Federal Reserve foreign exchange index.

After this period of stability, the dollar began to decline, falling from its index level of 93.9 in December of 1976, to a low of 83.3 in October 1978. This decline was followed by a partial recovery, with the index rising to 87.5 by September 1980.

First exchange rate cycle: October 1980 to April 1988. The first exchange rate cycle began in October 1980, with the value of the dollar soaring over the next 54 months to a level of 127.7 by March of 1985.

However, the real value of the U.S. dollar then began to fall. In the next thirty-seven months, the real value of the U.S. dollar

[1] The long-run equilibrium value of the U.S. dollar is the "natural" value toward which it gravitates over time after economic shocks cause it to deviate.

surrendered virtually all of its previous gain. The Federal Reserve's index fell back to 89.7 in April 1988, approximately where it had been in September 1980 before the exchange rate cycle began.

Stability: May 1988 to July 1995. During the next seven years, the real value of the U.S. dollar was remarkably stable, fluctuating within a narrow band. From May 1988 to July 1995, the Federal Reserve's index averaged 90.0.

Current exchange rate cycle: August 1995 to present. A second exchange rate cycle began in August 1995, with a surge in the value of the dollar. The dollar's value increased 34.2 percent between August 1995 and February 2002, peaking at a level of 113.3.

However, the real value of the U.S. dollar began to fall once again. In the last three years, the real value of the U.S. dollar surrendered about three-fifths of its previous gain. The Federal Reserve's index fell to 97.1 in March 2005. However, this index was still:

- 11.0 percent above its level of 87.5 in September 1980 immediately before the first exchange rate cycle,
- 15.0 percent above its level of 84.4 in July 1995 immediately before the beginning of the current exchange rate cycle, and
- 7.9 percent above its average of 90.0 from May 1988 through July 1995.

These facts indicate that the current foreign exchange value of the U.S. dollar is well within the range established over the last three decades.