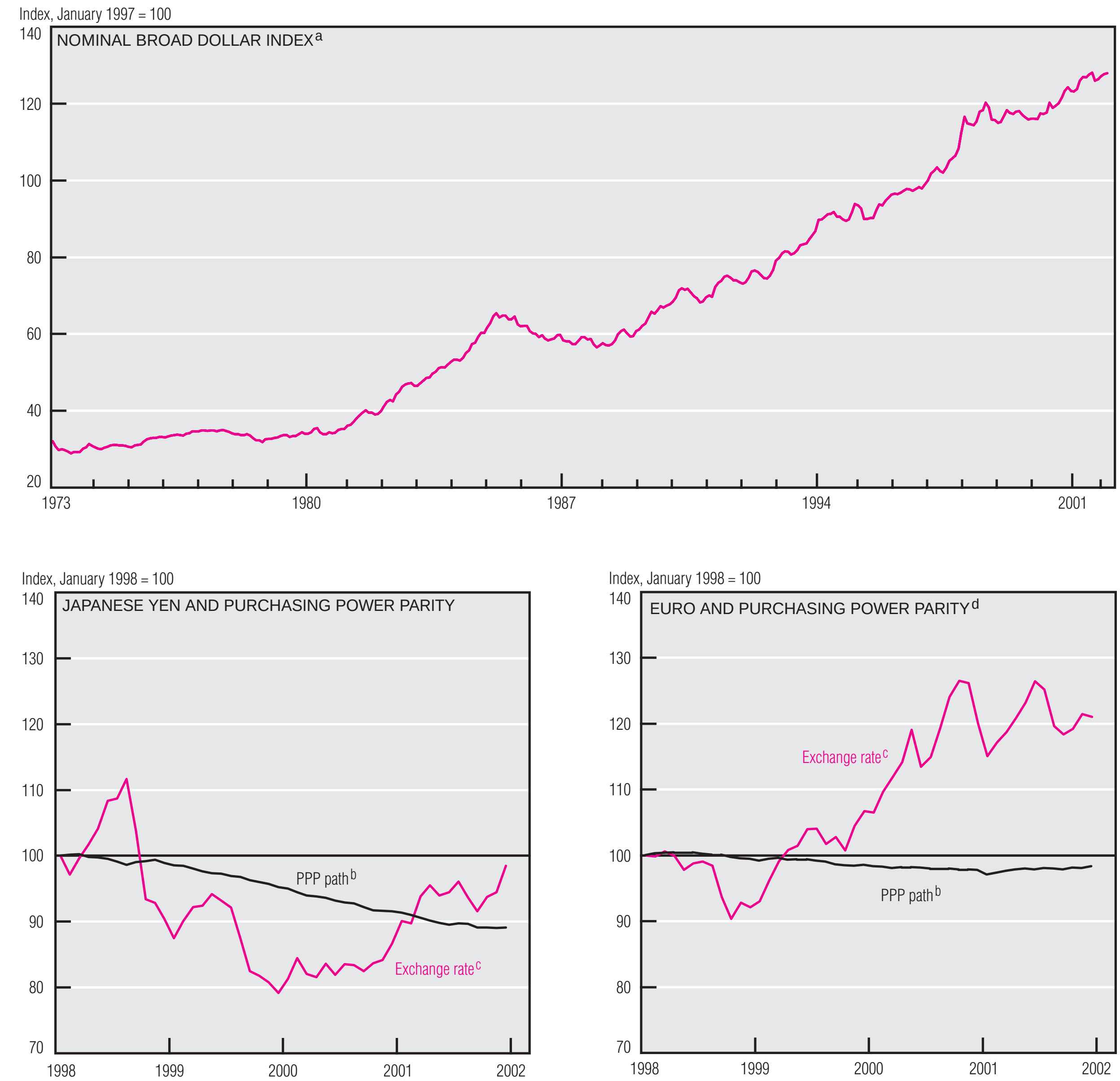
Is the Dollar Overvalued?



a. The nominal broad dollar index measures the average change in the dollar's nominal exchange value against the currencies of our 36 most important trading partners.
b. Ratio of foreign CPI to U.S. CPI.
c. Nominal exchange rate in foreign currency units per U.S. dollar.
d. For dates prior to January 1999, a "synthetic" euro is constructed from the currencies of the euro-zone countries.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Statistical Office of the European Communities; and Japan Ministry of Public Management, Home Affairs, Post, and Telecommunications.

Despite continuing weakness in U.S. economic activity and sharp reductions in the Federal Reserve's key target interest rates, the dollar remains strong in foreign exchange markets. Its persistence has surprised many observers. Some now complain that the dollar is overvalued, implying that its exchange value is fundamentally incorrect, detrimental to U.S. economic growth, and ultimately unsustainable.

"Overvalued" (or "undervalued") typically refers to the difference between a current exchange rate and its purchasing power parity (PPP) value. The PPP theory maintains that exchange rates will adjust to inflation differentials between countries. It relies on international trade and the arbitrage of goods prices. If, for example, prices are rising faster in the U.S. than in Japan, consumers will shift away from U.S. goods toward Japan's. To buy Japanese products, however, consumers must first acquire Japanese yen, and, in the process, they will bid down the value of the dollar relative to the yen. PPP contends that the dollar's depreciation will exactly offset the price advantage that Japanese goods enjoy. If the U.S. has a 2% annual rate of inflation and Japan's rate is zero, PPP predicts that the dollar will depreciate by 2% per year against the yen.

Using PPP as a guide, the dollar currently seems overvalued by nearly 11% against the Japanese yen, 23% against the euro, and 11% against the Canadian dollar. The U.S. dollar is undervalued by almost 28% relative to

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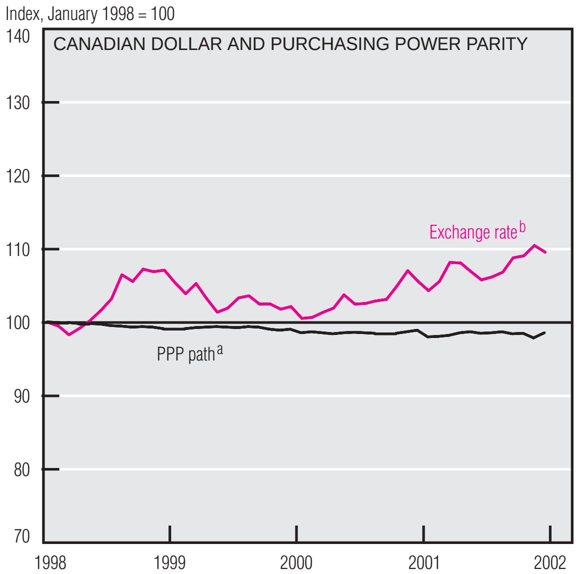
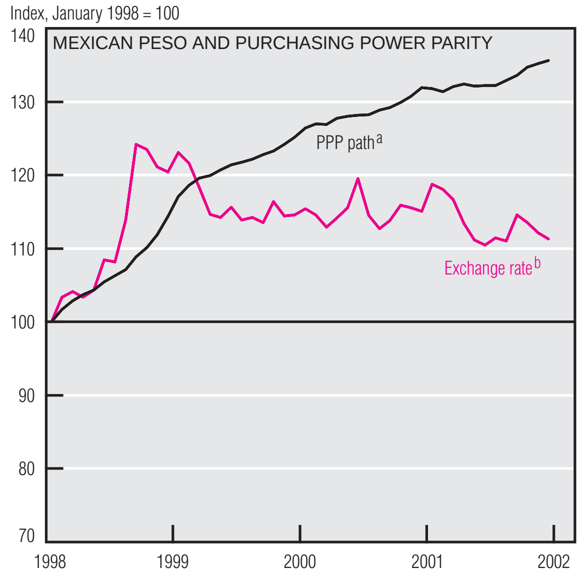
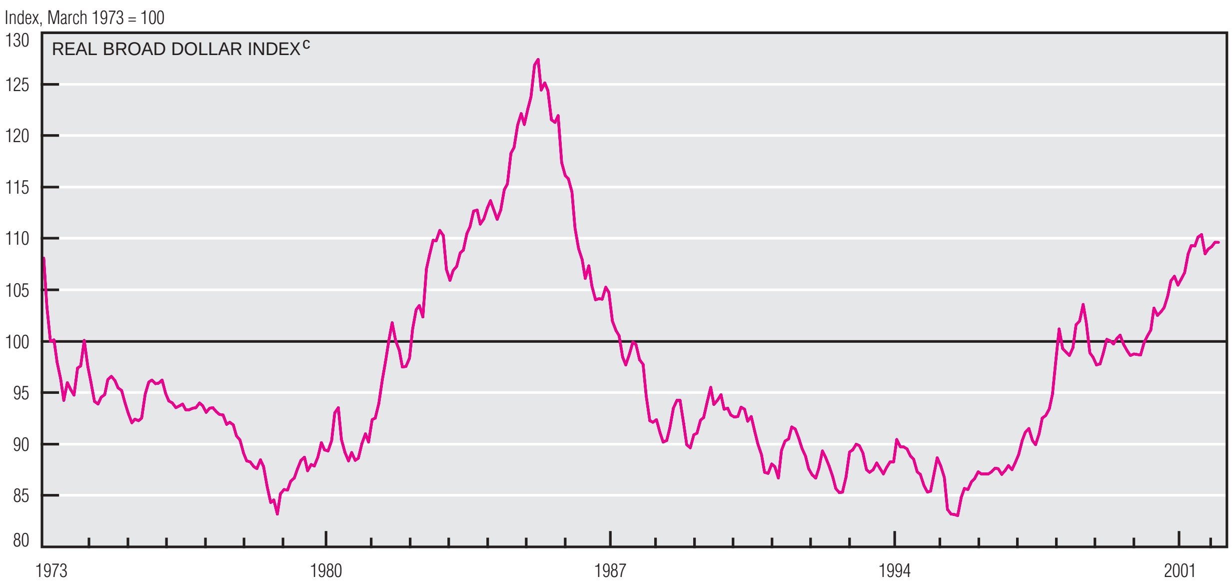
Is the Dollar Overvalued? (cont.)







a. Ratio of foreign CPI to U.S. CPI.

b. Nominal exchange rate in foreign currency units per U.S. dollar.

c. The real broad dollar index measures the average change in the dollar's real exchange value against the currencies of our 36 most important trading partners.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Banco de México; and Statistics Canada.

the Mexican peso. A more comprehensive assessment, however, is afforded by the Board of Governors' real broad dollar index. This statistic, which incorporates both exchange rate movements and inflation differentials, describes the dollar's value relative to PPP against the average of our 36 most important trading partners. By construction, the real broad dollar index equals 100 whenever the dollar is at its PPP value. If PPP always held, the index would constantly equal 100. This measure suggests that the dollar is currently overvalued by approximately 10%.

The real broad dollar index shows, however, that PPP is a poor guide to the dollar's foreign exchange value. Variations from PPP are the norm, not the exception, and the magnitude of the dollar's current departure from PPP is not unusual. Moreover, deviations from PPP can last many years. Exchange rates may eventually drift back toward their PPP values, but they need not stay there.

Deviations from PPP can stem from a host of fundamental economic factors. The dollar's recent strength, for example, may reflect expectations that past strong productivity advances will continue as the economy rebounds. While the word "overvalued" can have meaning when governments interfere with the determination of exchange rates, it is largely devoid of economic content when private market forces hold sway. Then, "overvalued" becomes a political statement.