Beyond the Border

Real Trade-Weighted Value of The Dollar Holds, Despite Fall Against the Yen and Mark

World currency markets were shaken in early March as the nominal value of the dollar declined to post–World War II lows against the Japanese yen and the German mark. From January 1 through April, the nominal value of the dollar fell 15.3 percent against the yen and 10.4 percent relative to the mark. Over approximately the same period, the real value of the dollar (adjusted for U.S. and foreign inflation differentials) was down 8.2 percent against the yen and 14 percent against the mark. A looming question for the U.S. economy is whether the decline in the dollar portends higher U.S. inflation as imports from Japan and Germany become more expensive.

Over the past 10 years, U.S. consumer prices have increased nearly 43 percent, while German prices increased 26 percent and Japanese prices increased only 14 percent. Although the dollar's long-term nominal decline against the yen and mark undoubtedly reflects the fact that U.S. inflation has been higher than German and Japanese inflation, the dollar's recent decline does not necessarily signal higher future U.S. inflation resulting from increased import prices.

Despite the dollar's recent fall against the yen and mark, the overall real trade-weighted value of the dollar has changed only slightly during the past year. From April 1994 to April 1995, the Dallas Fed's Real Trade-Weighted Value of the Dollar Index (which includes 99 countries) fell only 5.7 percent (*Chart 1*). The Real Trade-Weighted Value of the Dollar Index is calculated by weighting each country's dollar exchange rate by that country's share of total U.S. trade (exports plus imports) and then adjusting for inflation differentials between that country and the United States. Consequently, movements in the real trade-weighted value of the dollar approximate changes in the overall purchasing power of the dollar.

The real trade-weighted value of the dollar has remained relatively stable because of offsetting movements in the dollar's value across our largest trading partners. Although the dollar has been declining against the yen and mark, it has been appreciating against the Mexican peso and remained fairly stable against the Canadian dollar and other currencies. Since April 1994, the dollar has appreciated 48.1 percent against the Mexican peso and is unchanged against the Canadian dollar (*map*). Canada and Mexico represent nearly 30 percent of total U.S. trade, while Japan and Germany account for around 20 percent of U.S. trade. As a result, the dollar's decline against the yen and the mark has been mitigated by the dollar's rise against the peso and Canadian dollar.

Consequently, while U.S. consumers may see higher prices for imported German and Japanese products, overall U.S. prices may not increase that much because of lower or unchanged prices for Canadian and Mexican imports.

—David M. Gould

Chart 1
Real Trade-Weighted Value of the U.S. Dollar