

Commentary on ‘Causes of Appreciation and Volatility of the Dollar’

Jacob A. Frenkel

Introduction

Our experience with flexible exchange rates has been very sobering. We have been reminded time and again that exchange rates, and especially short-term changes in exchange rates, are unpredictable.

I am sure that many of us — academics, **policymakers**, and market practitioners alike — have shared at one point or another the frustration of what Governor Henry Wallich termed as “the allusive dollar.” When we thought that the purchasing power parity model worked, it collapsed; when we thought that the simple monetary model worked, it failed; when we thought that a richer portfolio-balance model worked, it also failed; when we turned to the current-account model, we did not get much help—and so on and so forth. In fact, as a first approximation, exchange rates seem to follow a random walk. Therefore, by and large, changes in exchange rates (aside for trends) are unforecastable.

In view of these inherent difficulties, market analysts have adopted one of the following two alternative strategies. First, they have been mainly concerned with long-term forecasts. In this vein we have recently been offered doomsday forecasts on the future course of the dollar. According to such forecasts the dollar is bound to fall at some future time and, when it falls it will fall very fast. Such crash-landing forecasts may at best be useful in highlighting possible implications of inconsistent macroeconomic policies. They **are** of little use for the short and the medium runs. Furthermore, since such long-run forecasts **are** typically open ended, in many cases they cannot even be refutable. In this sense the usefulness of such predictions may not be much greater than Keynes' dictum that “in the long run we are all dead” —a dictum about which Robert **Solow** of MIT once remarked that Keynes was always good in making long-term forecasts.

The alternative strategy adopted by market analysts reflects the belief that “if you can't forecast well, forecast often.” The basis for such a belief must

probably be the notion that "a theory a day keeps your critics at bay." As a result, there has been nothing more confusing than reading through the ex-post journalistic explanations offered for the day-to-day changes in the U.S. dollar. For example, over the past few years we were told that:

"The dollar *fell* because the money supply grew faster than expected—thereby generating inflationary expectations,"

but, on another occasion we were told that:

"The dollar *rose* because the money supply grew faster than expected—~~erby~~ ~~erby~~ generating expectations that the Fed is likely to tighten up and raise interest rates."

On another date we were told that:

"The dollar *fell* since the budget deficit exceeded previous forecasts—thereby generating inflationary expectations on the belief that the Fed will have to monetize the deficit,"

but, on another occasion we were told that:

"The dollar *rose* since the budget deficit exceeded previous forecasts—hereby generating expectations that government borrowing-needs will drive up interest rates since the Fed will be unlikely to give up its firm stance."

On yet another day we were told that:

"The dollar *fell* since oil prices fell--thereby hurting Mexico and other debt-ridden oil-producing countries whose bad fortune may bring about the collapse of important U.S. banks,"

but, on another occasion we were told that:

"The dollar *rose* since oil prices fell--thereby helping the debt-ridden oil-consuming countries whose improved fortune will help the vulnerable position of important U.S. banks."

How did the "theory a day" approach explain the zig-zag in the value of the dollar during the past three days? Here the explanation was given in terms of the estimates of GNP growth rate; accordingly we were told:

"The dollar changed again because the extent of the revision of the estimated GNP growth rate was smaller than the expected revision of previous forecasts of these estimates."

One cannot but sympathize with the difficulties shared by newspaper reporters and financial analysts who feel obligated to come up with daily explanations for daily fluctuations of exchange rates, and one can only imagine the deep frustration that yielded the recent headline in the *International Herald Tribune* according to which:

"The dollar rose on no news."

Branson's analysis

Evaluated against this background, William Branson's paper on the "Causes of Appreciation and Volatility of the Dollar," represents a serious effort to provide a logical story accounting for the evolution of the U.S. dollar since early 1981. His framework is attractive in that it recognizes that even though day-to-day changes in exchange rates are intrinsically unpredictable, economic theory and experience have taught us that broad trends can frequently be accounted for in terms of conventional economic fundamentals. Accordingly, in explaining the evolution of the dollar, **Branson** focuses on one important **fundamental—the budget deficit—which he believes did it all**. In his words "...the conclusion is clear: the shift in the budget did it!"

In order to establish his thesis **Branson** constructs a simplified *real* model in which the monetary sector is not even invited to make a guest appearance. According to the basic story, the announcement of The Economic Recovery Tax Act of early 1981 along with the announcement of multi-stage build-up of defense spending, implied large structural budget deficits and started the process of dollar appreciation. Treating the structural deficit as the exogenous shock and using the identities of national income accounts, **Branson** shows that the budget deficit must crowd out domestic spending by raising the saving-investment gap; alternatively (or in addition) the deficit can be financed by the rest of the world through the generation of a deficit in the current account of the balance of **payments**. **Branson** concludes, sensibly, that the rise in the rate of interest and the real appreciation of the dollar were necessary in order to bring about the saving-investment gap and the current account deficit needed to finance the large U.S. budget deficit.

This brings us up to February 1985. But what about the decline of the dollar that took place in the subsequent few months (and which I assume resulted in a change in the title of this conference from the original title on the "*strong* U.S. dollar" to the present title on "the U.S. dollar")? In order

to account for that reversal **Branson** introduces the critical issue of sustainability. He argues that the rise in U.S. debt-service requirement and the path along which U.S. debt increases continuously **are** not sustainable. The cumulative current account deficit will eventually make foreign investment in the United States risky and will command a risk premium. As a result it is likely that further capital inflows into the United States will not be forthcoming. The limited capital inflow will make the deficit in the **current** account of the balance of payments unsustainable, and will necessitate its reduction. The mechanism that will bring about such a reduction is a drastic depreciation of the dollar. According to **Branson** the depreciation which took place after the dollar reached its peak in February 1985 may have signaled the start of that process.

Even though this story seems consistent with the general course of events, **Branson** recognizes that there is a bit of a problem in accounting for the precise timing of the events at both ends of the process. To begin with, the announced Tax Act of 1981 implied that the structural deficit will occur only by late 1982. Yet, interest rates and the dollar started their upward trend much earlier. A similar difficulty is also present at the other end of the process. Specifically, it is not clear what caused the start of the reversal in late February 1985 (leaving aside the more important question whether the process of depreciation has actually began?) In order to deal with the difficult question of timing **Branson** relies on the powerful (but somewhat arbitrary) argument — expectations. Accordingly, the early 1981 credible announcement of the *future* deficit induced asset holders to anticipate a future appreciation of the dollar and a rise in interest rates. As a result, like all good asset market theories tell us, these anticipated future changes were translated into immediate changes in interest rates and exchange rates even though the policies which have allegedly induced these changes have not yet been undertaken. Similarly, **Branson** argues that the decline of the dollar can be explained in terms of expectations. Accordingly, the *inevitable future* implications of continuous debt accumulation have already raised current risk premia and, thereby, have induced the dollar depreciation that started in late February 1981.

Additional factors

Branson's analysis is consistent with the facts and, as such, it cannot be rejected on purely logical grounds. He designed his analytical framework in order to highlight the unique role that U.S. budget deficits have played in effecting the path of the dollar and of real interest rates. Within this framework he accomplished his task. My main comment, however, is that by focusing the discussion on U.S. policies alone and by constraining the analysis to a "real" model, Branson's explanation does not allow for two important

additional factors—those which stem from the monetary sector and those which stem from development in the rest of the world.

Monetary policy

Concerning the first, it seems clear to me that the drastic (and highly successful) course of the disinflationary monetary policy that was undertaken by the United States has surely contributed significantly to the early rise in real interest rates and to the early phase of dollar appreciation. Most likely during those early phases *actual* monetary policy rather than *expected* future fiscal policy was at the center stage. The evidence that lends credence to this alternative explanation is provided by the fact that *short-term* rates of interest rose. Such a rise can be easily accounted for in terms of tight money. It is much more difficult to account for it in terms of expectations about future budget deficits. Similarly, the recent depreciation **occurring** at the other end of the period under analysis (since February 1985) can also be explained in terms of conventional monetary factors. Accordingly, the dollar's drop owes much to the significant slowdown in the rate of growth of the U.S. economy coupled with the prevailing **growth** of the money supply. The combination of the path of monetary policy and the slow growth of real GNP has **meant** that, in relative terms, money was more loose than before and, therefore, the dollar depreciated. In view of these considerations I would suggest that in explaining the evolution of the dollar a stronger role be given to the course of monetary policy.

The budget deficit: a broader perspective

Branson's **formulation** views the "budget deficit" as the basic measure of the stance of fiscal policy. I believe that this concept, even when modified to allow for cyclical factors, may not be sufficiently operational for concrete policy recommendations. Almost any macroeconomic model suggests that there is a significant difference between the effects of budget deficits arising from a change in government spending and the effects of **equivalent** deficits arising from a change in taxes. (And one does not need to **believe** in the **extreme** version of the "Ricardian equivalence" proposition in order to make this assertion.) Further, most models suggest that the **structure** of taxes and government spending may be critical. For example, it **matters** very much whether the tax cut falls on the corporate sector or on households and whether the tax cuts **are** transitory or permanent. **Likewise**, it **matters** whether government spending falls on goods produced by the tradable goods sector or by the non-tradable goods sector and **whether changes** in spending **are** permanent or transitory. **Finally**, the exchange-rate and real interest-rate effects of budget deficits depends critically on **whether** the defi-

cits **are** likely to be financed through borrowing or through monetary expansion. All of these issues are of prime importance. The entire **profile** of the relations among exchange rates, interest rates, and fiscal policies may hinge on them. Therefore, even in a "real" model that focuses on the role of fiscal policies, I would prefer to *see* the budget deficit decomposed into its components.

I wish to emphasize that I am in full agreement with **Branson's** conclusion that fiscal policies in the United States have played a major role in recent years. It is almost self evident that the evolutions of the U.S. dollar and **real** rates of interest during the past few years cannot be fully explained without attaching a significant weight to U.S. fiscal policies. At the same time, however, it is noteworthy that the historical record concerning the relation between budget deficits and real exchange rates is not unambiguous. As a matter of fact the experiences of other countries as well as that of the United States **during other** periods do not suggest a clear cut, strong, and universal relation. In view of this ambiguity it would be useful if we supplement the data from the most recent U.S. experience with additional data pertaining to other experiences here and abroad during other historical episodes.

Knowledge of the broader historical record could be instrumental in preventing the repetition of past mistakes and could be justified by George **Santayana's** famous dictum according to which "those who cannot remember the past are condemned to repeat it." Unfortunately, when applying this dictum to the study of the relation between two macroeconomic variables like budget deficits and the real exchange rate one faces significant difficulties since it is frequently observed that "the past is not what it used to be." Furthermore, and in contrast with many of the experimental sciences, when forecasts of the impact of policies on the behavior of individuals **are** made on the basis of past experience one may frequently observe that also "the future is not what it used to be." The inherent difference between social and physical sciences reflects the impact of experience and memories on individual behavior. It renders the study of past records somewhat less useful since once we go through an experience (as individuals or as a society) we cannot ignore it and start all over again. Therefore, it can only be expected that statistical correlations which prevailed at some point in time may not remain intact under different circumstances. The present (and the future) are likely to differ from the past not because "people and governments have never learned **anything** from history" as argued by **Wilhelm Friedrich Hegel** but rather because the present has the benefit of hindsight whereas the past did not have the benefit of foresight. In view of these considerations, and in recognition of the fact that the recent episode represents a narrow segment of U.S. and other countries' experience, I would be a bit 'more cautious in drawing far reaching conclusions concerning the singular role of the budget deficit.

The role of foreign economics

The second factor that could be usefully added to Branson's analysis of the causes for the evolution of the U.S. dollar concerns fiscal policies in the rest of the world. In this context it is relevant to note that during the same period that the United States followed expansionary fiscal policies, the U.K., West Germany, and Japan adopted a relatively contractionary fiscal stance. The real appreciation of the dollar owes a great deal to the *combination* of tight fiscal policy abroad and loose fiscal policy at home. Further, the pace of economic recovery in Europe has been much slower than the U.S. pace—a lack of synchronization that has also contributed to the real appreciation of the dollar.

In addition to helping to account for the evolution of the dollar, the incorporation of the foreign economies into the analysis may also serve another useful role—it may contribute to the reduction of the pressures for protectionism. It is hard to recall another period in which sentiments for protection have been so widespread in the United States as they are at the present. An excessive emphasis on the U.S. budget deficit as the sole cause for the dollar **strength** and the growing frustration with the efforts to reduce the U.S. fiscal deficit by conventional measures have brought about new desperate arguments for the adoption of protectionist measures like import surcharges. The danger with such recommendations is that they might receive the political support of two otherwise unrelated groups. They **are** likely to gain the support of the traditional advocates of protectionism who claim to defend local industry and workers from foreign unfair competition. But, more dangerously, they may gain the support of those whose exclusive concern with the budget deficit leads them to support almost any policy that raises fiscal revenue. Import surcharges, once in place (even those surcharges that are adopted as "temporary measures") **are** hard to remove since, as George Stigler once remarked "a sustained policy that has real effects has many good friends." At the present there are very few measures whose long-term costs to the interdependent world economy may be as high as protectionist measures. Taxes on trade will hurt exports, and will restore inward looking economic isolationism instead of outward looking economic coordination. Protectionist measures will transmit the wrong signals to those developing countries that are still attempting to resist domestically popular pressures to default on their debt, and, further, **they** may ignite trade war. Therefore, in analyzing the causes for the evolution of the U.S. dollar it is useful to recall that out there, there **are** other economies whose own fiscal stance has contributed to the dollar's strength and who **are** likely to retaliate and open up a trade war if the United States attempts to "solve" its budgetary difficulties by means of import tariffs.

The safe-haven argument

Following his analysis of the mechanism by which the value of the dollar and the real rates of interest have been related to the path of the budget deficit, Branson mentions several additional explanations that have been advanced at one point or another. Among these explanations is the "safe haven" argument according to which the dollar strength can be explained in terms of portfolio shifts towards the relatively safe dollar-denominated assets. There are at least two interpretations of the safe-haven argument. The first emphasizes the *political* stability of the U.S. relatively to other parts of the world in which the risks of expropriations and defaults are higher. The difficulty with this interpretation is that, except for special situations associated with the Iranian revolution and with some of the Latin-American crises, it is hard to associate the periods of sharp rises in the value of the dollar with corresponding deteriorations in political stability abroad. Further, we have not observed a corresponding decline in stock-market indexes in Europe and Japan (a drop that should have taken place if indeed foreign investors divested themselves from other assets in order to purchase U.S. assets), nor did we observe a significant differential between rates of return on dollar-denominated assets issued in New York and other dollar-denominated assets issued in the Euro-currency markets.

The second interpretation of the safe-haven argument emphasizes the confidence that asset holders have in the overall course of U.S. macroeconomic policies. Thus, it focuses on the *economic* stability that is implied by U.S. policies. Accordingly, the successful disinflation and the economic recovery have made dollar-denominated assets attractive. The difficulty with this argument is that, as with the previous one, it is hard to identify those developments in recent U.S. macroeconomic policies that have contributed to enhance confidence by market participants exactly during periods corresponding to dollar appreciation. This difficulty is magnified once we recall that, on the whole, during the period of the dollar appreciation the market interpreted the sustained record budget deficits as bad news concerning the stabilizing effects of U.S. macroeconomic policies.

In principle, the short phase of dollar depreciation following its peak level in February 1985 could also be interpreted in terms of the safe-haven argument. Accordingly, the rise in external U.S. liabilities consequent on the cumulative current-account deficit changed the ratio of the outstanding supply of U.S. to foreign bonds. This change raised the risk premium on dollar-denominated assets and reduced their attractiveness. The difficulty with this argument (as well as with Branson's own interpretation of the depreciation) is that, as an empirical matter, various studies have found that the quantitative magnitude of the risk premium is extremely small. Furthermore, as a theoretical matter, by ignoring the role of stocks and other real assets the

specification of the risk premium as depending exclusively on the relative supplies of bonds of different currency denominations focuses on a very narrow segment of asset holders portfolios. **On the** basis of these considerations, I share Branson's skepticism concerning the force of the safe-haven argument.

Crash landing?

One of the great attractions of Branson's approach is his attempt to explain the evolution of the dollar in terms of fundamentals. My own comments attempted to supplement his choice of fundamental (the U.S. budget deficit) with two additional **ones**—U.S. monetary policy and foreign fiscal policies. The virtues of the "fundamentals-approach to the analysis of the dollar" are that once we identify the relevant list of fundamentals, we may proceed in making concrete policy recommendation as well as in making reasonable forecasts of the prospects for the dollar (based, of course, on forecasts of the likely course that will be followed by the fundamentals). These characteristics are not shared by other approaches like the "bubble approach" that has gained popularity in recent years in spite of the mounting evidence against it.

If the fundamentals approach is to be taken seriously then forecasts of the path of the dollar must be conditional on forecasts of the paths of the fundamentals. Since all the evidence suggest that at least for the medium run the U.S. budget deficit is there to stay, and since by all indications the Federal Reserve Board is unlikely to depart to a significant extent from its anti-inflationary posture, it is difficult to rationalize forecasts of dollar collapse and crash landing as long as these policies remain (and are expected to continue to remain) in place. Can expectations behave erratically and in so doing lead to a collapse of the entire house of cards? Of course they can. But, as long as expectations are based on the model whose outcomes they are purport to be forecasting, it is **unlikely** that they will behave in a manner that is entirely divorced from the implications of the actual changes in the fundamentals. Thus, I conclude that a crash landing is unlikely.

Exchange-rate volatility

In addition to dealing with the secular bends of the dollar, **Branson** points out that volatility is an intrinsic part of flexible exchange-rate regimes. As it were, volatility comes with the **territory**. In this context **Branson** notes that the fact that volatility is normal, does not imply that it is good. Thus he concludes without amplification that "policy **regarding** this volatility is rightly an urgent matter."

I definitely agree with Branson's statement that under a flexible

exchange-rate regime exchange rates are likely to be volatile especially if the underlying factors (including, of course, the underlying policies) are volatile. I also share Branson's judgment that volatility is an urgent matter. I am concerned, however, that such pronouncements, unless they specify how and whether we should act on that urgency, may lead (even unwillingly) towards the adoption of undesirable policies. They may result in the adoption of various intervention rules that may reduce the volatility of exchange rates at great cost. The key point to realize is that *volatility* of exchange rates is not the likely source of the difficulties but rather a *manifestation* of the prevailing package of macroeconomic policies. Fixing or manipulating the rates without introducing a significant change into the conduct of policies may not improve matters at all. It may amount to breaking the thermometer of a patient suffering from high fever instead of providing him with proper medication. The absence of the thermometer will only confuse matters and will reduce the information essential for policymaking. If volatile events and macropolicies are not allowed to be reflected in the foreign exchange market, they are likely to be transferred to, and reflected in, other markets (such as labor markets) where they cannot be dealt with in as efficient a manner.

The preceding argument ignored, however, one of the important characteristics of the gold-dollar system which various proposals for reduced flexibility of exchange rates attempt to promote, i.e., the characteristics of the "discipline of the exchange." Accordingly, it could be argued that the obligation to peg the rate or to follow a predetermined intervention rule would **alter** fundamentally the conduct of policy by introducing discipline. Experience seems to suggest, however, that national governments are unlikely to adjust the conduct of domestic policies so as to be disciplined by the exchange-rate regime. Rather, it is more reasonable to assume that the exchange-rate regime is more likely to adjust to whatever discipline national governments choose to have. It may be noted in passing that this is indeed one of the more potent arguments against the restoration of the gold standard. If governments were willing to follow policies consistent with the maintenance of a gold standard, then the standard itself would not be necessary; if however, governments are not willing to follow such policies, then the introduction of the gold standard per se will not restore stability since, before long, the standard will have to be abandoned. In short, no exchange-rate system can protect us from bad policies.

On international monetary reform

In view of the disruptive effects exerted by the strong and the highly volatile dollar, various proposals for reform of the international monetary system have been put forward. Is this the time for reform? I believe not! If

indeed the root cause for the current difficulties lies in the fiscal positions of the United States, Europe, and Japan, then the solution for the problems does *not* call for a monetary reform, for tariff and protectionism, for taxes on capital flows (or for other measures which throw sand in the wheels), nor does it call for **intervention** rules. Rather, it calls for a restoration of fiscal order in which the United States adopts more contractionary fiscal stance while Europe and Japan adopt a more expansionary stance. I believe that the central difficulties with the current regime do not rest with the exchange-rate system or with the exchange-rate policies; rather, they rest with the overall mix of the uncoordinated macroeconomic policies. It is unlikely, therefore, that the introduction of exchange-rate targets or other superficial measures dealing only with the symptoms of the disease can do any good unless they are accompanied by drastic changes in the way in which macropolicies are being designed. In fact, the adoption of policies that deal with anything but the ultimate root cause may do more harm than good. Placing excessive weight on the role of exchange rates may divert attention from the more central role that global macroeconomic policies play in the interdependent world economy.

In general, in assessing various plans for reform it is pertinent to recall that a critical feature of any operational monetary system must be a formal resolution of the so-called **(n-1)** problem. We have n currencies and only $n-1$ independent exchange rates. We thus have one degree of freedom and its disposal must be explicitly specified. It takes two to tango and it takes one for intervention. The original Bretton Woods system allocated the degree of freedom to the United States which obligated itself to peg the price of gold at \$35 an ounce; the other $n-1$ countries then committed themselves to peg their currencies to the U.S. dollar. A design of the international monetary system is not complete unless it provides a resolution of this **(n-1)** problem. Therefore, in evaluating the alternative proposals my question would be how do these alternative systems deal with the extra degree of freedom. A reform of the international monetary system should be viewed as a constitutional change that occurs once in a lifetime. It ought to be viewed as the "step of last resort." It ought to be thought of as the last bullet which should be used properly and which, once being fired, should better not miss. If the international monetary system needs to be reformed it should better wait until the world fiscal system gets its act together.