Dollars and Speculation

Many exchange-market analysts believe that speculators sometimes cause the dollar to deviate from the path it would normally follow based solely on economic developments. Occasionally, since early 1983, analysts have used this argument to explain the behavior of the dollar.

Exchange traders use all available information, including expectations of future events and policies, when buying and selling currency. Sometimes when new information becomes available, it is incomplete or partially incorrect, thus traders are slow to form firm opinions about its implications. Analysts then might rely solely on recent movements in an exchange rate to indicate market sentiment and future movements in the rate. Traders might then buy an appreciating currency, reinforcing the rise and expectations. More and more traders might buy the appreciating currency, perpetuating the speculative run.

The process continues, and the exchange rate moves further away from its "equilibrium," as long as participants believe that the dollar is further away from appreciation outweigh positive losses associated with an end to the speculative run. The further the exchange rate deviates from equilibrium, the greater the likelihood that the run will end and that investors will incur losses.

Speculative runs probably do not last very long, but they could form and fade away frequently. While they could be influential in the short term, they do not adequately explain long swings in exchange rates.

Recent Trends

The dollar has depreciated about 11 percent on a nominal and a real trade-weighted basis since February 1985. This depreciation is substantial in view of the dollar's persistent advance in recent years. As yet, however, it has offset only a small portion of the dollar's appreciation. Unless it continues, the depreciation's influence on the trade balance and on price levels is likely to be small.

The recent depreciation of the dollar, in large part, seems to reflect uncertainty about the future course of U.S. monetary policy. Economic activity appears to be slowing, federal borrowing requirements remain large, and the U.S. banking system is burdened with troubled agricultural and international loans. To exchange-market participants, these developments increase the likelihood that the Federal Reserve System might pursue more expansionary monetary policy in the future. Such a policy would promote a nominal dollar depreciation by raising prices. As explained earlier, a nominal depreciation of the dollar would do little to enhance the United States' international competitiveness. A more expansionary monetary policy also could lower the real exchange value of the dollar, because price levels often respond slowly to changes in monetary policy. The real depreciation, however, would only be temporary.

While the factors supporting the dollar's real appreciation in recent years no longer seem to favor a continued appreciation, it is too soon to argue that these factors favor a sharp dollar depreciation. The recent decline in the dollar's real exchange value is not much larger than that of early 1984, early 1983, or late 1981. To the dismay of exchange-rate forecasters, all of these depreciations reversed themselves.

The recent experience in exchange markets has shown that, because of the complicated interactions among economic variables and expectations, exchange-market analysts cannot forecast accurately the near-term path of exchange rates. Such failure is not uncommon when one is dealing with prices of financial assets.

The Dollar in the Eighties

In part, the unprecendented appreciation of the dollar since mid-1980 was an adjustment to a slower pace of inflation in the United States as compared to the pace of inflation in most other industrialized countries. If this were the only factor underlying the dollar's movements, the adverse impacts on production and employment would be quite limited.

According to one theory, exchange rates tend to adjust so that a dollar, after conversion to a foreign-currency equivalent, buys as much in a foreign country as in the United States. The currencies of countries with low rates of inflation should appreciate against the currencies of countries with high rates of inflation. Movements in exchange rates that simply offset inflation-rate differentials among countries are called nominal exchange-rate movements. Nominal exchange-rate movements do not alter the international competitive positions of nations and, therefore, do not contribute to a deterioration in a nation's trade balance.

Movements in exchange rates that either exceed or fall short of the adjustments for inflation-rate differentials represent real exchange-rate movements. Nominal exchange-rate movements alter the relative prices of traded goods among countries and, therefore, can have important influences on real worldwide economic activity.

Movements in the trade-weighted dollar do correspond to movements in the differential between the inflation rate in the United States and the trade-weighted inflation rate of our major trading partners. The dollar depreciated sharply between 1977 and 1980, as inflation in the United States accelerated relative to that in most other advanced industrialized nations. This expansionary monetary policy lost confidence in the resolve of U.S. policymakers to adopt and to maintain a credible anti-inflation policy.

The view stated herein are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

THE DOLLAR IN THE EIGHTIES

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The Nominal Trade-Weighted Dollar and the Inflation-Rate Differential

Chart 1 The Nominal Trade-Weighted Dollar and the Inflation-Rate Differential

INFLATION-RATE DIFFERENTIAL

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NOTE: Both U.S. and foreign inflation are measured by 3-month moving averages of changes in the consumer price index. Furthermore, the foreign inflation rate equals a trade-weighted average of inflation in 35 large foreign countries. The inflation rate for the dollar is calculated as the inflation differential, minus the domestic inflation rate.

SOURCE: Board of Governors of the Federal Reserve System; Federal Reserve Bank of Cleveland.

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In recent years, U.S. real interest rates frequently have exceeded historical levels. As chart 2 shows, interest rates on long-term dollar-denominated debt were more than 2 percentage points higher than interest rates on most other industrialized countries. Moreover, in the United States, the long-term interest-rate differential has narrowed over the past two years. The dollar, however, has appreciated 31 percent on a real trade-weighted basis since 1982.

Explain exchange-rate appreciation and the safe-haven view

An appreciation of the dollar could result from the perception of the United States as a "safe haven" for investments. If Americans and foreigners believe that the United States is a "safe haven" for investments, they are more likely to hold dollar-denominated claims. Much of the recent appreciation of the dollar has been tied to a belief that the United States is a "safe haven" for investments, and that this belief supports the dollar.

Exchange-rate appreciation and the safe-haven view

The dollar's safe-haven role derives from the perception of the United States as a "safe haven" for investments. If Americans and foreigners believe that the United States is a "safe haven" for investments, they are more likely to hold dollar-denominated claims. Much of the recent appreciation of the dollar has been tied to a belief that the United States is a "safe haven" for investments, and that this belief supports the dollar.


4. We assume here that holding both securities involves similar risks.

5. If people view current deficits as implying a higher required rate of return on U.S. government debt, then they may require a higher return on U.S. government debt than on dollar-denominated debt. For example, suppose the market believes that the United States is facing a large budget deficit. The deficit has equaled between 3 percent and 6 percent of GNP in the past three years. Many analysts expect the deficit to remain roughly equal to 5 percent of GNP throughout the decade. During the 1970s, the federal budget deficit averaged approximately 2 percent of GNP. During the 1980s, it rarely exceeded 1 percent.

6. The relationship between the deficit and interest rates is not simple; it depends on inflation-rate differentials, the size and expected duration of recent deficits, and the perception of U.S. policymakers about the size and duration of the deficit.