offsetting effects. This, of course, would raise the growth rate of GNP only temporarily, unless the dollar were to continue to depreciate. So the dollar’s 17 percent depreciation between 1985 first quarter and 1985 fourth quarter should, by the end of 1987, raise the level of real GNP by about 1 percent, if there are no other offsetting effects.

However, some offsetting effects are likely. The price rise that accompanies dollar depreciation will reduce the real value of financial assets, and consumers may respond to this reduction of their real wealth by spending less for goods and services.1 Moreover, the consequences of the dollar depreciation would have on output is not clear. Even sophisticated computer models used to predict economic activity yield conflicting forecasts. For example, the Federal Reserve Board’s MIT-Penn-SSRC model of the U.S. economy suggests that dollar depreciation would reduce real GNP, while the Board’s multi-country model suggests that depreciation would encourage economic growth.

Thus, it is not unlikely that an improvement in the trade balance would narrow the gap between domestic demand and domestic output primarily by reducing domestic demand rather than by increasing domestic output. A key to whether this in fact happens is the effect of depreciation on interest rates and on demand for interest-sensitive products. Dollar depreciation will tend to be accompanied by a rise in interest rates. Depreciation will reduce the trade and current-account deficits, thereby reducing the capital inflow that is always equal in size to the current-account deficit. The reduction in capital inflow will raise interest rates, unless there has been a reduction in the federal budget deficit and in federal borrowing needs, or an easing of monetary policy.

A reduction in the federal deficit might accompany dollar depreciation. The Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman Act), mandating a balanced budget by 1991, was recently enacted. If the budget deficit were reduced at a pace that coincided with the reduction of the trade deficit, equal reductions in federal borrowing and capital inflow could leave interest rates unchanged. In that case, dollar depreciation would not burden interest-sensitive sectors of the economy. However, the tighter fiscal policy itself would tend to reduce domestic demand, so there would still be an important offset to the increase in demand from trade balance improvement. Some analysts have capitalized that in the absence of federal deficit reduction, monetary policy could be eased to prevent interest rates from rising as the trade balance improves following dollar depreciation. This option has two serious shortcomings. First, an easier monetary policy could add to the inflationary pressures that dollar depreciation has already set in motion. Second, if inflation expectations were thus reignited, long-term interest rates might be pushed up.

Conclusions

Assessing the desirability of dollar depreciation is difficult for policymakers because it has both favorable and unfavorable effects. Depreciation tends to raise prices, but it improves the trade balance and helps workers and firms in the tradable goods sector. However, it tends to reduce capital inflows and to raise interest rates, thus hurting firms in interest-sensitive sectors. How depreciation will affect real GNP is uncertain, although conventional wisdom says the effect will be favorable. Between summer 1983 and summer 1985, the danger that inflation would accelerate had been reduced, while the danger of protectionism had increased. Moreover, the distress of many firms and workers in the tradable goods sector had increased and the growth rate of GDP had been proceeding slowly. Faced with the unfavorable and unfavorable effects of depreciation, policymakers apparently judged that in the economic environment of summer 1985, but that it had become a good idea in summer 1986.

BULK RATE
U.S. Postage Paid
Cleveland, OH
Permit No. 385

Federal Reserve Bank of Cleveland
Research Department
PO. Box 6387
Cleveland, OH 44101

ECONOMIC COMMENTARY

December 15, 1985

Is Dollar Depreciation? by Gerald H. Anderson

How Desirable Is Dollar Depreciation?

In September 1985, the Secretary of the Treasury announced his counterparts in the Group of Five (G-5) nations—France, Germany, Japan, and the United Kingdom—in announcing a joint effort to lower the exchange value of the dollar.

If this effort to depreciate the dollar is successful, there will be many effects on our economy, some good and some bad. The extent of these effects and their net impact on the nation’s well-being is uncertain. Moreover, the consequences of the efforts depend on the state of the economy when dollar depreciation takes hold. The effort to depreciate the dollar comes after nearly a five-year advance in its value. The dollar began rising in summer 1980 and reached a peak in the first quarter of 1985. Many times during this nearly five-year advance, some analysts urged policymakers to seek dollar depreciation, others argued that additional appreciation should be sought, and still others argued for a laissez-faire attitude toward the exchange rate. One may wonder why policymakers chose to seek dollar depreciation in September 1985, after waiting nearly five years earlier. One explanation is that economic conditions had changed between September 1983 and September 1985 in ways that substantially altered the risks facing the economy.

First, the dollar had appreciated an additional 6 percent on balance, despite a decline from its 1985 first quarter peak, adding to the difficulties facing U.S. firms in the tradable goods sectors, firms that export or compete against imports. Second, many U.S. tradable goods producers had been further weakened by the additional two years of strong foreign competition, threatening the survival of some. Third, a rising tide of protectionist sentiment was evidenced by 300 protectionist bills before Congress. Fourth, the inflation rate had remained relatively low and inflation expectations appeared to have fallen. Fifth, prospects had improved for reduction of the federal budget deficit. Sixth, economic growth had slowed from its rapid pace and capacity utilization had become flat or negative.

Conclusions

We examine some of the possible effects of dollar depreciation and discuss the difficulties that different economic factors cause in predicting how it will affect the overall economy.

Impacts of Dollar Depreciation

Most analysts expect the dollar to depreciate further. The effects of that depreciation will be felt differently for different products and will depend on such things as a producer’s margin, capacity utilization, expectations regarding the permanence of the exchange rate change, and terms of sales contracts.

2. Ibid. pp. 4.
5. In the United States, profit margins similar to those of the past.
The time pattern of trade balance improvement involves what is called the J-curve. Theoretically, currency depreciation could add to trade balance to get worse before it gets better—that is, the trade balance continues to worsen through time. Trade patterns adjust slowly to exchange rate changes because current contracts must be honored, and because it takes time to enter new markets or to find new suppliers. A J-curve can result, with some lagged impact, if the rise in volume is initially unchanged, so that total expenditure on imports rises. This might be true of export earnings, and thus worsen the trade balance. Later, import volumes may respond to the higher prices, reducing expenditure on imports and improving the trade balance. However, recent empirical research has suggested that the effect of the United States. Price indexes and "The Trade Balance and U.S. Prices," Federal Reserve Bank of New York, Quarterly Review, Summer 1983.}


8. A $12 billion reduction in changes in inventories and the real output gap between domestic demand and domestic output. The J-curve is the trade balance during the second quarter of 1986 and then improves through the second quarter of 1986 but, on balance, would improve by less than 11 percent in 1986 third quarter. With depreciation continuing at 2.5 percent per quarter (Path C), the trade balance could continue to worsen through 1986 first quarter, but then improve steadily, exceeding its 1986 third quarter level by $31.2 billion in 1987 fourth quarter and by $53.8 billion in fourth quarter 1988. These figures are not forecasts, of course, because they ignore any other effects, such as economic growth both here and abroad, or changes in protectionism, which could also affect the trade balance.

9. A major reason why the Administration joined the other G-5 nations to seek dollar depreciation was the hope that the resulting trade balance improvement would dampen efforts to promote trade protection and to ease protectionism. Indeed, many analysts have noted the prospect of protectionism, which could also affect the trade balance.