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Where is the Dollar Going?

The value of the dollar, measured in D-Mark, rose from DM 1.80 in 1980 to a temporary high of over DM 2.80 at the beginning of 1984. It then appeared to have settled at somewhat over DM 2.60, only to rise rapidly once more in the first weeks of May. In the previous period, from 1973 to 1979, the value of the dollar had fallen just as dramatically from DM 2.80 to around DM 1.80. Looking back on it, the phase of the strong appreciation of the real value of the D-Mark, and the strong depreciation of the dollar, is not so surprising. The magnitude of the real appreciation of the D-Mark against the dollar can be regarded as essentially the result of a disparity between confidence levels, based on the differing developments of monetary policy, inflation rates and the current account in the USA and the Federal Republic of Germany.

The reduction of the confidence level disparity and, finally, its reversal began in 1979. The second oil price explosion, in 1979/80, showed clearly that German exporters had already fully bid their hand in international competition. They could no longer compete internationally primarily with the quality of their products but were forced increasingly to compete via prices. The surplus on the balance of trade fell dramatically in 1979 and again in 1980, and the current account went into deficit in 1979 for the first time since the introduction of floating. The rate of inflation in Germany increased once more. In the USA, monetary policy switched in 1979 to a tight control of the money supply. The resulting fall in inflation rates did not begin until after 1980 but was then rapid. The high deficit on the American current account disappeared almost entirely in 1979; in 1980 a small surplus was achieved, and in 1981 a larger one. Thus, in 1979 the rise of the D-Mark against the dollar was checked. In 1980 the rapid depreciation – both nominal and real – of the D-Mark against the dollar began. The magnitude of the depreciation can, however, only be explained by the switching of capital which resulted from the reversal of the disparity in confidence levels.

This explanation of the rapid fall of the D-Mark against the dollar is satisfactory for the period up until 1981. The German balance of trade and current account have visibly improved since 1981, however. In 1982 a distinct current account surplus was again achieved. The American current account, on the other hand, ran into a considerable deficit in 1982, which has dramatically increased since then and shows no signs of improving. It is true that American inflation rates continued to decline rapidly up to last year, but German inflation rates have also been distinctly lowered since 1981 – the very restrictive monetary policy of the Bundesbank, especially in 1981, has clearly had its effect. Furthermore, in Germany it was possible to reduce the government budget deficit, whereas in the USA the explosive rise in the budget deficit could not be checked. Yet the reversal in exchange rate trends, which many were expecting, did not take place. Instead, the D-Mark continued to depreciate considerably against the dollar, in both nominal and real terms, in 1983 and even the initial improvement in the D-Mark this year cannot yet be regarded as a reversal of the trend.

This development is, however, less puzzling than it would appear at first sight. A key parameter in explaining it is the high real interest rate on dollar investments compared to the real interest rate on D-Mark investments. Since 1980, when the differential between real

interest rates on the dollar and those on the D-Mark was strongly negative, this differential has continually improved in favour of the dollar, thanks to the rapidly falling inflation rate (which has only recently begun to rise again somewhat) in the USA and has probably been distinctly positive for some time, even if it is taken into account that real interest rates, particularly on long-term investments, are difficult to determine, since they depend on inflationary expectations for correspondingly long periods. The change in the real interest rate differential offers at least a partial explanation for the real rise of the dollar; at the same time, this same differential implies that the dollar is expected to depreciate again in future.

One particularly important ground for the strong rise in interest rates was the dramatic increase in the American budget deficit, caused above all by government dissaving or, in other words, by borrowing for public consumption. This can certainly not be continued indefinitely. If the budget deficit is not reduced, there is a growing danger that, sooner or later, there will be a renewed acceleration of inflation or a severe recession or both.

In almost any other country such a rise in government debts accrued for consumptive purposes, a considerable part of which have, furthermore, been financed abroad, i.e. by an increase in the current account deficit, would rapidly lead to an abrupt loss of confidence in the country's currency and thus – since net capital cannot flow out so quickly due to the sluggishness of foreign trade – to a large real depreciation of the currency. That this has not happened to the United States is due to the fact that the USA, the richest country in the world, continues to be considered a first-class debtor. We can call this the millionaire's effect. A man who has great wealth at his disposal can borrow large sums from a bank for long periods and even crowd out other borrowers by the interest he is willing to pay, even when the bank knows that he is not using the borrowed money for investments but is throwing it out of the window in handfuls. Of course, he cannot keep on doing that forever. If the USA is not able gradually to reduce its budget deficit, confidence in the dollar will sooner or later be lost, and the exchange rate of the dollar in general, and against the D-Mark in particular, will fall. But when this will be, when the millionaire's effect will fade, whether in the next few months, in the course of the year, or not until next year or even the year after next cannot be forecast by the tools available to economists.

It could also turn out quite differently. There are some signs that the USA is about to solve the problem of its structural budget deficit, even if in small stages. If it succeeds in making these steps credible, there will probably not be an abrupt fall in the value of the dollar. Real interest rates will, of course, fall, the dollar will also depreciate in real terms and, finally, the structural deficit on the current account will be reduced; but all of that could take place very gradually. After all, the American economy has adapted itself to high real interest rates. The returns on invested capital are high due to decided wage restraint and the reduction of taxes on employers. Expenditure on machinery and equipment has increased rapidly since the beginning of 1983. If the government gradually withdraws from the credit market it is possible that investors will fill the resulting gap in demand on the credit market, given even a slight fall in real interest rates. The USA's current account deficit could, in that case, remain high, no longer because the budget deficit was keeping dollar interest rates and the dollar exchange rate high, but because the American economy offers the best investment possibilities in the world. Confidence in the dollar would be strengthened, so that foreigners would hardly see any reason to be less willing to invest their capital in the USA, even if the real interest rate differential were reduced.

It should not necessarily be surprising, then, if the dollar remains strong for some time to come. Whether the above applies in the same degree specifically to the exchange rate of the dollar against the D-Mark depends, of course, considerably on how far the Federal Republic succeeds in making investments more profitable and, thus, in strengthening the international competitiveness of the German economy. The upward movements of the dollar in connection with the discussion in Germany on the introduction of a 35-hour working week are an indication of this relationship. As against that, the political argument that the USA is a "safe haven" certainly plays a less important role.

Armin Gutowski