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# The Reagan Dollar

by George J. Viksnins, Washington, D.C.\*

**In a recent editorial (cf. INTERECONOMICS, No. 3/1984, p. 101) Professor Armin Gutowski commented on the surprising increase of the external value of the US dollar which seems to defy traditional explanations of exchange rate determination. The following article presents an American economist's view of the same subject.**

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As the domestic recovery gathers steam in 1984, with unemployment rates trending down much faster than most forecasters were expecting, the US locomotive will probably also pull along the rest of the world. The "debt crisis of 1982-83" should soon begin to fade away just like the "food and oil crisis of 1973-74", which had numerous professional pessimists calling for concerted international action to meet the "emergency." Once again, by the end of the 1970s the market system had provided unconcerted and unplanned action to erase the shortages and to deal with excessive price increases. Weather returned to more normal patterns, inventories were rebuilt, and food prices came down considerably. OPEC got too greedy – Libyan crude reached nearly \$40 per barrel in 1981, but came down to about \$30 per barrel by the fall of 1983. High oil prices signalled that the use of substitutes, additional production, and lower consumption would be required, and market participants reacted. So it will be with the debt crisis, as long as the financial markets are permitted to perform their allocational function.

## Reaction to "Funny Money" Policies

The unexpected inflationary upsurge of the decade of the 1970s benefitted debtors (individuals, business firms, as well as countries borrowing money at fixed rates) enormously. In 1972, the mortgage rate on new homes was only 7.6 %, while house prices over the next ten years rose by roughly 10 % per year. Since mortgage interest is tax deductible, every borrower became a financial genius, and the appreciation of real estate holdings became *the* topic for Georgetown cocktail parties. Moody's triple-A bonds were at 7.21 % in 1972, and corporate vice-presidents arranging long-term bond deals at such attractive rates quickly became company treasurers or CFO's when rates more than doubled later. Countries managing to get fixed-rate borrowing were also greatly benefitted; the World Bank

estimated in 1981 that a transfer of real purchasing power of \$150 billion or thereabouts had taken place from the lenders to the borrowers as a result of inflation.

Clearly, the market system had to react to such transfers of resources. Borrowers and/or investors had succeeded to such an extent in taking advantage of lenders and/or savers that the latter group had to change their foolish ways. Only a child should keep money in a passbook savings account, with the government fixing the rate at 5 % when inflation reached double digits. Indeed, there was perhaps an over-reaction, aided by a major change in Federal Reserve policy in 1979, which permitted interest rates to seek market-clearing levels. Mortgage rates in 1982 reached 15.14 %, corporate Aaa bonds 13.79 %, and Eurodollar rates more than 12 %. Since most developing countries now faced floating rates (whatever the LIBOR, or London Inter-Bank Offer Rate, was in any given year, plus a couple of points), they had to be a good deal more careful in their borrowing also. In addition to these sharply higher nominal interest rates, the lenders struck back at the borrowers politically as well – the election of Ronald Reagan in the United States greatly slowed down, perhaps ended for good, "funny money" policies in the world's most important country. The Reagan-Volcker challenge to "funny money", i.e. rapid inflation leading to negative interest rates and a depreciating paper currency, has since the last election led to the United States becoming a "safe haven" for capital from all over the world, as the nervousness of international investors subsided somewhat.

## Exchange Rate Development

If we look back to President Carter's last years in office, the international situation was considerably different. The price of gold was nearing \$1000 per ounce – itself a good summary measure of the desperate confidence crisis that the world was facing – and the inflation rate was running at a double-digit clip. On a

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trade-weighted basis, by his last year in office the US dollar had lost about 13 % since 1973; for a number of specific currencies, the loss had been much greater – during the decade of the 1970s, the once mighty dollar lost fully half of its purchasing power in Tokyo. The exchange rate in 1968 had been 360 yen, but in 1979 Mr. Carter's mismanagement (as well as union cupidity and management stupidity in Detroit) had produced a miserable 178 yen rate. However, in 1982, Japanese banks were accepting the "Reagan dollar" quite happily at 260 yen to one. The 1984 exchange rate, despite a large decline in US interest rates since 1982, and an enormous bilateral deficit, still hovers around the 230 yen to a dollar, or a bit less most recently.

Generally, the trade-weighted dollar, the exchange rate for our money taking most major foreign exchange rates into account, had appreciated by an amazing 49 % from 1980 to 1983. Since President Reagan came into office the French franc, for example, has lost about half of its purchasing power relative to the US dollar (from \$1 = 4.2250 francs in 1980 to \$1 = 8.6230 francs in January 1984). That change, of course, also partly reflects a vote of little confidence in the policies of Mitterand's government. However, it is interesting to point out that this exchange rate comparison definitely challenges all simple economic explanations of how foreign exchange rates are determined.

### Challenge to Mechanistic Explanations

First, if we look at relative prices, which the purchasing-power-parity theorists would have us do, the percentage change in the French Consumer Price Index from 1979 to 1982 is essentially the same as in that of the US. While it is true that the 1984 inflation rate in France is expected to be around 7.5 % (though I am willing to entertain a modest wager that it will exceed that), it is forecast at about 5.0 % for the US. Surely the expected 2.5 % inflation differential is not enough to cause the very large difference in exchange rates noted above.

Second, another simple economic rationale given for exchange rate movements is the one involving interest rate levels and their rates of change. This one is gruesomely wrong over the past four years. In absolute terms, nominal French interest rates have been consistently above US short-term rates, which would (should) lead to profit-maximizing investors wishing to hold their funds in franc-denominated securities, the latter yielding 12.3 % in late 1983 versus only 8.88 % in the US. Right? Wrong. While US interest rates have fallen much faster than those in France, relatively the US dollar has appreciated greatly, suggesting that

standard economic models seeking to account for exchange rate movements in terms of interest rate differentials have about the same explanatory power as inspecting the entrails of a chicken.

Third, a considerably more powerful theoretical comparison is yielded by a comparison of money growth rates and their direction. While in 1980 both countries showed a rate of growth in the money stock of about 8 % (in fact, US money growth was slightly higher than the growth rate in France), since then the growth rate in the money supply in the US has been somewhat lower, while the rate of monetary expansion in France has been increasing steadily, although it does depend upon whether one looks at M1, M2, M3, or even L.

### Governmental Credibility a Key Factor

Still, the main point of this harangue is quite simple – there are no mechanistic explanations that serve well to account for differences in either inflation rates or exchange values. A key factor seems to be governmental credibility or trust: the Reagan administration has apparently convinced both American consumers and foreign investors that it will not allow the US dollar to depreciate continuously either domestically or internationally. As a result, the gold price has been more than cut in half (from \$900 to less than \$400), the foreign exchange value of the dollar has risen (even for the D-mark, from 55 to 37 cents!), and the domestic inflation rate has been cut from 12 percent to less than 3 percent last year, and to 5 percent this year. All of these changes are better explained by the idea of "credibility" than by either interest rate differentials or inflation rate changes.

Thus, the media allegation that a \$200 billion government deficit here leads to high interest rates, leading to an appreciation of the US dollar, which in turn destroys the competitiveness of our export industries, seems rather simplistic and far-fetched. First of all, the budget deficit has two mutually off-setting effects on the foreign exchange value of the dollar, which are rather difficult to calculate precisely. If government purchases of goods and services grow by \$20 billion in the next twelve months and taxes are reduced by the same amount, assuming a G multiplier of 3 and a T multiplier of 2 (all very crude guesses), the effect on GNP would be an increase of \$100 billion. Again, very crudely, assuming a marginal propensity to import of 0.15, that would mean an increase in the *demand* for foreign exchange, or an increase in the *supply* of dollars, of \$15 billion. The net change in G-T over the past two years is in fact larger. Yet, in the financial markets, a recent

estimate for 1984 net foreign sources of funds in the financial markets is only \$26 billion (according to Morgan Guaranty). Therefore, it would probably take quite an interest rate hike in real terms to offset the weakening of the dollar due to import expansion through the standard Keynesian multiplier process. The strengthening of the dollar during the Reagan years is not primarily due to the impact of the deficit on the international capital market, but to differences in investor confidence – their basic belief that American policy-makers will turn out to be more responsible than those in the rest of the world.

### **Implications of the Presidential Election**

Thus, as we near the election, the Reagan dollar will probably weaken somewhat, but not by very much. The organized futures markets expect the Swiss franc to appreciate by roughly 5 % over the next twelve months, with the Japanese yen and the German mark going up by 3 to 4 %. With respect to most other currencies, the dollar is expected to remain quite strong, but not appreciate further. This should signal the major debtor countries that it will be difficult, but not at all impossible, to earn US dollars for debt service. As inflation in the industrial world rises somewhat, and the recovery proceeds, the real burden of the debt will decline somewhat, but certainly the market signal to the spendthrifts is loud and clear: "Neither a borrower nor a lender be", at least not in the real amounts of recent years.

To summarize the argument briefly, the US government's budget deficit affects the foreign exchange value of the dollar in at least two ways. First, increases in government spending tend to boost overall national income through the multiplier process, which leads to an increased demand for imports. In the longer run, higher public sector expenditures may also crowd out private investment outlays, and contribute to inflation. This would push the value of the dollar in a

downward direction. Second, the impact of a deficit on capital flows is a bit more ambiguous, since present interest rate levels are not the only consideration motivating the buyers of dollar-denominated assets. While it is true that fears about the continuation of a deficit in the \$200 billion range are contributing to high real rates in the US bond market, they are not greatly out of line with rates elsewhere. In Germany, for example, 1984 inflation rates are forecast at 3.0-3.5 %, while short-term interest rates are slightly above 6 %. That gives us a real rate of 3 % or slightly less. The official US forecast shows a Treasury-bill rate of 8.5 %, but a 1984 inflation rate of 4.5 %. That spread in real rates – 3 % in West Germany versus 4 % in the US – is hardly large enough to have New York "suck up" all European investment capital, or to ruin our export sector's competitiveness, or do anything very major.

In an editorial at the beginning of the year, the London *Economist* asked: "Will the Dollar Vote for Reagan?" and answered in the negative. On the basis of the argument outlined above, one would expect very little change, and on balance, a sort of a "don't know" attitude from the dollar until the elections. There will be some downward pressure from the current account deficit, but that will be countered by US real interest rates remaining positive and continuing "safe-haven" investments from Latin America and the Middle East. As President Reagan's re-election chances approach a greater level of confidence, the dollar should stabilize near present levels. It would probably appreciate slightly if meaningful action is indeed taken on a "down-payment" to reduce the structural budget deficit in the near future, which would also help the current account by reducing the probability of future inflation and monetary expansionism. To say that the US dollar is currently over-valued by 32 %, or some such silly number, is to substitute the judgment of an economist for that of the market. Guess who has more often been wrong in the past?

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