Is a Benign Dollar Policy Wise?

William Poole

Officially, the United States has a strong-dollar policy, whatever that is supposed to mean. In practice, what we see is a benign dollar policy, by which I mean that the United States is very unlikely to take any action to attempt to affect the value of the dollar on the foreign exchanges that it would not take for other reasons. My title asks the question "Is a Benign Dollar Policy Wise?" My answer is a resounding "yes."

Recent Behavior of the Dollar

Figure 1 shows the recent behavior of the dollar, which some observers regard with concern.[1] They focus on the decline in the dollar, but do not seem to have a long-run perspective.

Figures 2 and 3 provide a long-run perspective. When measured by the broad index, the dollar has strengthened over the years; meas-

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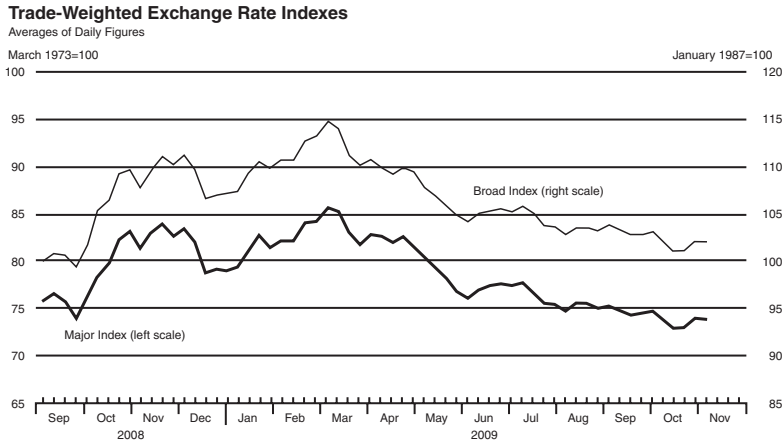
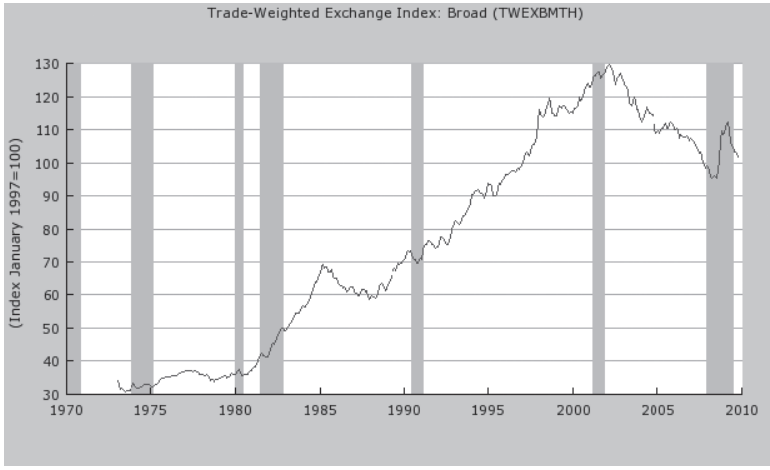
[1]Final edits on this article were entered in early March 2010. However, the figures were left as they were for the conference version of the article. At the time of the conference, November 2009, the dollar-euro exchange rate was $1.49 per euro. In early March 2010 the rate was about $1.36 per euro. The abrupt change from bearish dollar sentiment at the time of the conference to bullish dollar sentiment by March 2010, mostly as a consequence, apparently, of fiscal problems in Greece, nicely illustrates a main theme of the article. Short-run changes in exchange rates are entirely unpredictable. Moreover, an attempt to model exchange rate movements propelled by fiscal concerns, such as over Greece, would most likely end in failure. Final edits retained the November 2009 vantage point; thus, "recent," for example, refers to information and events in the period immediately prior to November 2009.

FIGURE 1
TRADE-WEIGHTED DOLLAR IN THE SHORT RUN



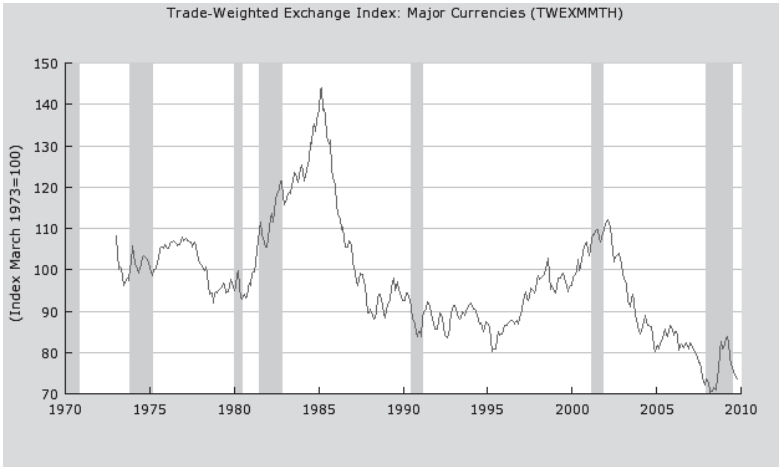
SOURCE: Federal Reserve Bank of St. Louis, U.S. Financial Data.

FIGURE 2
TRADE-WEIGHTED DOLLAR IN THE LONG RUN:
BROAD INDEX



NOTE: Shaded areas indicate U.S. recessions.
SOURCE: Board of Governors, Federal Reserve System.

FIGURE 3
Trade-Weighted Dollar in the Long Run:
Major Currencies Index



Note: Shaded areas indicate U.S. recessions.
Source: Board of Governors, Federal Reserve System.

ured by the major currency index, the dollar has depreciated. Even so, the major currency index is down by only about 26 percent since 1973, or a compound average depreciation of 0.84 percent per year. The shorter-run fluctuations are much more striking than the long-run trend. They are impossible to predict and difficult to explain even after the fact with statistically reliable models.

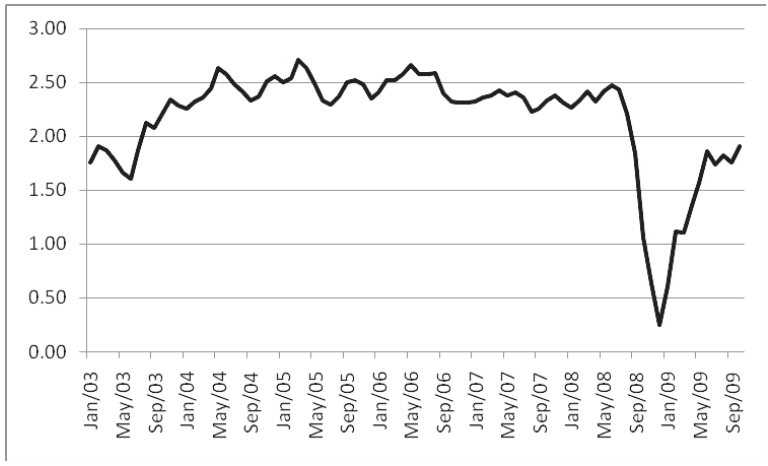
The clearest episode providing an analog to today's concerns is dollar depreciation in the late 1970s, which was clearly connected to rising U.S. inflation and loss of confidence in the Federal Reserve. Those offering this explanation of depreciation between March and November 2009 often point to increases in the price of gold accompanying dollar depreciation as evidence of inflation concerns.

It is important to emphasize that that the rising dollar price of gold and the dollar depreciation are not two separate measures of inflation concern. Over the six months ending November 2009, the price of gold rose by about 9 percent in euros. The higher price increase in dollars, about 19 percent, simply reflects dollar depreciation against the euro. Thus, the question is whether dollar depreciation/gold price increases reflect market concerns with regard to U.S. inflation.

I myself am concerned that the Federal Reserve will not be successful in keeping inflation below, say, 2 percent at an annual rate as the economic recovery gathers strength. But my concern does not seem to be reflected in the Treasury bond market. Inflation compensation as measured by the spread between 10-year indexed and 10-year conventional bonds is still right around 2 percent. In recent years, inflation compensation has been between 1.6 percent and 2.6 percent most of the time. The increase in inflation compensation in 2009 was a consequence of an abnormal decline in the conventional 10-year Treasury bond in the fall of 2008, in part from a flight to safety after the Lehman failure and in part due to Federal Reserve hints in December 2008 that it would intervene heavily in the Treasury bond market to drive down yields. Figure 4 tells the story.

In sum, dollar depreciation in 2009 is not clear evidence of rising inflation concern in the market. Such concern would also have to register in inflation compensation in the Treasury bond market, and it just isn't there. I interpret this dollar depreciation, therefore, as just

FIGURE 4
Inflation Compensation: January 2003–October 2009
(10-yr Nominal T-Bond Less 10-yr Indexed T-Bond, Constant Maturity Series)



Source: Data from Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED).

another inexplicable short-run dollar fluctuation, like so many in the past.

What Should the Fed Do?

A benign policy makes many people nervous, and leads some observers to call for action to stem the dollar's decline. If dollar depreciation reflected rising inflation expectations, then inflation concerns rather than dollar depreciation per se would justify a tighter Fed policy. The question, then, is whether the Federal Reserve should do something about dollar deprecation even though inflation expectations approximate the Fed's inflation target.

The Federal Reserve has essentially one aggregate policy instrument, which can usually be viewed as its target for the federal funds rate or the monetary base. The issue of how to characterize the policy instrument today, with the Fed's array of special credit facilities, would take me far off track. Thus, for present purposes just assume that such a characterization exists.

Under the Federal Reserve Act, the Fed has two policy objectives: high employment and low inflation—the dual mandate. Low inflation should be regarded as the *primary* objective, because its achievement is necessary to achieve sustained high and stable employment.

In an open economy, expansionary monetary policy works through the interest rate and the exchange rate. Currently, expansionary policy is having the expected effect of reducing interest rates on private securities—spreads over Treasury rates have been declining. And, the dollar has been depreciating, an expected feature of a monetary policy that is more expansionary in the United States than abroad. Lower interest rates will tend to boost private spending in the United States and a depreciated dollar will tend to boost exports and restrain imports. To the extent that other countries resist dollar depreciation by following more expansionary monetary policies, a third mechanism of expansionary U.S. policy is at work—encouragement of expansionary policy abroad with the effect of raising foreign income, output, and demand for U.S. exports.

For the United States, the issue is whether dollar depreciation is evidence that monetary policy is too expansionary. My view is that Fed policy is not too expansionary at present, given the depressed state of the U.S. economy. I do have concerns that the Fed will fail

to scale back its expansionary policy in the future in time to prevent higher inflation, but that is not an argument for less expansionary policy today. Nevertheless, if monetary policy is more expansionary today than it should be, the case needs to be made based on information beyond dollar depreciation. Note, for example, that MZM and M2 have been almost flat while bank credit has been declining almost constantly from October 2008 to November 2009.

Those who want the Federal Reserve to have a policy objective involving the exchange rate per se must explain the extent to which they are willing to compromise on achieving the dual mandate. It has been a staple of macroeconomic analysis for decades that a policy authority must have multiple instruments to achieve multiple objectives. Do advocates of tighter monetary policy want to slow progress on achieving high employment with price stability? That is, are they arguing for simply accepting 10 percent unemployment for a while to help stabilize the dollar exchange rate? The stark reality is that it is impossible to achieve multiple objectives with only the one monetary policy instrument. Sometimes this point is recognized by a call for application of additional policy instruments, but what are they?

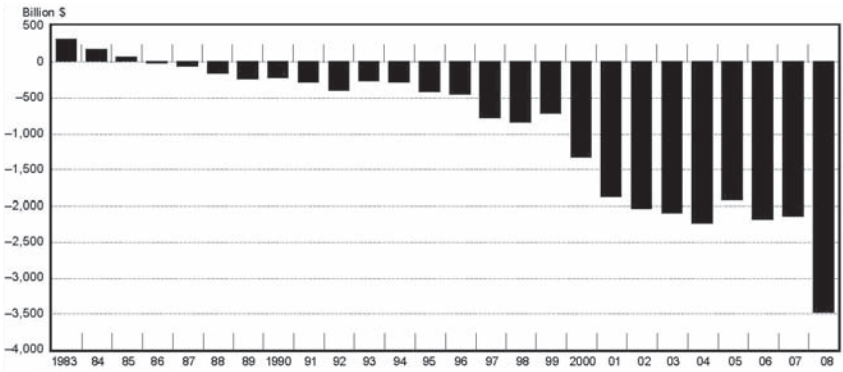
Direct intervention in the foreign exchange markets has at best a temporary effect and the considerable downside of destabilizing expectations about future interventions. The call for other instruments may also lead to trade restrictions in the form of higher tariffs and/or quotas on imports. These are always welcomed by protectionists but are highly undesirable.

Figure 5 displays the reason for some of the concern. At estimated market value, foreign-owned assets in the United States exceed U.S. assets abroad by about $3.5 trillion. The United States is, it is said, the world's largest debtor nation.

The "debtor nation" rhetoric is inaccurate in that some of the foreign-owned assets in the United States are equities and direct investments, such as auto production facilities. Most importantly, however, foreign claims on the United States are almost entirely denominated in dollars while U.S. claims abroad are mostly denominated in foreign currencies, or reflect direct investments abroad. These facts are extremely important for assessing the likelihood that dollar depreciation could become cumulative.

A depreciating currency is a real risk for the typical heavily indebted country because claims on the country are mostly denomi-

FIGURE 5
U.S. Net International Investment Position, Year-end, 1983–2008



Source: U.S. Bureau of Economic Analysis.

nated in currencies other than the home currency. For such countries, depreciation raises the home-currency value of the foreign claims, and may create a fiscal crisis. The U.S. situation is completely different. Dollar claims on the United States are not affected by dollar depreciation, while the dollar value of U.S. assets abroad increases.

The Bureau of Economic Analysis publishes regularly an analysis of the net international investment position of the United States, from which Figure 5 was taken. The BEA also publishes an interesting table decomposing the change in the international investment position. One of the columns in the table reports the effect of changes in currency values. Over the course of 2008, the dollar appreciated by 8.39 percent as measured by the trade-weighted major currency index. As a consequence of dollar appreciation over the course of 2008, the dollar value of U.S. assets abroad declined by $776 billion; also, foreign-owned assets in the United States declined by $91 billion, yielding an increase in the U.S. negative net investment position of $684 billion.

This phenomenon is critically important to understanding why dollar depreciation is a self-limiting process, provided that the U.S. inflation rate remains relatively low. Dollar depreciation increases the dollar value of U.S. assets abroad. Dollar depreciation during 2002–06 (see Figures 2 and 3) is why the net negative international

investment position of the United States did not change much, as seen in Figure 5, despite continuing large current account deficits. Dollar depreciation in 2009 had the same effect. Depreciation may also be part of the story behind U.S. stock price increases in 2009, as dollar depreciation boosted earnings from foreign operations of U.S. companies.

These remarks are predicated on the assumption that U.S. inflation remains relatively low. If inflation rises materially, then the situation will change dramatically. A flight from dollar assets would be likely, which would drive the dollar down, perhaps precipitously. Dollar weakness would feed back to further increase the U.S. inflation rate, and the situation could become increasingly unstable.

Concern over the U.S. international investment position seems centered on China, which has accumulated a large stock of dollar assets, mostly in the form of U.S. Treasury securities. As long as U.S. inflation remains low, these assets will retain their value in terms of U.S. goods and services. However, China will never—repeat, never—be able to realize this value unless it is willing to run a current account deficit—to import more goods than it exports. China has accumulated dollar assets by pursuing a policy of maintaining an export surplus, and as long as that policy continues China will accumulate assets abroad. The United States will keep faith with China, and other international creditors, if U.S. inflation remains low and the purchasing power of the assets over U.S. goods and services is retained. The United States never had any reason to promise to maintain the purchasing power of dollar-denominated assets in any other currency, such as the yuan. The dollar/yuan exchange rate is not within the control of the United States, nor should the United States make any effort to achieve any particular value for that exchange rate.

According to press reports, some countries are complaining that expansionary U.S. policy and dollar depreciation are forcing them to pursue more expansionary policies than they would like. That argument is simply wrong. Under the flexible exchange regime the world enjoys, every country has the option of permitting its currency to appreciate against the dollar. It is not the responsibility of the United States to conduct its policies so that other countries are relieved of making their own choices on their macro policies and exchange rates.

If China, for example, is unhappy about the dollar/yuan exchange rate, then tough luck. That is not a very diplomatic way of putting the

issue, but it was China's policy and not U.S. policy that led China to accumulate a large stock of Treasury securities. Neither the Federal Reserve nor any other part of the federal government has any obligation to attempt to maintain the purchasing power of dollar-denominated assets in any currency other than in dollars. The U.S. obligation is to maintain price stability at home. Success in achieving that objective is good for the United States and good for the world economy.

Conclusion

U.S. success in maintaining price stability, with the exception of the period from 1966 to 1981, is responsible for the high demand for dollar-denominated assets around the world. Other aspects of U.S. policy are also critically important, such as the rule of law, political stability, and absence of exchange controls. These policies taken together have made the United States the premier provider of safe assets in the world. That is why the goal of Federal Reserve policy should remain to be successful in meeting the dual mandate. That success, if it continues, will in time cause the memory of the policy failures, public and private, that created the Great Recession to fade.

A benign policy toward the dollar, and neither a strong nor a weak dollar policy per se, is what the Federal Reserve should pursue.