Draftings In

Volume 3
Number 3 *Draftings in Economics: Major Themes*

Article 6

1988

The Appreciation of the Dollar 1980-1985

Stephanie A. Staton
University of Northern Iowa

The Appreciation of the Dollar 1980-1985

by Stephanie A. Staton

Rarely has there been a currency whose real exchange rate has risen so much and for so long as did the dollar from 1980 to 1985. This prolonged appreciation caused a misalignment of the dollar, the world's key currency. Misalignment of the dollar as will be used in this paper means that the value of the dollar is "completely out of line with international cost and price relationships and also out of line with the trend of the American trade and current account" (Emminger, 1985, p. 20). According to Emminger, misalignment also produced distortions or a lack of proportionality between the dollar and foreign currencies. For example, a rise in the real value of the dollar means U.S. goods are more expensive relative to foreign goods. Because of these distortions, in February 1985, Secretary of the Treasury James Baker III initiated steps to devalue the dollar. The purpose of this article is to explain the reasons why the dollar was so strong and why it was devalued.

Exchange Rates

Two types of exchange rates can be identified: nominal and real. The nominal exchange rate is the price of the dollar in terms of a foreign currency. Using Hakkio's approach (pp. 36-37), a nominal exchange rate can be expressed by the equation

$$e = q(p^*/p)$$

where q^5 real exchange rate, $p = $ U.S. price level, and $p^* = $ foreign price level. The real exchange rate is the relative price of U.S. goods in terms of foreign goods. It reflects the underlying terms of trade between U.S. and foreign goods. An increase in the real exchange rate or the foreign price level causes the nominal exchange rate to depreciate. If tastes change such that foreigners buy U.S. goods instead of domestic goods, (e.g. U.S. beef instead of Japanese rice), this will shift demand and increase the relative price of U.S. goods, leading to a rise in the real exchange rate.

Hakkio lists three factors which cause real and nominal exchange rates to change. First, a positive shift in demand by a foreign country for U.S. goods tends to raise the relative price of these goods, leading to a rise in the real exchange rate. If domestic and foreign price levels do not change, the nominal exchange rate will also rise. If, for example, Japanese consumers need more dollars to purchase U.S. beef, they sell yen and buy dollars, causing the foreign exchange value of the dollar to increase. The opposite happens with a decrease in demand for U.S. beef.

Second, international investment and savings decisions affect the exchange rates. In addition to buying U.S. goods, Japanese investors might also buy U.S. assets such as real estate, stocks, or bonds. If Japanese investors do buy U.S. assets, the real exchange rate will rise. Their decision to buy U.S. assets requires the purchase of additional dollars in the foreign exchange market, resulting in an appreciation of the dollar. The decision to sell U.S. financial assets depreciates the real and nominal exchange rates.

Third, changes in U.S. and foreign price levels also affect nominal exchange rates. When inflation in the U.S. is higher than inflation abroad, the nominal exchange rate depreciates because foreigners reduce their purchases of expensive U.S. goods and therefore reduce their demand for dollars in foreign exchange markets. In contrast, when foreign prices rise faster than U.S. prices, the nominal exchange rate appreciates because the U.S. will import fewer of the more expensive foreign goods. As a result, the demand for foreign currency falls and the exchange value of the dollar rises.

The Strong Dollar

According to Hakkio and Whittaker (1985), when the value of the dollar rose during the period of 1980 to 1985, along with the appreciation came the misalignment of the dollar with respect to foreign currencies. The extent of the misaligned dollar is hard to estimate, partly because the exchange rate is determined in a world capital market, and a wide range of exchange rate behavior is possible. Another difficulty is that, if the dollar is misaligned, it is relative to some benchmark or point of reference which could in itself be in error.

Some causes of the strong dollar and the eventual misalignment that followed include inflation scares, high interest rates, and the increase in the size of the federal budget deficit. During the 1980's, "changes in real interest rates were the dominant influence on nominal interest rates and the dollar" (Hakkio and Whittaker, 1985, p. 5). The rise in the federal budget deficit raised U.S. interest rates, fears of inflation, and the real exchange rate. This appreciation of the dollar, which increased the price of U.S. exports and decreased the price of U.S. imports, led to a current account deficit and an increase in net foreign borrowing.

The exchange rate, along with the interest rate, jumped in 1981 because of public expectation that the budget deficit would worsen. Because the public expected the budget deficit to worsen, it also expected the exchange rate and interest rate to rise. This is because a higher budget deficit encourages higher interest rates which in turn increases foreign demand for dollars, thus causing the exchange rate to rise. These expectations eventually became reality in the manner of a self-fulfilling prophecy.

Specific Effects

The dollar misalignment had several effects. At first, the highly valued dollar had a positive effect on the United States. From 1983 to 1984 it prevented the U.S. economy from over producing by deflecting excessive foreign demand for U.S. goods. This reduced aggregate demand in the U.S.; however, because businesses did not recognize this misalignment, they failed to reduce production. The result was to change the relationship among interest, inflation, and exchange rates in the U.S. And the longer the misalignment lasted, the more the imbalance became disadvantageous to the U.S. economy.

Misalignment placed a drag on the economy. The U.S. current account, as noted by Hakkio and Whittaker, changed from a 1980 near-zero balance to a 1984 $100 billion deficit, illustrating decreasing foreign demand. Part of the current account deficit was due to a real appreciation of the dollar which caused the price of U.S. goods to rise and the price of foreign goods to fall, leading to a shift in demand from U.S. goods to foreign goods. The appreciation of the dollar also contributed to the decline in U.S. inflation by reducing the price of imports which also had the effect of stimulating foreign production.

The effect which the strong dollar had on Japan is the reverse of the effect on the U.S. The impact was at first negative. The strong dollar hurt Japan initially since high U.S. interest rates forced Japan to raise its own interest rates in order to attract financial capital. The strong dollar also contributed to Japanese inflation by increasing the price of imports into Japan. Later, this situation turned postive for Japan at the expense of the U.S., because the strong dollar and the U.S. trade deficit became a stimulus to Japan.

Devalued Dollar

Because of concerns about the high U.S. trade deficit, steps were taken in February 1985 to devalue the dollar. Secretary of the Treasury James Baker III orchestrated the decline. The strategy used was called the Plaza Accord. Under the Accord, the U.S., West Germany, Britain, Japan, and France agreed to shrink the dollar's value by having central banks sell dollars on the currency markets when the dollar was already declining. Over time, this caused the dollar to decrease in value by 32 percent. The result was a boost in U.S. trade.

According to Lord (1986), the U.S. strategy was to weaken the dollar in order to get other industrial nations to speed up their economic growth and lessen America's trade deficit. So far, this strategy has not worked. Stephen Magee's J-Curve theory suggests that when a nation devalues its currency, its trade deficit will improve but only after first worsening.[1] Despite a more than 40 percent drop in the dollar's value against the Japanese yen, the U.S. trade deficit refused to complete the J-Curve. Meanwhile the U.S. continues to press the Japanese to stimulate their economy so the J-Curve can be completed. Otherwise the U.S. will have to depress the dollar further.

Conclusion

The yen's appreciation against the dollar has cut into Japanese manufacturing profits, thus pressuring Japan's central bank to stop or slow the dollar's slide. Also, as the yen strengthens, foreign assets become cheaper, encouraging the Japanese to invest overseas at the expense of Japanese domestic investment.

At this time, the future is unclear. A further decline in the dollar, according to Paul Volker, former Federal Reserve Board chairman, would mean high inflation and high interest rates for the United States. For the Japanese, export markets will shrink if the yen continues to rise against the dollar, and heavy industry will deteriorate. A trade war with the U.S. is not out of the question.

Note

[1] *For further information, see Melvin, 1985, pp. 110-112.*

References

Emminger, Otmar. "The International Role of the Dollar," *Economic Review*, Federal Reserve Bank of Kansas City, Sept./Oct. 1985, 70 (8), pp. 33-43.

Hakkio, Craig. "Interest Rates and Exchange Rates—What is the Relationship?" *Economic Review*, Federal Reserve Bank of Kansas City, Nov. 1986, 71 (8), pp. 3-15.

Hakkio, Craig and Whittaker, J. Gregg. "The U.S. Dollar—Recent Developments, Outlook and Policy Options," *Economic Review*, Federal Reserve Bank of Kansas City, Sept./Oct. 1985, 70 (8), pp. 3-15.

Lord, Mary. "Dollar Diplomacy at the Brink," *U.S. News and World Report*, Oct. 13, 1986, 101 (15), pp. 49-50.

Melvin, Michael. *International Money and Finance*. New York: Harper and Row, 1985.