Flossbach von Storch
RESEARCH INSTITUTE

ECONOMIC POLICY NOTE 10/4/2018

US dollar weakness under the microscope

AGNIESZKA GEHRINGER

- Despite interest rate increases by the US Federal Reserve and the recent tax reform the effective US dollar exchange rate depreciated by eight percent since the end of 2015.
- For many observers this is a puzzle. Indeed, a similar policy-mix of a tax reform and monetary tightening by the Fed at the beginning of the 1980s led to a 40-percent appreciation of the US currency.
- However, the comparison between now and then is delusive. The currently moderate economic growth and inflation dampen interest rate expectations and consequently the appreciation of the US dollar. It looked different in the Reagan era.

Reagonomics

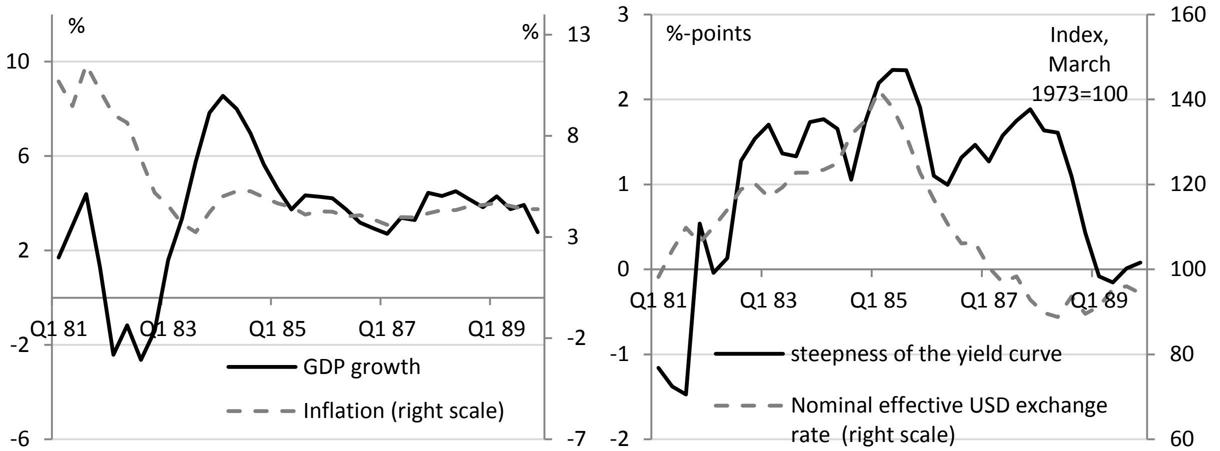
At the onset of the first term in office, the Reagan administration passed the Economic Recovery Act in 1981, through which the top individual income tax rate fell from 70 to 50 percent and businesses were aided with numerous provisions.[1] Thereupon the US economy recovered from the recession and, starting in the first quarter 1983, entered into a solid economic upturn. The acceleration of economic growth was so strong (from negative two percent GDP growth in 1982 to seven percent in 1984) that it led to a fast return of inflation. The Fed didn't hesitate an immediate answer and raised its policy interest rate between January 1983 and October 1984. This development continued up to the mid-1980s, with a steepening US yield curve and a 40-percent appreciation of the effective US dollar exchange rate. After 1985 the US economy began slowly to run out of steam (**Figure 1**).

[1] Among others, measures setting new depreciation rules and special tax treatment for buyers of upset thrift institutions were introduced, the amount of retained earnings exempted from taxation was raised, the rules for Subchapter S corporations (a category of small businesses) were relaxed and merger activity was fostered.

Why is the US dollar so weak today?

The current policy-mix of a moderately restrictive monetary stance and Trump's recent tax reform would, in principle, let expect a US dollar appreciation. However, the US economy is in a quite different economic shape today than it was in the 1980s. Contrary to the 1980s, the US economic dynamics is currently restrained compared with the other major economies, as is clearly shown by the Composite Leading Indicator in **Figure 2**. As a

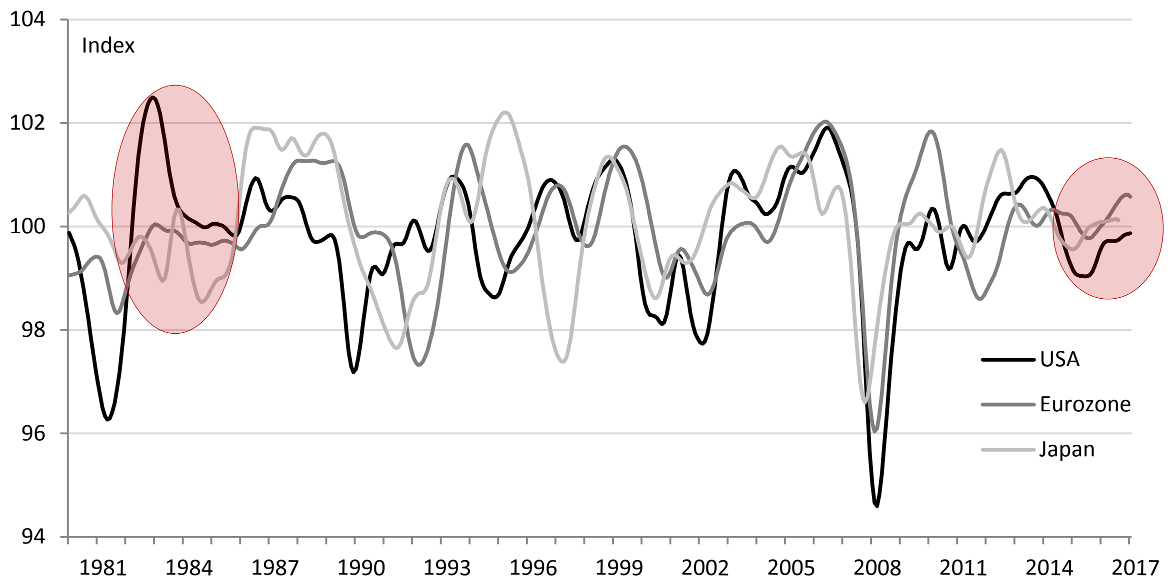
Figure 1. Economic conditions in the USA in the era of the Reagan administration



Note: The steepness of the US yield curve is defined as the yield differential between the 10-year and the one-year US government bond. The nominal effective exchange rate of the US dollar is trade-weighted against major US trading partners.

Source: Haver Analytics, own calculations Flossbach von Storch Research Institute.

Figure 2. **Composite Leading Indicator: shows cyclical developments of economic activity**



Source: OECD Data, Flossbach von Storch Research Institute.

consequence, the actual moderately positive momentum in the US is insufficient to exercise an appreciation pressure on the US dollar.[2] Much more positive surprises on growth and inflation would be required in order to push the US dollar higher.

Economic policy and the exchange rate

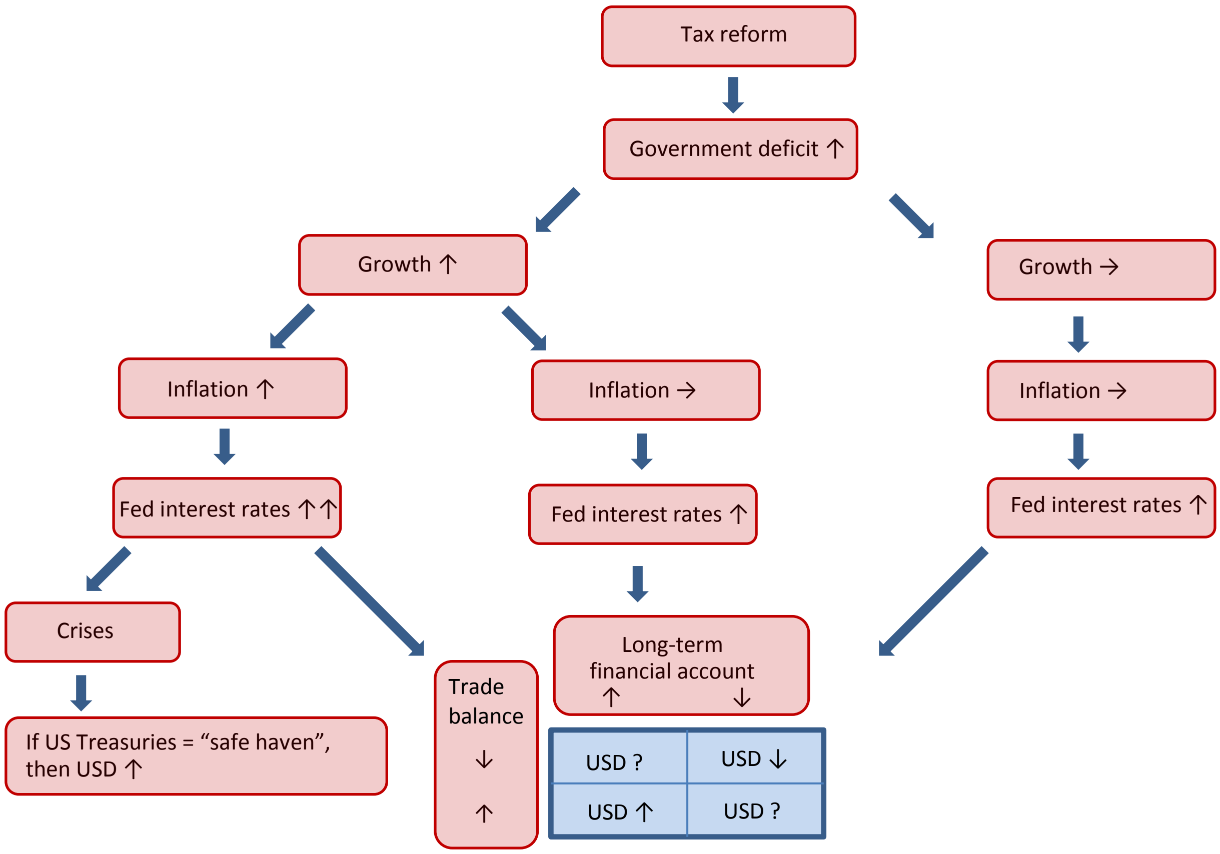
The link between economic policy and the exchange rate development can be represented in a simple arrow diagram (**Figure 3**). It seems very probable that Trump's tax reform will cause further deterioration of the government budget in the short to medium term. However, the influence on economic growth and inflation should be contained. This is more so due to the strain of the ongoing trade disputes. As a consequence, the Fed should not be forced to accelerate its currently planned interest rate normalization cycle (the arrows on the left in Figure 3).

The most likely at the moment seems to be a continuation of the scenario along the right arrows in Figure 3, with economic growth and inflation remaining moderate and the Fed proceeding with its cautious interest rate increases. Moreover, unless the economic dynamics of the US relative to the other major economies changes, there is no reason for a significant reversal in the direction of long-term international cash flows. Only such a change, indeed, would have a non-negligible impact on the US dollar.[3]

[2] It is worth acknowledging that the Fed policy is only apparently restrictive, given that financial conditions in the US continue to be loose.

[3] The long-term cash flows can be tracked in the so called basic balance. It results from the sum of the trade balance and the long-term financial account (direct investment and portfolio investment). The US basic balance deteriorated in 2017 by around USD 50 billion, almost entirely due to intensified long-term financial outflows from the US. The trade balance deficit remained almost unchanged between 2016 and 2017. As a consequence of the deterioration in the US basic balance during 2017, the US dollar depreciated.

Figure 3. The link between economic policy, economic activity and the US dollar



Source: Own elaborations Flossbach von Storch Research Institute.

SITE INFORMATION

Publisher: Flossbach von Storch AG, Research Institute, Ottoplatz 1, 50679 Cologne, Germany; Phone +49 221 33 88-291, research@fvsag.com, *Directors:* Dr. Bert Flossbach, Kurt von Storch, Dirk von Velsen; *Registration*: No. 30 768 in the Commercial and Companies Register held at Cologne District Court; *VAT-No*. DE200075205; *Supervisory authority*: German Federal Financial Services Supervisory Authority, Marie-Curie-Straße 24 – 28, 60439 Frankfurt / Graurheindorfer Straße 108, 53117 Bonn, www.bafin.de; *Authors*: Dr. habil. Agnieszka Gehringer; *Editorial deadline*: April 10, 2018