EconoFact Chats: The Strong Dollar, and Why It Matters

Kathryn Dominguez, University of Michigan

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

The Nobel laureate Milton Friedman said that the exchange rate is the single most important price in an economy. Lately, prices for the U.S. dollar in terms of euros, yen, pounds and other currencies have reached levels not seen in decades. The dollar recently traded at par with the euro for the first time in almost 20 years, and the dollar is at its strongest value against the yen in a quarter century, and the dollar now buys more British pounds than at any time since the mid-1980s. Why is the dollar so strong and what are the implications of this for the United States and for the world economy?

Michael Klein:

To answer these questions and others about foreign exchange, I'm pleased to welcome Kathryn Dominguez to EconoFact Chats. Kathryn is a professor of public policy and economics at the University of Michigan's Gerald R. Ford School of Public Policy. She has published extensively in scholarly journals on exchange rates in foreign currency markets. She's also a member of the panel of economic advisors at the Congressional Budget Office, the Advisory Scientific Committee of the European Systemic Risk Board, and the Economic Advisory Panel of the Federal Reserve Bank of New York.

Michael Klein:

Kathryn, welcome to EconoFact Chats.

Kathryn Dominguez:

Thanks, Michael. It's great to have the chance to talk to you about exchange rates, a subject we have both studied for a long time.

Michael Klein:

Yeah, usually we do this at conferences. Now we get to do it on air.

Michael Klein:

So Kathryn, Milton Friedman was a smart guy. Why do you think he said that the exchange rate is a single most important price in an economy?

Kathryn Dominguez:

Friedman understood the importance of exchange rates in translating prices of imports into domestic currency and prices of exports into foreign currency. These prices matter for people's decisions of whether to consume goods from abroad and the ability of firms to sell their products in foreign markets.

Michael Klein:

But the situation is a little different for the U.S. dollar, right?

Kathryn Dominguez:

That's right. The U.S. dollar holds a unique position in the global economy. U.S. exports are priced in dollars, but companies abroad also tend to price their exports to the U.S. in dollars.

Kathryn Dominguez:

The dollar is also used widely outside of the U.S. in trade between other countries and many commodities like oil, wheat, metals and many others are priced in dollars. Finally, many financial assets, including non-U.S. sovereign bonds, are denominated in dollars.

Michael Klein:

I remember finding it surprising that the trade between, say, Mexico and Japan would be in dollars, not in pesos or yen so that really illustrates the important role of the dollar in the world economy.

Michael Klein:

So Kathryn, with the dollar's recent strength, does that mean that we should see cheaper French wine, cheaper Japanese cars, cheaper Costa Rican coffee and Egyptian linens in this country?

Kathryn Dominguez:

That would be nice, but it's a bit more complicated than that. For example, the relative rates of inflation across countries also matter, and companies can change their pricing behavior in response to exchange rate changes.

Kathryn Dominguez:

But it is largely the case that changes in exchange rates will affect the relative price of goods, and it's important to note that exchange rate changes a lot more than the domestic currency price of most other goods and services.

Michael Klein:

What's the implication of this for the economy?

Kathryn Dominguez:

Well, when a currency strengthens, exports become more expensive and tend to fall, and imports become cheaper and rise. This leads to the trade account moving more towards deficit or towards a bigger deficit.

Kathryn Dominguez:

But it's important to note that exchange rates change for a variety of reasons so you can have a range of different outcomes with the exact same movement in the exchange rate. The exchange rate is both a cause and an effect.

Michael Klein:

Isn't it also typically the case, Kathryn, that when the exchange rate changes, it takes a while for that to show up in the trade account?

Kathryn Dominguez:

It does. For many countries, it can take three to five years to actually see the results of that exchange rate on the trade balance.

Michael Klein:

So I guess sometimes that sets up political issues where people think, "well, why isn't the trade account moving?" But it's because of this what economists call J curve effect where it takes a while, right?

Kathryn Dominguez:

Exactly.

Michael Klein:

Kathryn, you've done a lot of research on governments efforts to control the value of currencies. So when the currency seems to be out of line, like when the dollar is really strong now, why doesn't the U.S. government or other governments just step in and adjust exchange rates?

Kathryn Dominguez:

We did have government setting exchange rates during the Bretton Woods era after World War II. But that system broke down because governments, especially the U.S. government, had policies that were inconsistent with the pattern of fixed exchange rates.

Kathryn Dominguez:

In the post-Bretton Woods period from 1973 on, the dollar has been largely determined by market forces, not government policies. Of course, other exchange rates have been fixed during much of this time. The euro represents fixed exchange rates among its members, but the euro also floats against the dollar.

Kathryn Dominguez:

A very important result from international economics is that a government surrenders control of its monetary policy when it fixes its exchange rate. Conversely, its central bank has the ability to set monetary policy to achieve domestic goals when it is not forced to defend a currency peg.

Michael Klein:

So during the Brenton Woods period, which you referred to before, basically the United States could set its monetary policy. And because there were fixed exchange rates, other countries had to follow it, correct?

Kathryn Dominguez:

That's exactly right.

Michael Klein:

So other countries didn't like the inflationary policies of the United States, and it ended up causing the breakdown of the system and eventually completely in 1973.

Kathryn Dominguez:

Exactly.

Michael Klein:

Given that challenge of monetary policy and exchange rate policy, sort of having to trade off one or the other, is there anything a government can do to both maintain monetary policy independence and also, at the same time, to influence the value of its currency?

Kathryn Dominguez:

That's a great question and an exciting area of research in international economics.

Kathryn Dominguez:

There are times when it seems governments do have this ability. A good example of this was in the mid-1980s. The dollar was very strong, as it is today, and finance ministers and treasury officials of the seven biggest economies agreed to coordinate policies to weaken the dollar at a meeting at the Plaza Hotel in New York in 1985.

Kathryn Dominguez:

One of the critical features of that episode was the agreement to coordinate policies. A more typical situation is one where countries are each pursuing exchange rate policies that benefit themselves, but may put other countries at a disadvantage. This type of intervention can lead to allegations of currency manipulation and retaliatory policies that are likely to undermine the effectiveness of the original intervention efforts.

Kathryn Dominguez:

Another approach used by some emerging economies is to restrict cross-border capital flows which, if effective, reduces the ability of market forces to influence the value of the currency.

Michael Klein:

Kathryn, I'd just like to point out that the Plaza Accords or the Bretton Woods Agreement, these are like really wonderful hotels. So I use that, the Mount Washington Hotel in Brenton Woods or the Plaza Hotel in New York, I use that to try to convince my students that they should really focus on international macroeconomics, instead of, say, security studies where you have the Akron Accords. Nothing bad about Akron, but it's just not the same as the Mount Washington Hotel or the Plaza hotel.

Kathryn Dominguez:

Right. If you want to stay at a nice hotel, you've got to study international economics. I agree.

Michael Klein:

There's also the Rambouillet Summit so there are lots of good reasons to study international macroeconomics. Having nice hotels to look at and visit for field trips is one of them, I suppose.

Kathryn Dominguez:

Absolutely.

Michael Klein:

So Kathryn, why is the dollar so strong now?

Kathryn Dominguez:

To answer that, it's important to remember that the dollar does not just translate the price of goods from one currency to another. It is also an important determinant of the value of foreign assets in terms of home currency.

Kathryn Dominguez:

Here's an example. If you're holding a British bond and the pound weakens between the time you purchased that bond and when it matures, you will have lost money because at the time of maturity, you are trading cheaper pounds for more expensive dollars.

Kathryn Dominguez:

It should be the case that people take those potential future changes in exchange rate into account when they hold foreign assets so that there are no obvious profit opportunities, no $100 bills or 100 pound notes lying around.

Kathryn Dominguez:

But the implication of all this is that interest rates and expectations of future outcomes for the economy figure into today's exchange rate.

Michael Klein:

So that role of expectations makes exchange rates a bit like stock prices. People buy certain stocks, not just for the dividends, but for their expectation that, in the future, the price of the stock will rise.

Michael Klein:

I guess you're saying the same thing about currencies. If you think a currency is going to strengthen, that makes holding bonds denominated in that currency more attractive.

Kathryn Dominguez:

Exactly. That's why big news events, literally, something that's new, moves foreign exchange markets. For example, when Brexit passed, despite predictions that it would fail, there was a huge collapse in the value of the pound overnight.

Michael Klein:

The size of that collapse is because it was such a big surprise, right?

Kathryn Dominguez:

Absolutely. If we had anticipated that Brexit would pass, it probably would have not affected the pound whatsoever. It's the fact that we didn't expect it to happen that we were surprised by the news that we saw such a large exchange rate impact.

Michael Klein:

Again, what explains the current strength of the dollar, given your explanation of the role of the dollar in asset markets?

Kathryn Dominguez:

Market participants are expecting that the U.S. economy is going to be stronger than most other economies over the foreseeable future. This may sound surprising, given the U.S. is also dealing with

economic uncertainty, high inflation and fears of a recession. But other countries are facing the same challenges and the expectation is that the U.S. is likely to come out ahead of the others.

Kathryn Dominguez:

It is also to the dollar's advantage that interest rates are going up quicker in the U.S. than in other countries, which means that investments denominated in dollars are seen as more attractive because returns are higher. This return differential, as well as the safe haven status of the dollar, means that global investors are flocking to the dollar, reinforcing the dollar's strength.

Michael Klein:

Can you explain a little bit what you mean by safe haven?

Kathryn Dominguez:

Sure. Whenever the world is in crisis, investors are looking for a place to put their funds where they believe those funds will be safe and the U.S. has served as a safe haven, really since the end of World War II and whenever there's a crisis, it was true during the financial crisis in 2008, it was true during the pandemic, investors moved their funds to a place where they believe that the value of those funds will stay safe.

Michael Klein:

I guess the most striking example of that, as you mentioned, is 2008 because the crisis originated in the United States, and yet there is this inflow of dollars at that time to the place where the crisis originated because, even then, the U.S. was seen as a safe haven.

Kathryn Dominguez:

That's right. The view was even though it started in the U.S., that U.S. institutions and financial markets would be able to basically overcome the crisis in a way that would allow investors to be able to feel that their funds were safe, if they were left in the U.S. banking system or other financial markets.

Michael Klein:

In the introduction, I mentioned the pound and the yen and the euro. But the dollar is not strong against all currencies and, somewhat surprisingly, the Russian ruble recovered its value after its initial plunge in the wake of the invasion of Ukraine.

Kathryn Dominguez:

I'm so glad you brought this up. The ruble recovery is a great illustration of how a government can, under extreme circumstances, try to manage its currency value.

Kathryn Dominguez:

The Russian government raised interest rates and, very importantly, imposed strict limits on trading rubles for foreign currency. This was important for Russia because a plummeting ruble would have signaled to its population the costs of the war and made imports to Russia very expensive.

Kathryn Dominguez:

This is in line with where we started with Friedman's statement that the exchange rate is the most important price in a country so the Russian government and the central bank pulled out all the stops to support the ruble.

Michael Klein:

That's completely consistent with what you said before, there wasn't monetary policy independence. They had to raise interest rates and also they had to shut down foreign currency exchanges in order to achieve this. That was such an important goal that they're willing to do those two things to realize that goal.

Kathryn Dominguez:

Exactly.

Michael Klein:

Kathryn, earlier you mentioned that the current floating exchange rate system that began in 1973 with the collapse of the Bretton Woods system was one where there were fixed exchange rates, exchange rates didn't move, but we're seeing big swings in exchange rates now.

Michael Klein:

Do you think it would make sense to try to reconstitute a fixed exchange rate system in order to promote greater stability to go back to a Bretton Woods world?

Kathryn Dominguez:

Yes and no. Let me start with a reason for no.

Kathryn Dominguez:

As described earlier, the exchange rate is both an outcome and a cause of other economic events. One of the reasons the Bretton Woods system collapsed was that countries did not want to follow U.S. monetary policy, as they were forced to do before 1973. A reason that efforts to reconstitute fixed exchange rates in the 1970s failed is because floating exchange rates successfully served as a type of shock absorber when there was a big run-up in oil prices.

Kathryn Dominguez:

But I started my answer with yes and that's due to my concerns that in the current global monetary system, there are no agreed international rules of the game for exchange rates. Some countries like the U.S. largely allow their currencies to be market determined, while many others attempt to stabilize or peg their currencies often to the dollar.

Kathryn Dominguez:

This leads to situations where countries are accused of manipulating their currencies for unfair trade advantage, as well as the possibility of currency wars, which arise when all countries attempt to weaken their currencies at the same time, in the hope of gaining a trade advantage.

Kathryn Dominguez:

That's the tricky part with exchange rates. It's impossible for all countries to achieve the same exchange rate objective at the same time. Instead, going it alone can lead to global tensions and worse outcomes for all countries.

Kathryn Dominguez:

Right now, the world seems poised for a reverse currency war with many countries hoping to strengthen their currencies in the hopes of reducing inflation. This is exactly the moment when some form of international monetary coordination would be valuable.

Kathryn Dominguez:

But let me be clear. Coordination does not require a fixed exchange rate system.

Michael Klein:

The term currency wars was coined, I believe in 2010 by Guido Mantega, the finance minister of Brazil, when he thought that the United States was cheapening its dollar at the expense of countries like Brazil. But people like Ben Bernanke argued at that time that what the U.S. was actually doing was just trying to stimulate its own economy in the wake of the financial crisis. Furthermore, Bernanke argued that that would actually help Brazil because a stronger U.S. economy would pull in more imports from Brazil. So there's this tension there, I guess.

Kathryn Dominguez:

There's always that tension and I think if asked currently the Fed would also say that the policies in place are not there to strengthen the dollar, but rather to strengthen the U.S. economy against this high inflation.

Kathryn Dominguez:

But the spillover effects on other countries, including emerging markets, are likely to raise some allegations, again not of a currency war this time, but a reverse currency war, where the U.S. dollar appreciates and those other currencies depreciate.

Michael Klein:

That hurts these countries when they're battling inflation because they'd be finding that imported goods are going to become more expensive, right?

Kathryn Dominguez:

Exactly. So if everybody wants to fight inflation at the same time, there are going to be no changes in the exchange rate and likely more of a global economic downturn than would be necessary because all countries would be over-contracting to try to outdo each other and could lead to a much worse outcome overall.

Michael Klein:

Kathryn, what do you think is the actual scope for international monetary policy coordination that you mentioned? I know that you've done and published research in this area, but there's a big political issue as well. To what extent do you think countries are willing to sit down and agree to have policies that are mutually beneficial, instead of sort of what economists call ‘beggar-thy-neighbor’ policy, where you make yourself better off, but at the expense of another country?

Kathryn Dominguez:

Unfortunately, it seems that coordination is most likely to happen when things get really bad, when circumstances are so dire that it's in everyone's best interest to sort of band together. So I hope that's not where we're going, but that does seem often to be the environment in which coordination actually can happen.

Michael Klein:

That was like what happened during the Plaza Accord[s] because the dollar had strengthened so tremendously that everybody saw that as problematic for the world economy.

Kathryn Dominguez:

Exactly, and they all saw it in their best interest to work with the United States to bring the dollar down. Again, those circumstances don't happen too often, but when they do happen, those are the times when one can see coordination across countries.

Michael Klein:

Do you think that might be happening now with this decades-high value of the dollar?

Kathryn Dominguez:

I hope so. It's hard to know, but I could imagine the current circumstances again leading countries, all countries, to pursue contractionary monetary policy, basically trying to outmaneuver each other and leading to very bad economic outcomes which, again, might be what it takes to bring them all to the table to coordinate policies.

Michael Klein:

Well, I know if they do come to the table, people will be drawing on the ideas and the research that you've done and others have done as well. So thank you very much for joining me today, Kathryn, to explain what seems arcane, but actually hits people very hard in their own pocketbooks and their jobs and such, the value of foreign currency and the behavior of foreign exchange markets.

Kathryn Dominguez:

You're very welcome. It was a pleasure to speak with you today, Michael.

Michael Klein:

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