

Despite Short-Term Volatility, Dollar's Value Stable for Nearly a Decade

THE DOLLAR'S VALUE has been remarkably stable over the past nine years, according to the Dallas Fed's inflation-adjusted Trade-Weighted Value of the Dollar Index (TWVD), a measure of the dollar's value relative to the currencies of 101 U.S. trading partners. This recent stability contrasts with the dollar's 1981–87 performance, when the real (inflation-adjusted) TWVD appreciated more than 35 percent and then depreciated by nearly as much.

Since 1988, the real TWVD has stayed within a relatively tight band—never moving more than 5 percent higher or lower than the average value of 76.7. Interestingly, this represents a return to a pre-1981 pattern. From 1976 to 1980, the dollar also never deviated from its average level by more than 5 percent. Moreover, the 1976–80 average, 74.6, is very close to the 1988–96 average (*Chart 1*). What does the dollar's return to its earlier levels and stability tell us about the U.S. economy?

Long-run changes in the trend of the real value of the dollar primarily reflect changes in productivity differentials between the United States and the rest of the world in products that compete in world markets. So the dollar's stable behavior over the long term suggests that U.S. productivity has been fairly stable relative to the rest of the world. Although the dollar's run-up during the 1980s was substantial, most economists attribute this unusual appreciation and the subsequent fall to a sharp, temporary tightening of monetary policy combined with expansionary fiscal policy during the early years of the Reagan presidency.

If the real value of the dollar had shown persistent appreciation, the likely reason would have been an increase in relative U.S. productivity. For example, a permanent increase in the productivity of U.S. carmakers over their foreign counterparts would contribute to a sustained increase in the real value of the dollar. Sustained shifts in demand for U.S. or foreign goods could also change the long-run level of the exchange rate, although this would be less likely to drive long-run changes than would shifts in productivity.

The relationship between the real value of the dollar and long-run productivity differentials is summarized by the theory of *purchasing power parity*. This theory maintains that the

overall real value of any country's currency moves toward a long-run value with the rest of the world provided relative productivity differentials in traded goods remain constant and no prolonged shifts in relative goods demand occur. Hence, the long-run stability of the Dallas Fed's Real Trade-Weighted Value of the Dollar Index suggests that U.S. productivity relative to the rest of the world has remained fairly constant over the past 20 years.

But what drives short-run movements in the real TWVD? In the short run, even if the long-run relative productivity differentials don't change, the real TWVD can deviate substantially from its central trend. Over the business cycle, prospects for growth can change markedly, altering relative demand and the real exchange rate. Nominal (not adjusted for inflation) exchange rate volatility can also translate into real exchange rate volatility if domestic prices do not

instantaneously adjust to changing international conditions. So despite the movement of the real TWVD toward a long-run level, tremendous short-run volatility can occur.

Although the long-run trend in the real value of the dollar has remained fairly constant, on an annual basis, it has shown more volatility in the past nine years than in 1976–80. While swings of more than 5 percent in less than nine months were rare before 1981, they have been common since 1988. One possible

explanation is the further integration of world capital markets, which has increased both nominal exchange rate variability and real exchange rate volatility (as domestic prices are slow to adjust to international price differentials). Another explanation may be that there have been some unusual international events since 1988 that were unlike the influences of the late 1970s, such as the fall of the Berlin Wall in 1989 and the consequent changes in Eastern Europe, the 1992 European Exchange Rate Mechanism crisis and the 1994 devaluation of the Mexican peso. All these events could have contributed to greater short-run volatility while not substantially affecting long-run trends in U.S. relative productivity.

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