The dollars doldrums

By Barry Eichengreen

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Economic commentators are better at rationalizing past exchange-rate movements than at forecasting future trends. So, when it comes to explanations for the dollar's decline over the past year, we are confronted by an embarrassment of riches.

Donald Trump's first year as US president has been, if nothing else, a bounteous source of surprises.

One of the big ones in the circles I frequent is dollar weakness. Between January 2017 and January 2018, the broad effective exchange rate of the dollar fell by 8%, wrong-footing many of the pundits. I include myself among the wrong-footed (others can decide whether I qualify as a pundit).

Tax cuts and interest-rate normalization, I expected, would shift the mix toward looser fiscal and tighter monetary policies, the combination that drove up the dollar in the Reagan-Volcker years. Tax changes encouraging US corporations to repatriate their profits would unleash a wave of capital inflows, pushing up the dollar still further. New tariffs that made imports more costly and that shifted demand toward domestic goods would require offsetting effects in a near-full-employment economy in order to shift demand back to foreign sources. The most plausible such offset was, of course, appreciation of the real exchange rate, which could occur only through inflation or, more plausibly, a stronger dollar.

The markets, in their wisdom, rejected this logic for more than a year. It is thus incumbent upon those who of us made such predictions to "mark our views to market," as my Berkeley colleague Brad DeLong likes to say.

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The most popular explanation for dollar weakness is that Trump, through incompetence or misdirection, failed to deliver what he promised. There was no across-the-board import tariff. There was no abrogation of the North American Free Trade Agreement. There was no $1 trillion infrastructure package.

But there were, in fact, deep tax cuts. There were, in fact, interest-rate hikes by the Federal Reserve. And there were, in fact, tax changes creating incentives for the repatriation of profits. Other things equal, these developments should have propped up the dollar. So there must be more to its weakening than just Trump's failure to deliver.

Another popular explanation is that investors expected the real exchange rate to rise through inflation rather than currency appreciation. The dollar weakened, in this view, because the Fed fell behind the curve and risked losing control of the inflation process.

Conceivably, this interpretation could prove correct. But it is not correct yet. There was no surge in inflation between January 2017 and January 2018. Currently, the fear in the markets is not that the Fed is behind the inflation curve but that it will raise interest rates even faster than expected in order to preempt overheating. And if higher interest rates are good for one thing, they're good for the dollar.

Beyond this, there are at least 17 other narratives to explain dollar weakness. Some are insightful. Others are entertaining. Most, however, overlook the most plausible explanation, which is Trump-related uncertainty.

Investors have no way to forecast the impact of policies, because policies thought to be headed one way suddenly veer in the opposite direction. A big infrastructure bill turns out to be small. Withdrawal from the Trans-Pacific Partnership trade agreement turns into a possible decision to re-enter TPP. Steve Mnuchin, the Treasury secretary, seemingly abandons the United States' strong-dollar policy but then re-embraces it. Uncertainty is the order of the day, every day.

And there's nothing investors like less than uncertainty. This is especially true of investors in a currency whose strongest attraction is its safe-haven status. Investors traditionally flock to the dollar not simply because it is stable, but also because it tends to strengthen in a crisis, given that its issuer has impregnable defenses and possesses the deepest and most liquid financial markets in the world.

But now that issuer also has a president who is casting doubt on his country's defense alliances and who is, consciously or not, encouraging his Russian counterpart, Vladimir Putin, to build, or at least boast of, new offensive weaponry. It has a president who has encouraged the idea of a government shutdown, fueling doubts about the liquidity of the market in US Treasury bonds.

More chaos in the White House would only depress the dollar further. Working in the other direction is the fact that some of the dollar-supportive measures that observers expected Trump to adopt, such as tariffs on steel imports, are now coming, like it or not. It may be indicative that on March 1, when Trump announced his steel and aluminum tariffs and the stock market tanked, the dollar strengthened. Uncertainty may continue to dominate, but it may also be that the dollar's rise on March 1 was a harbinger of what is to come on foreign-exchange markets.

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