

The US dollar exchange rate has experienced strong and fairly widespread depreciation vis-à-vis other currencies since early 2017, following a period that began in 2014, in which the dollar appreciated notably in a context in which the economic recovery and, therefore, the normalisation of monetary policy, was at a more advanced stage in the United States than in other economies. As shown in Chart 1, the nominal effective exchange rate of the dollar appreciated by 25% between early 2014 and the end of 2016, subsequently depreciating by around 10% in effective terms. This depreciation was particularly pronounced against the euro (18%).

The behaviour of the dollar may seem somewhat surprising considering that the short-term economic outlook in the United States has gradually improved, especially after the approval of tax reform and the increase in public spending, and that the Federal Reserve's monetary normalisation process continues to be comparatively more advanced. Indeed, the short-term interest rate spreads vis-à-vis other areas – normally associated with exchange-rate appreciation given that capital usually flows to areas where returns are higher for a certain level of risk – have tended to increase (see Chart 2). Nevertheless, from a financial standpoint, a possible explanation of the recent depreciation of the dollar could be that, since the United States is further ahead with the withdrawal of monetary stimuli – to a large extent already discounted by the markets – it is to be expected that in the future it will be other areas that will normalise their monetary policies, such as the euro area, which would be reflected in a widening in their favour of the interest rate spreads at the intermediate maturities of the curve. This would be corroborated by developments in the difference in the spread between the two- and five-year rates in Germany, on one hand, and in the United States, on the other. This difference has shown, in the past year, a high correlation with the path of the euro-dollar exchange rate, as shown in the same chart.

An alternative explanation of the widespread depreciation of the dollar in the past year may be the fact that the economic outlook has improved not only in the United States, but more globally, and thus, in a favourable global financial environment, the appetite for risk and the search for returns in other markets has continued, contributing to the appreciation of other currencies. As Chart 3 shows, in the past year GDP growth projections for 2017 and 2018 in the euro area, for example, were revised upwards to a higher degree than those of the United States, which may have favoured a further appreciation of the euro.

However, aside from the temporary factors, there are other, more structural, determinants that would explain the depreciating trend of the dollar. For instance, the sizeable external imbalance in the

US economy, with a persistently high current account deficit which, having peaked at around 6% of GDP in the years before the crisis, has remained above 2.5% of GDP in recent years (see Chart 4), contrasting with the current account surpluses recorded in other areas. According to the IMF's most recent analysis of the global external imbalances (published in the External Sector Report, July 2017), in 2016, the United States ran an excess external deficit of around two percentage points of GDP, and the dollar was overvalued by between 10% and 15%, and therefore, the depreciation observed in 2017 would be part of the adjustment required to correct the imbalance vis-à-vis the rest of the world.

The fiscal stimulus measures that the United States is implementing will have a positive effect on economic activity and prices in the short term, and this could lead to higher-than-expected interest rate rises, triggering appreciation pressures on the dollar. However, it is very likely that the fiscal and external imbalances in the US economy will worsen, given its diminished cyclical slack (see Charts 4 and 5)¹. In this context, the protectionist measures adopted by the US government to keep the external deficit in check may lead to the appreciation of the dollar, but in the medium term, they may give rise to a trade confrontation that would exacerbate the external imbalance of the United States and reinforce the depreciation pressures on the dollar.

Indeed, the historical evidence of recent decades shows that the emergence in the United States of high budget and current account deficits (known as “twin deficits”) has been associated with strong depreciation of the dollar, as occurred in the mid-1980s with the expansionary fiscal policies of the Reagan administration and in the early 2000s following several tax cuts, as shown in Chart 6. In both cases, the increase in the external deficit of the US economy, triggered by a higher budget deficit, was followed by a substantial depreciation of the nominal effective exchange rate of the dollar of 35% between 1985-88 and 30% between 2002-2007. In the latter period, the introduction of tariffs in the United States was also accompanied by dollar depreciation.

¹ According to Congressional Budget Office (CBO) estimates of June 2017, the projected public debt (held by the public) would increase from the current 77% of GDP to 91% in 2027, before taking into account the effects of tax reform. Although it has not yet published the new projections which include these effects and the recently approved increase in spending, the Committee for a Responsible Federal Budget estimates that, as a result of tax reform, the debt will increase to 97% of GDP in 2027 and up to 99%, taking into account the rise in spending in 2018-19. Should the rise in spending and the tax cuts, which are temporary (such as those relating to personal income tax) become permanent, something that cannot be ruled out, the ratio of debt held by the public would increase to almost 110% of GDP within 10 years.

Chart 1
EXCHANGE RATE VS DOLLAR

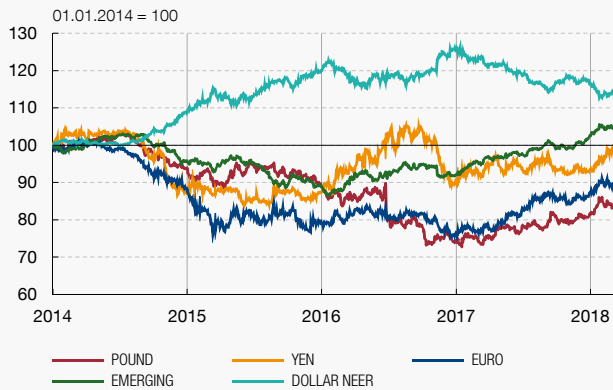


Chart 2
DOLLAR EXCHANGE RATE AND SPREADS

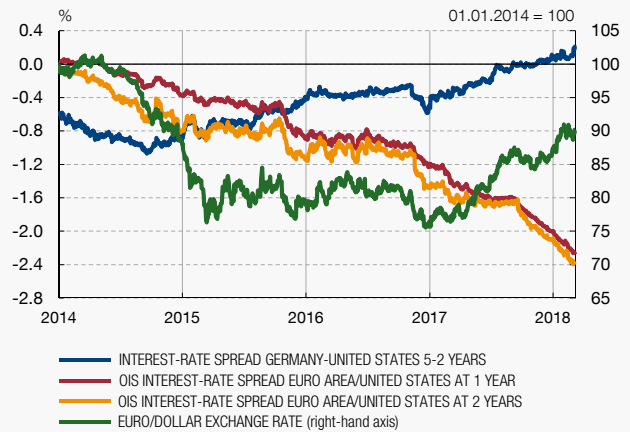


Chart 3
SPREAD. CONSENSUS PROJECTIONS GDP FEB 2018 VS JAN 2017

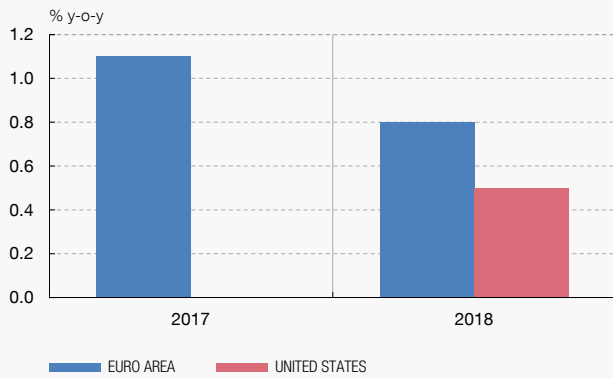


Chart 4
CURRENT ACCOUNT BALANCE

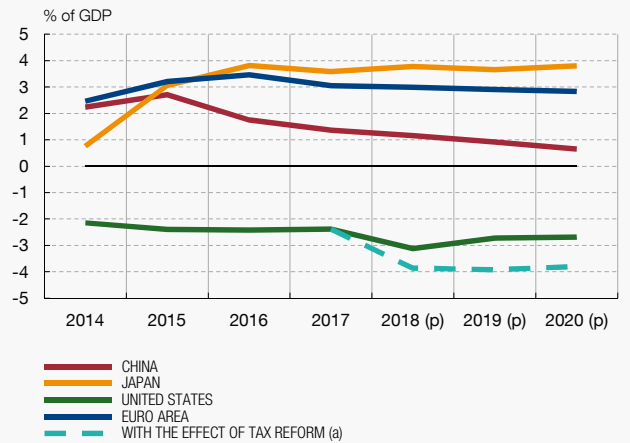


Chart 5
OUTPUT GAP AND PUBLIC DEFICIT RATIO (1967-2020)

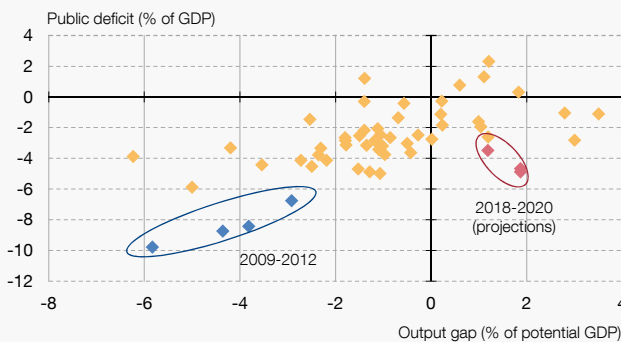
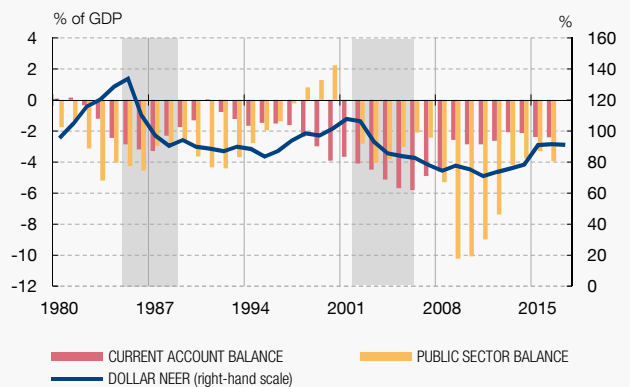


Chart 6
UNITED STATES: PUBLIC AND CURRENT ACCOUNT DEFICIT, AND DOLLAR NEER



SOURCES: Datastream, Consensus Forecast, Congressional Budget Office, IMF (World Economic Outlook), World Bank, own calculations with model NiGEM, Federal Reserve Bank of St. Louis.

a Assuming exogenous monetary policy.