Special Report

Derek Holt (416) 863-7707
derek.holt@scotiabank.com

USD Impact On Trade Competitiveness Is Being Exaggerated

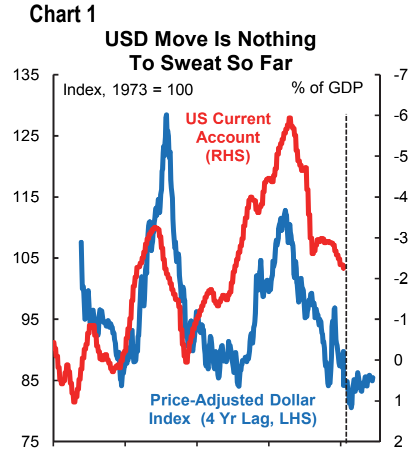
- **And few at the Federal Reserve are concerned.**

Much of the focus on the USD's appreciation and its potential to derail growth upsides seems misplaced. Further, the Federal Reserve's concerns about the dollar's rise have been exaggerated by commentators.

Little Change And Long Lags

Enter chart 1. The best way to look at a currency by way of influences on trade competitiveness is in trade-weighted terms and adjusted for relative rates of domestic and foreign inflation. A nation's competitiveness is driven by how the prices of its products change relative to other global producers on a trade-weighted average and after adjusting for the nominal exchange rate. That concept differs markedly from just the nominal exchange rate which has sharply appreciated (chart 2). The so-called real effective exchange rate is little changed so far; it is up by about 7% since 2011 when it bottomed. This is at best a loose guide, however, given the enormous uncertainty governing how currency changes impact growth. For one example of the literature, go here.

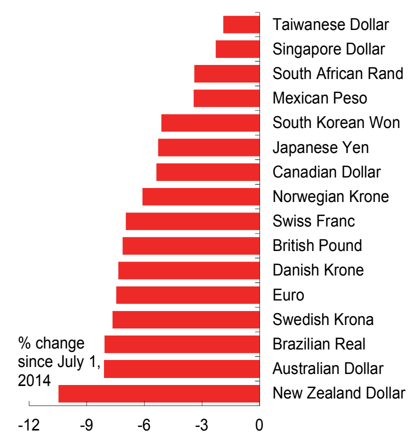
Chart 1



Source: Federal Reserve, Scotiabank Economics

As chart 1 shows, the optimal lag between USD movements and the broad current account balance of the US economy (on an inverted scale to make the connection easier to see) is about four years. The current account is the way to look at the USD impact on broad balance of payments dynamics since it has competing effects on imports and exports. So, at least thus far, we're left with little change in the currency that will have effects spread out over multiple years into the future once lagged adjustments on trade channels fully work their way through. When the debate was genuinely more serious was in the 1980s when this definition of the exchange rate soared, and then again during the dot-bomb period and its aftermath; the result both times was to sharply raise the current account deficit notwithstanding a bidirectional relationship. Today is hardly comparable by way of the currency swings we've witnessed thus far and we'd have to see double-digit rates of appreciation in this exchange rate to begin to treat it as a more serious risk.

Chart 2 USD Appreciation



Source: Bloomberg, Scotiabank Economics.

Energy Development May Trump The Currency

Further, as the US continues to substitute domestic energy production for imports and raise its energy exports via development of shale and non-shale reserves on the path toward net energy self sufficiency into next decade, the historical sensitivity of the current account balance to USD movements may be more muted (charts 3, 4). This is a classic supply-side shock and a favourable one at that from the standpoint of the overall health of the US economy including consumers and in ways that may override any effects of the currency on the broad trade account.

'A Couple' At The Fed Are Worried

Further, what the Federal Reserve has been saying about the currency's effects has been distorted in some popular market commentaries on the minutes to the September 17th FOMC meeting. Minority views were incorrectly positioned as if to represent a significant cross-section of opinion as we argued here. The actual

Scotiabank Economics
Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia.economics@scotiabank.com

quotes from the FOMC minutes are below and the emphasis should be put on the choice of words like 'some' and 'a couple' etc., as opposed to using words like 'most' or 'many' or 'almost all' which would have conveyed much greater concern:

> Page 9: "Some participants expressed concern that the persistent shortfall of economic growth and inflation in the euro area could lead to a further appreciation of the dollar and have adverse effects on the U.S. external sector. Several participants added that slower economic growth in China or Japan or unanticipated events in the Middle East or Ukraine might pose a similar risk. At the same time, a couple of participants pointed out that the appreciation of the dollar might also tend to slow the gradual increase in inflation toward the FOMC's 2 percent goal."

> Page 10: "While most viewed the risk that inflation would run persistently below 2 percent as having diminished somewhat since earlier in the year, a couple noted the possibility that longer-term inflation expectations might be slightly lower than the Committee's 2 percent objective or that domestic inflation might be held down by persistent disinflation among U.S. trading partners and further appreciation of the dollar."

Indeed, where majority FOMC opinion is signalled is in the following clip in discussing risks to the outlook:

> Page 11: "A significant majority of participants continued to judge the levels of uncertainty about their projections for real GDP growth and the unemployment rate as broadly similar to the norms during the previous 20 years. Most participants continued to judge the risks to their outlooks for real GDP growth and the unemployment rate to be broadly balanced. A few participants viewed the risks to real GDP growth as weighted to the downside; one viewed the risks as weighted to the upside."

Recent comments on the USD by New York Federal Reserve President William Dudley were also often exaggerated by commentators. In a speech this past Wednesday, Dudley remarked:

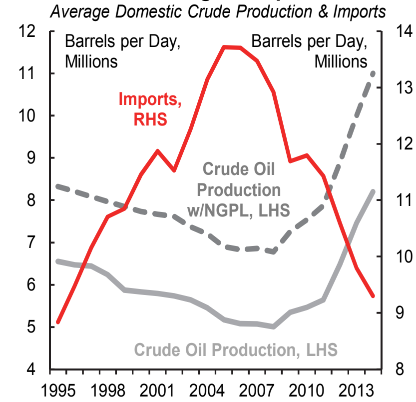
> "Of course, the appreciation of the dollar is likely due in part to increasing confidence that growth prospects in the U.S. have improved. Therefore, this development does not mean we should abandon the consensus forecast. Rather, as with the other issues I have discussed, I view this development as limiting the upside risk to that forecast."

Note that in the Sept projections, the Fed was already on the lower end of Bloomberg's consensus for US growth next year with a central tendency of 2.6-3% (Bloomberg 3%), 2.6-2.9% in 2016 (2.9% Bloomberg).

Chart 3

U.S. Domestic Crude Production Substituting for Imports...

Average Domestic Crude Production & Imports

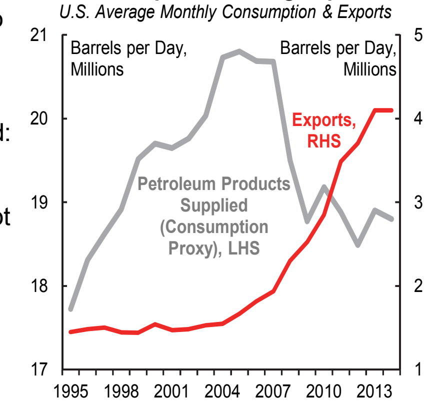


Source: Scotiabank Economics, EIA.

Chart 4

... In a Context of Falling Consumption & Rising Exports

U.S. Average Monthly Consumption & Exports



Source: Scotiabank Economics, EIA.

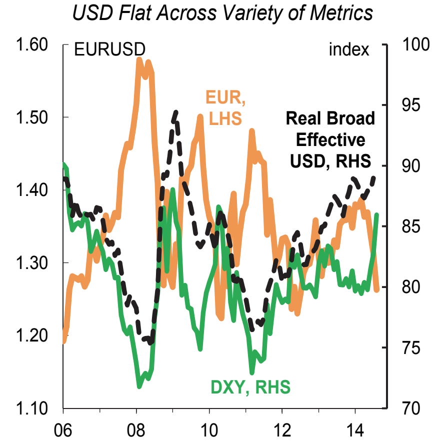
An Uncertain Outlook For The USD

Now of course at the end of the day, implicit to views on what the USD may or may not do to the US economy is the assumption that it will undergo a large change over coming years. For years we have heard that the Federal Reserve has been intent upon debasing the currency but there has been no evidence this has worked if it was truly their aim (which I strongly doubt). Chart 5 makes the point using multiple definitions of the exchange rate that debasement theories didn't pan out. If debasement theories did not pan out over recent years, then perhaps one's confidence that the USD will shoot to the moon as the Federal Reserve exits extraordinary stimulus should be tempered. In any event, what is encouraging is that the deep global imbalances of the pre-crisis period are gradually being reined in (chart 6) though perhaps replaced by financial sector froth and the risks this poses to global financial stability.

Chart 5

What USD Debasement?

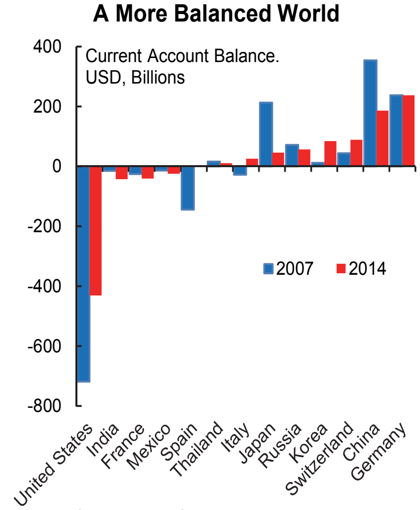
USD Flat Across Variety of Metrics



Source: Bloomberg, Scotiabank Economics.

Chart 6

A More Balanced World



Source: IMF, Scotiabank Economics