The Causes of Fluctuations in the Value of Dollars: Since the 1980s

Shuai Li*
Department of Business School, University of Ulster, Belfast, North Ireland, the United Kingdom. E-mail: meganlishuai163.com

Abstract: The purpose of the essay is to explain why the dollar has fluctuated since the 1980s and present several elements that affect the dollar value. At the same time, the essay states in detail how the value of the dollar changes as these factors vary. It finds that interest rates, inflation, political and economic stability of the United States and debt level all impact the value of the dollar, and every fluctuation in value is affected by more than one factor.

Keywords: The Dollar Value; Causes; Fluctuation; Interest Rate; Exchange Rate; US Dollar Index

1. Introduction

Exchange rate is the most common approach to measure the value of the dollar. And the US dollar index is a popular exchange rate measurement that compares the value of the dollar with a basket of foreign currencies[1]. Therefore, the US dollar index will be used as a measurement to reflect the fluctuations of the value of the dollar in the essay. In addition, there are influences at different levels such as economy and politics that affect the exchange rate, so the value of the dollar varies with economic, political and other changes.

With the aim of finding the causes of longer-term fluctuations in the value of the dollar and understanding how the changes of dollars’ value related to the reasons that can be found out, the essay first concisely explains the meaning of appreciation and depreciation of the dollar, then lists four main factors that have an impact on the exchange rate and also the value of the dollar, and states how these factors affect them. At the same time, this essay analyzes the causes of change of the dollar value in long term by observing the fluctuation of the US dollar index and combining with domestic and foreign events that influenced the value of the dollar.

2. Causes and explanations

2.1 Factors affecting the value of the dollar

An increase in the value of the dollar relative to another currency is the dollar appreciation. Inversely, depreciation of the dollar is a loss of the dollar’s value[2]. The value of the dollar is mainly affected by several factors, such as interest rates, inflation, political and economic stability of the United States and debt level.

Firstly, increasing interest rates generally improves the value of the dollar, because high interest rates will attract more foreigners to invest their money in the United States, then not only the capital account of the US will be in surplus, but also the demand for dollar will increase, thereby the value of the dollar increase. Secondly, low inflation rates which means that the dollar has more purchasing power, causing an appreciation of the dollar. For example, the coun-
tries such as Japan, Germany and Switzerland had low inflation during the last half of the 20th century, so the purchasing power of their currencies is stronger than those countries with high inflation rates. Thirdly, stable political and economic environment is beneficial to increase the value of the dollar, as such a stable situation allows foreign investors to invest more safely. If there is political turmoil or economic depression in the United States, investors will have no confidence in its currency and sell dollars instead of investing their capital in the US. Finally, there is a negative relationship between large debts and appreciation of the dollar. Generally, if the US has a heavy debt, the government needs to increase money supply to repay its debt, but an improvement of money supply may cause inflation\textsuperscript{[3]}, except for these factors, policies, balance of payment and natural disasters also play an important role in changing the value of the dollar. Therefore, in the next section, the essay will explain in detail why the value of the dollar has fluctuated at various stages since the 1980s.

2.2 Explanations for the fluctuations of the value of the dollar

Table 1 illustrates short and long terms fluctuations in the US dollar index since the 1980s. The first long-term change was that the US dollar index increased by about 40% from July 1980 to March 1985, followed by a ten-year decline. In August 1995, the US dollar index began to rebound and reached a peak in June 2001, then fell further and resumed its upward trend after July 2014, although there was a small upturn in 2008.

There were two reasons why the US dollar index had risen between 1980 and 1985. The first one was higher interest rate, in August 1979, the Federal Reserve raised its benchmark interest rate to 11%, until July 1981, the interest rate was increased to 22.36%. According to the theory of the interest rate parity, when interest rates vary from country to country, investors usually want to invest their capital in a country that has a higher interest rate to make a profit\textsuperscript{[4]}. The measure to improve interest rates had attracted a large number of overseas investors, so there were large foreign capitals that flowed into the United States but out of Latin American countries, which caused debt crisis of Latin America. The second one was that the dollar was not susceptible to accidents or politics\textsuperscript{[5]}, so people who came from Latin American selected to hold dollars in order to avoid risks. In a word, these two reasons led people to snap up dollars on the international market, thus the capital account of the United States was improved, which had contributed to an increase of the dollar’s value.

On the basis of the view of Alexandra, if a country has large deficits and debts, there will be less attractive for foreign investors\textsuperscript{[6]}, because a large debt usually promotes inflation. Even worse, a government may print money to cover deficits or pay off debts, however, increasing money supply generally leads to inflation. In terms of relative purchasing power parity, the percentage change in exchange rates are equal to the difference in inflation rates between the two countries. If a country’s inflation rate is higher than that of a foreign country, its currency should depreciate\textsuperscript{[4]}. Therefore, in the first half of the 1980s, when the Federal Reserve was raising interest rates, President Reagan cut taxes, resulting in a “double deficit” in both the current account and the government budget. Because of the “double deficit”,
the United States, Japan, Germany, France and Britain signed an agreement requiring that the yen and European currencies to appreciate relative to the dollar, so the dollar was largely sold off, then the dollar depreciated substantially between 1985 and 1995.

The rapid development of Internet technology had gradually increased productivity in the United States, providing a solid foundation for the appreciation of the dollar. The value of the dollar increased from 1995 to 2001, because the US internet economy was in a bubble and the Federal Reserve improved interest rate six times in a row. And these events became driving forces for sending money to America. However, the outflow of large capital triggered the Asian Financial Crisis, meanwhile, the Kosovo War in Europe had encouraged international capital to flow back to the United States.

After the internet bubble burst in 2001, America cut interest rates. There was an opposite effect of raising interest rates, the cuts made people less willing to hold dollars, and the dollar was begun to sell off and depreciated, although this action may be helpful to exports of the United States. Additionally, the 9 / 11 terrorist attacks occurred in the United States in 2001, which caused severe financial losses, hit consumer confidence and caused fluctuations in the value of the dollar. Continued interest rate cuts led to a sharp expansion of credit in the housing market, and the housing bubble burst then the subprime crisis erupted after the increase of interest rate from January 2005 to July 2014. It’s worth mentioning that the United States was hit by hurricanes Katrina and Rita in 2005, two of which caused more than $120 billion in property damage, and that investors worried that long term reconstruction efforts would crimp growth, so they reduced investment in the United States. Coupled with the impact of other countries, for example, the Japanese election so that the value of the yen rose significantly, China’s monetary policy reform, the German election so that the euro destabilized, the dollar’s value fell rapidly.

When the subprime crisis swept the globe in 2008, it was unbelievable that the value of the US dollar increased. An important reason was that the dollar was regarded as safe-haven asset which had characteristics of low risk and high liquidity. Similarly, when the euro crisis hit in 2009, people still thought it was a good idea to hold dollars, causing the dollar index to rise slightly during this period. Another reason was the shortage of dollars, European banks depended more on secured funding markets, such as foreign exchange swaps and Repo. However, while European banks were planning to exchange euros, pounds, and so on into dollars, American banks had no new demand for European currencies. Because of this imbalance between demand and supply of the dollar, the global banking system suffered from a severe dollar shortage. This shortage led to the appreciation of the US dollar. Unfortunately, the Madoff Ponzi scheme which was the biggest fraud in history occurred in the United States in late 2018, the majority of companies lost nearly half of their assets and even some firms went into liquidation, which caused domestic and international investors to lose confidence in the stock market, then the value of the dollar decreased.

Three causes should be considered to explain why the dollar has appreciated since July 2014. First, economic reform made the growth of China’s economy slow, so international investors began to invest their money in the United States, more capital flowed into the US, and the dollar was more popular. Second, some counties such as China and Japan continued to buy dollars in order to increase their exports by falling the value of their currencies, although purchasing dollar was beneficial to their exports, the value of the dollar raised. The third cause was that the Federal Reserve improved the Fed funds rate, there was no doubt that this was a good opportunity for the US to attract investors.

3. Conclusion

Based on the fluctuation of the US dollar index, the essay has explained why the dollar is volatile over the long term since the 1980s. It is now possible to understand how those factors affect the value of the dollar. It also has found that there is a close relationship between the fluctuation of the dollar value and factors which have an impact on the exchange rate such as interest rates, inflation and economic or political status. The fluctuation of the value of the dollar is not only controlled by the United States, but sometimes the value of the dollar is forced up or down by the change of other countries’ policies or economic conditions. And even if the dollar’s value fluctuates for the same reason, the
amount of change in the dollar’s value varies from period to period. The Federal Reserve raised interest rates in 1979, 1981 and 2015 respectively, but every change was different. The findings of the study suggest that each fluctuation in the value of the dollar is influenced by more than one factor. However, not every reason is mentioned in the essay because of the small scale of this study. Even so, the essay is useful in predicting the trend of the value of the dollar.

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