

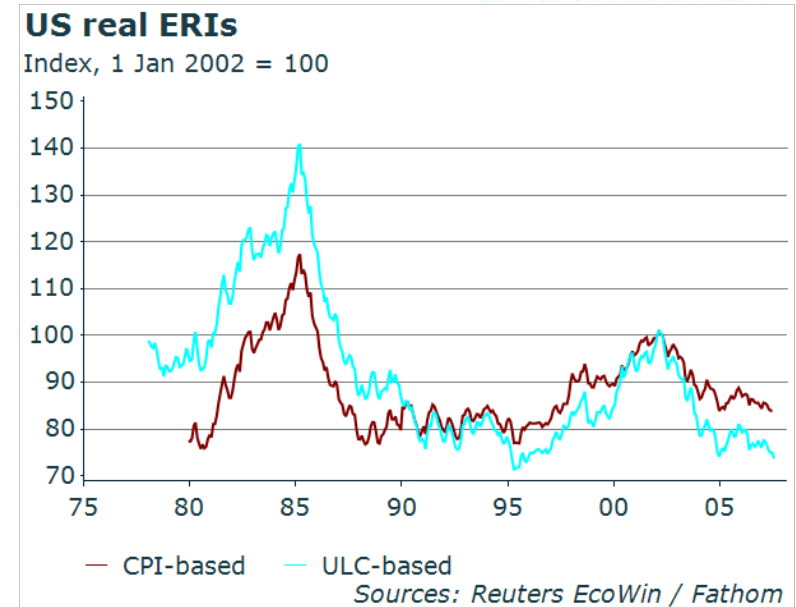
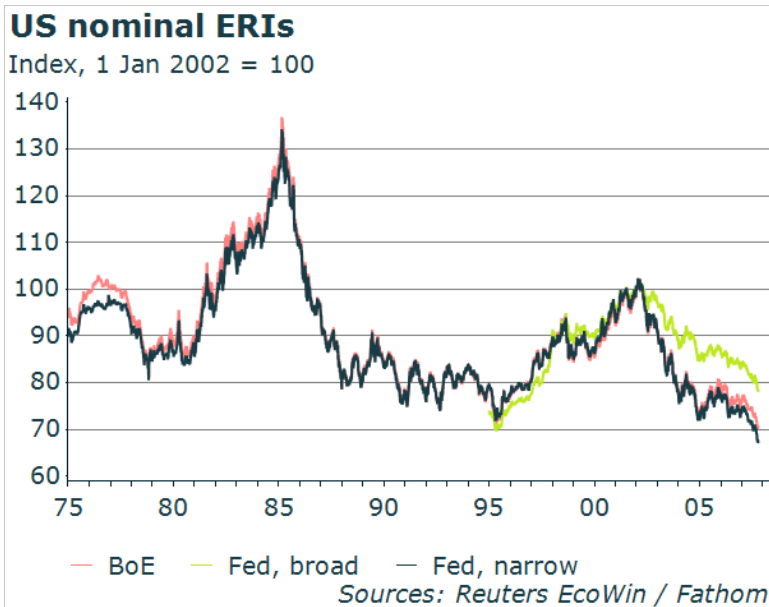
fathom



Dollar pegging

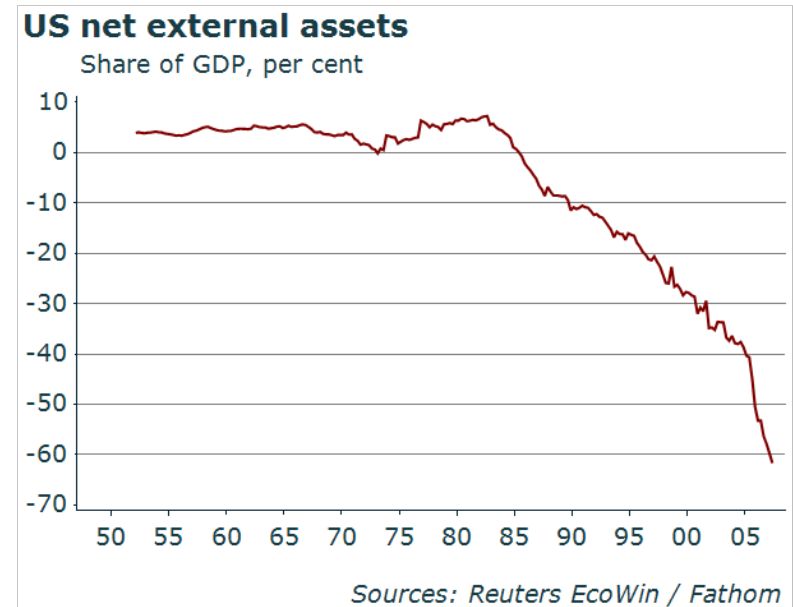
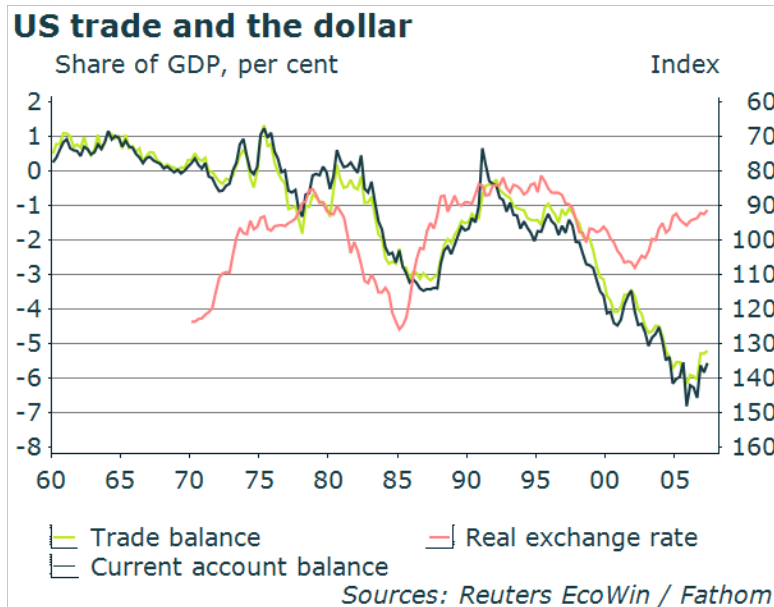
January 2007

Whither the US\$?



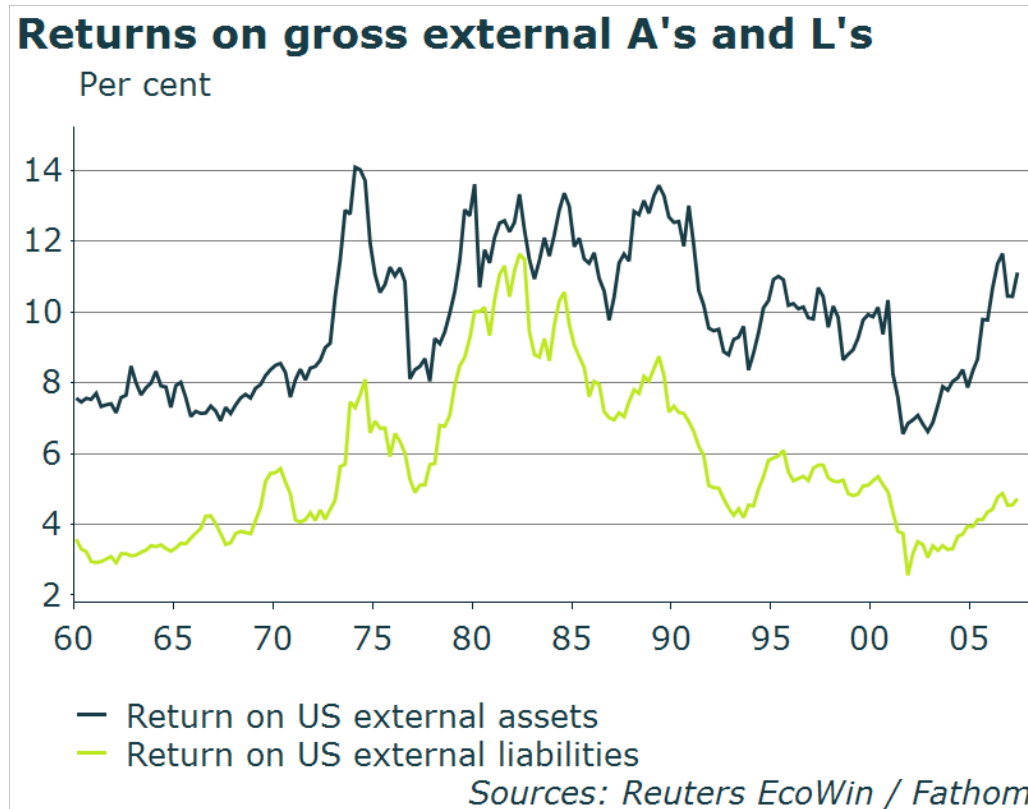
- Since early 2002 peak, US dollar has fallen some 30% against the major currencies
- It has fallen somewhat less against a broader basket, presumably because many of these are pegged to the dollar
- Our preferred competitiveness measure, based on relative ULCs, suggests it has fallen some 25% in real terms

Fathom's US\$ model



- The current account usually responds to real exchange rate changes with a lag of 2-3 years
 - But post 2002 dollar depreciation has had little impact – until now?
- Can use the relationship suggested by left-hand chart to estimate the exchange rate adjustment necessary to deliver any given net external asset position in steady state
 - Big drop in NEA post 2005 reflects relative stability of the \$ (no reval effects)

Persistent excess returns?



- In every quarter for which data are available, US residents have earned a higher rate of return on US assets than have overseas residents on US liabilities – mean returns are 9.8% and 5.7% respectively

Two alternative S-S conditions

Usual model:

- Where there is a single rate of return, the trade balance necessary to support a given net external asset position in steady state is given by:

$$\frac{X - M}{Y} = (g - r) \frac{B}{Y}$$

where $B=A-L$ is net external assets, r is the single rate of interest, $X-M$ is the trade balance, Y is nominal GDP and g is the rate of growth of nominal GDP

Alternative model:

- Where the rate of return on gross external assets (r^a) differs from the rate of return on gross external liabilities (r^l), the steady state condition becomes:

$$\frac{X - M}{Y} = (g - r^a) \frac{A}{Y} - (g - r^l) \frac{L}{Y}$$

Results

- Results change dramatically according to preferred interest rate assumption
- Table on the left suggests a further 40% real depreciation is necessary to maintain current NEA position
- Table on the right suggests the dollar has already gone too far (though short-term considerations, ie. UIP, may be holding it down)

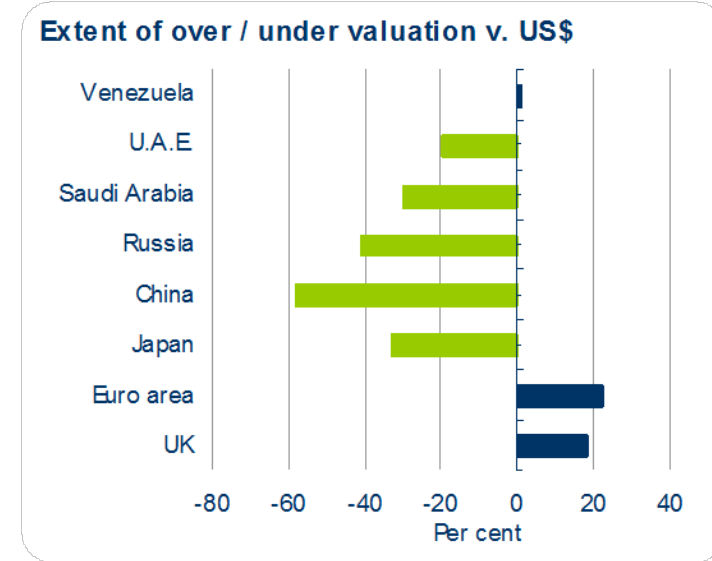
Results assuming a common interest rate in steady state					Results allowing for different interest rates in steady state				
Sustainable NEA position	-60	-30	0	30	Sustainable NEA position	-60	-30	0	30
Return on US external assets	8.0	8.0	8.0	8.0	Return on US external assets	9.8	9.8	9.8	9.8
Return on US external liabilities	8.0	8.0	8.0	8.0	Return on US external liabilities	5.7	5.7	5.7	5.7
Growth rate of nominal GDP	5.0	5.0	5.0	5.0	Growth rate of nominal GDP	5.0	5.0	5.0	5.0
elasticity	-8	-8	-8	-8	elasticity	-8	-8	-8	-8
B/Y	-60	-30	0	30	B/Y	-60	-30	0	30
A/Y	50	65	70	85	A/Y	50	65	70	85
L/Y	110	95	70	55	L/Y	110	95	70	55
Required trade balance	1.8	0.9	0.0	-0.9	Required trade balance	-1.6	-2.5	-2.9	-3.7
Current equilibrium trade balance	-1.3	-1.3	-1.3	-1.3	Current equilibrium trade balance	-1.3	-1.2	-1.2	-1.2
Required change in trade balance	3.1	2.2	1.3	0.4	Required change in trade balance	-0.3	-1.3	-1.7	-2.5
Required change in dollar from today	-38.8	-27.5	-16.3	-5.0	Required change in dollar from today	4.1	15.7	20.9	31.2
Implied change in dollar from peak	-53.8	-42.5	-31.3	-20.0	Implied change in dollar from peak	-10.9	0.7	5.9	16.2

Bilateral misalignments

The Economist "Big Mac" index

Big Mac prices

	In local currency	In US\$\$s	Implied PPP rate	Actual rate on 2 July	Under / overvaluation against US\$
UK	£1.99	4.01	1.71	2.01	18
Euro area	€ 3.06	4.17	1.12	1.36	22
Japan	Yen 280	2.29	82.1	122.0	-33
China	Yuan 11.0	1.45	3.23	7.6	-58
Russia	Rouble 52.0	2.03	15.2	25.6	-41
Saudi Arabia	Riyal 9.0	2.40	2.64	3.75	-30
U.A.E.	Dirhams 10.0	2.72	2.93	3.67	-20
Venezuela	Bolivar 7400.0	3.45	2170.0	2147.0	1



- Real effective index may be close to a sensible steady-state value
- But considerable bilateral misalignments remain
- In general, dollar needs to fall substantially against the Yuan, the Yen and most OPEC currencies
- It needs to rise against the euro and sterling