What is happening to the U.S. dollar?

Excerpts from an address by Robert P. Mayo, President, Federal Reserve Bank of Chicago, at the meeting of the International Trade Club of Chicago, February 9, 1978.

Last year the dollar depreciated by about 18 percent in value relative to the Swiss franc and Japanese yen, about 11 percent relative to the German mark, and about 10 percent relative to the British pound. It gained against some others, as for example, the Canadian dollar. Using an aggregate measure of the change in the exchange value of the dollar that takes into consideration the movement in the exchange rate in terms of currencies of our 15 major trading partners weighted by their relative importance, we find the dollar has depreciated by about 4½ percent over the past year.

The supply and demand

The movements in the value of the dollar took place within the framework of the floating exchange rate system in effect since 1973. In that system the exchange rates of individual currencies are permitted to move relatively freely in response to the forces of supply and demand. An important source of demand for, and the supply of, a country's currency in a free-market economy is the myriad of transactions that individuals and corporations residing in a country engage in, day-in and day-out, with residents of other countries. In the case of the U.S. dollar, foreigners who buy our products, services, and our securities need dollars to make payments to us; they represent a source of demand for dollars on the foreign exchange markets. On the other side, there are U.S. residents who purchase foreign goods, services, investments, and securities, and pay for them in dollars; they are a source of supply of dollars on the foreign exchange markets.

Other sources of supply and demand derive from the special position of the dollar in international finance. The U.S. dollar has been for many years an "international currency." It has been used as a currency of settlement for transactions between many countries outside the United States and as an official reserve asset. This role has led to a large demand on the part of official institutions, as well as private individuals and corporations abroad, for dollars to be held for transactions purposes as well as a storehouse of value. This foreign demand for dollars has been motivated by market-oriented considerations but also by psychological, political, and expectational factors. The occasional "hoarding" and "dishoarding" of privately held dollars abroad has been, at times, an important element influencing the supply of, and the demand for, dollars on the foreign exchange markets—and thus the movements of the exchange rate of the dollar in terms of other currencies.

Trade deficit as a source of excess supply

Over the past three years we experienced the development of a major imbalance in our international accounts, as our trade account shifted from a $9 billion surplus in 1975 to a deficit of $9 billion in 1976 and to more than a $31 billion deficit in 1977 on the balance-of-payments basis. This deficit in trade in goods was partially offset by our trade in services (which includes return on our investment abroad), but it still left us with some $18 billion deficit on the so-called current account. Translated into the supply and demand relationship, this meant that we have supplied $18 billion more to the foreign exchange markets through payments for these transactions than was demanded by foreigners to pay for similar transactions engaged in by them. The trade deficit thus represented one important known element of the excess supply that was experienced by the exchange markets.

In overall terms the underlying cause of our burgeoning trade deficit has been a faster growth in our imports than in our exports: while our imports were up by almost 22 percent in 1977, our exports increased by less than 5 percent. This rapid rate of growth in imports was particularly keenly felt in certain sectors of our industry as foreign products such as steel, shoes, television sets, and cars made deeper inroads into our domestic markets. As a result, we have witnessed a growing pressure for import restrictions as a means of solving the problems of the affected industries, as well as of our growing deficit. Our government used and is using existing channels developed through U.S. laws and international treaties to deal with legitimate complaints of individual industries against unfair foreign competition. But we must not permit ourselves to act unilaterally in regard to our import problems by the imposition of arbitrary import restrictions! Few, if any, nations would tolerate such measures! They would retaliate; protectionism invites more protectionism. And the spread of import restrictions that would follow would do a great damage to the U.S. economy as well as to our worldwide national interests! If we want to find a lasting solution to our trade problems, we must look deeper into the underlying causes and seek the solutions there.

Expanding U.S. economy draws in imports

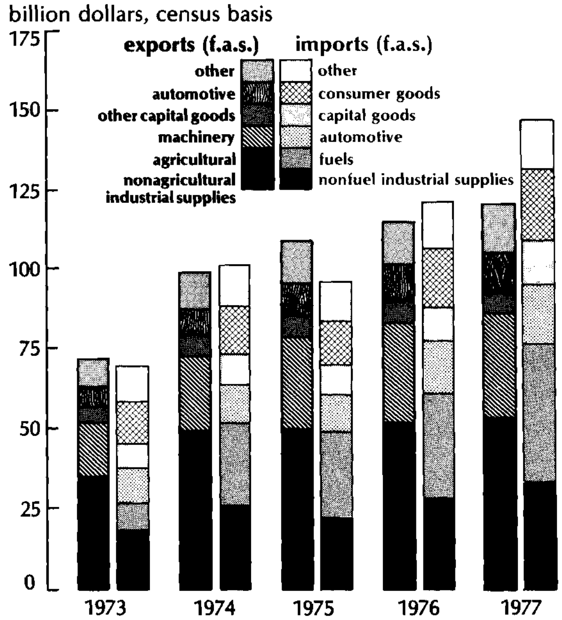
Probably the most important underlying cause of the rapid expansion in our imports relative to our exports has been the recent wide variation among the free world nations in economic performance. Our economy has been healthier, and has been growing considerably faster, than the economies of our major trading partners taken as a group. This expanding U.S. economy has been drawing in imports more rapidly than the sluggish economies abroad have been been increasing their demand for our products. There are two possible remedies for the imbalance in our trade arising from this source. We could slow down our imports by slowing down our economy, or we could hope for acceleration of our exports as a by-product of improvement in economic growth in major industrial countries abroad.

The first alternative we cannot accept. We need more growth, not less, so that we can make further inroads on unacceptably high levels of unemployment, and so that we can continue to provide stimulus to economic expansion worldwide by our own economic advances. Obviously, the second alternative is preferable, from the world's viewpoint, as well as our own. With this in mind, our government has consistently used international meetings—such as the economic summit of the heads of major states last year, the ministerial meetings of the Organization for Economic Cooperation and Development, and many other formal and informal channels—to nudge our friends abroad into economic expansionary action that would benefit them in reducing their record-high unemployment, benefit the developing countries of the world by providing further stimulus to their economic growth, and benefit us by improving markets for our exports.

The oil deficit

Another underlying cause of our rapid growth in imports—and of our trade deficit—has been our voracious appetite for imported oil. Last year our oil import bill came to about $45 billion—up from $36 billion in 1976 and up from less than $5 billion as recently as 1972. That $45 billion figure has become a millstone around the neck of the floating dollar! What can be done? In the final analysis, we must take our own energy bull by the horns! We cannot continue to live in a fool's paradise where, for example, the *real* price of gasoline is now about 16 percent lower, and natural gas and electricity is some 44 percent lower, than it was some 30 years ago. We need an effective national energy policy so that we can make decisive progress toward diminishing our reliance on imported sources of energy.

Surging trade deficit . . .



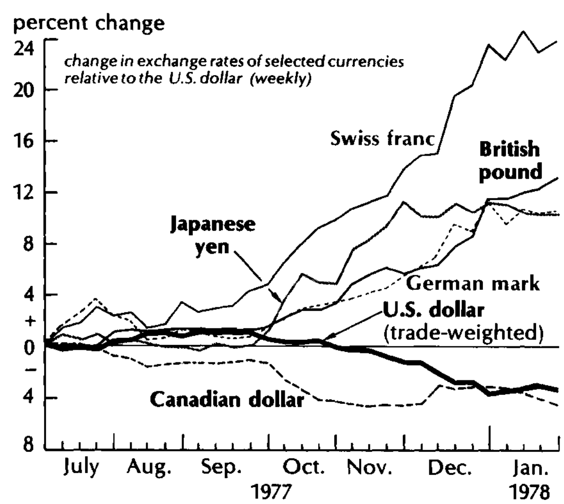
The exchange rates and international competitiveness

Another underlying cause of our deficit may have been a gradual erosion of the competitiveness of U.S. goods on the world markets. Competitiveness of any country's goods on the world markets is generally determined by the quality of its products, delivery promptness, and follow-up services—but above all, it is determined by the prices of its products. The final prices of a country's products on the world markets as they confront foreign buyers of these products are determined through a two-tier process. The first tier relates to the rate of price changes—the rate of inflation—which determines the prices of the country's goods in its own currency. Next, it is the movement of exchange rates through which specific domestic prices are "translated" into specific international prices. This constitutes the second tier through which international competitiveness is determined. On the "first tier" the domestic wholesale prices of manufactured goods rose by almost 7 percent in the United States, in Germany by 3 percent, in Japan by 2 percent, and in Switzerland they actually declined by almost 1 percent between the end of 1976 and late 1977. Obviously, our competitive position against these countries in terms of domestic prices eroded during the year, and the movements in the exchange rates of these currencies relative to the dollar—the second-tier process—may be viewed as compensating for the trends on the first tier. If we weigh the changes in the exchange rate of the dollar with respect to the currencies of Japan and 13 major European countries by the volume of trade, and adjust these weighted changes for the inflation in prices of manufactured goods experienced domestically by these countries, we find that although the dollar depreciated by about 10 percent in 1977 against these currencies taken as a group, the U.S. competitive position (as determined by the two-tier process) in respect to our 14 major trading partners was almost precisely the same at the end of 1977 as it was in 1973!

The capital account

To sum up, our current deficit may have been caused at least in part by our relative loss of competitiveness during the earlier part of

. . . contributes to the dollar's decline



the 1973-77 period, and the observed movements in the exchange rate of the dollar relative to major currencies has been a part of the lagged process by which markets have tended to reestablish that competitiveness.

Data for 1977 on the supply and demand for dollars on the foreign exchange markets arising from money and capital transactions between the United States and countries abroad are available only through September. They indicate that the demand for dollars in the capital account amounted to about $29 billion, while the supply of dollars (arising from acquisition of foreign assets and investments by U.S. residents) came to about $13 billion. This, on the surface, would appear to be a rather "favorable" constellation of the supply and demand forces. However, a close look at the figures indicates that three-quarters of that observed "demand" for dollars was actually a "residual demand," representing acquisition of dollars by foreign official institutions as they intervened in the foreign exchange markets in their efforts to moderate the rise of their currencies relative to the dollar! Private foreign demand for dollars appeared to have fallen quite short of supply in the money and capital transactions, particularly in the last few months of the year.

In part, the causes of this trend were "economic" in origin; in part, they were a reflection of prevailing market psychology. On the economic side, the trend reflected continued excess of our corporate long-term investment abroad over foreign investments in the United States. It also reflected the activities of U.S. banks and others in accommodating demand for credit around the world in the form of loans and purchases of foreign securities. It was largely the presence of adverse "psychological" factors in the market that resulted in reduced demand for dollars on the world's money markets.

Market psychology

The impetus toward reversing the adverse capital flows affecting the dollar must come from improvements in the "psychology" of the international financial markets. We have to restore the apparently shaken confidence of foreign investors—as well as U.S. investors. In our ability to reduce inflationary dangers, we must resolve national policy uncertainties in respect to our energy and tax policies.

There is no easy answer, and no easy solution, to what has been happening to the U.S. dollar. An improvement in the position of the U.S. dollar will require systematic progress on many fronts. We are on the right road. Our actions and our economic policies are evolving with the integrity of the dollar in mind. We are not practicing a policy of "benign neglect" in respect to the dollar as some of our friends abroad have accused us just because we have not intervened more heavily in the foreign exchange markets! Our policy of limited official intervention has proved to be very constructive thus far, particularly as it has tended to throw speculators off guard. Intervention is a management strategy, albeit a very valuable one; it is not a cure.

Conclusion

In perspective, our policies in respect to the dollar must be guided by two broad principles. One such principle derives from our existence as a viable member of the trading community of nations. That viability is largely predicated on our ability to maintain a healthy, noninflationary economy, and on our ability "to pay our way"—to see to it that our international accounts are kept in a reasonable balance. No nation, just like no individual, can go on spending forever more than it earns! The other principle comprises considerations involving the viability of the entire world trading system. That viability is predicated on the proposition that all trading nations must sacrifice certain self-serving objectives for the benefits they derive from a free international exchange of goods: no nation can expect to build economic benefits for itself by heaping adversities on others.

As long as we, as well as other nations, adhere to these principles of national and international responsibility, I am convinced that the future of the dollar will be secure.