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Exchange rate fluctuations and the dollar problem

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EXCHANGE RATE FLUCTUATIONS AND THE DOLLAR PROBLEM

'An attempt is made in this paper to review briefly recent developments in the foreign exchange markets, with particular reference to the chronic problem facing the US Dollar. This is followed by an examination of the major issues involved in the crisis of confidence and measures that might be taken to tackle the recurrent dollar problem, in a way to bring about an orderly exchange rate adjustment and smooth functioning of the international Monetary System'

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INTRODUCTORY SECTION:

Most of the international monetary problems on the eve of the collapse of the Bretton Woods System of fixed parities have again emerged under the present so-called regime of floating exchange rates. The world is again witnessing major disequilibria in the basic payments balances of many countries - large disequilibrating capital flows and widespread tendency to diversify reserves which has been giving the world's inflationary spiral an upward turn.

The dollar is again at the centre of the show - a lack of confidence focussed on the key currency of the system with much volatile dollar funds roaming around the world as "stateless money". The unrest in foreign exchange markets produced by distrust in the present trend in exchange rate alignment and disorderly capital flows have added to the problem.

An attempt is made in this paper to review briefly recent developments in the foreign exchange markets, with particular reference to the chronic problem facing the US dollar. This is to be followed by an examination of the major issues involved in the crisis of confidence and measures that might be taken to tackle the recurrent dollar problem, in a way to bring about an orderly exchange rate adjustment and smooth functioning of the International Monetary System.

RECENT DEVELOPMENTS:

The major features of the foreign exchange market recently have been the sharp decline of the US dollar and disorderly exchange market conditions.

From mid-1974 to mid-1976, a period of relative dollar strength, the dollar appreciated by more than 10% in real terms, and it remained relatively unchanged until September 1977, when heavy selling pressures against the dollar began to develop. The subsequent exchange rate volatility has brought about a major realignment of exchange rates. This has resulted in a continuous depreciation in the value of the US dollar vis-a-vis other major currencies shown in Table 1, with the exception of the Canadian dollar against which it has some bilateral gain in respect of the effective exchange rate changes (after adjustment for domestic price differentials).

Using 1973 as base (=100), the index of fluctuation in the exchange rates of the currencies of the industrial OECD countries against the US dollar are shown in Appendix Table 1. By the second quarter of 1978, the Austrian schilling, Belgian franc, Danish krone, Deutsche mark, Japanese yen, Dutch guilder, Norwegian krone, and the Swiss franc appreciated in value while the Canadian dollar, French franc, Italian lira, Swedish krona, and the British pound sterling were still at a depreciated value vis-a-vis the US dollar. The exchange developments have now resulted in an upward revaluation of the Deutsche mark against other currencies in the "snake". From September 1, 1977 to September 27, 1978, the exchange rate changes have resulted in a 10.19% depreciation in the value of the US dollar against the SDR.

A comparison of the relative trade-weighted exchange rates from Smithsonian further shows that the trade-weighted index value of the US dollar (18-12-71 = 100) against the currencies of the other 29 countries shown in Appendix-Table 2 has fallen to 97.38 on December 30, 1977 and 93.91 on August 30, 1978. This decline has now continued unabated right into the fourth quarter of 1978. An important issue to examine next is why the dollar's weakness has been so prolonged and the major factors involved in the resultant crisis of confidence in the exchange markets.

MAJOR ISSUES IN THE DOLLAR'S WEAKNESS

At the beginning of the present dollar crisis about a year ago, the view was widely held that the heavy selling pressures which developed against the dollar would become eased after a short period. The rising US oil imports and the resulting trade deficits were seen as the main contributory factors to the dollar's problem. Thus, the extent to which President Carter's energy programme could solve the endemic problem has been widely publicized and, perhaps, over-emphasized.

As it has now turned out to be, the crisis was not short-lived, and its dimensions seem to have been under-estimated. Many do not now share the widely held view that oil imports and the resulting trade deficits are the main reasons. There are, in fact, other important factors besides oil imports.

Among the other suggested important issues involved are those of rising inflation with sinking economic growth projections and a general lack of confidence by the financial markets in the economic and financial policy measures of the US Administration. This now seems to be supported by the 0.9% jump in US wholesale prices in September, 1978, thereby making these be 8.2% higher than in September, 1977.

There is also the market's impatience to see evidence of a major improvement in the US current account imbalances. From the fourth quarter of 1975 to the first quarter of 1977, the US trade balance swung from $11

APPENDIX–TABLE 1

INDEX OF FLUCTUATION IN THE EXCHANGE RATES OF THE CURRENCIES OF MAJOR INDUSTRIAL OECD COUNTRIES AGAINST THE U.S. DOLLAR*

(1973 = 100)

Currencies	1973	1974	101975	201975	301975	401975	101976	201976	301976	401976	101977	201977	301977	401977	101978	201978
1. Austrian Schilling	100	95.47	84.77	85.17	92.01	93.85	93.73	93.56	91.85	87.34	86.93	85.78	83.76	81.16	76.22	76.31
2. Belgian franc	100	99.59	89.47	89.78	97.74	100.47	100.61	100.73	100.16	94.07	94.30	92.78	91.43	89.31	82.75	82.40
3. Canadian dollar	100	97.77	99.83	102.16	103.06	101.73	99.52	97.88	97.73	99.21	102.98	105.21	106.96	110.15	111.31	112.71
4. Danish krone	100	100.75	91.42	90.46	97.75	100.31	101.62	100.44	100.46	97.18	97.36	99.33	100.08	100.16	93.92	93.41
5. French franc	100	107.99	96.15	91.64	97.83	99.33	101.54	105.58	110.18	111.94	111.73	111.19	109.77	108.57	106.79	103.40
6. Deutsche mark	100	96.98	87.48	88.10	95.52	97.17	96.33	95.71	94.72	90.12	89.63	88.31	86.35	83.21	77.68	77.71
7. Italian Lira	100	111.55	109.40	107.83	114.05	116.64	131.25	147.80	144.01	147.98	151.39	152.01	151.40	150.61	147.83	147.92
8. Japanese Yen	100	107.48	108.15	107.79	109.86	111.93	111.49	110.31	107.32	108.24	105.29	101.48	98.14	91.09	87.62	81.41
9. Dutch Guilder	100	96.18	86.31	86.26	93.92	95.39	95.69	97.05	95.51	90.05	89.53	88.31	87.66	85.66	79.55	79.54
10. Norwegian Krone	100	96.08	86.91	85.80	93.95	95.86	96.12	95.58	95.53	91.32	91.40	91.59	92.76	93.57	90.99	93.75
11. Swedish Krona	100	101.65	91.17	90.24	98.26	100.63	100.40	101.21	100.96	96.39	96.72	100.07	104.23	109.45	106.19	105.83
12. Swiss franc	100	94.09	78.66	79.54	84.17	83.71	81.43	78.80	78.27	77.26	79.58	79.31	75.73	68.99	60.93	60.52
13. British pound (sterling)	100	104.88	102.44	104.88	114.63	119.51	121.95	134.15	139.02	148.78	141.46	141.46	141.46	134.15	126.83	134.15

* Decreasing index numbers indicate the appreciation of the currency, and vice-versa.

Source: IMF, International Financial Statistics

v) The US could, subject to political acceptability or unemployment implications, accept a slower growth rate than such surplus countries as Japan and West Germany enjoy.

vi) Finally, physical controls might be employed to restrict imports but this might provoke retaliation, as already warned by its OECD trading partners.

Contrary to the stated objective of the new Article IV of the IMF, as regards exchange arrangements, the US does not appear to have seriously considered the need to promote stability by fostering orderly underlying economic and financial conditions. As regards the surveillance role of the IMF in this regard, there is still the unresolved issue of power allocation between the Fund and its members such that the Fund might not yet be able to effectively exercise surveillance to bring about orderly exchange rate developments.

The US Authorities have no doubt taken some limited measures recently in an attempt to support the dollar but they are still considered inadequate.

On August 23, 1978 the US Treasury announced an increase in the amount of gold offered at its monthly auction from 300,000 ounces to 750,000 ounces. This followed the Fed's initiative to aid the dollar on August 18, when it increased the discount rate to 7¾% from 71 1/4%. The Federal Reserve further announced on August 28 moves to make Eurodollar borrowing more attractive and thereby encourage demand for dollar-denominated assets. This action taken is to reduce from 4% to zero the reserve requirement on the foreign borrowings of banks - mainly Eurodollars - from their foreign branches and other foreign banks, and to cut from 1% to zero the same requirement on foreign branch loans to US borrowers.

In order to really deal with the issues involved in the dollar crisis, the US Authorities still have to employ in an effective manner a combination of some of the policy options indicated above. In particular, monetary policy must be tightened so that in the long run, the rising inflation rate declines and US goods become more competitive abroad.

The special problem which the unique role occupied by the US dollar in international finance since World War II has created for the US Monetary Authorities must be dealt with in a realistic manner. From the US standpoint, it is desirable to liberate the dollar from its role as reserve and intervention currency as swiftly and progressively as possible. In this regard, the US should welcome rather than feel hurt by such moves as that being considered by the OPEC to substitute a basket of currencies for the dollar in oil pricing, and for the SDR to take over some of the former role of the dollar. Another condition for the dollar rehabilitation is to take care of the present excessive dollar balances outside the effective control of the US.

As regards the role of official intervention in the foreign exchange market, this can, in principle, smoothen an otherwise disorderly market, but its success is constrained by the difficulty of identifying reversible short-run influences from those reflecting changes in underlying conditions. There is the problem of knowing exactly when intervention is worthwhile, for example, when a depreciating currency has hit its lowest market adjustment point. Intervention has the best chance of succeeding when it acts with the market trend rather than against it.

It appears there has been a growing awareness of the limited role of official intervention in the present dollar crisis. Official exchange market intervention has been moderate and limited, apart from substantial dollar purchases by the Japanese Authorities in July and large swaps by the Swiss National Bank early in August, 1978. Rather than arising from short-term capital flows or erratic exchange rate changes of limited duration which intervention is better suited, it has gradually dawned on officials that the dollar's weakness has been brought about mainly by the record US trade and current account deficits since 1976. This requires a more positive US action to deal with than a mere exchange intervention.

CONCLUDING SECTION:

An attempt has been made in the previous sections to review the present dollar problem and exchange rate developments as well as highlighting the important factors involved. As we have shown, apart from the widely publicized US oil imports as the major cause of the dollar problem, all the other factors examined have affected exchange rate expectations which have strongly influenced the present volatile exchange rate developments.

It could be seen, therefore, that it is unlikely that the passage of President Carter's energy programme alone is enough to eliminate the large US deficits in the near future. This wide dimension of the problem partly explain the present cool reaction of the exchange market to the passage of the energy programme some days ago. So also has been the cool reaction to the huge reduction in the US foreign trade deficit for August to $1.62 billion from $2.99 billion in July, increase in discount rate in August and the Federal Reserve's move to make Eurodollar borrowing more attractive so as to encourage demand for dollar-denominated assets.

The US Authorities should be fully aware of the fact that the burden of adjustment can neither be shifted on other countries nor can it expect automatic market adjustment forces to do the job under the present type of floating exchange rate system. More positive measure are, therefore, needed to deal with the fundamental problems, so as to reverse the present pessimistic view of many market participants who are yet to be impressed by the US handling of the affairs.

There is the overall need for countries - both the surplus and the deficit ones - to coordinate their policies to restore satisfactory growth and price stability as well as improve the functioning of the international adjustment process. In this regard, both surplus and deficit countries are duty bound to take necessary measures to avoid chronic surpluses and chronic deficits on eternal accounts. This is very important in any effort to correct the present balance of payments disequilibria, involving a better distribution of current account balances among countries, and to restore order in the disrupted exchange markets.

Failure to achieve this will adversely affect the world economy, as the instability of exchange markets persists and the possible adoption of restrictive trade and payments practices or inflationary policies by weaker countries which would result in another chaotic world economic situation.

The present international financial instability is particularly vulnerable to the economies of the developing countries - OPEC and non-OPEC LDCs. alike - with the large erosion of the dollar proceeds of oil exports by the OPEC Countries and of exports of primary commodities from other LDCs. Added to this loss of purchasing power have been (i) the rising rate of imported inflation from the advanced industrial countries, (ii) the adverse impact on the export earnings of LDCs. due to protectionist measures abroad, and (ii) problems of exchange rate management arising from the divergent, and sometimes rapid, movements of exchange rates for major currencies.

" In Nigeria, in particular, these adverse impacts have resulted in a drastic fall, as from 1976, in her oil proceeds and foreign exchange, and a greater use of Euro-dollar source of finance, with the attendant distortions in the implementation of development programmes in the 1975-80 Third National Development Plan."

All these have further increased the external financiing problems of the LDCs. and worsened the burdensome debt positions of many of them that have been increasingly resorting to the rather less suitable Euro-currency finance.

In Nigeria, in particular, these adverse impacts have resulted in a drastic fall, as from 1976, in her oil proceeds and foreign exchange, and a greater use of Euro-dollar source of finance, with the attendant distortions in the implementation of development programmes in the 1975-80 Third National Development Plan.

The unsatisfactory external environment, therefore, poses a serious impediment to the economic development of the Third World countries.

APPENDIX—TABLE 2

TRADE—WEIGHTED EXCHANGE RATES* FROM SMITHSONIAN

(Geometric Average - 1976 Weights)

Country	30.12.77	28. 6. 78	26. 7. 78	2. 8. 78	9. 8. 78	16. 8. 78	23. 8. 78	30. 8. 78
USA	97.38	95.97	94.57	93.91	93.31	92.56	94.04	93.91
Canada	90.79	87.74	87.31	85.84	85.83	85.42	85.86	84.91
Japan	124.90	145.72	153.85	159.74	157.94	159.66	154.83	157.04
Austria	126.08	126.01	125.60	125.30	126.89	126.57	126.54	125.66
Belgium	115.70	114.35	113.54	113.39	114.89	115.32	115.09	115.12
Denmark	110.12	112.58	111.86	111.70	111.94	111.24	110.55	111.33
France	96.53	99.04	100.82	100.98	99.56	100.35	99.37	99.38
Germany	140.75	140.80	140.32	140.12	142.23	142.77	141.44	142.26
Italy	56.53	57.01	57.01	56.68	56.40	56.38	56.17	56.42
Netherlands	120.70	122.03	121.02	121.29	122.01	122.29	122.04	121.46
Norway	122.72	115.70	114.12	113.82	115.26	115.35	114.60	115.11
Sweden	92.16	94.30	94.19	93.87	94.26	94.48	94.40	94.20
Switzerland	174.11	184.12	189.38	196.13	196.06	204.76	200.41	201.56
Finland	93.73	87.84	88.16	87.89	87.78	88.06	88.27	88.06
Greece	75.57	70.41	69.16	68.81	68.93	67.55	67.89	68.05
Ireland	81.14	79.38	80.12	80.14	80.06	80.06	79.90	80.00
Portugal	64.54	55.53	54.76	54.57	54.39	54.30	54.01	53.85
Spain	74.98	76.45	77.02	77.25	77.43	77.88	79.29	79.43
Yugoslavia	92.04	85.53	83.94	83.42	83.16	81.77	82.85	83.15
Australia	86.96	82.52	80.83	79.76	79.45	78.91	79.54	79.18
New Zealand	83.94	82.50	82.39	81.96	81.96	81.91	82.31	81.99
South Africa	81.44	80.45	78.16	77.95	77.30	75.85	78.03	77.08
Iran	98.05	95.31	91.84	91.36	90.83	88.83	91.46	90.13
Saudi Arabia	114.09	111.08	109.02	108.61	109.47	108.96	111.88	110.75
Brazil	32.07	27.87	26.94	26.77	26.48	25.76	26.30	25.92
Hong Kong	109.70	105.13	102.97	101.65	100.34	97.70	101.34	100.21
India	83.05	80.85	82.22	81.04	81.36	81.71	79.92	80.20
Malaysia	106.45	102.24	100.84	100.81	100.78	101.16	101.32	101.35
Singapore	108.35	105.72	105.94	105.80	105.84	106.16	105.30	105.52
United Kingdom	66.38	63.69	64.95	64.96	64.86	64.88	64.55	64.75

* Index showing trade weighted value of each currency against all other currencies in the Table (18. 12..71 = 100).

Source: Euromoney, September & October, 1978