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THE ROLE OF THE DOLLAR IN MONETARY POLICY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the symposium on
foreign exchange rate forecasting

sponsored by
International Risk Management

New York City

Thursday, January 29, 1981

SUMMARY

Since 1978, the Federal Reserve, on several occasions when the dollar was under pressure, has taken vigorous action to strengthen it. While domestic economic concerns must have priority, the United States could not remain unconcerned if it saw its currency's international value eroding. We have learned that the inflationary impulses emanating from a declining exchange rate are greater than had been thought. Especially when fighting inflation is our number one priority, maintaining the strength of the dollar internationally becomes an important objective. The new reserve-based strategy of the Federal Reserve, while it has increased the volatility of interest rates and exchange rates, permits a firmer control over the monetary aggregates and will help to bring inflation down and contribute to a more stable system of exchange rates.

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Since 1978, the Federal Reserve on several occasions has had to take vigorous action to strengthen the dollar. On occasion, when the dollar was under pressure, the discount rate was raised, with statements referring to disorder in the exchange markets or need to strengthen the dollar. On November 1, 1978, as part of an operation in which resources totaling up to $30 billion were assembled by the Treasury and the Federal Reserve jointly in defense of the dollar, the Federal Reserve raised the discount rate and also imposed supplementary reserve requirements. On October 6, 1979, again in the face of very strong pressures on the dollar, the Federal Reserve moved to a more rigorous method of controlling the money supply which quickly raised market rates by 150-300 basis points; it also raised the discount rate by one percentage point, and established marginal reserve requirements on managed liabilities. There has been widespread understanding of the need for these measures, all of which were taken in the face of unusual pressures. In this talk I want to examine more broadly the rationale for giving the value of the dollar a weight in monetary-policy decisions, not only in crisis conditions but more generally.

Domestic Concerns Come First

It has often been argued, and in my view rightly, that the United States has as its primary economic interest the state of the domestic economy, with international trade and finance playing a secondary role. The United States is like the ideal automobile, big inside and small outside. In addition, it has been said, again rightly in my opinion, that under a floating exchange-rate system, such as we have now, the defense of a particular exchange-rate level is not appropriate when it is in conflict with fundamental factors bearing upon the balance of payments. That is what floating rates are for -- to help bring about balance-of-payments adjustment, although they are by no means the only way of achieving adjustment. Too literal an interpretation of these general verities, however, might easily lead to a situation that has been characterized as "benign neglect." The United States has never practiced benign neglect and I do not believe it to be a proper policy for us. Rejection of "benign neglect," however, implies some attention to the exchange rate not only in times of crisis, but also in ordinary times.

The Consequences of Interdependence ---

The United States' characteristic of being big inside and small outside has been somewhat modified over the years, however. It was far more pronounced during the 1950's when imports of goods and services, on a current account basis, amounted to little more than five percent of GNP and international capital movements were modest in scope, than today when imports amount to about 13 percent of GNP and capital movements flow far more freely and through many newly created channels. Of course, the United States is very far removed from the condition of a small, open economy whose welfare depends heavily on its exchange rate, or even from that of a large country like Germany whose imports amount to over 30 percent of GNP. Nevertheless, growing interdependence has greatly increased the importance to the United States of the international value of our currency.

--- And of Floating

The change in the role of the exchange rate brought about by the shift from fixed rates to floating is obvious also, although perhaps not as drastic as some of the advocates of floating would have argued in the past. Today, neither the United States nor other countries need to defend fixed exchange rates while anxiously watching their exchange reserves dwindle. There has been considerable debate over whether fear of exhaustion of reserves with the threat of a major crisis imposes greater disciplines on governments and central banks than does the more or less gradual erosion of a floating rate. In my opinion, discipline under the fixed-rate system was greater. But this does not mean that any country, including the United States, could remain unconcerned if it saw its currency's international value eroding. We have learned that the inflationary impulses emanating from a declining exchange rate are greater than had been thought and exceed by far what one might deduce from the ratio of imports to GNP.

The Need for a Strong Dollar

In this light, attention to the international value of the dollar is very much in our own interest. In particular, at a time when fighting inflation is our number-one priority, maintaining the strength of the dollar internationally becomes an important objective.

Of course, this does not mean that the higher the value of the dollar the better under all conditions. The basic function of a moving exchange rate is to encourage balance-of-payments adjustment. Too high a rate would ultimately mean an undesirably large current-account deficit, just as too low a rate would ultimately mean an undesirably large surplus. The IMF's Article IV in the amended Articles of Agreement decided upon five years ago in Jamaica, requires countries to abstain from exchange-rate policies that would prevent effective balance-of-payments adjustment.

Of course, there are many factors other than the exchange rate that influence the balance of payments. Effective balance-of-payments adjustment, therefore, is quite consistent with a range of different exchange rates, depending on the various other influences. Some of the more obvious ones, such as the rate of inflation, the state of the business cycle, the rate of growth of the economy, and the performance of its energy sector in the face of rising oil-import prices, must be tackled both by the United States and by many other countries because of their intrinsic importance and not just because of their impact on the exchange rate.

The Fiscal-Monetary Mix

But there remain other policy choices that will influence the rate. In particular, the United States has made a choice concerning its fiscal-monetary mix, that is, the relative "ease" and "tightness" of its fiscal and monetary policy. Given our habit of enormous budget deficits, fiscal policy obviously must be described as easy. As a consequence, monetary policy, if not tight, has had to be tighter than it otherwise might have been. The consequence of this easy budget-tighter money mix is familiar: the government consumes an important part of the economy's saving and so raises interest rates; higher interest rates hold down investment. But higher interest rates also make for a stronger dollar and a stronger dollar, other things equal, shifts the current account toward less exports and more imports, i.e., toward a smaller payments surplus or larger payments deficit. Higher interest rates also attract the capital inflows that help compensate for the diminished strength of the current account. With its "easy budget-tighter money" fiscal-monetary mix, the United States has opted for less growth, for a weaker current account, for more capital imports, or at least less capital exports, and for a stronger anti-inflationary effect from the higher international value of the dollar. A reverse policy would generate the opposite effects.

The United States has chosen the present mix by following a line of least resistance and not because of a deliberate preference for its results. Therefore, one can speak of a "policy" only in quotation marks. But, whether policy or not, the results are the same. We can fairly say, therefore, that the dollar has been stronger as a result of these choices than it would otherwise have been, provided everything else had been the same. Naturally, if the alternative policies we might have pursued had been less inflationary, the current account and the dollar would have been stronger.

What the analysis of our implicit policymaking in arriving at our given fiscal-monetary mix demonstrates is that even with ceteris paribus there is scope for policies to influence the international value of the dollar. There is scope for having a current-account objective. Our fiscal and monetary policies determine such an outcome, in a broad sense, either by design or by default. My personal preference would be for design.

Of course, these are not the kinds of monetary actions one is apt to think of first when one speaks about the role of the dollar in Federal Reserve policymaking. But policies affecting the fiscal-monetary mix are nevertheless fundamental for the dollar. Moreover, they are continuously operative. We must, therefore, bear them in mind as we examine other monetary actions that are more specifically aimed at the dollar.

Balance of Payments Fundamentals

Among these possible actions, there are some that may influence the balance of payments in a fundamental way and others that are more transitory. I noted earlier that, by international agreement, exchange rates are to be governed by fundamentals. In one sense, that is a truism. In the long run, fundamentals will assert themselves whether we want them to or not. There is no way permanently to maintain an exchange rate that is altogether out of line with market forces. That is less true, however, in the short run. We must be clear, therefore, as to the nature of these fundamentals. No doubt many economic variables could be called fundamental. But, no doubt also, some are more fundamental than others.

In one view, anything acting upon the balance of payments and upon exchange rates could be called a fundamental factor, except market intervention. Interest-rate policy, in that sense, might be called a fundamental factor, even if a central bank's reason for keeping interest rates at a certain level were clearly that of affecting the exchange rate. But a situation could also be reached where the exchange rate maintained by interest-rate policy had clearly become unrealistic. In that case, it could well be argued that an effort was being made to avoid balance-of-payments adjustment. Adjustment, of course, is the principal purpose of exchange-rate movements, and it is a matter of international concern because disequilibrium maintained by one country imposes the obverse disequilibrium upon other countries.

Exchange Market Intervention

In another view, even some forms of exchange-market intervention could be regarded as being at least consistent with the rule that fundamentals are to dominate. For instance, a country might borrow abroad in order to finance what appears to be a temporary balance-of-payments deficit. It then makes little difference, for instance, whether this borrowing is done by official agencies as is the case in some countries, with proceeds being sold directly in the exchange market, or by the government with the proceeds going into the exchange market through intervention by the central bank. If the resulting exchange rate seemed to be in accord with underlying factors such as inflation, or reasonable equilibrium in the current account plus capital movements that are not part of the adjustment mechanism itself, or even a cyclically adjusted current-account equilibrium, it would be hard to argue that balance-of-payments adjustment was being impeded. A substantial volume of intervention could thus be consistent for a while with an interpretation of the concept of fundamentals along these lines.

I have argued before that, under some conditions, it might be advantageous to conduct intervention in terms of quantity rather than price, i.e., to feed a reasonably steady flow of exchange into the market over a period of time and allow the rate to adjust to the balance of supply and demand modified in this fashion. This, it seems to me, would allow fundamentals to show through more effectively and would reduce the danger that intervention might be misconstrued by the market as an effort to peg any particular rate.

This quantity oriented intervention would be a kind of analogue in the international sphere of the domestic technique of maintaining a stable rate of growth of the monetary aggregates.

The Dollar in Monetary Policy Making

The role of the dollar in U.S. monetary policy reflects the emphasis I have placed on fundamentals and the gradations among them. While specific action aimed to influence the dollar has been taken mainly at times of market pressure, the dollar is never altogether absent from monetary policy considerations. This is indicated by the wording of the Federal Open Market Committee's directive which each month contains a statement relative to the balance of payments. In recent years, the standard formulation has read "the Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation, encourage economic recovery, and contribute to a sustainable pattern of international transactions." In earlier years, instead of "a sustainable pattern of international transactions," the directive referred to "working toward equilibrium in the country's balance of payments" and still earlier to "maintaining or achieving equilibrium in the country's balance of payments." The present formulation does not specify the precise nature of the pattern to be achieved except that it be sustainable. Indeed, under our present balance-of-payments accounting system, the condition of "equilibrium" is no longer unambiguously defined. What is sought is a condition in which current and capital account flows interact with each other in a manner that does not clearly require further adjustment and in that sense does not create market pressures for the dollar.

At certain times more specific reference to exchange markets and to the dollar has been made by phrases such as "taking account of conditions (or "unsettled conditions") in the foreign-exchange markets." Following the November 1978 measures, the directive contained, for a number of months, a reference to "due regard to the program for supporting the foreign-exchange value of the dollar."

While the wording is extremely condensed, the analytical content of the Directive is that open-market operations are to be conducted so as to achieve the usual domestic policy objectives as well as one related to the pattern of international transactions. Achievement of this very flexibly formulated objective related to the balance of payments is to be sought both directly, through the fostering of certain monetary and financial conditions, and indirectly, through the economic impact of the domestic objectives on U.S. international transactions. The impact of the domestic objectives certainly must be regarded as "fundamental." The direct impact of monetary and financial conditions, principally interest rates, may be regarded as fundamental at least under the broader interpretation suggested above.

Open-market operations, of course, are not the only tool of monetary policy, but they are the tool wielded by the Federal Open Market Committee. The discount rate and reserve requirements, which on several occasions have been brought to bear more specifically on the dollar, are in the hands of the Federal Reserve Board. This is one reason why actions at times of market pressure usually have been taken by the Board. Discount-rate announcements referring specifically to the dollar occurred on five occasions in 1978 and three occasions in 1979. A typical formulation, by no means invariant, has been, "Action was taken as a further step to strengthen the dollar in foreign exchange markets." On occasion, these actions were supported by changes in reserve requirements.

Policy Instruments

This raises the question as to the nature of the instruments that can be brought to bear on the dollar and their method of functioning. I shall abstract here from nonmarket types of controls, such as the Voluntary Foreign Credit Restraint Program that was in operation from 1965 to 1974. Money supply, interest rates, and credit conditions are, of course, influenced by all instruments of monetary policy -- open-market operations, discount rate, reserve requirements, and interest-rate ceilings. The most immediate impact on the dollar comes through interest rates, although the effect of interest rates has, on occasion, been overwhelmed by what the market perceived as contrary effects of other fundamentals. While interest rates are most basically influenced by open-market operations, under the reserve-based strategy of controlling the money supply introduced on October 6, 1979, the discount rate has acquired greater importance. With a given supply of bank reserves, a change in the discount rate affects the willingness of banks to borrow from the Federal Reserve given the federal funds rate. Thus a rise in the discount rate will tend to raise the federal funds rate in some degree although probably not by an equal amount. Under the previous regime of controlling the monetary aggregates, based on the federal funds rate, an increase in the discount rate and a change in banks' willingness to borrow from the Federal Reserve would have caused the Federal Reserve to vary the amount of reserves supplied through open-market operations. Thus, the federal funds rate would have remained largely unchanged, unless open-market operations had been adjusted to allow the funds rate to move. The impact of the discount rate action on other short-term market rates would thus have been muted. The enhancement of the role of the discount rate under the new reserve-based procedures is significant because in the exchange market and particularly in foreign markets the discount rate seems to have preserved some of its ancient role as a signal.

The New Reserve-Based Strategy

The new reserve-based strategy for controlling the money supply has the potential for a distinctive impact on the dollar. Under the new procedures, interest rates have been distinctly more volatile, reflecting the interaction of a relatively smoothly growing money supply with variable demand for money. Accordingly, the FOMC has set the range for the federal funds rate at 400-600 basis points, as contrasted with 50 or 100 basis points during the final months of the preceding federal funds rate-based strategy for monetary control.

The tighter grip that the Federal Reserve has achieved over the monetary aggregates reduces the danger that they may grow excessively and enhances the prospects of bringing inflation under control, although no doubt only gradually. In this sense, the new procedure should create expectations and conditions fundamental to a stronger dollar.

This development has come at a time when according to widespread market reports, interest rates are receiving particular attention on the part of market participants as a determinant of exchange rates. This may have further added to volatility. One might perhaps expect that in the course of time both of these effects may diminish. The volatility of short-term interest rates may subside somewhat as the market increasingly recognizes that movements in the funds rate do not represent changes in policy on the part of the Fed, and that consequently there is no strong reason why other short-term rates should be linked very closely to the funds rate. For the time being, however, this linkage seems actually to have increased, as contrasted with the degree of linkage existing under the federal funds-based procedure, perhaps because market participants, having been deprived of the funds rate as a guide to Fed policy, nevertheless use the funds rate as a basis for expectations about future interest rate movements. Likewise, one might perhaps expect that spot exchange rates might become more resistant to the influence of short-term interest rate fluctuations if those fluctuations are perceived to be the mechanical result of the control procedure rather than an expression of policy intentions. But, as noted, the markets up until now seem to have gone in the opposite direction and to have placed greater weight on interest rates than previously.

The new procedure, however, should ultimately have favorable implications for the dollar. Its purpose is to permit a firmer control over the monetary aggregates and to reduce the danger that they might expand excessively. Achievement of this goal should in time help to bring down the inflation and meanwhile may create favorable expectations of that outcome. In that case, the fundamentals operating on the dollar will also improve.

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