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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

April 3, 1975

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Ralph C. Bryant

Attached is a memorandum by Helen Junz, entitled "Changes in OPEC countries' valuation of their currencies." This memorandum was prepared in response to a question raised at the March meeting of the Committee.

Attachment

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 1, 1975

To Mr. Bryant

From H. B. Junz

Subject: Changes in OPEC countries' valuation of their currencies.

CONFIDENTIAL (FR)

Summary. In recent weeks four OPEC countries have changed the basis on which they value their currencies in foreign exchange transactions, thereby cutting their former tie to the U.S. dollar. No change, however, has been made in the dollar price of oil exports. Of itself, the move towards a new valuation basis for the currencies of some OPEC members is only of limited economic significance. And the psychological impact on foreign exchange markets has been slight so far.

However, the changes in currency valuations came after repeated discussions among OPEC members regarding possible changes in the way in which oil prices are being computed. Those favoring a new formula were seeking to protect oil producers from the effects of both exchange rate changes and rising import prices. The major significance of the recent changes in currency valuations is that they may constitute a first step towards such a change in the method of determining oil prices.

The facts. In recent weeks a number of OPEC countries have changed the basis on which they value their currencies in foreign exchange transactions. Until the recent changes were announced, all OPEC countries had tied the foreign exchange value of their currencies

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to that of the U.S. dollar. That is, the several central banks had fixed official buying and selling rates for their currencies against the U.S. dollar. Consequently, the OPEC currencies floated down or up *pari passu* with the dollar and their relationship to other currencies was determined by the changes in the transaction value of the U.S. dollar vis-à-vis these currencies.

Under the newly adopted procedures a number of OPEC countries will cut their exclusive tie with the U.S. dollar, and instead will determine the exchange value of their currencies in terms of a composite of other currencies. In some cases this composite is the same as that used to determine the valuation of the IMF's special drawing right (SDR), in others it may differ from the SDR basket. The exchange rates for the currencies of these OPEC countries against the dollar now will depend on the dollar's exchange value in terms of these composites.

The countries changing the basis of their currency valuation are:

Country	Date	Basis of valuation
Iran	February 12, 1975	SDR basket
Saudi Arabia	March 15, 1975	SDR basket
Kuwait	March 18, 1975	Unspecified basket of currencies; on March 21 Kuwaiti officials announced that the valuation of the dinar currently is based on a basket of currencies excluding the U.S. dollar, but including the Japanese yen, the Dutch guilder, the French franc, the Swiss franc, the Deutschmark, and the pound sterling.
Qatar	March 19, 1975	SDR basket

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These four OPEC countries join a group of sixteen countries (non-members of OPEC) which have been determining the exchange value of their currencies on basis of some composite of other currencies for some time (See Table 1). The Iranian, Saudi and Kuwaiti central banks will continue to intervene in U.S. dollars, but they will vary their buying and selling rates for dollars according to the movements in the SDR transaction rate for dollars.[1/] The intervention currency of the Qatari authorities is the pound sterling.[2/] The establishment of the new valuation method for the various OPEC currencies was accompanied by immediate small revaluations of the individual currencies against the dollar. These ranged from about 1-1/2 per cent for the Iranian rial to 5 per cent for the Qatari riyal.

The functioning of the Iranian market for dollars since February 12 may serve as a good example of how the new systems may evolve. On the first day of the new procedures the rial/SDR parity rate was Rls 82.2425 = SDR 1 and the SDR transaction rate for the U.S. dollar was U.S.$1 = SDR 0.806824. Multiplication of these two rates yields the rial/U.S.$ middle rate of Rls 66.3552 per U.S.$ in effect that day. The Iranian authorities had decided to continue to avail themselves of wider margins under the IMF rules. Thus, the

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1/ Or in the case of Kuwait, to those derived from a different composite of currencies.

2/ Prior to March 19, official buying and selling rates for the Qatari riyal had been set in terms of the daily sterling/dollar rate. Now they will be set in terms of the daily sterling/SDR transaction value.

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rial on that day could fluctuate within a band of 2.25 per cent on either side of this middle rate. Thus, the lower limit for the rial was Rls 67.8481 per U.S.$ and the upper margin Rls 64.8623 per U.S.$. The authorities fixed the official buying and selling rates for the U.S. dollar on that day at Rls 67.75 and Rls 67.50, respectively. This rate, although within the prescribed margins, was close to the lower limit for the rial. In order to limit fluctuations, the Central Bank of Iran will change its official buying and selling rates for the U.S. dollar only when the prescribed margins have been exceeded -- or have been fallen short of -- for five consecutive days. During each of the five business days following February 12, the SDR transaction rate for the U.S. dollar (derived by the IMF in accordance with the basket valuation procedure) was such as to put the rial/U.S. rate below its lower limit. Consequently, on February 20, the Central Bank of Iran moved its buying and selling rates for the U.S. dollar downward by an amount representing about a 1.5 per cent appreciation of the rial.

It would seem that the other OPEC countries who have moved to value their currencies on the basis of a basket of other currencies are evolving a basically similar system to that followed by Iran: middle rates and bands around them are computed each day for the local currency/dollar rate based on the daily rate for the dollar in terms of the currency composite adopted by the particular authority as the

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basis of valuation of its local currency. But official buying and selling rates vis-à-vis the dollar are not changed daily so that occasional breaches of the adopted margins can occur.

Factors leading to the decision. A major consideration in the Iranian, Saudi and Kuwaiti decision to change the basis for their currency valuation at this time reportedly was the fact that forward quotations for the Iranian rial, the Saudi riyal, and the Kuwaiti dinar were at a growing discount against the Lebanese pound in the Beirut exchange market. These currencies are traded in fairly large volume in that market mainly because remittances by foreign workers and transfers to Palestinians are channelled through Beirut. In addition, because of the expectation that dollar rates would continue to move down, spot rates for these dollar-linked currencies also began to be quoted below the official rates maintained in national capitals. This was considered undesirable by the several national authorities and probably did contribute at least to the timing of the move.

But the main reason cited by the four OPEC countries for the change in the basis of the valuation of their currencies relates to the terms of trade effects that resulted from their previous tie to the U.S. dollar. As the exchange value of the dollar floated down vis-à-vis other major currencies, the currency values of the OPEC countries also moved downward. Consequently, imports from those industrial

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countries against whose currencies the U.S. dollar was depreciating became more expensive in terms of OPEC countries' currencies. But export receipts of these countries were, and are, determined by prices set in dollars. In addition, the increase in import prices related to the weakening of the U.S. dollar rate was felt to exacerbate already high pressures on the domestic price level.

Effects of currency valuation changes. The recent revaluations of some OPEC countries' currencies cheapen both exports and imports in terms of domestic currencies. The effect of these changes on the flow of goods and on the internal price level, even if effective revaluations were to be of more significant dimensions than registered so far, are likely to be minimal. The countries involved are already increasing their imports rapidly and some have reached physical limits to faster import growth, particularly in terms of port facilities. Thus, a rise in total import demand might only result in a shift in the growth of imports away from government to private purchasers, a shift that presumably would be resisted by these governments. In addition, the income distribution in these countries is so skewed, that changes in import prices probably have only limited effects on imports of consumer goods because the price advantages would be felt by only a very small segment of the population.

Moreover, trading with these countries is generally done at negotiated prices through official channels. Thus, the domestic-currency price at which foreign goods enter the local economy is

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largely determined by government agencies. In Iran and Kuwait all imports are strictly regulated and in these countries, as well as in Saudi Arabia, some measures have been taken towards subsidization of certain imports. This would appear to be a much more effective instrument for regulating the composition and price level of imports than changes in the value of the local currency.

Finally, the major inflationary impetus in these countries comes from greatly expanded budget expenditures associated with the high level of petroleum revenues. Under these circumstances, domestic monetary and fiscal management clearly would be a much more important factor in containing inflationary pressures than a revaluation.

On the export side, the change in valuation of local currencies that has occurred has little immediate effect. All the countries involved are to all intents and purposes single commodity producers with petroleum exports accounting for more than 90 per cent of total exports (See Table 2). Since prices of oil exports are denominated in dollars, only the remaining small percentage of other exports would be affected by the recent revaluations against the dollar.

A significant effect on the export volumes and revenues of these OPEC countries could materialize only if petroleum prices were to be stated on the new valuation basis (i.e. if they were expressed in terms of SDR's rather than in dollars). But it should be remembered that in the past, the fact that petroleum prices are being expressed

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in U.S. dollars has meant that importers in countries whose exchange rates have appreciated vis-à-vis the dollar have been able to obtain petroleum at lower local currency cost than would otherwise have been the case. And this may have affected the volume of demand to a certain extent. If oil prices in the future were to be tied to SDR's, the effect on the volume of oil exports would depend upon how demand responded in countries whose currencies were appreciating in terms of SDR's as compared with the responses in countries whose currencies were depreciating. On balance, the net effect on the volume of oil traded may be small.

However, effects on dollar revenues could well be significant at any one time. These would depend upon the movement of the dollar rate in terms of SDR's and this rate has shown considerable variability in past months. Since the second devaluation of the dollar in February, 1973, the dollar/SDR rate has fluctuated up or down by 1-1/4 per cent per month on average (See Table 3). But the net change over the period has been relatively small: in March, 1975 the dollar/SDR rate was 4 per cent below its March, 1973 level and equalled that prevailing in the third quarter of 1973, just before the large oil price increases were effected. Thus, a change in pricing basis might be a way of obtaining higher dollar returns without making an overt alteration in the "price of oil" as it would then be defined

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at a time when the dollar is weak in foreign exchange markets, but it would have the opposite effect when the dollar strengthened in terms of SDR's.

So far there is no evidence that any one of the four OPEC governments will actually attempt to move to a new pricing basis, although it is known that Kuwait would favor such a development. The Saudis, in line with their apparent greater willingness to see the real price of oil decline, have resisted arguments in favor of a SDR valuation for oil.

Action by other countries. The question whether other OPEC countries might follow the example of Iran, Saudi Arabia, Kuwait and Qatar remains open. Some might find it advantageous to aid a move towards linking of oil prices to SDR's or some composite of currencies. But, in the absence of such a link, disadvantages associated with a new valuation of their currencies may well outweigh advantages. The non-Arab OPEC countries are not as sparsely populated as are Kuwait, Saudi Arabia and the United Arab Emirates and partly as a function of higher density of population are attempting to diversify their economies. (This group does include Iran, which, however, has taken the step to a new valuation basis for its currency.) Therefore, they are likely to want to protect their budding import competing and export industries (other than petroleum). Where the major aim is

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to develop and protect infant industries, it is unlikely that governments would find it in their best interest to pursue exchange rate policies that encourage general increases in imports and discourage the growth of diversified exports. If the objective is to reduce the inflationary impact stemming from the external surpluses, selective import subsidies might be preferable to an upward valuation of the currency. Conversely, a revaluation in these countries might stimulate export subsidies aimed at offsetting the effects of the exchange rate change and might lead to a proliferation of similar or retaliatory measures elsewhere. Finally, if some large Middle East oil producers linked their oil prices to SDR's, other oil producers could conceivably alter their dollar price for oil in accordance with resulting changes in the Middle East dollar price without changing the basis on which they value their currencies.

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Table 1: IMF Member States Whose Official Buying and Selling Rates or Foreign-Exchange Intervention Points are Based on Some Composite of Other Currencies

Country	Type of Composite
Algeria	Trade-weighted EEC currencies mitigated to prevent underlying large fluctuations vis-à-vis the French franc.
Australia	Bilateral trade-weights.
Austria	Snake currencies and bilateral trade-weights.
Burma	SDR.
Cyprus	Bilateral trade-weights currently probably no longer in operation.
Finland	Bilateral trade-weights mitigated to iron out wide fluctuations in DM and £.
Greece	Trade-weights.
Ireland	Various factors, including price levels.
Malawi	SDR.
Malta	Trade-weights.
Mauritania	Bilateral trade-weights.
Morocco	Trade-weighted EEC currencies mitigated to prevent underlying large fluctuations vis-à-vis the French franc.
New Zealand	Trade-weights as well as financial relations weights.
Spain	Bilateral trade-weights.
Tunisia	Trade-weighted EEC currencies mitigated to prevent underlying large fluctuations vis-à-vis the French franc.
Yugoslavia	Various factors.

Source: IMF staff.

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Table 2. Trade of Selected OPEC Countries, 1973

Currency Unit	Exports of which: Value	Petroleum Value	Petroleum % of total	Imports c.i.f. value
Ecuador (mln. U.S. dollars)	541	250	46	532
Indonesia (mln. U.S. dollars)	1,964	1,327	68	1,095
Iran (bn. rials)	478	439	92	233
Iraq 1/ (mln. dinars)	147	142	97	53
Kuwait (mln. dinars)	1,130	1,039	92	311
Lybia (mln. dinars)	1,224	1,188	97	516
Nigeria (mln. naira)	2,209	1,822	82	1,233
Saudi Arabia 2/ (mln. riyals)	22,791	n.a.	n.a.	4,708
Venezuela 2/ (mln. bolivares)	16,340	15,140	93	10,717

1/ 1971.
2/ 1972.

Note: Petroleum export data for Saudi Arabia are not shown separately, but clearly such exports account for over 90 per cent of the total.

Source: IMF, International Financial Statistics, January 1975.