

*Revised  
version*

## WHAT IS HAPPENING TO THE U.S. DOLLAR?

ADDRESS BY ROBERT P. MAYO, PRESIDENT,  
FEDERAL RESERVE BANK OF CHICAGO  
AT THE MEETING OF THE INTERNATIONAL TRADE CLUB OF CHICAGO  
FEBRUARY 9, 1978

WHEN YOUR CHAIRMAN CALLED ME SOME TIME AGO AND ASKED IF I WOULD TALK TO YOU ON THE TOPIC "WHAT IS HAPPENING TO THE DOLLAR?", I WAS REMINDED OF AN OLD STORY I HEARD ONCE ABOUT MR. MONTAGUE NORMAN, THE LONG-TIME GOVERNOR OF THE BANK OF ENGLAND. BACK IN 1919, SO THE STORY GOES, MR. NORMAN WAS ATTENDING A MEETING WITH THE BANKERS OF THE CITY OF LONDON. THE POUND HAD JUST BEEN TAKEN OFF GOLD AFTER MORE THAN A CENTURY OF BEING THE UNDISPUTED, STABLE INTERNATIONAL STANDARD OF VALUE. IT WAS FLUCTUATING WIDELY IN VALUE AGAINST THE DOLLAR AND OTHER CURRENCIES. THIS WAS, OBVIOUSLY, A NEW, SHOCKING EXPERIENCE TO MANY BANKERS IN THE CITY. THEY BESIEGED MR. NORMAN WITH COMPLAINTS DEMANDED AN EXPLANATION AS TO WHAT WAS HAPPENING TO STERLING. MR. NORMAN IS SAID TO HAVE MOUNTED THE PODIUM AND WITH A SOLEMN VOICE TO HAVE DECLARED: "GENTLEMEN, I ASSURE YOU THE POUND IS STEADY AS A ROCK. IT'S JUST THOSE BLOODY FOREIGNERS WHO HAVE LOST CONTROL OF THEIR EXCHANGE RATES."

TODAY, IN TALKING ABOUT "WHAT IS HAPPENING TO THE DOLLAR?" I WISH, I COULD GIVE YOU, IN GOOD CONSCIENCE, A SIMPLE, "AUTHORITATIVE" ANSWER LIKE THAT--WITHOUT BEING FACETIOUS, AS OBVIOUSLY MR. NORMAN WAS. THE FACT OF THE MATTER IS, AS YOU KNOW WELL, THAT THE DAILY FLUCTUATIONS AND LONG-RUN TRENDS IN THE INTERNATIONAL VALUE OF THE DOLLAR--AND IN THE VALUE OF INDIVIDUAL CURRENCIES IN TERMS OF THE DOLLAR--ARE THE PRODUCT OF A GREAT MANY FORCES. SOME ARE ECONOMIC

IN ORIGIN AND SOME ARE PSYCHOLOGICAL. SOME ARE BASED ON RATIONAL AND SOME ON IRRATIONAL EXPECTATIONS OF MOVEMENTS IN PRICES, INTEREST RATES, FLOWS OF TRADE, POLITICAL DEVELOPMENTS, BUSINESS PROSPECTS, AND MANY OTHER FACTORS. MOVEMENTS IN THE EXCHANGE RATE ARE LIKE THE MOTION IN THE TIP OF AN ICEBERG--THE RESULT OF MOVEMENTS IN THE UNDERLYING MASS WHICH ARE OBSCURED FROM CLEAR VIEW. SO, IN ANSWERING THE QUESTION POSED BY THE TITLE OF MY TALK, IT SEEMED TO ME THAT I SHOULD EXPLORE WITH YOU SOME OF THE UNDERLYING FACTORS IN THE MOVEMENT OF THE EXCHANGE RATE OF THE DOLLAR, THEIR ORIGINS, AND THEIR FUTURE TRENDS AS I SEE THEM.

LET'S TAKE A LOOK FIRST AT WHAT HAS BEEN HAPPENING TO THE DOLLAR IN TERMS OF SOME COLD STATISTICS. LAST YEAR, THE DOLLAR DEPRECIATED SHARPLY AGAINST SEVERAL MAJOR CURRENCIES. IT DROPPED BY ABOUT 18 PERCENT IN VALUE RELATIVE TO THE SWISS FRANC AND JAPANESE YEN, BY ABOUT 11 PERCENT RELATIVE TO THE GERMAN MARK, AND BY ABOUT 10 PERCENT RELATIVE TO THE BRITISH POUND. THESE WERE THE MOVEMENTS THAT ATTRACTED A GREAT DEAL OF PRESS COVERAGE AND PUBLIC ATTENTION. HOWEVER, THE PRESS LARGELY IGNORED THE FACT THAT THE DOLLAR REMAINED RELATIVELY STABLE AGAINST SOME OTHER MAJOR CURRENCIES, AND THAT IT GAINED AGAINST SOME OTHERS, AS, FOR EXAMPLE, THE CANADIAN DOLLAR. INDEED, USING A BROADER MEASURE OF THE IN THE EXCHANGE VALUE OF THE DOLLAR THAT TAKES INTO CONSIDERATION THE CURRENCIES OF OUR 15 MAJOR TRADING PARTNERS WEIGHTED BY THEIR RELATIVE TRADING IMPORTANCE--THE TRADE-WEIGHTED EXCHANGE VALUE--WE FIND THE DOLLAR HAS DEPRECIATED BY ONLY ABOUT 4 1/2 PERCENT OVER THE PAST YEAR. THIS, CERTAINLY, HAS NOT BEEN A CATAclysmic DEPRECIATION--AS SOME MARKET OBSERVERS

WOULD MAKE US BELIEVE--PARTICULARLY WHEN IT IS REALIZED THAT EVEN WITH THAT DEPRECIATION THE DOLLAR IS NOW STILL WORTH MORE IN TERMS OF THOSE 15 CURRENCIES THAN IT WAS FIVE YEARS AGO! WITH THAT PERSPECTIVE IN MIND, LET'S LOOK AT THE UNDERLYING CAUSES OF THESE MOVEMENTS.

EVEN AT THE RISK OF DWELLING ON FACTS THAT WILL BE FAMILAR TO MOST OF YOU, I THINK A GOOD WAY TO START IS BY EXAMINING SOME OF THE "FUNDAMENTALS" OF THE SITUATION--THE WORKING OF THE INTERNATIONAL MONETARY SYSTEM THAT PROVIDES THE FRAMEWORK WITHIN WHICH EXCHANGE RATES ARE GENERALLY ESTABLISHED.

SINCE EARLY 1973, THE FREE WORLD HAS BEEN OPERATING UNDER A FLOATING RATE SYSTEM. THIS SYSTEM CAME INTO BEING FOLLOWING THE COLLAPSE OF BRETTON WOODS IN 1971, AND AFTER MANY MONTHS OF FUTILE EFFORTS TO REESTABLISH FIXED EXCHANGE RATES. IT IS NOT A PERFECT SYSTEM. WE HAVE BEEN REMINDED OF THIS REPEATEDLY IN THE PAST. AND SOME OF THE MOST RECENT DEVELOPMENTS CERTAINLY BEAR THIS OUT. BUT I THINK WE HAVE TO RECOGNIZE THAT THE FIXED EXCHANGE RATE SYSTEM HAS PASSED FROM THE WORLD STAGE, AND THE FLOATING SYSTEM IS VERY PROBABLY HERE TO STAY.

THE MAIN FEATURE OF THE FLOATING EXCHANGE RATE SYSTEM IS, OF COURSE, THAT 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 ARE 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 SETTLEMENTS OF TRANSACTIONS AMONG 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. THE EXISTENCE OF THE \$200 BILLION EURODOLLAR MARKET--WHERE DOLLARS ARE HELD, LENT, AND BORROWED FOR A VARIETY OF PURPOSES--IS ONE MANIFESTATION OF THE SCOPE OF THAT DEMAND. THE 60 OR SO BILLION DOLLARS HELD BY THE FOREIGN OFFICIAL INSTITUTIONS IS ANOTHER. THIS FOREIGN DEMAND FOR DOLLARS HAS BEEN MOTIVATED NOT ONLY BY MARKET--ORIENTED CONSIDERATIONS, BUT ALSO BY PSYCHOLOGICAL, POLITICAL, AND EXPECTATIONAL FACTORS. THE RESULTING FLUCTUATION IN "HOARDING" AND "DISHOARDING" OF PRIVATELY HELD DOLLARS ABROAD HAS, ON OCCASION, BEEN 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.

SO MUCH, THEN, FOR THE "BASICS" OF THE SITUATION. LET ME NOW TRY TO PUT SOME "MEAT" ON THIS BASIC SKELETON BY TRACING SOME

OF THE SOURCES OF THE SUPPLY OF AND DEMAND FOR DOLLARS AS THEY HAVE EMERGED IN THE REAL WORLD AROUND US.

OVER THE PAST THREE YEARS, WE EXPERIENCED THE DEVELOPMENT OF A MAJOR IMBALANCE IN OUR INTERNATIONAL ACCOUNTS. 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 INVESTMENTS ABROAD) BUT IT STILL LEFT US WITH AN \$18 BILLION DEFICIT ON THE SO-CALLED CURRENT ACCOUNT. 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 THEIR TRANSACTIONS. THE TRADE DEFICIT THUS REPRESENTED ONE IMPORTANT KNOWN ELEMENT OF THE EXCESS SUPPLY IN THE EXCHANGE MARKETS. WHAT HAVE BEEN THE UNDERLYING CAUSES OF THAT DEFICIT, AND HOW CAN WE DEAL WITH THEM?

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 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! MAKE NO MISTAKE. 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.

*IP* <sup>One of the more</sup> ~~PROBABLY THE MOST~~ IMPORTANT UNDERLYING CAUSES 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 GROWING CONSIDERABLY FASTER, THAN THE ECONOMIES OF OUR MAJOR TRADING PARTNERS TAKEN AS A GROUP. THE EXPANDING U.S. ECONOMY HAS BEEN DRAWING IN IMPORTS AT A MORE RAPID CLIP THAN HAS BEEN THE RATE OF GROWTH IN THE DEMAND FOR OUR PRODUCTS BY THE SLUGGISH ECONOMIES ABROAD. ] 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.

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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 OUR AS WELL AS THE WORLD'S VIEWPOINT. 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 ACTIONS 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. I HOPE OUR VOICES WILL BE HEEDED--FOR OUR COMMON GOOD--AND THAT IN THE COMING YEAR, WE SHALL SEE SOME IMPROVEMENT IN OUR TRADE ACCOUNT EMANATING FROM THIS SOURCE.

*But*  
*^* *important*  
A 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. TRUE, SOME 80 PERCENT OF THE 1972-1977 INCREASE IS ACCOUNTED FOR BY HIGHER PRICES RESULTING FROM THE ACTION BY OPEC IN 1973. BUT BE THAT AS IT MAY, WE WERE STUCK WITH A \$45 BILLION OIL BILL IN 1977. THIS IS A FORMIDABLE FIGURE--EVEN TO AN OLD U.S. BUDGET DIRECTOR LIKE MYSELF. THAT 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 MAY RESENT THE CARTEL PRICING

POLICIES OF THE OPEC. WE MAY AGONIZE OVER THE DISRUPTION THAT THE SUDDEN SHIFT IN PRICES OF ENERGY IS CAUSING TO OUR CHEAP ENERGY-ORIENTED ECONOMY AND OUR SOCIETY. WE CAN ARGUE, FOR A TIME AT LEAST, OVER THE ENVIRONMENTAL IMPACT OF INCREASED USE OF ALTERNATIVE SOURCES OF ENERGY. BUT 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 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.

HOWEVER, IN LOOKING AT OUR OIL-RELATED DEFICIT, WE MUST NOT LOSE SIGHT OF CERTAIN STARK REALITIES. OUR HEAVY RELIANCE ON OIL AS THE MAJOR SOURCE OF ENERGY IS THE PRODUCT OF MANY, MANY YEARS OF EVOLUTION. IT WILL TAKE MANY YEARS TO REVERSE THIS TREND. IT WILL TAKE MANY YEARS TO DEVELOP--AND INTEGRATE INTO OUR COMPLEX ECONOMY--ALTERNATIVE SOURCES OF ENERGY. THUS, WE CANNOT REALISTICALLY EXPECT TO CUT BACK OUR OIL IMPORTS SIGNIFICANTLY IN THE NEAR FUTURE. NOR IS IT POSSIBLE IF THE "PRICE" WE MUST PAY IS A SEVERE DISRUPTION IN OUR ECONOMIC GROWTH AND GREATER UNEMPLOYMENT. end

THERE IS ANOTHER DIMENSION TO THE OIL ISSUE AS IT RELATES TO OUR TRADE DEFICIT. IT IS THE MULTILATERAL NATURE OF OUR INTERNATIONAL TRADE--BOTH IN TERMS OF SPECIFIC COMMODITIES, AND IN GEOGRAPHIC TERMS. IN OTHER WORDS, WE SHOULD NOT EXPECT TO BALANCE OUR TRADE IN EVERY COMMODITY OR WITH EACH OF OUR TRADING PARTNERS! FOR EXAMPLE, OF THE TOTAL \$45 BILLION OIL-IMPORT BILL INCURRED LAST YEAR, \$34 BILLION REPRESENTED OUR BILATERAL IMPORTS FROM THE



OPEC COUNTRIES (THE REST WAS LARGELY FROM CANADA AND MEXICO). THIS \$34 BILLION WAS PARTIALLY OFFSET BY OUR \$14 BILLION SURPLUS OF NON-OIL EXPORTS TO THEM. IT IS THE BASIC PROPOSITION ON WHICH ALL INTERNATIONAL TRADE IS PREDICATED THAT EACH COUNTRY SPECIALIZES IN THE PRODUCTION AND EXPORT OF THOSE COMMODITIES IN WHICH IT HAS A COMPARATIVE ECONOMIC ADVANTAGE. FURTHERMORE, IT IS IN THE VERY NATURE OF THE WORLD'S MULTILATERAL TRADE RELATIONSHIP THAT EACH COUNTRY'S DEFICIT IN TRADE WITH THE UNITED STATES IS OFTEN MERELY A COUNTERPART OF ITS SURPLUS WITH ANOTHER AREA OR AREAS. IN THAT VEIN, OUR BILATERAL DEFICIT IN OIL TRADE WITH THE OPEC NATIONS MAY BE VIEWED AS BEING TO SOME DEGREE COVERED BY OUR BILATERAL TRADE SURPLUS WITH THE EUROPEAN ECONOMIC COMMODITY NATIONS WHO, IN TURN, ARE SELLING THEIR GOODS TO THE OPEC COUNTRIES. IN THE FINAL ANALYSIS, A VIABLE TRADE OF ANY COUNTRY IS PREDICATED ON THE COMPETITIVENESS OF ITS GOODS ON THE WORLD MARKETS!

AND THIS BRINGS ME TO YET ANOTHER UNDERLYING CAUSE OF OUR DEFICIT--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 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 BEING DETERMINED.

LET'S TAKE A LOOK AT THE SITUATION AS IT HAS UNFOLDED DURING THE PAST SEVERAL YEARS. ON THE "FIRST TIER," THE DOMESTIC WHOLESALE PRICES OF MANUFACTURED GOODS (PRICES GENERALLY MOST RELEVANT IN INTERNATIONAL TRADE) 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.

HOWEVER, 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 WEIGHT THE EXCHANGE RATE CHANGES <sup>for the dollar</sup> ~~OF A COUNTRY WITH~~ <sup>respect to the currencies of</sup> ~~ITS 14 MOST IMPORTANT~~ ~~TRADING PARTNERS (EXCLUDING CANADA)~~ BY THE VOLUME OF THE TRADE, AND ADJUST THESE FOR THE DOMESTIC RATE OF INFLATION IN THESE COUNTRIES, ~~WE~~ WE COME TO A CONCLUSION THAT MAY BE SURPRISING TO MANY. ALTHOUGH THE DOLLAR DEPRECIATED BY ABOUT 10 PERCENT IN 1977 AGAINST THE <sup>se</sup> ~~CURRENCIES OF A GROUP OF NATIONS THAT INCLUDED JAPAN AND 13 MAJOR EUROPEAN COUNTRIES AT THE END OF 1977,~~ THE U.S. COMPETITIVE POSITION (AS DETERMINED BY THE "TWO-TIER" PROCESS) IN RESPECT TO ITS 14 MAJOR TRADING PARTNERS WAS ALMOST PRECISELY THE SAME <sup>at the end of 1977</sup> AS IT WAS IN 1973!

TO SUM UP, OUR CURRENT DEFICIT MAY HAVE BEEN CAUSED AT LEAST IN PART BY OUR RELATIVE LOSS OF COMPETITIVENESS DURING THE EARLIER

*Japan and 13 major European countries*

PART OF THE 1973-77 PERIOD. BUT THE MOVEMENTS IN THE EXCHANGE RATE OF THE DOLLAR RELATIVE TO MAJOR CURRENCIES HAVE TENDED TO REESTABLISH THAT COMPETITIVENESS ALBEIT ON A LAGGED BASIS.

SO MUCH FOR THE PROBLEMS OF THE DECLINING DOLLAR AS THEY RELATE TO THE DEVELOPMENTS IN OUR TRADE ACCOUNT. LET ME NOW TURN TO THE MONEY AND CAPITAL MARKETS.

DATA 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 OF 1977. 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 CLOSER LOOK AT THE FIGURES INDICATES THAT THREE-QUARTERS OF THAT OBSERVED "DEMAND" FOR DOLLARS WAS ACTUALLY A "RESIDUAL DEMAND." THAT IS, IT REPRESENTED 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 THE EXCESS OF

OUR CORPORATE LONG-TERM INVESTMENT ABROAD OVER FOREIGN INVESTMENTS IN THE UNITED STATES--DESPITE ALL THE TALK WE HEAR ABOUT FOREIGNERS TAKING OVER OUR FARMS, OUR BANKS, AND OUR FACTORIES. 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.

WHAT CAN BE DONE ABOUT THESE FLOWS AS A MEANS OF IMPROVING THE TRENDS IN THE VALUE OF THE DOLLAR? FOR THE BENEFIT OF THOSE OF YOU IN THE AUDIENCE WHO STILL LIVE WITH THE PAINFUL MEMORIES OF THE "VOLUNTARY FOREIGN CREDIT RESTRAINT PROGRAM," THE "INTEREST EQUALIZATION TAX," THE "FOREIGN DIRECT INVESTMENT PROGRAM," AND OTHER PROGRAMS INSTITUTED TO SHORE UP THE DOLLAR IN THE SIXTIES, LET ME STATE CATEGORICALLY THAT I AM NOT AWARE OF ANYONE IN THE U.S. GOVERNMENT WHO IS PRESENTLY ADVOCATING OR CONTEMPLATING ARTIFICIAL SUPPORT OF THE DOLLAR BY IMPOSING RESTRICTIONS ON THE FLOW OF CAPITAL TO OR FROM THIS COUNTRY! I THINK EVERYONE TODAY RECOGNIZES THE VITAL ROLE U.S. BANKS, U.S. INDUSTRY, AND U.S. INVESTORS PLAY AS INTERMEDIARIES OF INTERNATIONAL FINANCIAL FLOWS, AND AS SUPPLIERS OF SORELY NEEDED CAPITAL TO THE ECONOMIES OF THE WORLD'S FREE NATIONS--DEVELOPED AS WELL AS DEVELOPING. MOREOVER, ANY RESTRICTIONS ON PRODUCTIVE CAPITAL FLOWS ARE UNNECESSARY WHEN IT IS RECOGNIZED THAT IT WAS LARGELY THE PRESENCE OF ADVERSE "PSYCHOLOGICAL" FACTORS IN THE MARKET THAT HAVE BEEN CAUSING THE RECENT ADVERSE DEVELOPMENTS IN THE INTERNATIONAL MONEY AND CAPITAL ACCOUNTS. AVAILABLE DATA SUGGEST THAT IT WAS THE HUGE SHIFTS OF SHORT-TERM FUNDS, AT TIMES SPECULATIVE IN NATURE, THAT AGGRAVATED THE DOWNWARD PRESSURE ON THE DOLLAR IN

THE FOREIGN EXCHANGE MARKETS.

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 AND TO MANAGE OUR AFFAIRS IN A WAY CONSISTENT WITH OUR LEADERSHIP POSITION IN THE WORLD ECONOMY.

THERE ARE, OBVIOUSLY, MANY ELEMENTS THAT GO INTO WEAVING THIS FABRIC OF "MARKET PSYCHOLOGY," AND IT WOULD BE PRESUMPTUOUS OF ME TO TRY TO UNRAVEL THEM IN THE TIME REMAINING. LET ME JUST MENTION A FEW AREAS WHERE POSITIVE ACTION, IN MY JUDGMENT, CAN GO A LONG WAY. WE MUST ALL GIVE OUR SUPPORT TO OUR GOVERNMENT TOWARD RESOLVING NATIONAL POLICY UNCERTAINTIES, SUCH AS OUR ENERGY AND TAX POLICIES. WE MUST DEMONSTRATE TO THE REST OF THE WORLD OUR RESOLVE TO FORMULATE RESPONSIBLE ECONOMIC POLICIES IN RESPECT TO INFLATION AND LONG-TERM ECONOMIC GROWTH. IMPROVEMENTS IN THESE AREAS WILL, I BELIEVE, CONTRIBUTE SIGNIFICANTLY TO AN IMPROVEMENT IN MARKET PSYCHOLOGY, AND THUS TO IMPROVEMENT IN THE POSITION OF THE DOLLAR INTERNATIONALLY.

IN TRYING TO ANSWER THE QUESTION, "WHAT IS HAPPENING TO THE U.S. DOLLAR?" I FOCUSED ON A NUMBER OF FACTORS THAT, IN MY JUDGMENT, HAVE PLAYED AN IMPORTANT ROLE IN THE RECENT DEVELOPMENTS. THEY WERE WHAT I WOULD CALL FUNDAMENTAL ECONOMIC FACTORS, THE RESULTS OF COMPLEX ECONOMIC INTERACTIONS WITHIN OUR ECONOMY, AND OF THE INTERACTION OF OUR ECONOMY WITH THE REST OF THE WORLD--THAT SUBMERGED PART OF THE ICEBERG THAT I REFERRED TO EARLIER. 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.

IN BROAD 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.