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Inflation And The Unstable Dollar

by Mark H. Willes

President, Federal Reserve Bank of Minneapolis

Although the declining or unstable dollar has become a familiar subject in the press, it probably seems irrelevant to many people. They hear about it and tuck it away in their memories right next to irregular Basque verbs, Ptolemaic astronomy, the ancient history of Tibet, and other miscellaneous information that has no clear bearing on their lives. Occasionally, perhaps, they wonder, "What does the unstable dollar have to do with me?"

In normal times, the international value of the dollar does seem rather far removed from most of us. Unless you are taking a vacation abroad or buying or selling in foreign markets, you usually don't have much need to pay attention to exchange rates. But there are certain critical times when changes in the international value of the dollar affects everyone, and this is one of those times. This is a critical time because confidence in the dollar has been so low.

The Value of the Dollar

The international value, or price, of the dollar is determined by supply and demand, as is the price of most other commodities. Part of the demand for the U.S. dollar is determined by confidence that the dollar as a store of value, a world money, or a reserve asset will hold its value. During much of 1978, this confidence seemed to be dissolving. This was the single most important reason for the dollar's decline.

To understand the decline of the dollar then, it is necessary to understand why the world was losing confidence in American money. I am convinced that this happened because our country maintained a high rate of inflation and because, in the eyes of the world, we were unwilling to do anything about it, at least until very recently. For the dollar to be sound, the world must have confidence that the U.S. will stick to budget and monetary policies that will control inflation.

People in foreign countries keep U.S. dollars on hand for the same reason you or I do--to make transactions conveniently. When dollars are accepted as the reserve currency, they can make international purchases conveniently because dollars don't have to be sold or converted every time something is bought. Dollars, however, like all currencies, have some costs. One of their most significant costs is that inflation nibbles away their purchasing power.

Nations, corporations, and individuals who are able to use any of the world's currencies naturally want to minimize the risk of inflation. All other things being equal, all prudent people will hold the currency that they expect to maintain its buying power the best--the currency of the country that they expect to have the lowest rate of inflation. The U.S. used to have a very low rate of inflation, and people used to believe this would continue. This is why the dollar became the world's money. Now, unfortunately, the U.S. is inflating faster than many other countries. From January to July of 1978, consumer prices rose nearly 6 percentage points in the U.S., while they rose 3.4 points in Japan, 1.8 points in Germany, and less than 1 point in Switzerland. It is no wonder that the dollar fell compared to the currencies of these countries.

Oil Imports and the Balance of Trade

Although the demand for the dollar is largely determined by confidence, it is also affected to a lesser degree by such things as international trade and investment opportunities. When the U.S. is selling a lot of its products abroad or is offering favorable interest rates or other investment opportunities, the demand for American currency increases, as people find more uses for the dollar. Much of the discussion of the dollar has focused on international trade, specifically our balance-of-payments deficit and our use of large quantities of imported oil. International trade has created some problems for the dollar but has not had a dominant effect. The U.S., in fact, could run a large balance-of-payments deficit without hurting the dollar as long as our creditors believed they would be paid back fairly. If the dollar is a form of "world money," growing world trade might require increasing amounts of dollars to serve as the medium of exchange. Under these circumstances, the U.S. could run persistent balance-of-payments deficits and still have the value of the dollar remain stable.

Oil imports are not primarily responsible for the decline of the dollar either. They are only a convenient whipping boy. They could not have caused the dollar to fall as precipitously as it did during most of 1978. In fact, the dollar fell rapidly in the first half of 1978 despite the fact that oil imports declined compared to year-ago levels. Our petroleum imports are indeed substantial--they add up to about 30 percent of our total merchandise imports. But every import, not just oil, adds to the supply of dollars in foreign countries. Oil is just part of the problem in international trade, and international trade is just a part of the problem with the dollar.

Since oil has frequently been accused of causing the dollar's demise, however, it is worth noting that the U.S., when the size of its economy is taken into account, actually imports less oil than many industrial countries. Although it consumes more foreign oil than many countries, it also produces more goods and services and supports a larger number of people than many countries. The U.S. should, of course, do everything possible to conserve the world's scarce resources. But only a small fraction of the income from America's production goes to buy foreign oil. In every year since at least 1969, in fact, the U.S. has imported less oil as a percentage of its gross national product than either Japan or Germany--considerably less. Yet the yen and the mark have been notably stronger than the dollar. If oil imports alone determined the strength of a currency, one would have expected the dollar to increase in value and the yen and the mark to fall.

If the amount the U.S. spends on imported oil fails to account for all the dollar's problems, could the way the U.S. finances its oil purchases--with huge debts to the oil-producing countries--be to blame? The evidence suggests that the oil deficit has little to do with the dollar's fluctuations. In the winter of 1973 and 1974, when oil prices increased sharply and our debt to the oil exporters began to grow rapidly, the dollar rose in value. Likewise, the dollar fell for most of 1978, even though our deficit with the oil-producing countries was diminishing.

This means that reducing our petroleum imports would not guarantee any improvement in the dollar. Every year the oil-producing countries spend billions of dollars on American goods and services, buy billions of dollars of American stocks, bonds, and securities, and deposit millions in American commercial banks. If we substantially reduced our oil imports, they couldn't continue to spend and invest in this way. The ensuing reduction in foreign purchasing and foreign capital might do the dollar as much harm as good. For this reason, no one could say for sure that this country would be better off if less oil were imported. The problem is not oil but inflation.

The Anti-Inflation Program

The high rate of inflation in the U.S. is behind the world's loss of confidence in the dollar. That's why the passage of the energy bill didn't affect the price of the dollar. That's also why President Carter's first speech on inflation on October 24, in which he announced some voluntary wage and price guidelines, didn't work. Money may talk, but it doesn't always listen. It needs action not words. The dollar continued to fall after the President's speech. Although the speech did contain the substantive announcement that the federal deficit would be cut to $30 billion, it failed to convince people that the Administration was serious about fighting inflation.

As a result, the President wisely decided to take some additional strong actions to increase confidence in the dollar. Hopefully, this marks a turning point. On November 1, he announced a number of measures that caused the dollar to gain strength at least temporarily. The measures are of two main types. One type is demand oriented. It allows the U.S., with help from Germany, Japan, and Switzerland, to intervene forcefully in foreign exchange markets to keep the demand for dollars steady. By means of swap and other agreements, the U.S. has arranged to borrow some $30 billion in

German marks, Japanese yen, and Swiss francs to buy dollars and keep the exchange rate stable. If the dollar falls despite our efforts, though, the foreign currencies will have to be repaid at a new--and higher--price. These measures are, in effect, a $30 billion bet that we will succeed in controlling inflation and keeping the dollar strong.

The second group of measures is supply oriented. These measures are designed to support the dollar by controlling inflation. They consist of commitments for both fiscal and monetary policies. The fiscal policy commitment is to cut the federal deficit to $30 billion or less, as President Carter announced earlier. The monetary policy commitment is to slow the growth of the money supply. This is to be accomplished initially by raising the discount rate--the interest rate banks must pay the Federal Reserve for short-term loans--by 1 full percentage point; by allowing other short-term interest rates to rise; and by increasing the reserve requirements on large deposits. These are strong moves. Some critics call them harsh medicine, because they fear they will precipitate a recession.

Avoiding A Recession

If the moves are harsh medicine, the reason they were prescribed now--when they had been avoided so far--is that markets were on the verge of a major disorder. Financial disorder could generate a breakdown or at least a slowdown in international trade, which could lead to a recession. When the dollar as a measure of value becomes less certain, markets work less well. Transactions that were once made in dollars tend to be made by more cumbersome means, such as by barter or packages of different currencies. Since this is time-consuming, difficult, and generally inefficient, the result is a reduction in trade. This could bring about a recession.

Secondly, a major disorder could reduce trade by encouraging more protectionism on the part of foreign governments as well as the U.S. Foreign governments could establish barriers to keep out products from this country, as the products became lower and lower in price. The U.S. could try to prevent foreigners from buying our capital goods, as these goods likewise got lower and lower in price. This protectionism could diminish trade to the point where many manufacturers could not reach their former markets. If firm action had not been taken, the domestic and international consequences could have been painful. The harsh medicine--if it was indeed harsh--was needed to prevent a recession.

In brief, then, the dollar has weathered a crisis of confidence at least for the moment. This crisis was caused by our rapid inflation and was serious enough to warrant the strong action taken by our government. How does this affect all of us? Specifically, have we avoided a recession caused by international forces only to stumble into a recession caused by government actions? No, thankfully we haven't.

First of all, the actions were not all that harsh. Raising the discount rate, for instance, will push interest rates up--but not too high. Interest rates, when adjusted for inflation, are still quite moderate. They could even go up further without hurting the economy. Second--and probably more important--the actions signal the world that we are finally willing to take the difficult steps necessary to control inflation. This increases confidence in the dollar, helps keep the dollar as the money of the world, and thus reduces the uncertainties of international trade and finance. This means that one potential cause of a recession has been avoided. Moreover, the actions reduce not only international uncertainties but domestic uncertainties. This, in turn, creates an environment more conducive to business investment and real economic growth. This means that another potential cause of a recession has been avoided.

A word of caution: we could have a recession. There is no guarantee that we will avoid one. A major strike, a hard winter, or any large and unexpected shock to the economy could lead to a recession. But if we have a recession, it will not be caused by the actions taken to deal with inflation and the dollar.

The problems of the dollar have forced us to do what we should have done for domestic reasons anyway: that is, begin in earnest to fight inflation. The key now is to persist. The more we persist, the more we will be able to lower people's expectations of inflation. As more moderate expectations of inflation begin to be reflected in such things as labor contracts and interest rates, we can begin to fight inflation more effectively with fewer costs. As we persist, the world will develop more and more confidence in the dollar. Then we can look forward to a more stable, more productive, and less inflationary environment. In time, perhaps it will even seem natural to classify the unstable dollar with Basque verbs and other miscellaneous information once again.