Federal Reserve
Bank of
San Francisco

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Dollar Problems

The dollar strengthened in world markets last week, amid news of an expanded Federal Reserve "swap" line and rumors (later officially confirmed) of central-bank intervention to support the market. That improvement, however, came after two months of almost steady decline. Following the two devaluations of December 1971 and February 1973, the dollar was effectively devalued by 15.2 percent from the pre-Smithsonian level.* After fluctuating for several months, it weakened again in May and June, so that effective devaluation amounted to 21.3 percent by July 6. Then, a week later, the figure was back up to 19.5 percent as the dollar improved.

A number of factors were involved in the declining fortunes of the dollar these past several months. Foreigners seemed to be increasingly worried during this period about the nation's political and economic stability—in particular, by the accelerating American inflation. Other factors included the tightening of monetary and fiscal policies abroad, and a sharp speculative run-up in the price of gold.

Under these circumstances, because of the many political and financial issues that are still unresolved, the present system of flexible exchange rates undoubtedly will continue. However, central-bank intervention in the market is a possibility from time to time. To this end, the Federal Reserve announced last week a $6.25-billion expansion of its swap network—the reciprocal currency arrangements which the U.S. could utilize to support the dollar if it so desired.

Growth of swaps

The swap-line between the Federal Reserve and other central banks was developed in 1962 and substantially expanded through the years until 1971, in an era when fixed exchange rates were the dominant mode of international transaction, and the dollar was the dominant intervention currency in the foreign-exchange market. It was designed to facilitate foreign central-bank maintenance of the fixed-exchange rate regime, by giving the Federal Reserve the option of providing a temporary exchange guarantee for excess dollar holdings of foreign central banks, while minimizing their claims on U.S. gold reserves.

These lines of credit were made deliberately short (90 days with a maximum of three renewals) because they were intended to be used only to meet temporary surpluses of dollars in the hands of foreign central banks. Intermediate-term dollar surpluses were to be handled via other instruments—and, of course, excessive long-term acquisition of dollars was to be handled by an official change in the exchange rate.

*Dollar devaluation is computed on the basis of the exchange rate between the dollar and the currencies of the eleven countries which have the largest trade with the United States. The base period for the computation is May 1970; thus, the floating of the Canadian dollar since June 1970 is included in the computation.

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In this fixed-exchange rate era, the Federal Reserve did not normally intervene in the foreign-exchange market. Its role was to maintain a fixed value of dollars in terms of gold while all other central banks maintained a fixed rate between their national currencies and the dollar. Thus, the swap network was only used as a vehicle to facilitate foreign central bank intervention in the foreign-exchange market, that is, provide an exchange guarantee in lieu of their conversion of excess dollars into our gold holdings. It was not a source of Federal Reserve intervention in the U.S. market.

When President Nixon announced suspension of gold convertibility in August 1971, the Federal Reserve simultaneously suspended all further active use of the swap-lines. With a single exception early this year, there have been no new swap drawings. The suspension of swap drawings was a natural development in our program of encouraging foreign central banks to set new and more realistic exchange rates rather than encouraging them to maintain the old rates.

Appropriate rate?

Last week's decision to expand the swap network—reinforced by the later official announcement of direct Federal Reserve intervention in the foreign-exchange market—represents a change in the August 1971 policy. The question arises as to what induced this change. Knowledgeable observers would suggest the following. The appropriate exchange rate for any currency is that which leads to equilibrium in the balance of payments. There is a strong feeling that the continued devaluation of the dollar in the private foreign-exchange market is making the dollar *undervalued*; moving the dollar away from the exchange rate which would provide balance-of-payments equilibrium.

The reason the dollar is undervalued on a balance-of-payments criteria is that in its role as an international currency there has been a major *stock adjustment* occurring. The devaluation of the dollar, which was necessary to eliminate its previous *overvalued* position, has simultaneously led to a reduction in the demand for dollars as a medium for holding international assets. As the private market diversifies its portfolio of international assets to contain less dollars and more of other currencies, the value of the dollar has been forced below its balance-of-payments equilibrium value.

It can be argued, under these circumstances, that the market is not performing its proper function and that it is necessary for the central bank to intervene to bring the exchange rate into line with long-run balance-of-payments equilibrium. In the current case, that would mean some appreciation of the dollar, presumably by central-bank intervention.

For intervention

The strongest argument for intervening in the market is the fact that the dollar is clearly undervalued for balance-of-payments purposes. Conversely, most European currencies and the Japanese yen are overvalued. There is a long history (most recently with respect to the U.S.) where countries with overvalued currencies have tended to move toward protectionist trade legislation. This is designed to protect export and import-competing industries from the "unfair" competitive advantages which those foreigners would now enjoy. The natural constituency in favor of free trade rapidly diminishes when the number of industries which benefit from world trade is shrinking.

It can also be argued that if the present exchange-rate trend of a devaluing dollar continues, we will not only get no trade concessions from the Europeans and Japan but will most probably face new trade restrictions on our exports. This would be a major blow to the trade liberalization moves of the last generation.

Against intervention

On the other hand, we have no idea of the amount of intervention needed to reverse the devaluation of the dollar. It must be remembered that there are few capital controls on U.S. residents, so that we face the prospect of dealing not only with portfolio diversification of private nonresidents but also of all U.S. residents who may choose to reduce their dollar balances and increase their foreign-currency balances.

In addition, other central banks have found themselves overwhelmed in their attempts to maintain exchange rates that the market does not believe viable. The classic case was that of the Bank of France, which in mid-March 1973 planned to stay open with a fixed-exchange rate when all other European banks had gone to a float. It was forced to hastily close its window in 45 minutes after it had taken in excess of $1 billion. There is no technical reason to assume that any other central bank can be any more successful in the foreign-exchange market.

Role for swaps

Even if one were to accept the argument that Federal Reserve intervention in the exchange market is both proper and effective at the present time, the swap line is probably not the appropriate method to mobilize the resources for such intervention. It is unlikely that the current undervaluation of the dollar is a temporary phenomena, and the swap line was designed as a short-term facility to meet only temporary problems.

What then is the proper role of swaps? They could be utilized to prevent "disorderly market conditions" when and if they occur. This can be defined as roughly the foreign-exchange equivalent of a domestic "credit crunch" where there is no price at which transactions can be conducted. In this very specialized case, private markets could be considered as having at least temporarily broken down, so that the steadying hand of the central bank would be both desirable and welcome.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/4/73	Change from 6/27/73	Change from year ago Dollar	Change from year ago Percent
Loans adjusted and investments *	73,868	+ 444	+ 10,018	+ 15.69
Loans adjusted—total*	56,526	+ 341	+ 9,979	+ 21.44
Commercial and industrial	20,126	+ 8	+ 3,211	+ 18.98
Real estate	16,533	+ 73	+ 2,825	+ 20.61
Consumer instalment	8,391	+ 41	+ 1,351	+ 19.19
U.S. Treasury securities	5,730	− 45	− 542	− 8.64
Other securities	11,612	+ 148	+ 581	+ 5.27
Deposits (less cash items)—total*	71,063	+ 19	+ 8,053	+ 12.78
Demand deposits adjusted	20,898	− 185	+ 906	+ 4.53
U.S. Government deposits	1,005	− 47	+ 150	+ 17.54
Time deposits—total*	47,702	− 162	+ 6,840	+ 16.74
Savings	18,096	+ 56	− 133	− 0.73
Other time I.P.C.	20,339	+ 28	+ 5,095	+ 33.42
State and political subdivisions	6,577	− 248	+ 1,030	+ 18.57
(Large negotiable CD's)	9,713	− 31	+ 4,526	+ 87.26

Weekly Averages of Daily Figures	Week ended 7/4/73	Week ended 6/27/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	86	73	35
Borrowings	174	186	10
Net free (+) / Net borrowed (−)	− 88	− 113	+ 25
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (−)	+ 577	+ 808	−1,264
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (−)	− 277	+ 168	− 76

*Includes items not shown separately.

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