Research Department
Federal Reserve
Bank of
San Francisco

August 5, 1977

Business & Financial Letter

# Bouncing Dollar

The dollar dropped sharply against nearly all the other major currencies throughout most of July. But then, just when the market was getting the jitters, it rebounded as smartly as it had dropped. Yet the air is still filled with uncertainty about the future course of dollar exchange rates.

For quite some time, the foreign-exchange market has puzzled many observers. On a trade-weighted basis, the dollar remained remarkably stable throughout the first half of this year, and indeed, at midyear was 5.5 percent higher than two years ago. How could the value of the dollar have moved up and stayed up, in face of the well-publicized deterioration in the U.S. trade balance in the past several years? Moreover, has an "overvalued" dollar contributed to this trade problem?

**Trade competitiveness**

During the first half of 1977, the U.S. merchandise-trade deficit (balance-of-payments basis) reached a record high of $14.8 billion—a $30-billion annual rate. This was a very sharp deterioration compared to a $9.2-billion deficit in 1976 and a $9.0-billion surplus in 1975. The same pattern has been repeated in the current-account balance, in which the trade figures play a prominent role.

Does this indicate an erosion of U.S. trade competitiveness in the world market? Statistics have been cited to show that the United States spends a much smaller amount on export promotion, relative to export volume, than do her major trade competitors. The growing share of foreign manufactures—such as autos, color TVs, and shoes—in the U.S. market appears to suggest a weakening of the U.S. competitive position. Because of the fears aroused by this situation, the Administration has been kept busy trying to ward off demands for increased protection against foreign imports. Meanwhile, the continued high value of the dollar in the face of a rapidly deteriorating trade balance has caused some observers to charge that the dollar was overvalued and due for a sharp depreciation. In fact, to some, the condition appeared reminiscent of that which prevailed prior to the dollar devaluation in 1971.

A closer examination, however, would show that the present condition is qualitatively different from the pre-1971 situation. Since 1970, the U.S. wholesale-price index has increased 5 percent less than the trade-weighted average index of the other major industrial countries, whereas the U.S. dollar has depreciated 11 percent against the trade-weighted value of those foreign currencies. The same favorable situation has prevailed over a longer time span. The U.S. inflation rate since 1965 has been 4 percent less than the average of the other major

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industrial countries, and the dollar has depreciated about 9 percent over that period. Thus, if by trade competitiveness is meant price competition, U.S. competitiveness has improved, not deteriorated, compared to the pre-1971 period.

The sharp deterioration in the trade balance during the last two years can be attributed to two factors—one structural and one cyclical. The structural factor refers to a two-thirds rise in the volume of oil imports, primarily attributable to a continued U.S. subsidy to oil imports and to an effective penalty on domestic oil production, resulting from the existence of price controls. In value terms, the $19-billion increase in oil imports accounted for almost one-half of the swing in the trade balance of the past two years. The cyclical factor refers to the considerably stronger economic recovery in the U.S. than in the rest of the world. In the past two years, the U.S. economy has grown at a 5.7-percent annual rate (in real terms), compared to an average 4.3-percent growth rate in other industrial nations.

**Capital flows: private and official**

The explanation for the 5.5-percent dollar appreciation since mid-1975 meanwhile must be sought in the capital-flows data. Indeed, recorded foreign capital inflows more than doubled from $15 billion in 1975 to $33 billion in 1976, while unrecorded capital inflows (i.e. statistical discrepancy) increased from $5 billion to $11 billion. During the same period, U.S. capital outflows also increased (from $32 billion to $43 billion), but only partially offset the increase in capital inflows. The same pattern appears to have persisted through the first quarter of 1977 (for which preliminary data are now available) and also through the second quarter (for which data are still incomplete).

Foreign official capital inflows more than doubled in size between 1975 and 1976, and accounted for $18 billion of last year's total recorded inflow of $33 billion. The magnitude of these official flows raises a question about the working of the managed-float exchange-rate system. There have been recurrent charges of foreign central-bank interventions in the exchange market to keep their currencies from appreciating during a period of high unemployment. Measuring this factor is difficult, because central banks as a rule do not publish data on their exchange-market interventions, but some rough estimates can be made on the basis of published data on official reserves.

In 1976, foreign-exchange reserves of foreign central banks increased by more than $25 billion, compared to a $5-billion increase in 1975. A similar heavy buildup of reserves has continued into 1977. Of the 1976 increase, OPEC countries accounted for only $7.4 billion, while $8.5 billion wound up in the hands of Japan, Germany, and Switzerland. The OPEC reserve increases could be regarded as similar to private capital flows. The increases recorded by the major industrial countries, on the other hand, reflected attempts to slow down the rate of appreciation of their respective currencies.

**Recent developments**

At this point, only conjectures can be made regarding the factors underlying the abrupt drop in the dollar's exchange value during July. Trade-balance deterioration is not likely to have been a *direct* factor, since it had been going on for two years, with no apparent effect on the exchange rate. There is also no indication of an abrupt withdrawal of foreign central banks from the exchange market. One must therefore look for a cause to a sharp decline in foreign private capital inflows, including OPEC funds—reflecting perhaps increased uncertainty over the short-run prospects of the dollar. This could have occurred as a result of official U.S. insistence on the need for appreciation of the strong currencies as an aid to the international adjustment process.

Over the longer run, the value of the dollar will depend not only on the prospects for the U.S. trade balance, but also on the dollar's continued usefulness as an international liquid asset for both foreign official and private holders. For both types of holders, there does not appear to be any real alternative to the dollar on the horizon.

**Hang-Sheng Cheng and Nicholas Sargen**

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**
(Dollar amounts in millions)

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 7/20/77 | Change from 7/13/77 | Change from year ago Dollar | Percent |
|---|---|---|---|---|
| Loans (gross, adjusted) and investments* | 98,473 | - 390 | + 9,644 | + 10.86 |
| Loans (gross, adjusted)—total | 75,771 | - 63 | + 8,908 | + 13.32 |
| Security loans | 1,834 | - 276 | + 456 | + 33.09 |
| Commercial and industrial | 23,573 | - 50 | + 1,817 | + 8.35 |
| Real estate | 24,492 | + 113 | + 4,097 | + 20.09 |
| Consumer instalment | 13,140 | + 76 | + 1,838 | + 16.26 |
| U.S. Treasury securities | 8,782 | - 65 | - 850 | - 8.82 |
| Other securities | 13,920 | - 262 | + 1,586 | + 12.86 |
| Deposits (less cash items)—total* | 97,137 | - 916 | + 7,372 | + 8.21 |
| Demand deposits (adjusted) | 27,716 | - 972 | + 2,686 | + 10.73 |
| U.S. Government deposits | 469 | + 125 | - 102 | - 17.86 |
| Time deposits—total* | 67,042 | - 123 | + 4,591 | + 7.35 |
| States and political subdivisions | 5,645 | - 17 | - 411 | - 6.79 |
| Savings deposits | 31,947 | + 34 | + 5,431 | + 20.48 |
| Other time deposits‡ | 27,547 | + 71 | + 256 | + 0.94 |
| Large negotiable CD's | 10,074 | - 227 | - 1,996 | - 16.54 |

| Weekly Averages of Daily Figures | Week ended 7/20/77 | Week ended 7/13/77 | Comparable year-ago period |
|---|---|---|---|
| **Member Bank Reserve Position** | | | |
| Excess Reserves (+)/Deficiency (-) | + 74 | + 23 | - 19 |
| Borrowings | 6 | 3 | 1 |
| Net free(+)/Net borrowed (-) | + 68 | + 20 | - 20 |
| **Federal Funds—Seven Large Banks** | | | |
| Interbank Federal fund transactions | | | |
| Net purchases (+)/Net sales (-) | + 1,364 | + 897 | + 92 |
| Transactions with U.S. security dealers | | | |
| Net loans (+)/Net borrowings (-) | + 244 | + 345 | + 259 |

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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