the LEDGER

economic education newsletter

A Yen For the Dollar

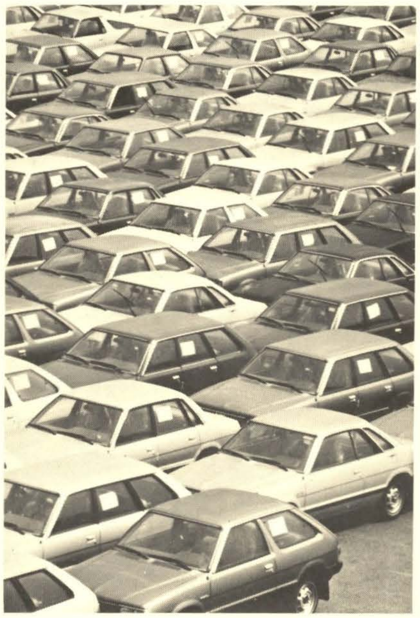
Throughout the summer of 1978, the once almighty dollar faltered. There were periods when it lost value by the hour.

"Stagflation" (high U.S. inflation coupled with economic stagnation) helped trigger a worldwide retreat from the dollar. Investors worried that the steadily rising U.S. inflation rate was eroding the value of dollar-denominated investments, while currency traders feared there were simply too many dollars abroad. Added to this was the widely held perception that American businesses and industries were consistently losing ground to foreign competitors. All these factors combined to undermine confidence in the dollar.

To anyone who remembered the years when Marshall Plan money helped to rebuild Europe, the world of August 1978 seemed turned upside down. European hotels and restaurants no longer welcomed American dollars, and unfavorable exchange rates forced scores of dispirited Americans to cut overseas vacations short.

For the first time in living memory, vacationers from Europe, Asia, and Latin America flocked to New York, Miami Beach, and points west; and foreign bargain hunters swarmed to the United States on shopping sprees. German chancellor Helmut Schmidt led European leaders in a chorus of concern over the dollar's steep plunge, and OPEC millionaires rushed to exchange weak dollars for strong German marks.

The August 27, 1978 issue of the British weekly news magazine, *The Economist*, carried a disconcerting cover photo that reflected how far international confidence in the dollar had fallen; dozens of dollar bills lay crumpled against a background of candy wrappers, cigarette butts, and empty beer cans. "Dollar in the Dirt," declared the cover story.



Courtesy of Massport

A Japanese car that would cost $7,000 when the dollar trades for 230 yen, could drop in price to $6,700 if the dollar climbs to 240 yen.

Changing Times

A lot can change in five years. By the summer of 1983, the journalistic focus had shifted from "Dollar in the Dirt" to "Why the Dollar Will Drop" (*Fortune*, September 5, 1983). American tourists once again enjoyed affordable meals on the Continent, and European leaders voiced concern over the dollar's *strength*.

The dollar had begun to regain ground after the United States resolved to fight double-digit inflation with a more restrictive monetary policy. In late 1979, the Federal Reserve moved to curb the growth of America's money supply, and U.S. interest rates rose sharply. (Slower money supply growth exerts upward pressure on interest rates.) As interest rates soared, the American economy slid into recession, and inflation slowed markedly.

Higher rates and lower inflation also prompted investors from around the globe to exchange marks, francs, pounds, and yen for dollars in order to take advantage of high-yielding U.S. financial assets. The increased demand for dollar-denominated investments pushed the dollar ever higher against other major currencies.

Strong, Stronger, Strongest

From an American perspective, the strong dollar of 1983 would certainly seem preferable to the shaky dollar of 1978, but the dollar's resurgence has created a variety of complex economic and political problems. American manufacturers, for example, now find themselves at a competitive disadvantage because a strong dollar lowers the price of foreign-made goods relative to the price of goods produced in the United States. A Japanese car that would cost $7,000 when the dollar trades for 230 yen, could drop in price to $6,700 if the dollar climbs to 240 yen. American companies that produce textiles, shoes, steel, electronic equipment, and machine tools are experiencing similar pressures, and the clamor for protective tariffs is mounting.

A strong dollar even affects U.S. businesses that don't face stiff foreign competition. Take the case of a Massachusetts firm that received an order from France for antique colonial furniture kits. When the dollar rose to a record high against the franc, the French importers re-

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luctantly halved their original order because they could not afford as many kits after converting their francs to dollars at the new rate.

Indeed, a strong, perhaps even overvalued, dollar has a profound impact on the world economy because world oil prices are set in dollars. When the dollar rises, most countries pay more for imported oil because they must exchange more of their own currencies for dollars.

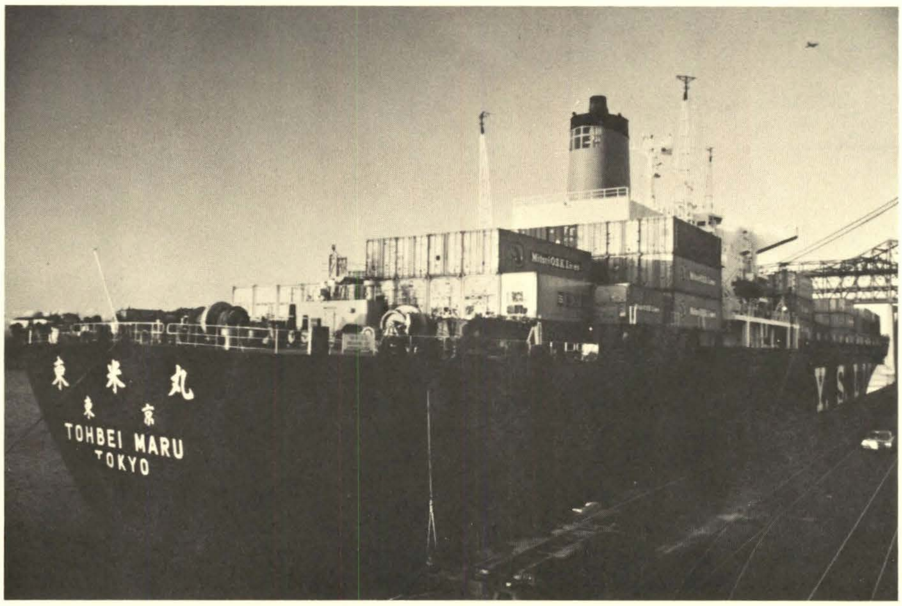
Unfriendly Exchange

Whereas the late 1970s saw oil-producing countries shift their surplus cash from shaky, inflation-plagued dollars to stronger German marks, the 1980s have seen that trend reverse. When U.S. interest rates continued to rise in 1980 and 1981, OPEC countries began switching back to dollar-denominated investments in order to take advantage of higher yields. By mid-1983, the dollar was once again, for all intents and purposes, the world's sole reserve currency.

Some analysts attribute the influx of foreign capital and the dollar's resurgence to the relative stability of America's political and economic institutions. Proponents of this "safe haven" theory point to France's nationalization of several key industries following the 1981 election of Socialist president Francois Mitterrand. They contend that such policies frightened investors, triggered a massive outflow of capital, and placed the franc under tremendous pressure. By contrast, peacetime nationalization of U.S. businesses and industries is virtually unthinkable.

Most foreign exchange experts agree, however, that American political and economic stability offer only a partial explanation for the dollar's resurgence. The consensus seems to be that high U.S. interest rates are primarily responsible for the strong dollar. As long as "real" U.S. interest rates remain high relative to interest rates abroad, foreign demand for U.S. financial assets will continue, and the dollar will remain strong. (The "real" interest rate represents the difference between the "nominal" or stated interest rate and the rate of inflation.)

As high U.S. interest rates have lured ever larger sums of foreign capital to the United States, foreign political leaders have increasingly pressured American policymakers to cut U.S. budget deficits, bring down U.S. rates, and intervene in the currency markets in an effort to force down the dollar's value. The issue of currency market intervention has led to particular friction between the United States and its European allies.



Courtesy of Massport

A strong dollar lowers the price of foreign-made goods relative to the price of goods produced in the United States.

In recent years, the U.S. Treasury has opposed regular currency market intervention on the grounds that such action would probably produce only short-term gains and could tend to forestall needed changes in economic policies. But during the summer of 1983, currency trading threatened to become "disorderly," and the United States agreed to participate in a limited market intervention. (In this instance, "disorderly" refers to sharp changes of the exchange rate between the dollar and other currencies.) The U.S. Treasury directed the Federal Reserve to act jointly with several West European central banks, selling dollars and buying marks and yen.

In a publication entitled *Foreign Exchange Markets in the United States* (see **Multi-Media**), Roger Kubarych points out that this type of central bank intervention creates two effects. One is an ordinary supply-and-demand effect; the other is an effect on market expectations, on which he offers the following observation:

Through the size, timing, and visibility of their operations, monetary authorities provide indirect information about official attitudes toward current market exchange conditions. Market participants may interpret the clues to official attitudes in different ways. But they rarely ignore them altogether when forming their own decisions on whether to buy or sell a currency.

According to an article in the August 16, 1983 edition of the *Wall Street Journal*, traders generally regarded the well-publicized July/August intervention as a "political sop to the Europeans by an American administration that doesn't really believe in such maneuvers." Currency markets calmed down somewhat after the intervention, but the dollar continued its strong performance.

Expectations, say many currency traders, are nearly as important as reality, and expectations are more apt to be influenced by U.S. money supply figures than by a very limited market intervention. When the basic U.S. money supply increases, the dollar generally rises against other currencies on the expectation that money supply growth may lead to a more restrictive U.S. monetary policy and higher U.S. interest rates. If, however, money supply growth continues unabated, the dollar could slide on the fear that inappropriate money supply growth might rekindle inflation.

Currency markets also respond to projections of a high U.S. budget deficit since traders generally expect that a high deficit will lead to increased government borrowing and higher U.S. interest rates. High rates, in turn, attract foreign capital and bolster an already strong dollar.

European politicians voice particular concern over the large federal deficit because they believe a large deficit keeps U.S. interest rates "artificially" high and thereby exerts upward pressure on European rates. This, of course, causes political headaches for European leaders since high rates make Western Europe's economic recovery more difficult.

People on both sides of the Atlantic would probably agree that a slight drop in the dollar's value would be a good thing for Europe and the United States. Disagreement comes over what, if anything, could or should be done to bring about such an outcome. Some analysts back strong central bank intervention in the currency markets, whereas others favor letting market forces determine exchange rates. But an increasing number of variables complicate any international economic issue, and the exchange rate question defies a simple answer. Indeed, perhaps only one statement applies with any degree of certainty to foreign exchange rates and currency markets: a lot of things can change in five years.

New England Update

CONNECTICUT

The **Greater Hartford Center for Economic Education** at Central Connecticut State College has announced the schedule for its 1983-1984 *Distinguished Speakers Series.*

- Tuesday, October 11, 1983, 7:00 p.m.
  Theodore W. Schultz
  1979 Nobel Laureate for Economic Science
  Professor of Economics, University of Chicago
  Theme: *Education as a Long-term Investment*
- Thursday, February 23, 1984, 7:00 p.m.
  Eli Shapiro
  President, National Bureau of Economic Research
  Theme: *Innovations in Financial Institutions*
- Thursday, March 29, 1984, 7:00 p.m.
  Henry C. Wallich
  Member, Board of Governors of the Federal Reserve System
  Theme: *Foreign Debt and American Banks*

All lectures are free and open to the public; admission by ticket only. For ticket information, please call (203) 827-7318.

MAINE

The **Maine Council on Economic Education** and the Foundation for Teaching Economics will offer a 1-day October workshop in the Portland area, and the University of Maine at Orono will serve as the location for a follow-up session to the Council's summer course. The Council will also run a series of fall workshops in Hampden as part of the DEEP program. For details on the Council's fall activities, please contact: Robert Mitchell, Executive Director, Maine Council on Economic Education, 22 Coburn Hall, Orono, ME 04469; (207) 581-1467.

MASSACHUSETTS

The **Economic Education Council of Massachusetts** (EECM) has elected James F. Connors its new part-time executive director and relocated its headquarters from Hingham to Boston. (New address and phone: Economic Education Council of Massachusetts, 14 Beacon Street, Suite 613, Boston, MA 02108. Phone: 227-6691.)

Mr. Connors, who heads his own public relations firm of James F. Connors & Associates, succeeds retiring EECM executive director Daniel W. Gibbs, Jr.

The EECM also has a new chairman. Frank LeBart of the John Hancock Mutual Life Insurance Company succeeds outgoing chairman Al Peckham.

FOLLOW-UP

1) How does a strong dollar affect the U.S. inflation rate?
2) Many economists believe that inappropriate, unrestrained money supply growth leads to inflation. If the Federal Reserve adopts a more restrictive monetary policy in response to higher than expected money supply growth, currency traders might then expect the dollar to rise against other currencies. Why?
3) If the U.S. money supply grows at an inappropriate rate and the Federal Reserve decides not to adopt a more restrictive monetary policy, the dollar could slide on the fear that inappropriate money supply growth might rekindle inflation. Why might traders expect a higher U.S. inflation rate to signal a weaker dollar?
4) A larger federal deficit almost always means that the U.S. government must borrow more money. Why might a large deficit lead to higher interest rates and a stronger dollar?
5) How do high U.S. interest rates put upward pressure on European interest rates?

Multi-Media

Foreign Exchange Markets in the United States, *Revised Edition*; written by Roger M. Kubarych, published by the Federal Reserve Bank of New York.

More and more people are becoming aware of the important implications that changes in the dollar's value have for output, employment, and the price level in the United States as well as abroad. Few firms can overlook increasing global interdependence and the impact it has on everyone's livelihood.

Roger Kubarych, senior vice president and deputy director of research at the Federal Reserve Bank of New York, has updated *Foreign Exchange Markets in the United States* with two objectives in

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mind: to keep it accurate, readable, and accessible to a wide audience; and to give a flavor of how the foreign exchange markets have evolved since the late 1970s. The 50-page booklet is available at no charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, NY 10045.

Your Credit Rights, published by the Federal Reserve Bank of Minneapolis.

Your Credit Rights has been developed for use with secondary and post-secondary students and adults studying consumer credit and consumer credit protection laws. Sections included are: 1) An overview of Consumer Credit; 2) The Equal Credit Opportunity Act; 3) The Fair Credit Reporting Act; 4) The Fair Debt Collection Practices Act. Two more sections are currently being developed: 1) Truth in Lending; and 2) The Fair Credit Billing Act.

Each section contains several learning activities and a variety of teaching strategies to meet the instructional objectives. Activity instructions, vocabulary, key concepts, answer keys, masters for making overhead transparencies and classroom sets of all student materials are included.

Your Credit Rights can be placed in a three-ring binder allowing removal of sections or individual sheets for lesson preparation and classroom use.

To order *Your Credit Rights* please write to Office of Public Information, Federal Reserve Bank of Minneapolis, 250 Marquette Avenue, Minneapolis, MN 55480 or call (612) 340-2446. (One free per instructor)

Banking Regulation: Its Purpose, Implementation, and Effects; written by Kenneth Spong, published by the Federal Reserve Bank of Kansas City.

Commercial banking in the United States has long been subject to regulation. This regulation has undergone many changes and evolved to the point where nearly every aspect of banking is reviewed by a supervisory authority. The general public, bankers, politicians, and regulators have all played roles in developing the present system of banking laws and supervision. As a consequence, the regulatory system now has a significant influence in determining the types of banking services available to the public.

Banking Regulation: Its Purpose, Implementation, and Effects describes the bank regulatory system and its influence on the banking system. It also provides a perspective on how banking regulation evolved and the purpose it serves. Finally, it outlines many of the changes taking place in banking today and their implications for banking regulation.

Copies of this clearly written 150-page book are available at no charge from the Public Affairs Department, Federal Reserve Bank of Kansas City, 925 Grand Avenue, Kansas City, MO 64198.

Fed Update

MIDDAY MUSIC AT THE FEDERAL RESERVE BANK OF BOSTON

A series of midday musical programs continues at the Federal Reserve Bank of Boston's auditorium. All performances begin at 12:30 p.m. and are 30-40 minutes in length. The public is invited at no charge.

The remaining schedule is as follows:

Thursday, October 6	-	Boston University Back Bay Brass
Thursday, October 13	-	New England Conservatory
Tuesday, October 18	-	Susan Lauck, piano
Thursday, October 27	-	New England Conservatory
Thursday, November 3	-	Boston University School of Music
Thursday, November 10	-	Longy School of Music Longy Wind Ensemble Basil Chapman, conductor
Tuesday, November 15	-	Boston University School of Music
Thursday, December 1	-	Concert Dance Company of Boston
Thursday, December 8	-	The New Ehrlich Theater The Royal Paste and Paper Circus
Thursday, December 15	-	New England Conservatory

The auditorium is located on the ground level of the Reserve Bank at 600 Atlantic Avenue, across from South Station.

Programs are subject to change without notice.

MONEY FUN FOR EVERYONE

The Federal Reserve Bank of Boston is hosting a morning of *Money Fun For Everyone* on December 28, 1983 from 9:30 a.m. to 11:30 a.m. The free program is geared to children of all ages and their parents. It will feature a variety of educational activities, a tour of the Money Department, a view of Boston from the Bank's 31st floor, and light refreshments.

Space is limited and preregistration is a must. For reservations, please call 973-3452. All children must be accompanied by an adult.

NO CHARGE

The Federal Reserve Bank of Boston will no longer charge a rental fee for 16mm films.

SURVEY

We are trying to make our audiovisual materials available to an even greater number of schools and organizations. You can help us by completing the enclosed survey card and returning it to us before December 31, 1983.

the LEDGER

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