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A Stable Dollar?

The behavior of both policymakers and the dollar at the end of 1987 and the beginning of 1988 resembled their behavior surrounding the Louvre agreement of February 1987. On both occasions, policymakers in industrial countries, responding to very sharp drops in the dollar, expressed their desire for exchange rate stability and a commitment to implementing policies consistent with such stability. On both occasions, their statements were initially greeted by skepticism and a strong drop in the dollar.

Notwithstanding the initial skepticism, the dollar's drop in the Spring of 1987 was followed by a strong rebound that lasted through the summer. The rebound was triggered by massive intervention and news about a declining trade deficit. The decline in the dollar to post-war lows in the last week of 1987 also was followed by a strong recovery, in the first week of January 1988 (see Chart 1). The dollar remained above its December lows even after the 140 point drop in the Dow Jones Industrial Averages on January 8, and improved further on news of a sharp reduction in the nominal trade deficit.

This *Letter* reviews recent efforts to stabilize the dollar, and discusses some of the factors that will influence its value in coming months.

Market intervention

Since the Louvre agreement, industrial countries have adopted two sets of complementary measures to stabilize the dollar. First, they have increased intervention in exchange markets to levels that are unprecedented in recent years. Second, they have made adjustments in their economic policies to make them broadly consistent with dollar stability.

The increase in the volume of intervention by foreign governments is generally reflected in sharp increases in their holdings of foreign reserves because U.S. trading partners who intervene to prevent the dollar from falling must purchase dollars. West Germany's foreign exchange reserves (excluding gold) rose from an average of $39.2 billion in 1980-1985 to $61 billion in October 1987, or 56 percent between the two periods. Japan's foreign exchange reserves, historically well below Germany's at an average of $21.4 billion in 1980-85, more than tripled to $67.5 billion in October 1987. In April 1987 alone, in the face of increasing pressure on the dollar, Japan increased its reserve holdings by an unprecedented $9.5 billion; continued intervention contributed to raising Japan's reserves by nearly $1 billion a month between July and October of 1987. Although more recent data on reserve holdings are unavailable at this writing, they should show further increases if press accounts of massive intervention to stabilize the dollar were correct.

Intervention has not been limited to preventing dollar declines; it also appears to have been timed to *discourage sharp increases in the dollar's value*. Thus, between May and August 1987, when the dollar was appreciating, there were reports of dollar sales by some of the central banks of major industrial countries.

Policy stance

The durability of a stable dollar policy ultimately depends on whether it is consistent with correcting external imbalances, i.e., on whether countries will coordinate their policies to reduce the U.S. trade deficit without further dollar depreciation. Otherwise, downward market pressures on the dollar may be difficult to contain.

In particular, dollar stability requires changes in the macroeconomic policies of major industrial countries to achieve two complementary objectives. The first is to reduce the U.S. external deficit in a way that does not rely on continued dollar depreciation, and the second is to keep dollar assets more attractive than foreign currency assets. To achieve the first objective, there must be a relative decrease in U.S. spending and an increase in foreign spending. This can be accomplished by tightening fiscal and monetary policy in the U.S. compared to policy abroad.

The second objective generally means that U.S. monetary policy must be less expansionary than monetary policy abroad. This will tend to strengthen the dollar by limiting the supply of dollars (ratifying dollar purchases in exchange markets by central banks) and raising domestic interest rates above foreign rates.

In line with this analysis, the U.S. government committed itself at the Louvre meeting and once again in December 1987 to reducing its budget deficit substantially, while Germany and Japan committed themselves to stimulating their economies.

Fiscal policy in the U.S. tightened significantly in 1987, and the federal budget deficit (on a unified budget basis) declined over $73 billion in fiscal year 1987 to $148 billion. Further reductions of approximately $76 billion are projected for fiscal years 1988 and 1989 (of the $76 billion, $8.5 billion are in asset sales, which have only a limited effect on economic activity).

At the same time, there has been some fiscal stimulus abroad. The Japanese cabinet in early June 1987 approved a 6 trillion yen (1.8 percent of Japan's GNP in 1986) package of spending increases and tax cuts to increase aggregate spending. In December 1987, the government committed itself to maintaining public spending at a level at least as high as that achieved in 1987. West Germany's government deficit is estimated at over 1¾ percent of GNP for 1987, and the Organisation for Economic Co-operation and Development (OECD) projects a further rise in Germany's deficit to 2¼ percent of GNP in 1989.

Notwithstanding a strong injection of dollar liquidity after the stock market decline in October 1987, U.S. monetary policy last year tended to be less stimulative than that of West Germany and Japan. A less stimulative monetary policy stance in the U.S. relative to its trading partners means that U.S. interest rates will tend to rise relative to interest rates abroad. Chart 2 shows the differentials between the three-month eurodollar rate and the euroyen and euro-deutschemark deposit rates. The differentials have increased since early 1987, particularly during periods when there was downward pressure on the dollar — in the spring, early fall, and after the stock market decline in October. The increase in the differentials in the last two months of 1987 was largely the result of greater monetary stimulus abroad, particularly in West Germany.

Nevertheless, the policies adopted by industrial countries may not suffice to achieve a stable dollar. Some observers contend that the projected fiscal contraction in the U.S. is too small to guarantee a correction in the U.S. external deficit that will prevent a further dollar depreciation. While Japan's economy grew very rapidly in the second half of 1987 (at an annualized 8.4 percent in the third quarter), over the same period, domestic demand in Germany declined by ½ percent. A declining population and persistent unemployment dampen domestic demand in Germany, where there are also impediments to further fiscal stimulus.

In addition, there is no guarantee that U.S. trading partners will maintain expansionary monetary policies. Japan and particularly Germany (where money has grown over target) were reluctant to maintain their monetary stimulus last fall. Both raised interest rates and tested the Louvre agreement even before the stock market decline of October 1987. In January 1988, Germany announced its intention to offset (sterilize) the expansionary impact on the German money supply of its intervention to support the dollar.

The policy dilemma

The uncertainty about whether the policy changes underway will suffice to stabilize the dollar highlights the dilemma facing policymakers. On the one hand, industrial countries have two main reasons for adopting policies that are consistent with dollar stability. First, independent of their efforts to stabilize the dollar, macroeconomic policies along the lines suggested by the Louvre accord are good for their economies. In the case of the U.S., a tighter macroeconomic policy that dampens domestic spending will help reduce an unprecedentedly large trade deficit. In the cases of Japan and Germany, continuing economic stimulus is needed to offset the deflationary impact of their currency appreciation, which reduces their trade surpluses.

Second, the governments of the major industrial countries believe a stable dollar also is in their best interest. Industrial countries may have rea-

Chart 1
Trade-Weighted Dollar

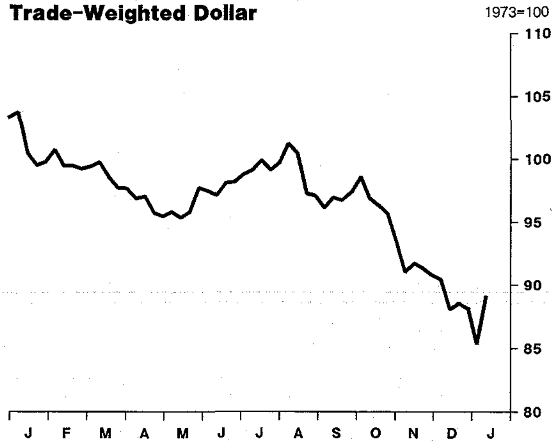
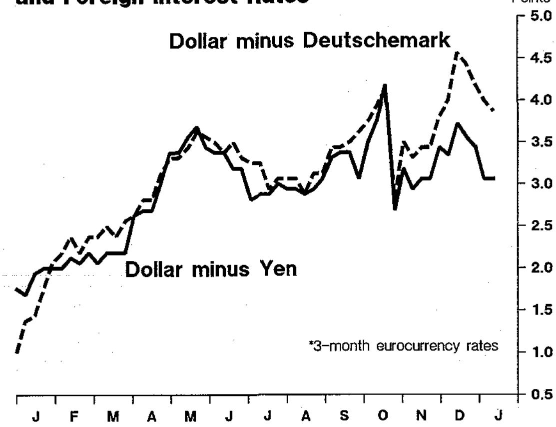


Chart 2
Increasing Differential Between U.S. and Foreign Interest Rates*



sons for not wishing to rely exclusively on continued dollar depreciation to improve the U.S. trade balance. The over-40 percent drop in the dollar since its February 1985 peak may already suffice to bring about significant reductions in the real trade deficit over and above the $25 billion real improvement observed from the third quarter of 1986 to the third quarter of 1987. Furthermore, the adverse effects on economic growth of an excessive fall in the dollar could reduce rather than improve demand for U.S. goods. Finally, continuing dollar depreciation could rekindle inflation, induce a sharp rise in U.S. interest rates by encouraging a flight from dollar assets, and create disturbances in financial markets.

On the other hand, efforts to reduce the external deficit and stabilize the dollar have potential costs. The U.S. may be concerned that less stimulative economic policies would lead to economic contraction, while U.S. trading partners fear that economic stimulus on their part may prove inflationary. Because these concerns are not entirely unwarranted, they tend to limit the willingness of the industrial countries to pursue more aggressively the policies contemplated under the Louvre agreement.

If the measures adopted so far are sufficient to ensure continued reduction in trade imbalances, dollar stability might be achieved easily. Otherwise, industrial countries will have to reconsider the extent to which they are willing to re-align their policies further to guarantee a stable dollar.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author.... Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/27/88	Change from 1/20/88	Change from 1/28/87 Dollar	Percent[7]
Loans, Leases and Investments[1 2]	203,620	– 337	4,325	2.2
Loans and Leases[1 6]	180,486	– 395	1,488	0.8
Commercial and Industrial	50,762	– 397	– 2,463	– 4.6
Real estate	70,605	– 50	4,036	6.0
Loans to Individuals	36,331	– 11	– 4,644	– 11.3
Leases	5,827	– 2	403	7.4
U.S. Treasury and Agency Securities[2]	16,092	67	2,605	19.3
Other Securities[2]	7,042	– 9	122	1.7
Total Deposits	198,959	– 5,037	– 2,373	– 1.1
Demand Deposits	47,677	– 4,164	– 1,788	– 3.6
Demand Deposits Adjusted[3]	32,506	272	– 13,115	– 28.7
Other Transaction Balances[4]	19,621	– 564	1,024	5.5
Total Non-Transaction Balances[6]	131,662	– 308	– 1,609	– 1.2
Money Market Deposit Accounts—Total	42,691	– 620	– 4,262	– 9.1
Time Deposits in Amounts of $100,000 or more	30,168	284	– 1,616	– 5.0
Other Liabilities for Borrowed Money[5]	23,727	220	– 6,639	– 21.8

Two Week Averages of Daily Figures	Period ended 1/25/88	Period ended 1/11/88
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	130	2
Borrowings	11	20
Net free reserves (+)/Net borrowed(–)	119	– 17

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change