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The Post-Devaluation Weakness of the Dollar

BETWEEN THE MIDDLE OF MAY and early July of 1973, the price of the dollar in the foreign exchange market fell sharply. The amount of the decline was greatly exaggerated by some reporters, who cited figures of 25 percent or more, which really measured only the dramatic decline against the German mark, the Swiss franc, or an average of a few European currencies. The fall against an average of the currencies of the major U.S. trading partners was much less—6.3 percent, when each country is weighted in proportion to its bilateral trade with the United States. The dollar remained stable against the currencies of our two major trading partners, Canada and Japan, and also against those of the United Kingdom and Italy. Even this smaller average decline, however, presents something of a mystery, coming as it did after the dollar had been devalued on February 12, 1973, for the second time in fourteen months, and when people who follow these matters generally held that it was, if anything, already below its long-run equilibrium value.

Explanations Suggested by Others

Many explanations of this weakness have been offered. Nobody knows their relative importance or even whether some have any importance at all, but a catalogue of plausible reasons may be of interest.

At the outset, it may be pointed out that, contrary to a widely held opinion, the decline of the dollar, like the fall of any other price, does not necessarily imply that net private sales of dollars substantially increased or that purchases other than by monetary authorities dropped. If would-be buyers and would-be sellers of the dollar (or anything else) simultaneously change their opinions as to what it is worth, its price can change in the absence of any transaction. Such a change is commonly referred to as a "marking up" or "marking down." While it is very unlikely in practice, something approaching it may occur when everyone hears of an event simultaneously and interprets its significance for the commodity in question in the same way. Something like that evidently operated in the case of the dollar, for there was apparently no net outflow of private capital during the second quarter of 1973. The preliminary figures, in fact, indicate that the net flow was inward.

In view of the widespread opinion that the dollar was "undervalued" after the February devaluation, its subsequent weakness in the foreign exchange market requires explanation, for the usual meaning of "undervaluation" is that the commodity in question is likely to rise in price, so that people who believe it to be undervalued would presumably buy it in anticipation of that rise, thereby bringing the rise about. I shall review the many reasons given for the dollar's decline from early May to July, and try to reconcile that decline with the belief that the dollar was already undervalued before that decline began.

1. One of the most common explanations is that price rises in the United States accelerated rapidly after the beginning of 1973. Price increases not caused by increases in foreign demand always tend to weaken the value of a currency in the foreign exchange market, especially if they are more rapid than those in competing countries, because they are likely to foreshadow a loss of exports and an increase of imports. The acceleration of the U.S. price rise during the winter and spring of 1973 was not limited to exportable farm products and would probably have weakened the foreign exchange value of the dollar even had it not been more rapid than that abroad, if only because it reversed a previous slowing of the inflationary movement and thereby suggested a weakening in effective control by the government and the possibility of further acceleration.

2. Simultaneously with the acceleration in the rate of price rise in the United States, monetary policies in some European countries, notably Germany, were tightened and interest rates in most of them rose. Although one might argue that the German controls against capital inflows would

Table 1. Relation of German and U.S. Interest Rates, March–August 1973
Percent

	Representative money market rates			*Domestic corporate bond yields*		
At or near end of month	*Germany*	*United States*	*Excess of German rates*	*Germany*	*United States*	*Excess of German yields*
March	9.50	7.10	2.40	8.83	7.60	1.23
April	12.50	7.22	5.28	9.26	7.50	1.76
May	12.63	7.75	4.88	10.45	7.64	2.81
June	14.00	8.54	5.46	9.82	7.90	1.92
July	14.50	10.13	4.37	10.99	8.42	2.57
August	13.75	10.93	2.82	10.28	8.13	2.15

Source: Morgan Guaranty Trust Company of New York, *World Financial Markets*, September 18, 1973, pp. 17, 20.

insulate the deutsche mark from this development, these controls can at best restrain such inflows. For one thing, they do not prevent Germans who have invested abroad from bringing their capital home. Second, they do not prevent increases of commercial credits in the form of the so-called leads and lags—that is, increasingly early payments for German exports and increasingly delayed payments by Germans for their imports, which, on given expectations about future changes in the mark, are influenced to some degree by the difference between interest rates in Germany and other countries.

The relation between interest rates in the United States and Germany before and during the months of 1973 in question is shown in Table 1.

3. Furthermore, Germany showed its determination to suppress its price rise to the maximum extent possible by adopting a tighter fiscal policy. On May 9, it announced increases in taxation, curtailment of planned government expenditures, and other measures to reinforce the restrictive monetary policy adopted in February. Other countries also intensified their anti-inflationary monetary and fiscal policies, which may have been expected to check both their demand for imports and the deterioration of the competitive position of their exports.

4. The sensational revelations precipitated by the Watergate break-in and the publicity given to other actions associated with the White House raised serious questions in the minds of many asset holders about the ability of the administration to govern and, more specifically, to initiate and

carry out effective policies to combat inflation. This was unquestionably an influence, and continues to be.

5. Related to this influence but also partly independent of it is a fear that, under any circumstances, the recent rapid rise of prices in the United States will end in a severe credit squeeze followed by a recession. A recession would normally be regarded as strengthening the net U.S. trade position, both by restraining business activity and thereby U.S. imports and by restraining domestic demand for exportable goods and thereby encouraging exports, but it also tends to make investment in the United States, especially in common stocks, much less attractive to foreigners.

6. Also tending to weaken the dollar was the fact that just when a huge increase in foreign demand for U.S. agricultural products was contributing greatly to an improvement in the trade balance, the United States limited exports of soybeans, cottonseed, and related products, and also of scrap metals. The imposition of the first export controls was regarded as a setback for trade improvement, and the subsequent controls—made necessary by shifts of foreign demand into commodities substitutable for those subject to the first set—clouded still further the prospect for improvement and consequently for an increase in the demand for dollars.

7. Another adverse factor in the long-run outlook for the dollar was the suddenly emerging and much publicized prospect that the United States would have to expand vastly its imports of oil and gas. Increases from some $5 billion in 1972 to between $11 billion and $15 billion by 1975, and to $25 billion—even $35 billion—by 1985, have been talked about.

8. During May and June, the Japanese monetary authorities sold over $1.6 billion of foreign exchange reserves to keep the yen up in the face of their payments deficit. These sales, however, were smaller than those made during March and April, which amounted to about $2.3 billion.

9. Superimposed on these considerations was the rise in the price of gold in private markets. If this rise had been no greater than that in some average of the prices of foreign currencies, it would have reflected merely the decline in the value of the dollar. But the price rose in foreign currencies as well. In general, a rise in the price of gold is more likely to be an effect of distrust of the dollar than a cause, but it is to some extent also a cause. It has been attributed to a distrust of all currencies, resulting in a movement from assets denominated in currencies into gold itself (where its ownership is permitted), and to a revival of speculation that gold might be restored to a central monetary role after all. It might be supposed that a general move-

ment out of currencies into gold, while raising the price of gold in relation to all currencies, could not affect the relation between the dollar and other currencies. This is not the case, however. Even if asset holders wanted to convert into gold the same percentage of assets held in every currency, the absolute quantity of assets denominated in dollars is so much larger than that in other currencies that the volume of dollars offered might be greater than the volume of other currencies. Even apart from this consideration, the relative, as well as the absolute, movement out of dollars clearly would be greatest of all the currencies. One reason is that the recent experience of dollar holders has been less happy than that of holders of other currencies.

In this connection, it is hard to avoid the conclusion, even if only in retrospect, that the second devaluation of the dollar was very damaging to the desire to hold dollars. Because it was quite unexpected, it must inevitably have raised the fear that it could happen again, especially since it was medicine that the U.S. Treasury appeared to enjoy taking. One investment adviser who believed that the dollar was undervalued explained that he did not recommend purchase of dollars because, having thought the dollar already cheap before the second devaluation and having persuaded clients to buy dollar-denominated assets, he had made a mistake that proved very costly to them. Although his conviction that the dollar was undervalued was even stronger after the second devaluation than before it, his confidence in his own judgment was naturally shaken. Many others must have felt the same way. The second devaluation appeared to be quite arbitrary; if the dollar could be devalued arbitrarily once, it could be again. This response to it, moreover, was reinforced by the U.S. government's declaration at the same time that it intended to end the controls over the outflow of capital and to refrain from market support of the dollar, and by its implied intention to impose only moderate restraint on demand.

This is an impressive list of reasons for the dollar's weakness. All of them have some, and several have much, plausibility. Nevertheless, it is hard to reconcile any but the last one with the widespread view that the dollar is undervalued. With one-year money available in some European countries at 7 percent to prime borrowers and probably 8 percent to other good borrowers, one would suppose that anyone confident that the dollar would rise in the course of a year would have borrowed foreign currency, bought dollars, and invested in U.S. Treasury bills at the then available yield of 7 ½ or 8 percent, expecting to be able to pay off his loan a year later by buying back the foreign currency at a lower price. More generally, one would have expected a movement of capital into the United States so long as the expected rise in the price of the dollar was greater than any excess of foreign interest rates to borrowers over the interest rates obtainable by lenders in the United States. Since that excess was no more than 2 percent in any European country except Germany and by late spring the dollar appeared to have been widely regarded as undervalued by significantly more than that amount, the absence of a flow of capital into the United States is hard to reconcile with the belief in a substantial undervaluation.

One explanation is that the fall of the dollar has been greatly exaggerated by the publicity given to its movement in relation to the major European currencies. As I have noted above, the dollar fell little during the May–July period in relation to the Canadian dollar and did not fall at all in relation to the Japanese yen—and Canada and Japan together account for some 40 percent of U.S. trade. It fell by only about 4 percent against the pound sterling. Given these facts, an interpretation suggesting that the seven European currencies participating in the joint float rose against the rest of the world appears more accurate than one that suggests that the dollar fell in relation to all other currencies when it and many other currencies of major traders fell in relation to the seven. This point was forcefully made by the Morgan Guaranty Trust Company in its *World Financial Markets* (issue of June 19, 1973, p. 2), which concluded, "The recent exchange-market events should not be described as a run on the dollar." Measuring the decline of the dollar against an average of the major currencies, with each currency weighted by bilateral trade of the issuing country with the United States, the Morgan Guaranty Trust Company calculated that the dollar declined by about 3 percent during May. The total decline against this average of foreign currencies, from early May to the low point in early July, was approximately 6.3 percent, according to their calculations.

Even though the fall of the dollar was less severe than the headlines during the spring suggested, it was substantial. Moreover, the view that the dollar was undervalued was certainly widespread by the beginning of June, if not before, yet it continued to fall. Since July, there has been a recovery, but as of mid-August it accounted for only about half of the May–July loss. Moreover, as was announced in September, the dollar was supported in July by approximately $575 million of purchases by the Federal Reserve System and the German Bundesbank, indicating that even this partial recovery was not accomplished by private market forces, at least not alone. In short, something remains to be explained.

Another Possible Explanation

I suggest that the concept of undervaluation is being used in two different senses, and that these are associated with two different concepts of the balance of payments. In one sense, the dollar is undervalued because its present price is sufficient to strengthen not only the net merchandise balance but the entire net balance on goods and services and perhaps also the basic balance (that is, the combined balance on goods, services, unilateral transfers, and long-term capital) to a degree that will bring one, two, or all three of these balances into surplus in the next few years. It may be noted that all but one of the foregoing explanations of the dollar's weakness invoked influences that could be expected to be relevant only over, at most, two or three years; the sole exception is the feared increase in imports of oil and gas.

Probably, however, another factor is at work. There is evidently a widespread belief that over the longer future the dollar will be a much less secure currency in which to hold assets than it was in the past, and that a wise investor should reduce the dollar-denominated proportion of his total portfolio. Even if this belief were confined to foreigners and involved only their dollar-denominated liquid assets and, among them, only those held in the United States, it would have affected assets totaling approximately \$90 billion at the end of March (nearly \$20 billion held by private foreigners, and \$70 billion held by foreign official agencies). In addition to these liquid liabilities of the United States, foreigners held long-term and nonliquid short-term assets in the United States consisting of some \$66 billion at the end of 1972, and acquired more in the first quarter of 1973. They, together with Americans, also held assets denominated in dollars but located in other countries, which Morgan Guaranty estimated at approximately \$95 billion at the end of March.[1] Although these are not liabilities

1. See *World Financial Markets*, July 26, 1973, p. 8. According to this source, these estimates "differ significantly from those published by the Bank for International Settlements (BIS) in its recent annual report. The estimates given here take into account to a much greater extent than those of the BIS the rapid growth and proliferation of Eurocurrency banking outside traditional European centers," including Canada, Japan, the Bahamas, Singapore, and Panama.

of American residents—at least not directly—an effort to sell them would weaken the dollar in the foreign exchange market. An attempt by investors to substitute other assets for some of the dollar-denominated assets in their portfolios would be a transitory phenomenon in the sense that once the shift was made, there would be no further attempt to sell dollars; but this portfolio adjustment, even if pursued for a relatively long time, would involve enormous amounts of money, since dollar-denominated assets of foreigners evidently amount to at least $250 billion.

Although this hypothesis appears straightforward enough, further consideration of it reveals a number of possible motivations for such asset shifting. It also reveals some interesting questions, different answers to which would have different implications for the exchange value of the dollar.

First, suppose that there is a reduction in the desired proportion of dollar-denominated assets but none in the total amount of financial assets that people want to hold; they want merely to shift a portion of their financial assets denominated in dollars into assets denominated in other currencies. That implies a shift out of dollars into other currencies and would certainly tend to lower the price of the dollar in the foreign exchange market relative to the desired currencies.

In contrast to that development, consider, second, a general movement out of currencies into goods in fear of continued inflation—a common explanation of recent events. The effect of this kind of shift is less clear. As was noted in the discussion of gold purchases, the volume of financial assets denominated in dollars is larger than the volume denominated in any other currency. If all holders of financial assets wanted to reduce their holdings by the same proportion and convert them into real assets, therefore, the absolute volume of dollar-denominated assets offered would exceed that in any other currency. But this supply would not be offered—at least in the first instance—in the foreign exchange market; it would be offered first in the market for real assets. Whether the dollar would be weakened by a shift out of financial assets of the same proportion for assets denominated in each currency evidently depends on the currency demanded by the sellers of the real assets, as well as on the currency denomination of the financial assets people wish to dispose of. Suppose, to take an extreme and hypothetical example, that 60 percent of all financial assets are held in dollar-denominated form and 40 percent in other currencies, and that all holders wish to reduce their holdings in each currency by the same percentage. But suppose also that these would-be sellers want to convert 75 percent of the assets to be disposed of into real assets owned or currently produced by sellers who, whether American or not, want to be paid in dollars. Even though a flight from dollar-denominated financial assets exceeds in absolute amount the flight from assets in other currencies, it could raise the price of dollars in the foreign exchange market because there would be a net increase in the demand for dollars, at least initially.

If the real assets purchased were not currently producible and the sellers were content to hold dollar-denominated financial assets at their now reduced prices, that would be the end of the story. But suppose that the initial holders wanted to hold currently producible durable goods—say, Cadillacs or metals produced primarily in the United States—or invest in U.S. housing developments or office buildings. On a large enough scale, such a movement could raise the costs of producing exportable and import-competing goods enough to affect the U.S. trade balance adversely. Thus, even in this case of a portfolio shift into real assets sold for dollars, the initial favorable effect on the foreign exchange value of the dollar might be offset.

There is no need to spell out further complications. The main point is that a general flight from financial into real assets would not depress the dollar merely because there are more dollar-denominated assets to escape from than there are assets in other currencies. The effect on foreign exchange rates depends not only on the relative quantities of financial assets denominated in various currencies that holders wish to dispose of but also, in the first instance, on what currencies have to be bought to pay for the real assets into which they want to shift. Note also that the countries of residence of the buyers and sellers are relevant only insofar as they influence the currencies offered and demanded.

A third possible cause of a shift out of dollar-denominated financial assets relates to holdings of monetary authorities. Even if a reserve currency were in equilibrium under a regime of fixed exchange rates, a mere shift to a system of floating rates, or even of very flexible rates, would put the dollar under pressure if that system were expected to be permanent. Under such systems, foreign monetary authorities presumably would have a lower stock demand for total international reserves, including foreign currencies, than they have under a fixed-rate system, and would want to dispose of some of their dollars if they became convinced that the more flexible system was the wave of the future, even if their previous holdings had been no larger than they wanted.[2]

Finally, some reduction in the stock demand for dollars should be expected to result from the arrangements among members of the European Community to limit the fluctuations in exchange rates between their currencies. And a further reduction should result from the planned monetary unification among the EC members, to the extent that asset holders expect the plan to be carried out. The existing arrangement to limit fluctuations among some of the members (France, Germany, Belgium-Luxembourg, the Netherlands, and Denmark) and two nonmembers (Norway and Sweden) provides that the jointness of their "joint float" should be maintained by intervention in their own currencies. The countries whose currencies are supported are supposed to repay the supporting countries only partly in dollars and need not do so until the end of the month following the month of intervention. The rule that settlement is to be only partly in dollars has been breached repeatedly, but future adherence to it, in contrast with the earlier method of day-to-day intervention in dollars, would permit a reduction in the necessary holdings of official reserves in these countries that may not be insignificant. If it is believed that unification is making progress, a much larger reduction in both the official and private stock demand for dollars is likely. There are several reasons why European monetary unification may be expected to have that effect but limitation of space prevents discussing them here.[3]

2. It may also be noted that in any system that permitted monetary authorities to intervene in the foreign exchange market—the only kind that can realistically be contemplated—the U.S. authorities would probably want larger reserves of foreign currencies than under the gold-dollar system. Any such addition to the U.S. stock demand for foreign currencies would depress the dollar while the shift occurred. This, however, was probably not an element in the weakness of the dollar during the spring of 1973.

3. They are fully discussed in my paper, "Implications for International Reserves," in Lawrence B. Krause and Walter S. Salant (eds.), *European Monetary Unification and Its Meaning for the United States* (Brookings Institution, 1973), especially pp. 225–27; in the comments on that paper by Peter B. Kenen, especially pp. 245–47; and in the paper by Richard N. Cooper, especially pp. 253–54 and 259–62. While Cooper thinks European monetary unification would in itself have no substantial long-run effect on the world economy, his qualifications of that conclusion envisage a reduction in the stock demand for dollars, at least for a number of years. See also Cooper's "The Future of the Dollar," and the comments on it by Peter M. Oppenheimer, Pascal Salin, and Motoo Kaji, in *Foreign Policy*, No. 11 (Summer 1973), pp. 1–32.

On the relation among the various roles of an international currency, see also Benja-

This hypothesis of a reduction in the desired stock of dollar assets does not imply that the dollar has ceased to be the preferred currency in which to denominate transactions or to hold assets. It implies only that the strength of the preference for dollars is diminishing. Such an implication would suffice to account for the dollar's remaining below the value consistent with elimination of the deficit in the basic balance.

This conclusion may be supported by some illustrative figures. Suppose, for example, that foreign asset holders wished to reduce the dollar-denominated proportion of their liquid assets only, and by only 20 percent (which would be a much smaller percentage of their *total* financial assets), and were willing to do it over a period of three years. On the assumption that these assets amount to $180 billion, this would involve liquidation of $12 billion a year. For the United States to finance that outflow at present exchange rates without official intervention to support the dollar would require that its net balance of payments on the official-settlements definition not be in deficit. This, in turn, would require the basic balance to be in surplus by at least $12 billion a year, compared with deficits of $9.8 billion in 1972 and of estimated annual rates of $3.8 billion and $3.1 billion, respectively, in the first two quarters of 1973. Then a portfolio adjustment of $12 billion a year confined to foreigners, and further confined to their short-term holdings of dollar assets, would require, under a floating dollar with no intervention and the consequent zero official-reserve-transactions balance, that the U.S. basic balance improve by about $22 billion a year over the 1972 figure, by about $16 billion over the annual rate of the first quarter of 1973, and by about $15 billion over that of the second quarter. On the assumptions of this illustrative case, these figures overstate the necessary improvement in that they ignore the growth of total portfolios that may be expected in a growing (and inflationary) world economy, but they understate it insofar as foreigners also wish to reduce the proportion of their non-liquid dollar holdings and insofar as U.S. residents also wish to reduce the proportion of their financial assets denominated in dollars.

These figures are enough to indicate that even a reduction in the desired

min J. Cohen, *The Future of Sterling as an International Currency* (St. Martin's, 1971); Alexander K. Swoboda, "Vehicle Currencies and the Foreign Exchange Market: The Case of the Dollar," in Robert Z. Aliber (ed.), *The International Market for Foreign Exchange* (Praeger, 1969); and C. Fred Bergsten's forthcoming book, tentatively entitled, *The International Roles of the Dollar and U.S. International Monetary Policy* (New York: Council on Foreign Relations).

proportion of dollar-denominated assets that was relatively moderate and that was carried out in equal amounts over, say, three years, would require a series of large basic surpluses. After this adjustment of portfolios had been accomplished, such surpluses would no longer be necessary. One could then expect the dollar to appreciate and the main elements of the basic balance to relapse through the mechanism of the strengthened dollar toward an approximately even position, or to a small deficit offset by an inflow of liquid capital corresponding to long-run growth of portfolios having a stable currency composition.

On this view, the dollar would continue to be weak for some time. While it would make a comeback when these portfolio adjustments were completed, that would take several years.

If what has been happening reflects such a change of views about the long run, it is no wonder that the initial decline that began in May was not counteracted by short-term speculative support. The apparently general view that the dollar has been undervalued may be correct in the sense that the dollar has been cheaper than it need be to restore balance in the U.S. merchandise trade account, goods and services account, or basic balance. But even if this view is correct—and I believe it is—it does not imply that the dollar will rise in the foreign exchange market during the period in which those deficits are eliminated.

Regarding the relation between the strength of the dollar and the balance of payments, the improvement in the U.S. balance of payments on the official-reserve-transactions definition in the second quarter of 1973 in itself has no significance for the future strength of the dollar. It was not only foreseeable but unavoidable. Given that the dollar was floating in relation to most currencies during the whole of the second quarter, with relatively little official intervention, the balance on that definition had to be something between a small deficit and a small surplus, depending on the amount of official intervention in the exchange markets. (A surplus occurred mainly because the Japanese authorities sold $2.9 billion of reserves during the quarter to prevent the yen from falling.) Since the U.S. deficit had been enormous in the first quarter—an annual rate of $42 billion, seasonally adjusted—it could not have failed to improve in the second quarter.

This improvement means merely that ex post purchases and sales other than by monetary authorities were nearly equal in the second quarter. It did not imply, therefore, that the dollar would necessarily strengthen, although that has happened. To draw conclusions about whether nonofficial supply and demand forces have changed so as to strengthen the dollar requires knowing what forces reduced the first quarter's excess of sales over purchases and their relative importance. Was the change independent of the May–July decline or did it result from that decline? This question involves merely the rudimentary distinction between increases in purchases, decreases in sales, or both that result on the one hand, from a movement of the demand curve, the supply curve, or both, and, on the other hand, from movement along the existing curves when a price floor that has been set above the equilibrium level is removed. Since the floor under the dollar (and also the ceiling over it) was removed almost entirely, there is no way of telling whether the previous excess of sales over purchases of dollars other than by monetary authorities disappeared because the demand and supply curves moved or because the price was permitted to fall.

More significant for the future strength of the dollar than the simple improvement of the official-reserve-transactions balance is its composition. While by far the largest part of it stemmed from termination of the first quarter's huge outflow of liquid and other short-term capital, an improvement also occurred in the basic balance, particularly in the goods and services component (see Table 2). This could not have resulted from the decline of the dollar during May, June, and early July.

Also, less than half of the absolute improvement in the merchandise balance since the fourth quarter of 1972 (the last one unaffected by the second devaluation) was attributable to the increase in agricultural exports spurred by the world grain shortage. The substantial increase in nonagricultural exports and the dampening of the growth in imports suggest that the decline in the dollar that had already occurred before May was having its conventionally expected effect, although it was also supported by the boom abroad.

A Judgment about Portfolio Shifts

What I have said about the possibility that a desire to readjust the composition of portfolios accounts for the May–July weakness of the dollar was intended to put forward a hypothesis, not to express a commitment to it. My personal judgment is that such shifts are occurring to some degree. That view is strengthened, as noted above, by the recently announced information that in July the Federal Reserve System had sold the equivalent

Table 2. Summary of U.S. International Transactions, Selected Periods, 1972 and 1973

Billions of dollars

Transaction	1972 Year	1972:4	1973:1	1973:2	Change, 1972:4 to 1973:2
		(seasonally adjusted annual rates)			
Merchandise exports, total[a]	48.77	52.85	61.28	66.99	14.14
Agricultural goods	9.49	10.75	15.28	16.65	5.90
Nonagricultural goods	39.28	42.10	46.00	50.34	8.24
Merchandise imports[a]	−55.68	−59.83	−65.12	−67.91	−8.08
Merchandise balance[a]	−6.91	−6.98	−3.84	−0.92	6.06
Services, total	2.30	3.50	4.44	3.38	−0.11
Investment income, net[b]	7.86	8.93	9.24	8.28	−0.64
Other[c]	−5.56	−5.43	−4.80	−4.90	0.53
Balance on goods and services	**−4.61**	**−3.48**	**0.60**	**2.46**	**5.94**
Remittances, pensions, and other transfers	−1.57	−1.72	−1.59	−1.52	0.19
U.S. government grants, excluding military	−2.17	−1.81	−1.38	−2.20	−0.39
U.S. government capital flows, net	−1.34	−2.34	−1.34	0.38	2.72
Private long-term capital flows, net	−0.15	3.12	−0.08	−2.25	−5.37
Balance on current account and long-term capital	**−9.84**	**−6.22**	**−3.79**	**−3.13**	**3.10**
Nonliquid private short-term capital flows, net	−1.64	−3.93	−7.17	−4.22	−0.29
Allocations of special drawing rights	0.71	0.71	0	0	−0.71
Errors and omissions, net	−3.11	−5.96	−15.68	0.92	6.88
Liquid private capital flows, net	3.54	9.47	−15.35	7.93	−1.54
Balance on official reserve transactions	**−10.34**	**−5.94**	**−42.00**	**1.50**	**7.44**
Means of financing					
Decrease in official reserve assets	0.03	−0.44	0.88	0.07	0.51
Increase in liabilities to foreign official agencies	10.31	6.38	41.12	−1.57	−7.95

Source: *Survey of Current Business*, Vol. 53 (September 1973), Tables B1 and 1, pp. 38, 41. Component figures may not add exactly to totals because of rounding.

a. Excludes exports under U.S. military agency sales contracts and imports of U.S. military agencies.

b. Includes fees and royalties received and paid on direct investment.

c. Includes military transactions.

of \$273 million in foreign exchange to support the dollar and that these efforts were "strongly reinforced by coordinated Bundesbank purchases . . . totaling somewhat more than \$300 million."[4] That intervention shows that autonomous changes in private supply and demand conditions did not alone end the decline of the dollar in July and cause the partial recovery since then. Furthermore, they did not do so with the unsupported help of private responses to the narrowing of differences in interest rates between the United States and Germany, although those must have been a factor.

Some adjustment of portfolios is probably inevitable, for there is little doubt that the relative economic and political dominance of the United States in the world has diminished. In this sense, those who think that the long-run shrinkage of U.S. hegemony suffices to explain the deterioration in the price of the dollar are probably right, even though they almost never establish the connection between this generalized cause and the mundane movements in the foreign exchange market. Because general recognition of this long-run change appears to back up projections of past losses by holders of dollars, I assume that a desire to make long-term shifts out of dollars is a force now at work.

Nevertheless, I also doubt that decisions involving *massive* amounts of dollars have been irrevocably taken. It is far from clear (to me, at least) that the decrease in U.S. power will be great enough to induce a massive long-run reduction in the proportion of assets held in dollars. What currencies, after all, are long-run competitors? I doubt that any single country outside the communist bloc will succeed to a predominant position in the near future. The United States still provides the most competitive capital and financial markets, and that fact contributed to the demand for dollars as a currency in which to conduct transactions and to hold wealth in liquid forms. This advantage was gravely damaged by the second traumatic devaluation, but probably can be largely, if not wholly, regained in time. Although some regard Germany as a strong candidate, an equally likely competitor, in my view, is an aggregation of countries—the European Community led by Germany; but the conflicts within the community and the continental dislike of keen competition among financial institutions make it doubtful that any of its currencies, including the still hypothetical

4. See Charles A. Coombs, "Treasury and Federal Reserve Foreign Exchange Operations," Federal Reserve Bank of New York, *Monthly Review*, Vol. 55 (September 1973), p. 217.

unified community currency, will succeed to the position formerly held by the dollar.

I conclude, therefore, that although some shifting out of dollars is inevitable, the size of the shifts still hangs in the balance, and will depend heavily on unfolding events, including policy decisions by the U.S. authorities.

Discussion

LAWRENCE KRAUSE EXPRESSED doubts that the experts were agreed in February 1973 that the dollar was undervalued. Nor did he believe that the case for such a verdict had been compelling. Enormous uncertainties surround any estimates of the long-run equilibrium value of the dollar. The exchange markets in recent months have reflected these uncertainties; and Krause thought that it was very difficult to second-guess the market. While Franco Modigliani agreed with Krause that the exchange market provides a measure of the "warranted change" in a currency's valuation, he underlined the possibility of destabilizing speculation in the short run. He felt that the sharpness both of the decline in the dollar's value during the spring and of its subsequent rebound implied that such forces had been at work. He pointed to the desirability of intervention by central banks in exchange markets to contain the impact of such speculation in the future. Modigliani felt that a limited amount of such intervention could help a system of floating exchange rates work more effectively.

William Branson expressed basic agreement with Salant's views on portfolio shifts. It seemed quite plausible that world traders would want to diversify their portfolios into a wider range of currencies because of greater uncertainty about exchange rates. But he was skeptical that such adjustments would take anywhere near the three years Salant implied, in view of earlier studies of his own that had found fairly short lags in the flow of liquid capital. Alan Greenspan added that portfolio adjustments may already have passed their peak as an influence on exchange rates. Much of the overhang had been created through massive intervention by central banks acting to support the dollar in the past. He felt it was important that such mistakes not be repeated in the event of some temporary weakness of the dollar in the future. Barring such mistakes, he felt the worst might well be over in terms of shifts away from the dollar.

Modigliani pointed out that any expected appreciation of the dollar would add to the total expected return from dollar holding, thus slowing down the dishoarding of dollars. He and Fred Bergsten stressed the possibility of consolidating excess dollar holdings (for example, in the International Monetary Fund) as a way of both containing downward pressures on the dollar and increasing stability in exchange markets.

Several participants mentioned other factors that might operate to hold down the international value of the dollar. Branson noted that a decline in U.S. interest rates relative to those abroad could have important effects in that direction during the months ahead. David Fand suggested that expectations that U.S. investment controls might be relaxed and that American citizens might be allowed to hold gold could be exerting downward pressure on the dollar's exchange rate. Bergsten stressed the great and growing competition of the deutsche mark with the dollar as a major transactions and reserve currency. He noted that the mark had surpassed sterling as the second leading reserve currency and now absorbed over one-fourth of the transactions in the Eurocurrency market. Moreover, German exports now exceed U.S. exports. He concluded that the mark was a "dominant new force" in international finance, and that shifts into it were likely to generate continuing downward pressure on the dollar.

A number of participants commented on the relationship between exchange rates and domestic inflation. William Poole wondered whether exchange markets were reflecting a belief abroad that, in view of its record since the mid-sixties, the United States is unlikely to contain inflation in the years ahead. Modigliani and Branson emphasized that the United States has not been more inflationary than its trading partners, although, as William Fellner pointed out, U.S. export prices have risen more rapidly than those of Germany and Japan. Murray Weidenbaum suggested that inflation might be more tolerable to the public in countries with rapidly rising real incomes than it was in mature countries like the United States. He felt that a growing reaction against inflation has recently been revealed in the political process and that that reaction might exert more influence on U.S. policies in the future.