

ECONOMICS USA
Program #28
“Exchange Rates: What in the World in Dollar Worth?”

Learning Objectives

PURPOSE:

To show the effect of exchange rates on trade and domestic growth and inflation, and the effect of domestic economic events of foreign exchange rates.

OBJECTIVES:

1. If the value of the dollar compared to other currencies increases, goods exported from the U.S. will cost more in terms of foreign currencies than before, and imports will cost less than before. Therefore, net exports will tend to fall, depressing economic growth in the U.S., and stimulating growth overseas.

2. A country's ability to import and export changes over time because of underlying changes in relative wage rates, productivity, technology, etc. When such long-term changes occur, either the exchange rates have to be realigned or the country which has lost its competitive ability will have to endure a long period of slow growth in order to restore the trade balance.

3. The following will tend to cause the dollar to fall vis-à-vis foreign currencies:

a) a higher real growth rate in the U.S. (because it will cause net exports to fall)

b) a higher inflation rate in the U.S. (because people will want to hold currencies that are not depreciating)

c) a lower interest rate in the U.S. (because people will convert their dollars to foreign currencies to earn high interest)

d) pessimism regarding the relative value of investments opportunities in the U.S.

The converse of these effects will cause the dollar to rise.

KEY ECONOMIC CONCEPTS:

government intervention in currency markets
economic activity, inflation, interest rates, and exchange rates
gold standard
balance of payment deficit or surplus
flexible exchange rates
purchasing power parity

ILLUSTRATIVE EVENTS:

1. the abandonment of the gold standard in the 1930's.
2. the breakdown of the Bretton Woods system
3. the fall of the dollar in 1978 under the float system

Program Transcript
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TEASER

DAVID SCHOUMACHER: Early in the century, gold was the standard against which most of the world valued its currency. Why would the United States break from the gold standard in 1933? In 1944, world leaders designed a blueprint for a new international monetary order, a plan dependent upon the strength of the American dollar. What led to the collapse of the heralded Bretton Woods Agreements?

2002. A new currency went into circulation in 12 countries of the European Union. Would the new euro challenge the dollar as the world's reigning currency?

In a global marketplace our economy depends on the international value of the dollar. It affects how much we pay for foreign goods and how well our exports sell overseas. Exchange rates. What in the world is a dollar worth? With the help of economic analyst Richard Gill we'll examine that question on this edition of Economics USA. I'm David Schoumacher.

(MUSIC PLAYS—OPENING TITLES)

(EXCHANGE RATES: WHAT IN THE WORLD IS A DOLLAR WORTH?)

PART I

DAVID SCHOUMACHER: It is only in recent years that exchange rates could vary from day to day. For generations, exchange rates were fixed and currencies freely convertible to gold. To cast aside the predictability of the fixed exchange rate system was considered more than unusual. It was nearly unthinkable. Why then, in 1933, would the United States do the unthinkable? Why would it

abandon the stability of the gold standard? Before the Great War, the gold standard symbolized stability and prosperity. And the British pound was considered as good as gold. But in 1925, Parliament set the exchange rate of the pound for gold beyond its real value. As a result, British goods became expensive. Exports declined. Factory workers were laid off. England's economy began to unravel. In 1931, the government collapsed. A new government broke with tradition. England went off the gold standard and devalued the pound, sacrificing international status for domestic recovery. But for the rest of the world, the financial repercussions were staggering.

CORRESPONDENT: "The shouting of frantic brokers reflects the deluge of wires from all parts of the globe. What is the pound worth today?"

DAVID SCHOUMACHER: With a stroke of a pen, those European banks, which had been holding pounds, lost millions. Reacting to what he called the "earthquake in Europe," President Herbert Hoover proclaimed America's steadfastness to the gold standard. But despite official pronouncements, many Europeans feared that America would be next to devalue its currency. International investors rushed to redeem their dollars for gold. Boatloads of American gold reserves were shipped overseas. To protect the American banking system, to preserve confidence in the dollar based on the gold standard, Herbert Hoover directed the Federal Reserve System to make changes, changes that would, quote: "Keep the American dollar ringing true in every city in America and in the world." The Fed responded by raising its discount rate, forcing American banks to push up the rate of interest paid to their depositors. The result: Foreign investors earned more interest and were enticed to leave their money in U.S. banks. The strategy worked. Confidence in the dollar was restored and the gold drain was plugged. But there were other, more serious ramifications. Dr. Edward Bernstein, formerly Principal Economist, U.S. Treasury Department:

BERNSTEIN: "Britain was the most important trading country in the world. If they let the value of sterling fall, say, relative to the dollar and the Franc, it meant

that Britain would be exporting much more and importing less. We would be losing exports to the British and we would be swamped by British goods. Our farmers, already having great difficulty, suddenly were confronted with a big drop in the price of cotton, wheat and other agricultural exports. This was a great blow to the United States.”

DAVID SCHOUMACHER: The loss in exports forced many manufacturing plants to close. Thousands more jobs were lost and America was driven deeper into the Depression.

HOOVER: “We find some who are maintaining that the world has outgrown the use of gold as a basis of currency and of exchange.

DAVID SCHOUMACHER: Tied to doctrines and traditions from the past, the Hoover Administration staunchly defended the gold standard, hoping that stability, in the long-run, would encourage recovery. But in the 1932 Presidential race, Franklin D. Roosevelt questioned the wisdom of Hoover’s domestic policy.

ROOSEVELT: “...that the major issue of this campaign is the economic situation. The people are now asked to judge whether the present administration has been wise in its economic policies, as revealed in the President’s statements and the President’s actions. I propose to show that this leadership misunderstood the forces that were involved in the economic life of the country.’

DAVID SCHOUMACHER: Roosevelt was elected on a platform willing to break with the past. In his inaugural address, Roosevelt pledged to establish a sound domestic economy, even at the expense of international financial stability.

ROOSEVELT: “Our international trade relations, though vastly important, are secondary to the establishment of a sound national economy.”

DAVID SCHOUMACHER: Within six weeks, FDR acted on this pledge. He abandoned the gold standard. The result: U.S. exports became cheaper, more jobs

were created. Though it would take years for the Great Depression to end, a critical step toward recovery had begun. The Roosevelt Administration was willing to move in new directions to get the country working again. FDR helped restore America's competitive position in exports and encouraged recovery by breaking off from the cherished gold standard. We asked economic analyst, Richard Gill, what was so important about the gold standard in the first place? What was really lost when it was abandoned?

(MUSIC PLAYS—COMMENT & ANALYSIS I)

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RICHARD GILL: The gold standard was cherished historically for two main reasons. First of all, by giving each national currency a fixed value in terms of gold, it gave the world, in effect, a single common currency. But, also, secondly, it provided a mechanism for keeping every nation's balance of payments in balance. The theory of this went back to David Hume, the 18th century Scottish philosopher. Suppose you have two countries trading together. Let's call them imaginatively country A and country B. And that country A is exporting like mad to country B, while the latter is exporting very little and importing a lot. What happens under the gold standard is this: country B pays for its excess imports by shipping gold to country A. A bad thing? Not really. Because now A has a bigger money supply than before and B has a smaller money supply. This means that the price level in country A will tend to rise, more money as it were chasing fewer goods, while in country B, prices will fall, their money supply has gone down. And now we come to the nice part of it – the equilibrating mechanism, as economists call it. Prices are higher in country A, so its exports will be more expensive. Prices are lower in country B so its exports will be less expensive. Exports from the high-export country, A, will fall. Exports from the low-export country, B, will rise. Trade will come back in to balance. The original problem has been solved! Would that it were always so in real life! The problem in the 1930s was that countries were not willing to go through this adjustment process. To allow an outflow of gold and a reduction in your money supply, when your economy was already seriously depressed, was simply unacceptable.

Roosevelt said he would put “first things first”. Another way of saying this is that countries in a depression were not going to “let the international tail wag the domestic dog.” Under really serious pressure, the gold standard collapsed.

PART II

DAVID SCHOUMACHER: 1944. The battles were still long and fierce. As the Allies swept across Europe, there was no longer any real question that Germany would be defeated. But there were grave concerns about whether the countries of the world could recover from the economic ravages of the war/. In July 1944, world economic leaders met here in Bretton Woods, New Hampshire. It was at this hotel that representatives of 44 countries met for 22 days to create a blueprint for a New World economic order. But why would that system, so carefully crafted here, eventually collapse? Dr. Edward Bernstein was chief technical advisor to the U.S. delegation at the Bretton Woods conference. Mr. Bernstein, what did the delegates who assembled here hope to accomplish at Bretton Woods?

BERNSTEIN: “We had two different objectives. One was to get monetary stability without the rigidity of the gold standard. The other was to prevent a recurrence of the disorders, deflation and the depression that followed the First World War. We hoped we could get through a reconstruction period where Europe would once again be a great producer. We hoped that we could establish a world trading system in which all could share in prosperity. And we wanted stability.”

DAVID SCHOUMACHER: To insure stability, the Bretton Woods Agreements outlines a new system of international cooperation. The lynchpin of the system was the American dollar and its convertibility to gold.

BERNSTEIN: “Europe was either occupied or had been conquered and every country in Europe needed resources. It needed to restock. It needed food. And of course, it had to be reconstituted. We were the only country that had the real

resources to spare for that. And of course you'd have to buy these resources with the dollar."

DAVID SCHOUMACHER: So Bretton Woods provided a framework for the rebuilding of Europe. And the United States played the key role in financing Europe's recovery. The Marshall Plan, created in 1947, gave millions of dollars to Europe. This flow of dollars and goods was soon supplemented by loans and private investments from the United States. The American economy reaped immediate benefits from Europe's rebuilding. As fast as the dollars were pumped overseas, they flowed back here to pay for American machinery and goods. In the decade following the war, Europe imported billions of dollars worth of products from the United States. But by the mid-fifties European economies were no longer so dependent upon American goods. By the 1960's, our payments abroad for imports, investments and foreign aid had exceeded our receipts. Why did this payments deficit occur? Dr. Joan Spero, Senior Vice-President, Corporate Affairs at American Express:

SPERO: "A payment deficit emerged in the late 1950s for three fundamental reasons. The U.S. economy was heating up due to the war in Vietnam and due to expenditures on the Great Society, and we had inflation at home. As the dollar became over-valued, we began to suck in more imports and we began to export less in relation to imports. So we went into balance of trade deficits, finally, in 1971. And the third factor is the capital outflows from the U.S., which continued throughout the 1960s for investment reasons and for financial flows."

DAVID SCHOUMACHER: Where a decade before there had been an international dollar shortage, now the world faced a dollar glut. This overwhelming supply of dollars piled up in the vaults of foreign central banks. These banks began to redeem dollars for American gold. Between 1964 and 1966, U.S. gold reserves dropped by 2 billion dollars.

SPERO: "The U.S. really did not know what to do about the dollar in the late 1960s and the Europeans didn't know either. We had a fixed exchange rate

system. It was part of our reality: it was part of our economic philosophy and ideology and religion. And what the U.S. wanted for a long time was not a devaluation of the dollar but a revaluation of other currencies. Well, this was politically and economically difficult and unacceptable for other countries so we were in a logjam. We were really in a block that we didn't know how to get out of."

DAVID SCHOUMACHER: The United States pressured foreign central banks to retain their dollars. The government also tried to restrict the amount of money invested or spent overseas, but to little avail. None of these acts could halt the growing dollar glut, nor convince currency speculators that the dollar would not be devalued. Speculators dumped billions worth of dollars on the foreign exchange markets. By the time Richard Nixon assumed the Presidency, the system so carefully crafted at Bretton Woods was on the verge of collapse. Dr. Marina von Neuman Whitman, former economic advisor to President Nixon:

WHITMAN: "The overall system needed to be reformed and overhauled, and that in order to set the stage for that...in order almost to get other countries' attention and force them to focus on the need to reform, that step of closing the gold window, and thereby effectively ending the pegged-rate system, had to be taken."

DAVID SCHOUMACHER: With no effective room to maneuver, Nixon broke from Bretton Woods.

NIXON: "I have directed Secretary Connally to suspend temporarily the convertibility of the dollar into gold or other reserve assets, except in amounts and conditions determined to be in the interest of monetary stability and in the best interest of the United States."

DAVID SCHOUMACHER: Forty years after the historic conference here, economists and politicians still applaud the goals and the accomplishments of Bretton Woods. It was an historic undertaking to set up rules and procedures to

promote world trade that would benefit all nations. Many of the institutions and policies are still in service. But not the exchange rate system. It fell victim to changing patterns of trade and investment. Eventually the world was flooded with so many dollars that the dollar could not hold its value. We asked economic analyst Richard Gill whether any fixed exchange rate system could last forever.

(MUSIC PLAYS—COMMENT & ANALYSIS II)

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RICHARD GILL: Forever, as they say, is a very long time, and the experience under Bretton Woods, as in the 1930s, suggests that when supply and demand pressures get too great, a fixed exchange rate system, even if it has some flexibility, has a tendency to buckle. Actually, the key words there are, in fact, “supply and demand”. We can draw supply and demand curves for dollars in terms of foreign currencies, let’s say German marks, in very much the same way we would draw them for commodities like wheat or personal computers. The demand curve here reflects the desire of Germans to buy our exports or to make investments in the United States. The supply curve reflects our desire to buy German exports and to invest in Germany. Where these curves intersect is what we might call the equilibrium exchange rate between dollars and marks, here, five marks to the dollar. Now, what happened in the immediate post World War II period was that the equilibrium value of the dollar was above its official exchange rate. This was the period of the famous “dollar shortage”. This shortage can be measured here, the amount by which the demand for dollars exceeded the supply at the official exchange rate. Then things changed. Europe and Japan rebuilt their productive capacities. Germany had an “economic miracle”. We were investing abroad and also demanding more and more foreign imports. The new situation looked like this. There was now an excess of dollars supplied in relation to the demand for dollars at the official exchange rate. We had a “dollar glut” and, in fact, a series of dollar “crises.” Possibly, some solution might have been worked out under the general terms of the Bretton Woods Agreement, but it would likely have been too painful domestically to apply, particularly when another much simpler path beckoned us- a path that had the

advantage, some would say disadvantage...of being recommended by many highly respected economists. Let the exchange rate be determined by supply and demand: Let it fluctuate, let it float! Why not?

DAVID SCHOUMACHER:

Why not indeed. For forty years the dollar was dominant as it floated against each of the European currencies. The dollar would rise and fall vis-à-vis foreign currencies based on respective growth rates, inflation, interest rates, and investment opportunities. Then a historic change took place in the way most of Europe did business.

In the 1990's a growing European Union decided to exchange their multi-currencies into one currency, the Euro. On January 1st, 2002 the first Euro coins and bills officially went into circulation in twelve of the fifteen European Union member countries.

MARTIN FELDSTEIN:

No more French Francs, no more German Marks, no more Italian Lira just one single currency for twelve different European countries and that's absolutely unprecedented for a major country to give up it's own currency and to shift monetary policy to a single authority beyond it's control.

MICHAEL MUSSA:

With the advent of the Euro at the beginning of 1999, the world had essentially immediately, a currency to rival the dollar as the world's leading currency.

DAVID SCHOUMACHER:

The euro is the currency of the Euro Zone; the dollar is the currency of the United States. Two economies of roughly equal size means that the international involvement of those economies with each other and with the rest of the world are roughly on the same scale.

MICHAEL MUSSA:

So the international importance of the Euro for private business is likely to be of roughly the same order of magnitude as the international importance of the dollar for private businesses.

MARTIN FELDSTEIN:

The creation of the Euro was really a political event more than an economic event, of course it has economic consequences but the reason the Europeans did this was to accelerate their move to a European federation, to a United States of Europe.

DAVID SCHOUMACHER:

Having a common currency in which to do business, having increased the integration of European business enterprises and other activities across border is more likely to build a single European market rather than a fragmented market.

What the euro means is that member countries will no longer be able to have their own monetary policies. What that means is that the interest rate in France and Spain and Germany and Ireland must be the same, that there cannot be different interest rates because there is only a single currency. Why is that a problem?

MARTIN FELDSTEIN:

Well, if for example Spain has an economic downturn, a recession when they had their own currency, when they had their own central bank they could cut interest rates and try to make their economy grow more rapidly and the Spanish currency the peseta, would fall relative to others and that would increase their exports. The European central bank may say well, Europe's doing all right.

We're worried about inflation. We have to raise interest rates while one or more of the individual countries may say but we're slipping into recession, we want to lower interest rates. So, I think there is a potential for economic conflict between some of the countries and others.

MICHAEL MUSSA:

So far I would judge that the Euro has been a considerable success in terms of its positive impact on economic performance in the Euro area.

MARTIN FELDSTEIN:

Germany has been a low inflation country throughout the post World War II period and other countries had the choice, if they didn't keep their inflation as low as Germany then they would have to devalue their currency relative to Germany and that was a kind of black mark. It was a kind of humiliating thing for the country to do. So, German anti-inflationary policy became the guiding policy during much of the last several decades. But now Germany is just one among a dozen countries that sit at the European Central Bank and over time I think there will be political pressures for more inflation and Germany will no longer be able to be the dominant force in keeping inflation low as it had been in the past.

MICHAEL MUSSA:

Europeans in the Euro area a few years from now I think will probably wonder why we ever did it any other way.

DAVID SCHOUMACHER:

The economic impact of the euro on the U.S. has been relatively small but we are seeing more conflict between Europe and the United States on a whole range of economic and political issues. The creation of the euro and with it the elimination of any possibility of exchange market turbulence has served the euro well, during various financial crisis that have occurred in recent years. We asked economic analyst Nariman Behravesch for his thoughts on the euro.

NARIMAN BEHRAVESH:

The launch of the European Monetary Union and the euro was a momentous event for the Western Europe. The transition from 12 currencies to one went as smoothly as anyone could possibly expect. Moreover, it moved Western Europe

one step closer to having a unified financial market. Even more important, it forced many fiscally profligate countries such, as Italy, to clean up their act. However, between the official launch of the euro as an electronic currency in January 1999 and the circulation of coins and bills three years later, the currency markets gave the euro a big thumbs down – as you can see in the graph. The value of the euro against the U.S. dollar fell by almost 30%, before rebounding in 2002. The lack of confidence in the euro can be attributed to many factors; however, the biggest concern has been that the “one-size-fits-all” monetary and fiscal policies imposed by the European Monetary Union have hurt growth. Specifically, many analysts and government leaders have complained that the new European Central Bank has kept interest rates too high, in an attempt to establish its inflation-fighting credibility. Also, the various treaties that set up the ground rules for the single currency have put a fiscal straightjacket on all the member countries. This has created some rather unfortunate outcomes. For example, in 2002, with it’s economy dead in the water, Germany could do nothing to boost growth – not lower interest rates, not boost spending, not cut taxes. Until Europe works out some of these kinks in its new currency, the euro will have trouble establishing itself as a global reserve currency to rival the dollar.

DAVID SCHOUMACHER:

What in the World is a dollar worth? Well, since the Seventies we’ve learned to let the market decide with a little help from its’ friends at the Treasury Department and finance ministries of the big industrial nations. What difference does it make? Well, with imports, exports, and jobs here and abroad, hanging on whether currencies go up or down, it makes all the difference in the World. What’s ahead for the dollar? Well, no one can say for sure but you can bet there’ll be more ups and downs, more attempts at international coordination, and with the euro, a new and more powerful currency in World markets and a new and more powerful partner in currency coordination meetings. For Economics USA, I’m David Schoumacher.