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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

May 2, 1975

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached for your information is a memorandum by R. M. Kubarych of the New York Reserve Bank, entitled "Exchange Market Implications of Recent Changes in Valuation of OPEC Currencies."

This memorandum, like that by Helen Junz of the Board staff distributed on April 3, 1975, was prepared in response to a question raised at the March meeting of the Committee.

Attachment

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CLASS II FOMC

April 15, 1975

To : Mr. Holmes

From: R.M. Kubarych

Subject: Exchange Market Implications of Recent Changes in Valuation of OPEC Currencies

This memorandum discusses the exchange market implications of recent actions by mid-east oil producing nations to link their currencies to the SDR or other market-basket formulae. This move reflects an attempt by oil producers to protect themselves against any further decline in dollar rates. They receive the bulk of their payments in dollars and hold most of their reserves in dollar-denominated assets, diversifying into the major Continental currencies largely out of new revenues and without any evident restructuring of their existing portfolios. Consequently, they suffered significantly from the decline in dollar rates between October 1974 and February 1975. The shift in denomination of OPEC currencies began February 12, when Iran cut its link to the dollar and established a mechanism for adjusting the riyal/dollar rate to take account of variations in the SDR value of the dollar. Since then Saudi Arabia and Qatar also adopted an SDR link in mid-March, while Kuwait has pegged its currency to a market basket of currencies reflecting the composition of its trade.

To gauge market reaction to these moves, we surveyed exchange traders in New York as well as our usual contacts at European central banks, who passed on comments of traders in their respective markets. The shift to SDR-denomination at first unsettled the exchange markets, as it was interpreted by many traders as signaling a loss of

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confidence in the dollar at a time when the dollar was weak. By March, however, the dollar was recovering and the impact of further announced valuation changes was muted. The market had come to recognize that the immediate impact of these changes was largely confined to the OPEC countries themselves. The pegging of OPEC currencies to the SDR or other market basket was accompanied by modest revaluations vis-a-vis the dollar, which reduced the domestic cost of imported goods, thereby countering inflationary pressures in these countries to some extent. But oil prices are denominated in dollars or sterling and are not influenced by changes in the value of mid-east currencies. Moreover, the market saw no reason to expect that these changes foreshadowed a change in the dollar's role as the principal transaction currency for oil payments. Mid-east currency and financial markets are too undeveloped for oil payments to be made in the currencies of these countries themselves. In addition, various exchange controls in Europe and objections by European authorities to the increased use of their currencies would impede widespread invoicing of oil payments in Continental currencies.

By the same token, the market has become much more relaxed about the prospects of some alteration in the method of pricing oil. From the point of view of the oil producing countries, the timing of the currency valuation changes has proven to be unfortunate. After floating down with the dollar for several months, the mid-east currencies' links with the dollar were broken at the moment that the dollar was beginning to recover. With the dollar improving, if oil began to be priced in SDR or foreign currency terms, the

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equivalent dollar price would naturally have to fall--to the benefit of the U.S. trade position. As many dealers see it, the worldwide market for oil is currently soft and economic pressures are pushing in the direction of lower prices. To the extent that this could be achieved by a technical move to SDR pricing while the dollar is on the upswing, rather than by a straightforward price cut, the effect would be simply to avoid a loss of face politically for OPEC. There is some thinking in the market that the switch may soon be made and that the dollar would benefit. Consequently, the April 3 decision by the OPEC Commission to recommend a market-basket pricing formula had no impact at all on dollar exchange rates.

There is a danger that OPEC might wait until after the dollar had recovered significantly to shift to a market basket pricing formula. Not only would this increase the risk of an upturn in the dollar price of oil should dollar rates ease back again, but it might be viewed as a signal that OPEC members felt the dollar had gone about as high as it would go and were about to begin diversifying more actively into European currencies. Thus, the potential for a destabilizing market impact remains. For the time being, however, the market generally believes the dollar will continue to recover and has become much less excited about the prospects for technical adjustments in oil pricing.