The Dollar: National and International Bulwark*

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I should like to talk to you tonight about the dollar—the role it plays in the world and the urgent problems we face if we want to see that role maintained. My theme runs about like this: The strength of the United States, both at home and abroad, is inextricably linked with the strength of the dollar, and the dollar in turn is a key component of the free world's financial structure. While the dollar still commands a high degree of confidence, there has been a perceptible lessening in its relative strength during the past five years of heavy international payments deficits for the United States. Despite all our efforts to date, and some of them have been quite effective, the payments deficit remains much too high. A prolongation of heavy deficits cannot fail to damage the dollar badly, and to damage along with it the payments system that has fostered economic growth here and abroad since the end of World War II. As a nation, we have the power to arrest and reverse these deficits, and to do so in a way that will preserve the basic structure that we want. Like all major national issues, the problem is one of priorities—in this case, whether we are willing to assign a top priority to the goal of restoring the dollar's unquestioned standing.

The dollar attained pre-eminence in much the same undirected, almost unconscious, way that the United States became a great nation. Gradually, it became the medium of exchange for a large part of the world's trade and investment transactions, sharing this role principally with the pound sterling. Beyond this, the special role of the dollar as a standard and store of value was clearly recognized in the Bretton Woods Agreements of 1944, which provided for world currencies to be valued in either gold or the dollar. Indeed, the world's monetary reserves now consist largely of gold and dollars.

The role of the dollar as a reserve currency rests on several considerations: (1) a strong United States economy, in which the dollar is expected to remain immediately usable for a wide variety of goods and services at reasonably stable prices; (2) a strong United States creditor position in the world, with our foreign assets—largely long term—exceeding our total foreign liabilities by a substantial margin; (3) our large gold stock, now comprising some 40 per cent of the world's monetary gold, and available to foreign monetary authorities at the fixed price of $35 per ounce.

Faith in a currency has the quality of being scarcely noticeable until there is reason to question it. Until recently, the dollar's impregnable position was so taken for granted that few observers bothered to analyze carefully what lay behind this strength and what might endanger it. We can all recall the concern for those nations in Europe and elsewhere that faced a so-called "permanent dollar gap". Yet within a few years the dollar has lost some of its lustre and is no longer immune from occasional fears and suspicions. At home, the conclusion is inescapable that concern over the dollar's future is, in Chairman Martin's words, "a major shadow over our economy", restraining that full flowering of business confidence that is essential to the vigorous economic growth we all seek.

The question naturally arises whether we should welcome or deplore the unique position of the dollar—in short, whether the burdens of a key currency are worth bearing. This is not the place for lengthy analysis, but I believe the tangible and intangible benefits from this role are great. Clearly, we must recognize the importance of a strong dollar if our national voice is to carry full weight in political, military, and economic dealings with other nations. It is clear, too, that only a dollar of unquestioned soundness can continue to share with gold the role of providing the world's monetary base. Moreover, I cannot

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conceive how we could relinquish the key position of the dollar, even if we were willing to, without also isolating ourselves from our partners in world trade and payments—obviously at enormous real cost.

Even if our international payments were now in balance we would still have the responsibility, as the world's leading banker, for running our internal affairs so as to maintain the confidence of our foreign depositors and our own people. For those foreign dollar holdings, representing an accumulation of past deficits, confront us with a sobering relationship between our liquid assets and liabilities. But the position of the dollar would be far stronger if we put a stop to the deficits that have reduced our gold stock and swelled our short-term indebtedness to the rest of the world.

Before considering ways to eliminate the balance-of-payments deficit, let's recall how it has been financed to date. Over the past five years the deficits have aggregated about $16 billion. Of this, about $7 billion was paid for through sales of our monetary gold. Another $7 billion was financed through increases in dollar holdings of official foreign and international monetary authorities, while the private dollar holdings of foreign banks, corporations, and individuals increased about $2 billion. There are limits, however, to the willingness of either official or private foreign entities to add to their holdings of dollars. Relatively easy credit conditions in this country tend to discourage private holders of dollars, even though the Federal Reserve System and the Treasury have sought to prevent this easy credit from being translated into excessively low short-term interest rates. To the extent that dollar investments appear unattractive to these private holders as compared with investments in their own or other countries, the dollars tend to find their way into foreign central banks' reserves. Once these official dollar holdings reach ample levels, there is naturally a reluctance in some countries to enlarge further the dollar component of their growing monetary reserves, and they tend to use additional dollars to buy gold.

Until a year or two ago these gold outflows or increased dollar holdings were the only means for settling our deficits with foreigners. But in recent months the Federal Reserve has arranged reciprocal currency drawing rights with most of the countries of major importance in international payments, while the Treasury has also acquired foreign exchange by issuing United States bonds denominated in foreign currencies. These arrangements, eliminating any exchange risks, have been useful in reducing immediate claims on our gold, and in avoiding or moderating temporary imbalances such as those caused by international tensions or speculative pressures—against other currencies as well as the dollar. The stability of the exchange markets during the Cuban crisis was a good case in point. These Federal Reserve and Treasury arrangements mark new milestones along the path of more effective international financial cooperation, which I am happy to say has not been affected by the recent policy differences among the major western nations on the military and trade fronts.

There are also other major means of financing a deficit, at least temporarily, which are still untapped and which constitute a most important reserve. I am thinking specifically of the normal resources as well as the enlarged lending facilities of the International Monetary Fund. But so long as the United States is in the process of correcting a long-continued deficit, the Fund is probably best regarded as pretty much a "lender of last resort"; it would be foolhardy to neglect going to the root of the problem because of the existence of these special resources. And besides, it is obvious that any borrowing from the IMF is only a respite and that future repayment of such borrowing would require not merely equilibrium in the balance of payments, but actual surpluses.

I have heard our swaps and foreign currency borrowings criticized as "cover ups" that cause us to lose sight of the underlying need for payments equilibrium; but I can assure you that neither the Treasury nor the Federal Reserve has had the slightest illusion that they are in any sense a substitute for the needed remedial actions. Rather, apart from their longer term value as a contribution to world liquidity, they serve at present as a holding operation while we undertake, by more fundamental measures, to get our basic payments deficit under control.

This brings us to the nature of the deficit itself. The bare bones of this problem can be set out as follows: (1) we have heavy Government commitments abroad, military and economic; (2) we have large private capital outflows—including direct investment, long-term portfolio investment, and volatile short-term flows; and (3) while we sell more goods and services abroad than we buy from abroad, and recoup a growing return from our large foreign investments, the excess is not large enough to offset the other factors.

It is easier to prescribe what *not* to do to get rid of our deficits than it is to find the right combination of remedies. First, it is clear that the United States has rightly rejected devaluation of the dollar or any impairment of the interconvertibility of gold and the dollar at the fixed price of $35 per ounce. Such a step would be a breach of faith with our friends abroad, and with our own citizens, that would undoubtedly wreck the international financial structure we have been building since World War II. Incidentally, we have seen within recent years how disturbing to inter-

national confidence any tampering with fixed exchange rates can be. I am confident that none of the major nations will upset our world financial structure by seeking temporary competitive advantage through exchange rate adjustments—and clearly such action is unthinkable in the case of the dollar.

Second, we should not take steps that run counter to our basic objective of unrestricted trade and investment flows. Of course the tying of our economic aid is somewhat vulnerable on this count but it can be justified as a temporary measure, facilitating special Government transactions largely outside the ordinary commercial channels. Any form of exchange control, however, whether by legal restriction or by moral suasion, is clearly excluded if we adhere, as I am sure we will, to the sound principle of promoting a free flow of trade and payments.

Let me digress a moment. Many people have told me that they have heard that the Treasury—or the Federal Reserve Bank of New York speaking for the Treasury—has advised bond underwriters, insurance companies, commercial bankers, or managers of pension funds not to extend dollar credits, or arrange for such extension, to foreign borrowers. To be sure, where large amounts are involved, we have always felt free to discuss with those concerned the timing of such payments, having in mind the desirability of avoiding undue market pressures. But I would like to emphasize as strongly as I can that we at the Federal Reserve and the Treasury have not interfered with private decisions to lend abroad nor raised objections as to amounts. These are private business decisions and they should remain so.

Having touched on what we should not do, let us turn to the possibilities that are open to us for a vigorous attack on our payments problem. First, with respect to increasing our exports and our favorable trade balance, the level of our costs and prices is crucial in the long run—and it is the long run that will count, since a major change in our export volume can hardly be achieved overnight. We should welcome the efforts that are being made to get America more "export minded", to provide Government assistance in finding markets, and to streamline our methods of export financing and insurance; but important as these aspects are, it is on the field of costs that the battle will be won or lost. In the past couple of years, sharp rises in European wage rates and attendant price increases have helped us to some extent, but it would be foolishly complacent to count on Europe to continue indefinitely this involuntary help. For one thing, rapidly rising productivity abroad is still working hard in the opposite direction; and besides, serious resistance to higher costs on the part of foreign governments and central banks is beginning to appear in a number of countries.

Some in this country argue that we needn't worry too much about costs but rather should push for faster growth, on the theory that a more active economy would automatically boost productivity and reduce costs. Much as I would welcome more rapid growth, I don't think we can count on this for "automatic" cost improvement. On the contrary, unless we consciously aim at vigorous cost control, higher business activity could reawaken the inflationary pressures that plagued us in the nineteen fifties. Keeping wage and salary increases within the limits of national productivity gains would seem to be a minimal target in this area. Corresponding moderation is also essential in other cost elements, including executive compensation, as well as in pricing policies.

With respect to our Government financial commitments abroad, while I am encouraged by the reductions initiated or accomplished in the last year or two, a great deal more remains to be done. The tying of our economic aid is not a full answer to that source of dollar drains, since a part of the tied aid may well be used to buy goods that would have been purchased from us even in the absence of aid. Doubtless, further gains can be made in the area of sharing the aid burden more equitably with our friends abroad, even granting the difficulty of reaching agreement on fair yardsticks for sharing. I suspect that greater emphasis on multilateral aid would produce real long-run savings. I'm sure many of you have read with keen interest, as I have, the report of the President's advisory committee on foreign aid (known as the Clay committee), and I am heartened by the attention being given to these proposals by the Government. I would also hope that the program of matching United States military spending abroad with foreign military purchases in this country will be pushed to the maximum. This, too, should result in meaningful savings of foreign exchange.

But even after all these have been done, we may still face the hard question whether we can afford all of the commitments we have taken on, or whether some of them which do not directly contribute to our military security should not be substantially reduced. In seeking an answer, we cannot forget that the widespread use of, and reliance on, a strong dollar by the entire free world is a vital part of our national strength—political as well as economic.

We come now to capital movements. Our efforts to sustain short-term interest rates over the past year or two have been helpful, but the outflow of short-term capital remains too large. Partly, this outflow is due to the tendency of corporations, and sometimes banks, to take advantage of the higher rates obtainable abroad, often in the Euro-dollar market. Sizable outflows of long-term capital are also continuing. While the interest rate ga

has been narrowed somewhat by declining rates in Europe in the past year or so, I am doubtful that we can count on further declines substantial enough to relieve us of this problem. I see no reason, for example, to believe that foreign monetary authorities will refrain from using restrictive credit measures to protect their currencies from the threat of cost or price inflation.

As I have already indicated, I am glad that our Government has taken a firm position against direct controls over capital flows. We should by all means continue our efforts to encourage further development of the European capital markets and a larger influx of foreign long-term capital into this country. However, this problem is not one that can be solved overnight by the removal of various remaining European government restrictions. A psychological heritage of inflation fears, scarcity of savings, and heavy domestic capital needs all suggest that improvement in this direction will be relatively slow.

There remains, of course, the possibility of curbing the capital outflow through changes in our interest rates and credit availability. While this is, in a sense, "home territory" for the Federal Reserve System, I would hasten to add two caveats: (1) The level of interest rates and the availability of credit, especially long-term credit, depend importantly on the balance of savings and investment within this country, as well as on deliberate monetary policy. In the last year or two, with our resources less than fully employed, there has been a distinct tendency for the supply of savings to outrun investment demands. (2) We must not, of course, lose sight of the effects of monetary policy on our domestic economy. Fortunately, we do not need to worry about having to make money any easier, in view of the country's present ample liquidity.

For several years now, monetary policy has walked a narrow path between international and domestic considerations, and it will undoubtedly have to continue to do so. But I am convinced that what might appear to be a stark short-term conflict between domestic and international objectives disappears in the long run. There could be but a precarious gain in domestic activity if we do not surmount our long-run payments problem—while a vigorous domestic economy that attracted funds to these shores would contribute most importantly to achievement of balance in our international accounts. But in any case, as I have said on previous occasions, monetary policy must be prepared to act decisively in defense of the dollar if the need should become sufficiently acute.

Let me say a word about tax policy. Once we get away from the controversial details of the proposed program, I am impressed by the broad support for a reduction in both individual and corporate income tax rates as a means of removing a drag on our economy and improving the atmosphere for productive private investment. I have been bothered by the unduly sharp distinction drawn between tax reduction and tax reform, since it seems clear to me that the most needed reform is a reduction in tax rates. Apart from objections to the specific measures presented as reforms, most of the dissatisfaction with the tax program seems to reflect doubts as to whether there has been enough restraint on the spending side. I have been encouraged by recent statements that defense and space outlays should reach a plateau in the next year or two. However, I am not at all sure that there could not be some further paring even in these two categories. And it is all too evident that some of the civilian programs are much larger than could be justified on sound economic grounds. Evidence of more effective limitation of total expenditures would, quite logically, facilitate wider acceptance of tax reduction.

Hopefully, tax reduction and the resulting stimulus to the economy would benefit our balance of payments, both by making investment in this country more attractive and by making United States funds somewhat more expensive and less readily available to foreign borrowers, as domestic demands for credit became more pressing. Moreover, tax reduction would free monetary policy from some of the burden it has been carrying of encouraging domestic business expansion, leaving it better able to respond promptly and flexibly to international strains on the dollar. I was gratified by Secretary Dillon's clear recognition of this point in his excellent address to the ABA Monetary Conference in Princeton last month.

I have heard the objection that our foreign friends' confidence would be so shaken by the enlarged budget deficits resulting from tax cuts that we would lose the benefits to be gained in other directions. This view I cannot share. I believe that they would not be disturbed by a temporarily enlarged budget deficit—provided it was soundly financed and that expenditures were being brought under control. Under these conditions, they could expect an accompanying economic expansion and associated credit developments leading to a better payments balance.

Perhaps a word is in order here about Federal deficits in general. That a long series of substantial deficits should be avoided seems to be incontrovertible. There have been too many examples in history of inflation engendered by uncontrolled deficits to permit us to lose sight of the ever-present threat of abuse. Having in mind the usual gap beween targets and actual performance, we would be unwise to abandon the objective of balanced budgets over an extended period of time. But this is quite different from saying that a Federal deficit automatically spells inflation,

present or future. As the experience of the last four years seems to have shown, much depends on the nature of demand or cost-push pressures in the economy arising from the combination of all relevant factors, both public and private. Moreover, the means of financing the deficit can be crucial. The 1962 experience in this regard was reassuring, and I am sure that neither the Federal Reserve System nor the Treasury would countenance an inflationary method of financing whatever enlarged temporary deficits may result from tax reduction.

I believe a solution of our balance-of-payments problem can be found in some combination of actions along the lines that I have sketched this evening. A good start, of course, has already been made on most of these measures. The harder steps lie ahead of us, but they are no less urgent on that account. We cannot have a vigorous and expanding economy, nor can we play a role in world affairs worthy of the United States, if the dollar becomes a weak currency. We still have time for the right measures to become fully effective if we have the courage to see them through—and I firmly believe that we do.

FEDERAL RESERVE OPEN MARKET OPERATIONS IN 1962

The Board of Governors of the Federal Reserve System has published in its *Federal Reserve Bulletin* for April 1963 a report entitled *Federal Reserve Open Market Operations in 1962.* This report—which was prepared by Robert W. Stone, Manager of the System Open Market Account and Vice President of the Federal Reserve Bank of New York, assisted by associates on the Trading Desk—describes the open market operations of the Federal Reserve System against the background of broad System policy objectives, on the one hand, and money and capital market developments, on the other. The report is reprinted as an insert in this issue of the *Monthly Review.* Additional copies may be obtained from the Public Information Department, Federal Reserve Bank of New York, New York 45, N. Y.