America's Role in Making the World Financial System Work*

By ALFRED HAYES

President, Federal Reserve Bank of New York

It is a privilege to address this influential and well-informed gathering, and I find it especially gratifying to return here because of pleasant memories of my service as a panel member of this international finance session on several occasions many years ago. At a time like the present, with a change of national administration in the offing, it would seem useful to take stock briefly of where the United States economy stands and where it seems to be heading, and to see how it fits into the current world financial picture. I have no thought of presenting a detailed economic analysis but would merely like to underline a few of the major facts and problems that seem important to me. Because this gathering has a broad world outlook, I shall talk principally about the international aspects of our economic position, but inevitably the international and the domestic aspects are closely interwoven.

As we survey the international financial scene, I think we can find some cause for satisfaction in the resiliency of the world financial system itself and the remarkable growth of central bank cooperation. We have come through a twelve-month period during which the world financial structure has been subjected to extreme strains, including the devaluation of sterling, tremendous speculation in the foreign exchange and private gold markets, and major civil disorders in France. Not only has the structure survived, but world trade has continued to expand, and international investment flows have reached new peaks despite numerous artificial barriers placed in their way. The dollar has been faring better in the exchange markets than in a good many years.

The fact that the present system, based on fixed exchange rates clustered around the centerpiece of the $35 gold price, has not only served the world well for more than twenty years but has withstood the shocks of the past year is testimony to its fundamental soundness and adaptability to changing circumstances. In the light of this record, we should think more than twice before subjecting this system to radical revisions. Fortunately, we hear less these days than we did a while ago about the alleged benefits of a higher gold price or the demonetization of gold. On the other hand, exchange rate flexibility has recently received renewed attention from some quarters. For the most part, suggestions for radical change in the system of fixed exchange rates have come from those not closely associated with the workings of the market itself. Certainly the burden of proof is on the proponents of such change, and there has been no support for these suggestions from the major monetary authorities.

Now, my comments so far might prompt the hasty conclusion that all goes well with the dollar and that the future should give us little cause for worry. Unfortunately, such a conclusion would be entirely false. The underlying tendencies in the United States balance of payments justify continuing concern. For years the persistent United States payments deficits, together with their counterpart of persistent European surpluses, have cried aloud for effective action to bring about the necessary international adjustments. Of course there is no agreement even in academic theory as to how the adjustment burden should be apportioned between deficit and surplus countries. Still less is there agreement in practice. But I think it is obvious, especially in view of the dollar's enormous importance as a trading and reserve currency, that the responsibility for cutting our deficit to a manageable size must ultimately rest on the United States, even though the surplus countries must share in this responsibility.

Until the acceleration of the Vietnam war in 1965, our

* An address before the international finance session of the fifty-fifth National Foreign Trade Convention, New York City, November 18, 1968.

record was not bad. We had made considerable progress in improving our trade balance for five years or so, mainly because we had kept our costs and prices remarkably steady while many other important countries were experiencing a good deal of inflation. At the same time, we were gradually reducing our net military outlays abroad. We did have trouble on the side of capital movements, in part because the relatively easy monetary policy associated with stimulation of a lagging domestic economy kept interest rates here low in relation to the rest of the world. And to meet this problem we experimented with various monetary techniques that I need not describe here, we shifted more of the burden of stimulating business to fiscal policy in the form of important tax reductions, and we were even forced to resort to interference with the export of capital in the form of the interest equalization tax and the voluntary credit restraint program. On balance we were making painfully slow but visible progress toward equilibrium, and the rest of the world was helping us, whether actively or passively, by allowing expansionary and even inflationary policies to dominate their own economies.

The story is very different since mid-1965. I do not see how we can escape the conclusion that since that time the United States has handled its adjustment responsibility very badly. By failing to foresee the stimulative effects of a sharply stepped-up war effort and to take promptly the needed countermeasures, especially in the fiscal area, our authorities acquiesced in the development of a price-wage spiral of the classical type, where bloated demand leads to price increases and excessive wage settlements; the latter intensify the readiness of producers to raise prices, and in turn the rising cost of living gives a new impetus to rapid wage gains. The inflationary spiral has had a tremendous psychological effect that has shown up in many ways, including an upsurge in land prices as well as the rapidly growing preference of investors for equities over fixed-income securities. In all this perhaps the most ironic aspect is that in the past three years, at long last, the policies needed to meet our domestic and our international needs have converged, after many years when we had to weigh carefully domestic against international considerations. On both counts we have had every reason to counter inflation since 1965, and yet we have not succeeded in bringing it under control.

The damaging effects on our trade balance of a booming inflationary economy have been all too clear, and especially so in 1968. For years we had thought of a favorable United States trade balance of at least \$4 billion to \$6 billion as a *sine qua non* of overall payments equilibrium—an item that would go a long way toward paying for both private capital outflows and government expenditures abroad. These private and official outflows have burgeoned rapidly as American industry has moved dynamically to extend its activities throughout the world and as our government has taken on ever-growing responsibilities, stemming from our political, military, and economic leadership. To see our trade surplus reduced to something like \$1 billion is a shock indeed. In fact, if one excludes government-financed exports, we have had an actual deficit on trade account in each of the past four quarters. Under other circumstances the effect on the dollar's standing in exchange markets might have been disastrous.

But this year powerful factors were working in the opposite direction. Not the least was the startling and salutary rise in foreign investment in United States equities to something approaching a \$2 billion annual rate. Undeniably inflation, by contributing to the upward movement of stock prices, was one of the reasons for this inflow, although basic faith in the American economy and superior marketability of American stocks were also of great importance. At the same time the program of restraints on United States capital outflows—voluntary in the case of banks and other financial institutions and mandatory in the case of the nonfinancial corporations—was producing big dividends in terms of our balance of payments. An unprecedented volume of offshore financing of United States direct investment was a major factor contributing to the effectiveness of the program. Also, tight money in this country combined with rather liberal credit policies in certain foreign countries—notably Germany—set the stage for a \$3 billion rise in borrowings of dollars by United States banks from their branches abroad. The events in France and Czechoslovakia, by creating new doubts as to the political stability of Europe, clearly enhanced the relative standing of the United States as a safe depository for invested funds. As a result of these and other developments, some of the important foreign central banks which customarily worry about excessive holdings of dollar resources have been hard put to find enough dollars for their minimal needs. Hence the better performance of the dollar in the exchange markets to which I referred earlier.

As we look ahead, I think we must recognize that this is not a situation that can be counted on to last. It may be true that much of the feeling about the superior safety and profit opportunities of American equities may endure indefinitely. Thanks in part to the energetic sales efforts of American financial institutions, a steadily growing number of foreign investors are becoming interested in our equity market. But, if there should be a sharp setback in American stock prices, the inflow of funds could shrink rapidly, at least for a time. Also, it is unlikely that in the coming year United States banks will increase their net borrowings from foreign branches at anything like the rate of the past year. Nor can we expect as much benefit to our payments balance in 1969 as was the case in the past year from capital export restraints on United States banks and corporations. In this respect much of the improvement in 1968 represented a one-shot adjustment to the restraints imposed at the start of the year.

This brings us back to the key question: How are we going to make real and lasting progress toward equilibrium in the United States balance of payments? Without such progress there will be grave jeopardy to the continued functioning of an international financial system that has, on the whole, served the cause of world trade and investment better than any visible alternative. From what I have already said I am sure you can guess where I believe the main part of the answer lies. We simply must rebuild our trade surplus to at least the $4 billion to $6 billion range of a few years ago, and that means that we have to check, and check unmistakably, the inflationary forces and expectations that are so dominant in the economy today. There are ample reasons for doing this from a purely domestic standpoint. But the international reasons are equally compelling.

At this point I might digress for a moment to touch on some of the principal current problems of domestic economic policy. With the passage of the fiscal package in June, it was widely expected that the pace of business would be slowed very markedly and without too many months' delay. There were many economists who even feared that the slowing effect would be excessive and would send the economy into a recession by early 1969. I never espoused this view, and by the same token differed from some who believed that the tax-spending package required a deliberate and substantial easing of monetary policy. On the other hand, I was content to see market expectations last summer bring some appreciable decline of interest rates from their earlier record highs, partly because this promised some relief to the savings institutions, a consequent better flow of mortgage funds, and greater encouragement to residential construction activity. Such encouragement served as a useful form of insurance against the possibility of an unexpectedly sharp slowing of the economy.

In retrospect, I think nearly everyone underestimated the strength of the economy. Few observers guessed that consumers as a group would raise their spending rapidly in the third quarter, despite higher taxes, by saving a very much lower proportion of their after-tax income. Other sectors of the economy also turned in a somewhat stronger performance than had been expected. The degree of restraint on total Federal spending has turned out to be rather less than hoped for. The result of all this has been that resources have been more fully used than the earlier forecasts had suggested, and so far there has been no conclusive evidence of a slowdown in the rate of increase of costs and prices. As we look back over the past six months, the rate at which bank credit has grown has, in my view, been faster than was desirable in this inflationary environment even though some of the increase could be explained by special circumstances. Although economic growth is always an important goal of national policy, under present conditions I believe we must accept a slower than normal growth rate, for some period ahead, if we are to have any hope of stopping the inflationary spiral. If we do not stop it, then growth at the excessive pace we have seen earlier this year, accompanied by sharply rising prices for goods and labor, can only prove illusory. In the long run, mounting inflation would encourage further speculative excesses, would be clearly inimical to a solution of our pressing social and economic problems, and would bring about a very sharp correction at some later date. A rational and gradual slowdown at this time would be far wiser.

Over the years there has been much discussion of the fiscal-monetary policy mix, and the possibilities for varying this blend for the purpose of dealing most effectively with both domestic and international objectives. Such efforts have occasionally met with some success. However, it has been apparent that fiscal policy is very difficult to apply in a timely way, whereas monetary policy is by nature highly flexible, although less effective than fiscal policy when massive results are needed. We should continue to try for as sound a mix as possible, and in practice I believe most of the short-run adjustments will have to be made on the monetary side. On the other hand, we must recognize that an extremely loose fiscal policy poses such difficult debt management problems that monetary policy may be very severely handicapped, as was true during much of the 1966-68 period.

One significant fiscal decision in the coming year will be whether or not to continue the 10 per cent surcharge after June 30. In the absence of developments dramatic enough to alter the whole inflationary environment, it appears to me that the surcharge may still be needed after June 30. Furthermore, even with suitable fiscal and monetary policies, we will need restraint by business and labor with respect to prices and wages. An understanding of the need for wage and price policies that are compatible with underlying productivity gains is an essential element in a concerted attack on the forces of inflation.

While appropriate monetary and fiscal policies are essential to improving our international payments position, we should also strengthen programs designed specifically to create favorable conditions for an inflow of both foreign capital and foreign tourists. The measures taken a few years ago to reduce the tax burden on foreign investors were quite useful, and I would assume that additional measures along similar lines may commend themselves to the Administration and the Congress in the future. The need for active encouragement of exports is so obvious, especially in a gathering like this, that I need do no more than touch the point.

Another very important area for possible balance-of-payments improvement has to do with curtailing government outlays abroad when this can be done without undue sacrifice of political or military objectives. The possibilities in Europe, however, look rather more limited than they did before the Czechoslovakian crisis. Of course a lasting settlement in Vietnam would bring large savings. As for economic aid, the needs are so enormous in the developing countries that there are serious risks in the cuts that have already been made in our aid program. Thus there seems to be little or no scope for further cuts in our total foreign outlays in this sector. However, balance-of-payments considerations aside, it may be hoped that multilateral aid will grow both absolutely and relatively, and this may mean greater recourse to our private capital markets and less direct government-to-government assistance.

As for the complex of voluntary and mandatory restraints on the export of American capital, there is, I fear, no easy answer. These were always intended as stopgap measures, a sort of holding action while more fundamental improvements were given time to operate. It follows, however, from the inflationary distortions in the domestic economy and their dire consequences for our trade balance that the time for getting rid of this apparatus has been further delayed. Repugnant as these restraints may be to our basic belief in the maximum freedom for international trade and investment, they are vastly preferable to the chaotic state to which the world payments system would be reduced if confidence in the dollar were to be lost. They are also vastly preferable to any reversion to protectionism, which could easily degenerate into a mutual international competition in retaliatory measures.

To those who point out that restraints on direct investment may be seriously counterproductive in the long run, I would answer that American enterprises abroad have so far, fortunately, not felt a very heavy restraint upon their activities. Gross foreign investment of such enterprises has reached a new high this year, thanks mainly to the development of the Euro-bond market; and after all it is their gross investment, not the flow of investment funds from the United States, that will have the greatest influence on their future profits and competitive position abroad. In sum, I hope American business, finance, and government will not press for dismantling these restraints with undue haste. Despite the understandable impatience of United States banks and corporations, it might also be well to note that there is no escape from these restraints by tampering with the basic financial mechanism —the fixed $35 gold price and a system of fixed exchange rates. In fact, such tampering would make balance-of-payments adjustment much more painful than it is now.

So far I have been speaking entirely of what we can and should do to help ourselves. I believe that the major surplus countries can do much on their side to speed the needed adjustment. Most important, perhaps, is their obligation to foster strong economic growth and to take some modest risks in weighing the dangers of inflation against those of recession. However, we certainly cannot urge that they deliberately court inflation. At present there are hopeful signs of stronger expansion in some of the leading industrial nations.

We might also expect the surplus countries to do everything that is possible to reduce trade restrictions, including nontariff barriers, and encourage capital outflows, both private and government. For the past year or so Germany has provided an outstanding example of how a country can finance a large trade surplus with long-term capital outflows.

The foreign-aid record of some European countries seems to me to leave something to be desired. The expanded program of aid by the World Bank should provide a fine opportunity for the surplus countries to contribute a larger share of the overall flow of economic aid to the less fortunate countries. And a more equitable sharing of mutual defense costs, with Europe increasing its participation, would seem essential. I hope there will be even more effort in the future than in the past to bring together the major industrial countries so that these adjustment questions may be attacked in an atmosphere of mutual understanding and cooperation.

Meanwhile I am sure that international cooperation will continue to play a big role in preserving and improving the financial mechanism that supports all of the world's trade and investment activities. I find it most heartening that the monetary authorities of the leading industrial countries are in full agreement as to the need to defend the essential elements of this mechanism. While recognizing that the new special drawing rights will play an increasingly important part in providing monetary resources over the years, the authorities also see the need to preserve the existing role of gold and dollars as international reserves. I am glad to note that this means a general disposition to reject suggestions for radical change of the financial mechanism. It was also heartening that the principal industrial countries were able to reach agreement in Washington two months ago as to the best working relationship between the two-tier gold system and the distribution of newly mined gold.

The world has made major headway in the past decade or so in learning how to supplement owned monetary reserves with judicious use of credit to absorb payments imbalances that might otherwise have very damaging effects. First and foremost, the International Monetary Fund has grown in strength and influence, with its larger quotas and its borrowing arrangements placing it in an ever-better position to deal with relatively persistent payments swings. I would assume that both quotas and borrowing arrangements may be expanded further to meet developing needs over the coming years. Mr. Schweitzer discussed one interesting possibility at the recent Washington meeting, i.e., greater use of borrowing arrangements with individual countries to meet special needs for particular currencies.

Turning to the Federal Reserve System, I think we can look with justifiable pride on the development of the swap network, which started on a very modest scale in 1962 and has grown to its present aggregate of over $10 billion. In recent years these swap facilities have provided an invaluable mechanism to absorb the initial shock of unusually heavy movements of funds across the exchanges, thus permitting gold to play a much less active role in the settlement of temporary imbalances. Over the past seven years, credits extended under the swap network have amounted to more than $15 billion. Both the Federal Reserve and our partners in this network have constantly stressed the temporary nature of these facilities. As recently as last July, all Federal Reserve borrowings under the swap lines had been fully repaid, leaving the entire facilities available on a standby basis. I should like to take this occasion to pay tribute to the splendid spirit of understanding and cooperation among central bankers that has characterized this swap development from the outset.

As we look ahead, there is ample ground for optimism on the outlook for world trade and investment, provided the major countries, including the United States, can nurture this spirit of cooperation and keep in check the ever-present forces of short-sighted nationalism. In our arrangements with other nations there must always be some willingness to compromise on what may seem at first glance to be our own best interest, in order to produce maximum benefits for the international trading and financial community as a whole. If we are to avoid resort to special treatment or protection, we must follow general fiscal and monetary policies that enable business to be vigorously competitive in markets at home and abroad. In contrast, a protective shield would, in time, leave our business firms too flabby to venture forth into the world. As I have argued throughout these remarks, our domestic and our international goals require the same policies.

No group can see the need or be more influential in pressing for the best solutions than you gentlemen who are gathered here today. I urge your wholehearted cooperation in working toward our common goals.