Recent Developments in the Defense of the Dollar*

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Although the tragic death of President Kennedy has darkened our thoughts for the past two weeks, we have had to continue to grapple with those problems and duties that are still our concern. One of the matters that he saw clearly as a primary concern to the nation is our balance of payments and the maintenance of unchallenged confidence in the dollar as a keystone of the international financial structure. In discussing our balance of payments in this distinguished company, I think I can take for granted that we are all generally familiar with the essential facts, which have been worked over ad nauseam in the course of the past five years. This afternoon I would like to philosophize on the role that monetary policy can be

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expected to play and in fact has played in approaching a solution. In a way this is a good moment to take stock on these matters. The third-quarter figures of course show a tremendous improvement over the second quarter—yet, if carefully examined, they also indicate that the hard core of our deficit still remains to be dealt with. The third-quarter deficit, an annual rate of around $1½ billion, compared with a very disturbing $5 billion rate in the second quarter. A part of that excellent gain reflected certain special and nonrecurring items, however, and it remains to be seen whether we are continuing to do as well. Current indications are that our goal of payments equilibrium is still not in our grasp, and I hope that euphoria over the third-quarter achievement will not give any American the idea that we can afford to relax our efforts in this area.

Ever since our payments problem emerged in 1958, or at least since it became a recognized problem a year or so later, there has been no doubt that we have had the power to cure it. The difficulty has lain in selecting a cure that would not jeopardize either our own economy or the gradual development of a world economy and payments system embodying maximum freedom both of private trade and of private investment. In the decade and a half after World War II the United States strove mightily, along with some of our principal Allies and former enemies, to build this kind of world economy. High standards were set which none of us could really wish to reject or even to weaken. And it is against these standards that any program to restore balance in international payments should be measured.

Recently, I have become concerned over what I take to be an increasingly nationalistic approach all over the world to foreign trade and investment problems, instead of an approach in keeping with these broad postwar objectives. I say this even though we clearly enjoy closer international cooperation than ever before in the field of technical currency defenses, such as the Federal Reserve's swap arrangements, the Treasury's foreign currency borrowing, more effective use of the International Monetary Fund, and the cooperative approach to the problems of the London gold market.

Let us consider our own approach to the problem. Some items in our payments could safely be attacked through very specific measures without endangering overriding principles. For example, net military outlays abroad could be cut gradually but substantially as our Allies have become better able to share the mutual defense burden. The same is true of our foreign economic aid program. Furthermore, tying of aid could be pursued without doing too much violence to our general goal of freer trade, since we were dealing with a special Government spending program outside the normal channels of private trade. But it was clear at the outset that more generalized and impersonal Government policies would have to be used if our over-all balance-of-payments program was to have enough impact on private transactions without supplanting our longer run goals. I have in mind here fiscal and monetary policy, and also what might be called "wage-price" or "incomes" policy. First, to touch briefly on this third area of policy, which might be described as the use of Government influence to help prevent cost increases that could do severe damage to our trade balance, this is a new and experimental field in the United States and accordingly there is a lack of tried and effective instruments to be used. There is also the ever-present risk that measures may become too specific and encroach unduly on the private decision-making processes of business management and of labor. Nevertheless, we have seen interesting progress in this field.

With respect to fiscal policy, I must confess to a feeling of keen disappointment with the showing of the past two years. During all this time competent observers have repeatedly stressed the promising possibilities in a better "mix" of fiscal and monetary policy. A tax cut, by reducing an unduly heavy burden on businesses and individuals, could strengthen incentives and stimulate business activity. The consequent growth of credit demand and of pressure toward firmer interest rates, as well as the improved investment opportunities in this country, would presumably have a significant effect on net capital outflows. At the same time the burden on monetary policy of stimulating domestic expansion would have been reduced. In my judgment this is a logical line of argument and a desirable policy move. But some two years after this program was proposed, and despite a wide measure of support from most sectors of the economy, taxes have not yet been cut. For those who had hopes that fiscal policy might gradually become a more flexible instrument offering interesting possibilities for better meshing with monetary policy, the experience has been most disillusioning; and we find ourselves thrown back on the necessity of relying heavily—too heavily in fact—on monetary policy, which remains by far the most flexible and adaptable means for wielding a variable and generalized Governmental influence on the course of economic events.

In a broad sense monetary policy may be considered to cover Treasury debt management as well as Federal Reserve policy. During the past few years balance-of-payments considerations have played an important part in both these areas. The Federal Reserve has tried to encourage a firm short-term interest rate structure while still aiding business expansion by accommodating a very substantial growth of bank credit. This growth is still continuing. Debt management has contributed significantly to firm short-term rates by a strategic placing and timing of new issues in the short-term area, while achieving a desirable lengthening of the national debt through the imaginative use of advance refunding techniques.

As for monetary policy, even though detailed balance-of-payments data are not yet available for the third quarter, it seems highly probable that the rise in short-term market interest rates since the July discount rate increase and the accompanying increase in Regulation Q ceilings on time deposit interest rates has been a major cause of the recent shrinkage in the payments deficit. So far, so good. It would be rash, however, to conclude that the heavy net outflow of short-term capital has been eliminated and that we are in more or less comfortable equilibrium with the rest of the world. I think too much attention tends to be directed at the so-called "covered" spreads between rates on United States three-month Treasury bills and rates on comparable investments in the United Kingdom or Canada. In the first place, there are countless other channels for short-term capital to flow out of the country—bank loans, placements of deposits in the so-called Euro-dollar market, acceptance financing, purchase of foreign finance paper, to mention only a few. Uncovered spreads may be of more practical influence than covered spreads in some areas, and in many instances uncovered spreads still favor foreign markets. Secondly, we must bear in mind that our persistent balance-of-payments deficit has been reflected in sizable surpluses built up by the European Continent, rather than by the United Kingdom or Canada. To some extent, sterling and the Canadian dollar may be considered parts of a bloc of currencies, including the United States dollar, that have shared some degree of vulnerability as against the major Continental currencies.

At this point the question may well be raised whether, despite the rise in United States short-term rates, credit has not remained so freely available that more dollars have been lent abroad than our payments deficit would warrant. Certainly the shifting of policy toward somewhat lessened ease has had some beneficial effect in this area, but I find a good many bankers who believe that their readiness to lend money to good customers, either here or abroad, has been little affected to date. Beyond this, we may also ask whether monetary policy and debt management might have done more for the balance of payments if domestic considerations had left us free to encourage an upward tendency in long-term, as well as short-term, rates. Granted that long rates are always determined primarily by the underlying forces of savings and investment demand, there is still considerable room for influence by Federal Reserve or Treasury action. It has been pointed out many times that comparative rates are only one factor, and perhaps a relatively minor one, affecting foreign long-term borrowing in this country, because of our large and highly organized capital market which permits transactions on a scale that would be impossible in any other country. This does not mean, however, that comparative rates are of no consequence.

A serious complicating factor has been introduced into this picture by the resurgence of strong inflationary tendencies on the European Continent in the past year. In a number of countries these tendencies have been strong enough to force rather severe Government counteraction, including restrictive action in the credit area. The French discount rate increase in November was a case in point. For a long time now the European authorities have realized that credit moves of this kind involve a risk not only of damaging the United States efforts toward payments equilibrium, but also perhaps of being self-defeating if they serve to attract funds from abroad which would merely fan the inflationary flames. Hence, the major European countries have been most cautious in taking such steps and have tried to accompany them with technical measures designed to check the inflow of foreign funds—but it has long been apparent that, if the domestic inflationary problems should become acute enough, the authorities would feel forced to act, regardless of the consequences to the United States. Any acceleration of this trend in Europe toward higher interest rates would of course pose just that much more serious a problem for United States monetary policy and could conceivably call for defensive countermoves on our part. I would like to point out again, however, that recent European rate increases have been rooted in internal factors in those countries rather than a response to higher rates here.

Let's return to the domestic scene and see how the mild lessening of monetary ease of the last year or so has affected the domestic credit structure and the domestic economy. The most striking aspect is the almost continuous steep growth of total bank credit, and of total liquid assets of the nonbank public. These rates of growth have been very little affected so far by the mild policy changes to which I have alluded. Furthermore, bank credit and liquid assets have risen faster than gross national product and are now higher in relation to GNP than at the trough of the recession in early 1961. This contrasts sharply with the experience in earlier postwar expansion periods, when these ratios tended to decline. They suggest that ample credit has been provided for the economy and that there is no validity to the contention that monetary policy has been "restricting" domestic growth. Actually, the rate of increase in real GNP since early 1961 has been more than 5 per cent per annum—a very sizable rate of gain, and one comparing favorably both with earlier periods in this country and with recent gains abroad. Furthermore, it has been achieved with a much more modest change in the price level than in previous years.

In my judgment, the very real gains in over-all per capita output in the last few years deserve as much attention as the stubborn problem of unemployment, which continues to move in the 5 to 6 per cent range. We pay too little attention to the detailed composition of aggregate unemployment, and we know far too little about the extent of unfilled job vacancies. It seems significant to me, for example, that unemployment among married men has declined rather steadily in the past two and a half years, dipping below 3 per cent in September. All of us agree that it is highly desirable to reduce unemployment to a frictional level, although I am not sure that we know how to translate this level into statistical terms. I suspect, however, that specific measures in the direction of improved training and greater labor mobility are a most promising avenue toward reducing unemployment. Certainly, many jobs can be found for people once they acquire the proper training or move to localities where jobs are available. In tackling our unemployment problem through measures aimed at a general increase in overall demand, we should be mindful of the fact that at a certain point an intensification of demand may begin to jeopardize the remarkable record of price stability that the economy has enjoyed now for about five years. An atmosphere of very intensive demand could make it much harder to maintain the balance between wage increases and productivity gains that has characterized the last few years and that deserves much of the credit for stable prices. The monetary authorities must always be alert to signs of serious bottlenecks in the productive process or of excessive wage demands that could bring renewed cost and price pressures, just as we are also mindful of the need to foster real growth and expanding employment opportunities.

There is another reason for taking a careful look at the recent rates of growth in credit and liquidity. With industry tending to generate savings big enough to take care of a large share of investment requirements, there has been a tendency for credit standards to be lowered and for ample credit to find its way into speculative channels, as, for example, certain types of real estate, commodity, and securities transactions. To some extent, this is characteristic of any period of business expansion; and I don't want to convey the impression that I see evidence of widespread abuse of credit. I do, however, believe that this kind of consideration suggests the need for a careful look at the rate of credit expansion from here on.

To sum up, I feel that monetary policy has given a fairly good account of itself, granted the absence of more effective coordination of fiscal policy. I believe we have been of some assistance in the balance-of-payments area while maintaining an appropriately helpful attitude toward the domestic economy. But as I look ahead, I see little likelihood that our problems will be much easier than they have been in the recent past. Nevertheless, I am optimistic on the possibility of our finding a sensible approach to our monetary problems, as I believe we have up to this time. I can only hope for a broader public understanding of our role and of the practical difficulties confronting us.

Now for just a word on the tortured subject of international liquidity, which seems to exercise a peculiar fascination on the minds of so many of our economists and journalists. Several points seem especially worth making at a time when both the "Group of Ten" headed by Under Secretary Roosa and the International Monetary Fund have embarked on studies of longer range liquidity needs. In the first place, there is very general agreement that there is no shortage of international liquidity at the moment—in fact a number of countries may be suffering from some overabundance. Second, it seems premature to do too much worrying about the consequences for world liquidity when the United States ceases to run a deficit. Our major worry is the more urgent problem of eliminating the deficit. Third, no brilliant scheme for some new international financial mechanism can relieve us of the pressing obligation to solve our payments deficit problem. The greatest weakness of nearly all such schemes lies in their tendency to diminish, for everybody, disciplines and incentives toward maintaining payments equilibrium. Fourth, international liquidity is not a new subject that is only now receiving the attention it deserves from the Treasuries and monetary authorities of the world. On the contrary, it has been very much in the forefront of discussion for several years now at the monthly meetings of central bankers at Basle, the Paris meetings of various OECD committees, and at the International Monetary Fund. Not only has there been discussion of the subject, but a great deal has been done to add to international liquidity through the arranging of large credit facilities, involving the Federal Reserve and Treasury along with counterparts in other countries and the IMF, that can be quickly mobilized to cover sudden heavy swings in the various countries' balance of payments. Fifth, the most promising avenue for adding further to international liquidity would appear to lie in this area of credit extension both by the Fund and on a bilateral basis. It seems to me probable, and certainly desirable, that the findings of the study groups now working on the liquidity problem will favor progress in this direction rather than in the direction of grandiose new mechanisms that would tend to perpetuate imbalances. Central bankers are sometimes accused of excessive conservatism and lack of imagination. However that may be, I am quite willing to stand on the record of the last few years, which has shown a remarkable advance in cooperative international credit facilities—and I am sure we can look forward with confidence to important future advances along the same lines.

In this connection, I'd like to digress just a moment to say a word about the most recent demonstration of the effectiveness of these credit facilities and the speed with which they can be mobilized. I refer, of course, to the tragic events of Friday afternoon, November 22, when the world was rocked by the news of the incredible shooting of President Kennedy. The shock waves of the first report from Dallas had immediate repercussions in both the securities and the exchange markets and, in the case of the latter, there was a clear risk that panic selling of dollars might suddenly develop. To forestall any such reaction, the Federal Reserve Bank of New York, acting on behalf of the Federal Reserve System, immediately moved into the market with sizable offerings of five major foreign currencies. The ability of the System to react so quickly and so decisively in exerting this stabilizing influence on the stunned exchange markets depended mainly on the existence of a tried and tested network of reciprocal credit arrangements with the major foreign central banks of the world. The market knew that our offers to sell foreign exchange were backed under these so-called swap facilities by resources—available at a moment's notice—amounting to nearly $2 billion, in addition to whatever balances of foreign currencies we had on hand. Needless to say, we were very quickly in contact with our colleagues in Canada and in Europe—even though it was past the closing hour in European markets—to work out a coordinated approach for official intervention in the major exchange markets during succeeding days. In the event, the markets' awareness of the vast resources available to the authorities here and abroad, and the knowledge of their ability and determination to use these resources in a concerted and effective fashion, made sizable intervention unnecessary.

The ability of the authorities to deal successfully with situations—in this case the most sudden and unforeseeable situation imaginable—that in the past might well have led to exchange market crises demonstrates, it seems to me, the role that mutual credit facilities have played and can continue to play in providing international liquidity in a meaningful sense.

Just one final word about the dollar and its role in the world. The dollar's position as the leading reserve currency, as one of the major instruments for the conduct of international trade and investment, and as the official yardstick for all other currencies in the International Monetary Fund, did not result from any deliberate or official campaign to urge other countries to give it such recognition. These developments resulted from such basic facts as the enormous economic strength of the United States, virtually complete freedom for foreigners and Americans to use dollars for any purpose they liked, and our readiness at all times to convert officially held foreign dollars into gold at a fixed price of $35 per ounce. If foreign countries continue to hold dollars as a major part of their reserves, as I believe they will, it will not be because of any effort on our part to persuade them that this would be a nice thing to do, nor will it be because of any technical innovations related to the manner of holding reserves. The reason will remain what it is now, a basic belief in the strength of the United States economy and in the existence of the will on the part of the American authorities and the American public to maintain unquestioned the dollar's integrity. For my part, I am confident that we shall continue to merit this belief.