Monetary Policy and a Liberal International Economy*

By ALFRED HAYES
President, Federal Reserve Bank of New York

It is indeed a privilege and pleasure for me to be with you today. With our nation's attention increasingly turned to contacts with other nations, I particularly welcome an opportunity to comment on the underlying philosophy behind our commercial and financial relationships, and on the important role of monetary policy in helping to achieve our economic goals. It is all too easy in a world where each day's news may bring fresh problems, and needs for adaptations of policy, to lose sight of the broad guidelines that we would like to follow, and it is to these objectives that I would like to direct your attention today.

I think it would be generally agreed that, by and large, the international economic ideals of the Free World since World War II could be regarded as "liberal" in the best sense of the term. Under the leadership of the United States and the other major industrialized nations, there has been a more or less consistent pursuit of greater freedom of international trade and international investment. The autarkic and restrictive record of the thirties convinced most thoughtful people that the road to world economic progress lay in the opposite direction; and even before the end of World War II the foundations for a "liberal" economy were being built through such farsighted innovations as GATT, the International Monetary Fund, and the World Bank.

Two decades have passed since these beginnings, and as we look back on the vast growth of economic well-being in the Free World during this period we can hardly fail to feel much satisfaction. The record among individual countries has varied widely, both in the extent of economic growth and in the methods used to achieve it; thus, with respect to the domestic economies both the proponents of free enterprise and the backers of "dirigisme" can point to considerable success. But as far as international economic relationships are concerned, the postwar development has been unequivocally in the direction of greater freedom and the abandonment of controls inherited from the war and prewar years. At the same time, world trade and international investment flows have grown enormously —at a pace far exceeding that of most individual domestic economies. This growth has been most heartening, and I am confident that there is ample opportunity for further progress.

The financial background for these remarkable economic gains is fairly clear. Gold has continued its centuries-old role of providing a highly convenient basis for monetary values; and the dollar, tied firmly to gold at the fixed price of $35 per ounce, has been a most useful partner for gold, together with sterling, in providing monetary reserves needed to support the far-flung structure of world trade and payments. As I have pointed out on other occasions, the key role of the dollar as a reserve currency is not something deliberately sought or created. Rather it has been the inevitable result of the American economy's strength, and the usefulness of the dollar as a medium of international payment and as a standard against which other countries could measure their own currencies.

When we examine the nature of our progress toward greater freedom of world trade and payments, we must admit that it is not a matter of smooth and uninterrupted gains. Belief in such continuous progress could lead only to disillusionment. If we are to maintain a levelheaded view and if we are to retain our faith in ultimate progress, we must recognize that forward steps are interspersed with backward steps and that at any one time there are conflicting forces and crosscurrents at work. Often the great advances in themselves create problems which may cause remedies to be sought in a restrictive direction—but what

* An address before the eighth International Forex Congress at the United Nations, New York City. October 3, 1964.

counts is the net result of all these forces, which we hope will continue to be expansion rather than the reverse.

The achievement of currency convertibility some six years ago was an example of a great advance leading to some problems and some restrictive countermeasures. Convertibility made possible, for the first time in many years, large-scale movements of short-term funds from country to country; and these movements could, and occasionally did, reach a size great enough to threaten the stability of one or more major currencies. Even the dollar was not immune to such threats. The flows of funds also frequently interfered with the current domestic objectives of the monetary authorities, and this at a time when monetary policy was taking on greater importance in country after country. In the classical economic model, the answer to excessive international flows lay in monetary countermeasures; but classical economics reckoned without the kind of conflict between domestic and international objectives that has become so active and sharp in these post-convertibility years in both the United States and Europe. Hence an urgent need arose for reviewing the techniques of monetary policy to see whether both domestic and international needs could be served at once; and, as the possibilities along these lines were necessarily limited, there was a new impetus to finding an appropriate "mix" of monetary and other general governmental financial policies, notably fiscal policy. But in addition there was some recourse to specific restrictions on capital movements to help to keep them within bounds.

The other avenue of response to the problems emerging in the wake of convertibility took the form of a tremendously improved and intensified system of cooperative measures entered into by central banks and treasuries, either bilaterally or on a collective basis. The history of this cooperation has been written so fully that I need not go into any detail—least of all before this sophisticated audience—but it did effectively remove the threat that short-term capital movements might unleash speculative forces sufficiently strong to undermine some of the major currencies. Fortunately, the monetary authorities most active in constructing these lines of defense never lost sight of the fact that cooperative extension of credit does not *solve* a payments imbalance but merely provides time in which orderly forces can be marshaled to achieve a basic remedy. I should add, at a time when international liquidity is receiving so much attention, that in the Federal Reserve Bank of New York we have consistently felt that the most promising approach to adequate liquidity in the future lies in the further development of international credit facilities, both short and medium term and both bilateral and multilateral, along the lines clearly marked out in the last few years. The proposed 25 per cent increase in IMF quotas, for example, is a useful and appropriate step in keeping up with the growing volume of world trade and payments, and expanding needs for liquidity.

So far I have been speaking of problems that would have arisen even in a postwar world characterized by basic equilibrium of international payments. But in fact the problem has been greatly complicated by the emergence around 1958 of a large United States deficit and a similarly large—and related—European surplus. The reasons for this disequilibrium are hard to disentangle in any precise fashion—but I would number among the primary causes: (1) the remarkably vigorous recovery and advance of the European economy, partly as a result of massive American aid; (2) the unavoidable assumption of major responsibility by the United States for military leadership in the postwar world, plus major responsibility for assistance to the less developed countries; and (3) insufficient attention in the United States of the 1950's to the importance of keeping United States costs and prices highly competitive in an increasingly competitive world. Indeed there was a sublime overconfidence at that time on the part of Americans in the dollar's immunity to balance-of-payments problems. And we were not alone in our illusions; all of you can remember the days when the "intractable dollar gap" was believed in even more fervently abroad than in our own country.

Perhaps we should include among basic causes of the disequilibrium the avid interest in foreign travel of an affluent American society, the quite understandable wish of American industry to preserve and extend its activities abroad through direct investment, and the natural attractions of the huge American capital market, fed by a vast flow of savings, to all the potential borrowers in a rapidly growing world economy. Movements of short-term capital should perhaps not be regarded in quite the same light as other segments of our deficit, but it must be remembered that any sizable outflows of short-term capital, such as we have had during recent years, are a continuing serious problem when these outflows are superimposed on an already large underlying deficit.

Efforts to reduce the United States payments deficit have made notable progress in some directions, but we still have a considerable way to go before we reach equilibrium. There is no doubt that the payments problem is still serious—requiring intensive remedial efforts on the part of the United States Government and American citizens in general.

This is not the time nor place to go into detail on the many-pronged attack on the United States balance-of-payments deficit that has been undertaken and intensified in the last few years. Of primary importance has been the achievement of stable costs and prices, in contrast to the marked inflation of costs and prices in most European countries. It would be my hope that over the next few years we could not only maintain but even improve on this record of stability by achieving some reduction in costs and prices. Indeed, in some industries where productivity gains have outpaced wage increases there have actually been unit cost reductions. We have yet to see the follow-up in the form of price cuts on any significant scale, but I can think of no more potent method of working toward basic international equilibrium, while at the same time providing our own consumers directly with some of the fruits of over-all productivity gains. Unfortunately, recent wage settlements warn us not to generate overoptimism on this score, however, and we shall have to work harder than ever to maintain the record of stability of the last few years.

The Government has made a good start in attacking the balance-of-payments deficit through a reduction of net military outlays abroad. Much has also been done through the tying of the largest part of our economic aid, but it should be recognized that tying is no final answer since aid funds may merely be substituted for other sources of exchange in many instances. With regard to the aid question, I feel that there is a valid case for greater sharing of these burdens by European countries enjoying a surplus in their international payments—for even if per capita wealth is the most important criterion for burden-sharing, this is no reason to ignore the balance-of-payments aspects as an additional basis for sharing, just as the transfer problem loomed very large in our own early postwar assistance programs. Moreover, there are weighty reasons for a better sharing of aid, which transcend balance-of-payments considerations altogether—in terms of broadening the base of Free World cooperation.

The other two principal lines of attack on the payments problem have been (1) monetary policy (together with some considerable assistance from debt management and fiscal policy) and (2) direct measures to influence the volume of long-term capital outflows. Whether monetary policy has done its part adequately is, of course, a question to which there is no agreed answer. There are those who tend to attribute our payments deficit almost entirely to an excessive creation of credit and money, but there are also those who argue that preoccupation with our international deficit has produced an insufficiently easy credit policy, not responsive enough to the needs of the domestic economy.

I would have to reject both of these extremes. I would not be so immodest as to contend that our policy has been exactly right, but I do believe that through innovation and development of varied techniques we have been able to contribute a good bit to payments equilibrium, largely by reducing incentives to short-term capital outflows. Doubtless we could have done more had it not been necessary at the same time to encourage greater use of the economy's unused resources. And this would be particularly true of our role with respect to longer term capital flows, for we have been rightly concerned about too much upward pressure developing on longer term interest rates—given the great importance of the long-term capital market to the well-being of domestic business. I should add, however, that the possibilities are not unlimited for cushioning long-term rates against the impact of developments in the short-term area.

Notwithstanding these constraints, I think there can be no question that monetary policy has made a valuable contribution to the economic expansion of the past forty-odd months. And that contribution is continuing; bank reserves, bank credit, and the money supply have continued to grow in 1964 at about the same substantial pace as in 1963. I can see no evidence that the economy has been short of required money and credit. On the contrary, the question could be raised whether continued increases on the scale of recent years might not be a little too generous even from a domestic point of view. On the international side, the fact that interest rates have been consistently lower here than in most major foreign countries, the indications of substantial placements abroad of United States investment funds, the readiness of banks to lend abroad in large volume and for a variety of purposes, and the continuing outflow of short-term capital—all suggest that a lesser degree of monetary ease can at any time, if needed, make a significant contribution to the balance of payments.

The conflict of domestic and international goals is, as I have said before, more apparent in the short run than over an extended period, for in the long run a strong economy and a balanced international position are surely complementary goals. But this does not prevent a very real conflict and a need for choice at specific times and under certain circumstances; and such circumstances have been all too frequent in recent years, not only in the United States but also in Europe. Two special factors have made and will continue to make the problem particularly hard to deal with in our own country: (1) international trade and payments form a much smaller share of our total national economic activity than in other major industrial nations, so that many Americans have trouble conceiving of any international factor as even approaching the importance of strictly domestic economic considerations; (2) but at the same time the dollar's role as the leading world currency and, more generally, this country's role in world affairs require us to give particular weight to international factors in our policy formulation.

While the conflict of domestic and international aspects has been especially troublesome in the United States, it has appeared in so many major countries in recent years that there has been a widespread effort to find ways of relieving monetary policy from a part of its domestic burden in order to free it for a role in which it could be obviously highly efficient and useful—namely, in influencing international capital flows. Hence the emphasis both here and abroad on finding a better "mix" of monetary policy and other generalized and "impersonal" national economic policies, notably fiscal policy. Unfortunately this search has been up against a serious handicap—the fact that fiscal policy, although potentially more powerful than monetary policy as a means of affecting the domestic economy, at least in this country, is still sadly lacking in the flexibility needed to make it an instrument of comparable usefulness. We have only to recall the period of some two and a half years between the initial moves toward a major personal and corporate income tax cut in this country, and the enactment of the law early this year, to feel some sense of frustration with the flexibility of fiscal policy. More than once, and in more than one country, I have heard it said that monetary policy would have to take on added burdens at a particular time because of the political difficulty of working effectively through fiscal action.

I would hope, however, that there would be no letup in the efforts to find a proper way in each country of making fiscal policy more flexible and thereby more usable as a means of achieving over-all domestic goals. One important reason why I strongly favored the last tax reduction was the belief that it would free monetary policy to give more attention to our international responsibilities. That argument is as valid today as it was two or three years ago. There is evidence that the tax cut is already achieving its objective. With domestic business going ahead at a very healthy pace—in part doubtless because of the tax cut—the Federal Reserve System is clearly in a better position to use its powers, as needed, in defense of the dollar's international strength.

With respect to the remaining avenue of attack on our payments deficit, i.e., direct influence on capital flows through selective measures, we are in the midst of an experiment with a novel variant of such measures, the interest equalization tax. With the tax so recently enacted, it is perhaps too early to assess its full effects, although it has obviously had an important impact on the volume of new foreign issues in this market. In any case, it is essential that by the end of 1965, when the tax is scheduled to expire, we shall have dealt effectively with our deficit by means which are conducive to expansion of world trade and investment.

Fundamentally we must recognize that recourse to the United States market by borrowers all over the world is a perfectly natural response to heavy capital needs and limited savings abroad, combined with a great abundance of savings in this country. Capital flows reflecting such fundamental economic factors should not be cut too drastically just because we have a payments deficit, any more than foreign aid participation should be decided mainly on balance-of-payments grounds. Of course, there is the problem of financing such capital outflows, but it is part of the general problem of our payments deficit and should not be mistaken for a specialized sectoral problem that must be solved within the confines of this one sector.

Perhaps the greatest risk of all in selective measures for influencing capital flows is the danger that they may lull us into a comfortable feeling that monetary policy can now relax and focus all its attention on domestic affairs. In my judgment nothing could be further from the truth. Regardless of whether selective controls are being used, monetary policy cannot escape its duties as a partner, and a powerful one, in our concerted effort on many fronts to rid ourselves of the payments deficit that has persisted for seven years, imposing such a burden on our energies and our efforts to promote sound economic growth. Maintenance of stable costs and prices is probably of first importance in this concerted effort; and monetary policy must be prepared to act promptly and effectively, in the light of unfolding events, both to help preserve this vital cost-price stability and to bring a better equilibrium in international capital flows. Monetary policy cannot do this job singlehanded, but I believe that the Federal Reserve System is, as it must be, ready to do its full part to preserve the dollar as a source of economic strength at home and as the financial keystone for the liberal international economy which we all seek.