Priorities in International Finance*

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Ever since my early days as a commercial banker and investment man, I have thought of "The Money Marketeers" as one of the most sophisticated groups of financial experts to be found anywhere. I am honored to have been given this opportunity to speak to you tonight, particularly as this enables me in a sense to pay tribute to my old friend, Marcus Nadler, for whom all of us felt such respect and affection, and whose death meant such a very real loss to the New York financial community and the whole financial world.

The name of your organization might suggest that I should talk tonight about the money market. But surely there are few aspects of that market on which you are not more expert than I am, and those few involve questions of official policy on which, as you can readily understand, I would not be able to comment very freely in any case. Furthermore, it occurs to me that, whereas international financial matters have been receiving much attention in our press and elsewhere in recent months, this is an area where there is great confusion about what is at stake and what practicable courses are open to us. Please don't jump to the conclusion that I think myself capable of drawing a clear blueprint of future international financial arrangements. All I would like to do tonight is to offer a few observations on a few key issues.

Perhaps a reasonable starting point is the much-tortured subject of the United States balance of payments—for the disposition of our deficit is central to almost all the major issues. While international payments equilibrium has been a recognized goal of official United States policy for five or six years, it has not been the only goal of policy, and the attainment of the balance of payments goal has indeed been elusive. There are few who would deny that our large-scale deficits have continued much too long. Under these circumstances, I found most heartening the pronouncements of the highest American authorities, on the occasion of the recent Bank-Fund meetings in Washington, that whatever measures are needed to achieve balance will be taken. I have never doubted our country's ability to balance its accounts if we were sufficiently determined to do so—and I feel sure that the continuing high degree of foreign confidence in the dollar reflects a similar conviction. But having said this, I hasten to add that the road will not be easy.

Of course one of the most important things we must do is to continue the rather remarkable stability of costs and prices achieved in the past five or six years. Without this stability, notwithstanding the considerable inflation in the principal European countries, we would be in a really parlous state today. And we should bear in mind that continuing inflation in Europe is unlikely, for the Europeans are understandably bending every effort to bring it under control. Since keeping costs and prices stable is indeed vital, those who feel a natural repugnance toward Government intervention in our free market economy would do well to consider the contribution of the Administration's wage-price guideposts to our recent successes and to ponder unwanted alternatives.

Despite my emphasis on this need for cost and price stability, I would add that our balance of payments experience over the last five years or so makes one thing very clear: No attack on the problem will be effective unless it is persistent, and unless it deals in concerted fashion with all the major elements in our international accounts rather than with one or two alone. Time and again we have made pronounced progress in one sector,

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only to find new weaknesses developing elsewhere. Our trade balance has improved, but our capital outflows have burgeoned; or our military and aid payments have been reduced, but our net tourist outlays have reached new highs; or foreign bank lending has been sharply curtailed, but direct investment has risen to a new record. This year we have had the satisfaction of seeing an overall surplus reported for the second quarter, the first quarterly surplus in eight years. But, as Secretary Fowler has stressed so often, there were special factors acting in our favor in this period, and for the year as a whole another deficit is expected, although undoubtedly smaller than that of 1964, or than the average of recent years.

The point of all this is that we can't afford to let up for a moment in our efforts to eliminate the deficit, nor can we assume that we can deliver on our assurances of equilibrium without exerting greater effort than we have done to date. But obviously the effort must be made in the most careful way, keeping in mind at all times both the importance of domestic economic needs and the desirability of continuing to work toward a world of freer rather than more restricted trade and investment flows.

To borrow at this point a favorite term of the international economists, what we are dealing with here is the "adjustment process." We cannot assume that this "process" is automatic or painless. The crux of the problem is this: How can we adjust our policies, wisely and with sufficient speed, to eliminate our deficit? Of course, the fact that it is largely up to us to take corrective actions does not absolve the surplus countries of responsibility. Quite the contrary. There is much they could be doing in the way of enlarged contributions to economic aid and joint defense arrangements, development of better capital markets, reduced restrictions on borrowing by foreigners, reduced barriers to imports, etc. The surplus countries could also most usefully put more emphasis on firmer fiscal policy when they face the need to restrain domestic inflationary pressures, rather than relying too heavily on monetary policy. Monetary restraint too often increases their surpluses by pulling in additional short- and long-term funds from abroad. But, granted all this, we can profitably devote most of our thinking and energy to the possibilities that lie within our own hands; we can't afford to rely on anyone else but ourselves for the solution.

Our efforts in the last few years to solve our payments problem have brought to a head a basic underlying question of philosophical approach. As we approached the problem, we had to ask ourselves to what extent should we use specific measures designed to place obstacles in the way of international movements of trade and investment, and to what extent should we use more impersonal generalized policies which may—in fact, must—have important domestic as well as international repercussions? Fortunately, we have eschewed outright interference with foreign trade, for it is widely recognized that restrictions in this area, which so clearly hamper the efficient allocation of resources, could start a chain of counterrestrictions with disastrous consequences throughout the trading world. However, capital movements are something else again. Here there is even a sort of international sanction for setting up obstacles, as the Articles of Agreement of the International Monetary Fund specifically permit restrictions on capital flows. And certainly our European friends in recent years have often urged us to limit our capital outflows through specific measures, just as most of the major European countries themselves have done more or less consistently since World War II. In passing, I might add that their motives for urging limitations on our capital outlays have been strongly reinforced, on occasion, by nationalistic resentment of our heavy equity investments in European enterprises.

While we cannot overlook this general background of pressure for capital restrictions, let us not lose sight of what I would consider an even more important fact of the world's postwar development, namely, the yearning and effective striving for a world system with minimum restrictions on international payments. The whole philosophical background of such great postwar achievements as the Marshall Plan, NATO, EPU, OECD, etc., was one of building a wider, better integrated community of nations. In practice, it proved possible to dismantle a vast array of trade and exchange restrictions, some of the latter dealing with capital movements; and our own Government has frequently urged the principal European countries to relax their barriers to capital outflows. The advent of exchange convertibility at the end of 1958 was of enormous influence in enhancing confidence in European currencies and markets, and in stimulating a sharp rise in flows of capital between countries, especially short-term flows. With the emergence of this confidence and with the development of the Common Market, there was, of course, also a sharp growth in United States equity and direct investment on the Continent. This great increase in the mobility of capital funds of all kinds has compelled governments on both sides of the Atlantic to revert to various restraints on the flow of capital funds to or from their domestic markets. It is greatly to be hoped that these restraints will prove temporary.

Through the last few years of heavy United States deficits, the financial authorities of this country have engaged in more or less continuous soul-searching on the question to what extent we should advocate steps that were clearly backward steps in terms of this broad postwar sweep toward more liberal payment flows. I think it is accurate to say that both the interest equalization tax, in the summer of 1963, and the President's Voluntary Credit Restraint Program of last February were adopted reluctantly and only after it was concluded that general policies, including monetary policy, could not under the circumstances yield results fast enough to deal with the threat of a serious weakening of the dollar's international standing. There was no doubt in my mind last winter, for example, that some kind of voluntary restraint was essential for the defense of the dollar. Yet over all this span of time there were voices urging that monetary policy be given more of a chance to show what it could do.

In saying this, I don't want to minimize what monetary policy already has done, and is continuing to do, to help our payments problem. During the last business recession, for example, the extremes of monetary ease that had characterized earlier recessions were avoided. On a technical level a number of devices have been adopted to support short-term interest rates, including open market operations outside the bill area and the use of reserve requirement reductions as a means of supplying reserves without putting direct downward pressure on interest rates. Last, but not least, general monetary policy has itself made a contribution by gradually cutting back on the degree of monetary ease, particularly when the economy began to pick up steam after mid-1963 and moves toward a less easy policy were both feasible and desirable. To an important extent the recent strength of the domestic economy has reflected an easier fiscal policy. In such a context, monetary policy could, and in fact did, move toward reduced ease, while still providing a flow of bank credit that facilitated the gratifying expansion of the United States economy.

The Voluntary Credit Restraint Program as applied to the banks, which is of course a Federal Reserve responsibility, has been extremely successful in meeting its objectives, and I should like to acknowledge the splendid spirit in which the banks have cooperated to make the program work. And to me, because of its flexibility and adaptability, this voluntary approach to this type of problem has been preferable to legislative measures which often have too sweeping an effect and have a tendency to remain in force beyond the time they are essential. But I am also well aware what the Restraint Program has meant in the way of sacrifice of normal and profitable activities. A number of nonfinancial corporations have likewise taken on significant costs in pursuance of the related Commerce Department program.

The Voluntary Credit Restraint Program was always thought of as a temporary measure. Yet its very success points up the difficulties we shall face when we make the transition to a more permanent state of affairs. For we shall have to be reasonably sure that underlying forces affecting our international payments will rapidly assume the role of these special restrictions in achieving balance. To me this means that we should see some of the underlying corrective forces commencing to work even while the voluntary program is still operative. It thus is reassuring that the upsurge in domestic demand for bank loans may already be having some impact in this respect by making foreign loans less attractive. It is quite clear to me that the voluntary program must find continuing support from more general policy measures of benefit to our payments position. An additional reason for such support is the risk that the longer the voluntary program remains in force the less effective it may prove to be in the face of normal market pressures.

When I speak of more general policy measures to benefit our payments position, I would not want to be interpreted as losing sight of the requirements for domestic growth. I cannot help reverting to earlier developments during the current business upswing in which a change in policy mix facilitated an underlying readjustment. Easier fiscal policy, accompanied by a less easy monetary policy, provided during 1963 and 1964 a viable method by which underlying forces could be brought to work on a more permanent solution of our balance of payments problem.

We in this country have much work ahead of us in solving these problems of ours. While there is no reason why we cannot also devote considerable attention to the future shape of the international payments system, the priorities seem to me reasonably clear. However, let's take a quick look at the current status of the movement toward reform of the international financial system. In passing, I might point out that some of the more vociferous advocates of reform talk as if the present system were completely static. In fact, it has been changing rather remarkably in the last four or five years, both through the International Monetary Fund and with the addition of many new forms of useful cooperation among leading central banks and governments. The central bank swaps and other types of foreign exchange cooperation, in particular, have demonstrated their flexibility and adaptability to changing needs. The facilities available under the Federal Reserve swap network, which now stand at the not inconsiderable total of almost $3 billion, for example, have been swiftly expanded whenever such an expansion was indicated. The network can now provide routine financing in response to seasonal flows of funds or to divergent money market developments in different centers; it can equally mobilize huge resources to help beat off speculative attacks on one currency or another. Since its inception, the total activity under its facilities—drawings and repayments by both the Federal Reserve and by foreign central banks—has exceeded $5½ billion.

Most of these new developments have involved better means of providing international credit where and when it is needed, and in appropriate amounts. After all, the meaning of "international liquidity" is merely the aggregate of the monetary reserves, and the ready access to additional reserves, of all the world's national monetary authorities together. Thus credit plays as much of a part as owned reserves—and when we analyze the matter more closely, the line between credit and owned reserves other than gold is very thin indeed.

Another way of classifying forms of liquidity is to think of a whole spectrum from unconditional liquidity, i.e., liquidity that can be used by the country in question quite freely, without satisfying conditions or answering questions, through various degrees of "conditionality". For example, access to one of our swap lines is virtually automatic, whereas a large drawing on the International Monetary Fund beyond the gold tranche may require lengthy discussions, negotiations, and assurances of future performance by the borrowing country.

I am sure you are fully familiar with the principal lines of reasoning that have given rise to the widespread examination of possible new sources of liquidity. On the one hand, the surplus countries of Continental Europe have long felt that a way must be found to force the United States to stop running deficits which, it is said, have the effect of producing an unwanted and inflationary growth in Europe's monetary reserves and money supply. Because of the role of dollars in their reserves, and the fact that their central banks buy and sell dollars in order to stabilize their exchange rates in accordance with the rules of the Fund, they contend that the United States tends to obtain automatic financing of its deficit through additions to foreign holdings of dollars. In actual practice, the leading central banks of Europe have become increasingly reluctant to add to these holdings in the last five years and have worked actively with us in developing the various arrangements—Federal Reserve swaps, debt prepayments, foreign currency bonds, etc.—that have enabled them to avoid increasing their uncovered dollar holdings. They could, of course, always demand gold from the United States in exchange for their dollars but—with one notable exception—the European countries have refrained from pushing too hard in this direction for fear of unduly disturbing the whole international financial structure. They remain most anxious to see our deficit considerably reduced or eliminated and believe that future monetary arrangements should be set up so as to make this kind of large-scale deficit financing impossible.

As against this view, which essentially wishes to force greater discipline on the major deficit countries, there has been an opposite approach by those who, at the extreme, welcome new liquidity schemes as a means to escape discipline. Then there are a large number who, while not in this extreme camp, lean toward the view that the greatest problem over the coming years will be inadequate liquidity to support world economic growth.

Essentially there is no difference of opinion between European governments and the United States Government on the need for eliminating our deficit. As I indicated earlier, the statements of President Johnson and Secretary Fowler in Washington last month left no doubt on this score. But major differences of view around the world emerge on the question as to how much of a problem the elimination of this source of additional liquidity will create for the rest of the world, and how soon. At one extreme there are fears that we may face an imminent crisis of deflation and depression—at the other extreme the view of more than one European central bank that there will be no problem for a good many years, in view of the fact that we have been flooding the world with dollars for some time and that it should take quite a while before the resulting excess of liquidity is absorbed as the world economy grows. While I believe there is no likelihood of an imminent shortage of liquidity, I do believe that it is a sound idea to explore now what we ought to do should a shortage become perceptible—and this, as I understand it, is the essence of Secretary Fowler's initiative last summer regarding an international monetary conference.

In any case, regardless of the question of a possible liquidity shortage, I strongly believe our international financial system has to continue to evolve. As I have said, we have not stood still and we cannot afford to do so in the future but must continuously adapt existing arrangements to meet changing needs. This does not mean, however, that we can hope to find through new liquidity schemes a means to escape discipline. No monetary system, however ingenious, can be designed to permit continuing imbalances that are bound to flow from unsound policies. On the contrary, it seems to me that in the future a greater degree of discipline than we have had in the recent past is inevitable.

Last month's annual IMF meeting in Washington produced some measure of agreement on procedural steps for getting ahead with a study of how to meet liquidity needs. On the substantive questions, some of the speeches were notable for the frankness and clarity with which they propounded sharply differing views. And to a considerable extent these differences carried over into the procedural debate, with some of the major industrial countries, whose currencies would presumably be importantly involved in any new liquidity scheme, reluctant to see decisions taken by too large a group of countries—whereas the less developed countries, fearful that diminished world liquidity could damage their own expansion plans, were equally reluctant to see decisions taken anywhere except in the Fund itself, where all these less developed countries are represented. While I can readily understand their interest in adequate liquidity, I cannot but feel that comments from some of these countries have tended to confuse the issue of development finance with international liquidity. These issues involve distinct problems and they can be effectively tackled only through separate approaches.

As you know, the Ministers of the Ten instructed their Deputies to get on with the work of determining what basis of agreement can be reached on any needed changes in the monetary system, and at the same time urged that consultations proceed as to how these recommendations might best be brought up for review in a wider forum. It was noticeable and—it seems to me—quite appropriate, that the Fund spokesmen themselves made very clear the Fund's own special concern with the whole problem of international liquidity.

Without trying to go into detail on the many schemes that have been proposed for improving the international monetary system, let me merely point to a few principles that I think are worth keeping in mind:

(1) Granted that United States deficits certainly cannot continue to provide new reserves on a large scale as they have in the past, it does not follow that there will be a severe shortage of owned reserves within the next few years. For one thing, there is no fixed rule as to the need for reserves in relation to the total amount of world trade and other financial transactions. Transactions between countries are financed in national currencies, with the dollar and sterling playing key roles. It is only in settling net payment imbalances between countries that reserves come into play. It may well be that these imbalances may grow as the volume of world trade and payments increases. But there is always the hope that progress in developing flexible corrective policies will accelerate the adjustment process and thus reduce the size of the payments swings to be financed.

(2) I am impressed by the way in which credit extensions in recent years have provided very effectively for liquidity needs arising out of adverse payments swings. The experience with exchange crises in the United Kingdom, Canada, and Italy demonstrates dramatically that liquidity may be needed in very large amounts at a specific time and place, and such needs can be met only by the extension of credit, both bilaterally and through the International Monetary Fund. While we have made great progress with enlarged and improved credit facilities, we have by no means explored all the potentialities of this approach. Offhand, I would guess that in dealing with needed additional liquidity there is far more promise in a growth of international credit than in the creation of a synthetic international currency.

(3) Advocates of new international currency units have not yet fully acknowledged the political authority that would have to be vested in the international institution administering the creation of these units in order to avoid both excessive expansion and undue rigidity. Creation of such a currency, which would essentially involve the allocation of new purchasing power to recipient countries, without the obligation of repayment, obviously would not automatically provide the same discipline that credit arrangements impose upon deficit countries and, for that matter, also upon surplus countries extending the credits. Corresponding disciplines under a system embodying a synthetic currency would require a full-fledged international central bank, for which the world is not yet ready.

(4) It would seem to me unwise to look elsewhere than to the International Monetary Fund for major additions to international liquidity, although these might usefully be complemented by further expansion of other credit arrangements among governments and among central banks. The Fund has served us well as it has continued to evolve in the twenty years since Bretton Woods. Building onto it fits in with the evolutionary approach I have long favored. The latest quota increases now in process of ratification are a big step toward making it better able to cope with major disequilibria. Also, let us not forget that there is a great store of experience and expertise in the Fund which should continue to be brought to bear on these problems.

(5) More specifically, if it should be later concluded that some new form of reserve asset is required, even after taking account of the vast possibilities for improved credit facilities, the most logical starting point would appear to lie in the direction of developing the automaticity of drawings that now exists for each country's regular gold tranche and super-gold tranche in the Fund. As the Ossola Report has emphasized, these are already international reserve assets of the countries concerned. But there may be possible technical changes that would enhance their status for this purpose, as well as special measures that would enlarge their volume, and thus offer the hope of supplementing other forms of reserve assets.

(6) Above all, I think we should vigorously resist any effort to downgrade or replace the dollar as the principal reserve currency. It is noteworthy that apart from sterling, whose use as a reserve asset is confined largely to the sterling area, no other currency has presented itself as a candidate for the role. We should bear in mind that other major currencies lack many of the dollar's attributes. Only the United States sells gold freely to foreign monetary authorities against its own currency. As a practical matter, other currencies are convertible into each other only through the dollar. Money markets in other countries (with the notable exception of the United Kingdom) are so narrow that it would not be at all easy to find an adequate volume of instruments to earn an adequate return on reserves if they were accumulated in other currencies. Also, most countries resist the idea of placing foreign holders of their currency in a position to exercise any significant influence on their own financial markets and domestic economies by disposing of these holdings as they might see fit. Thus we would do well to recognize that the dollar is not just one of many more or less similar strong currencies. It is in fact unique, and our world of international finance is by its very nature asymmetrical.

(7) Despite the inadequacies of any composite reserve unit, the markets could interpret proposals for such units as involving a downgrading of the dollar. Thus, I find in most of the proposed new units the great risk of damage to the dollar as the key currency in the present system. I have yet to see any adequate assurance that the introduction of the proposed units would not lead, directly or indirectly, to increased pressure for conversion of dollars into gold, either after the scheme is put into practice or even while it is under negotiation. Of course, some of the schemes are avowedly inimical to the dollar as a reserve currency—but all should be scrutinized very carefully from this point of view. Any plan that weakens the dollar's reserve currency standing could destroy far more international liquidity than it would create.

(8) Whatever may be decided in the way of enlarging world liquidity, it seems to me quite probable that the best way would be to proceed gradually, step by step, rather than to seek some full-blown new plan that would drastically change a system which, on the whole, has proved to be workable and flexible. Early agreement on initial steps would be highly desirable. Thus, for example, if it were decided that greater Fund automaticity would be useful, a change along these lines could be put into effect without delay with the understanding that a study of further possible steps, to meet new contingencies, would be carried on in the ensuing year or years. In other words, the approach would be evolutionary rather than revolutionary.

In closing, let me revert to the major point I tried to stress earlier. Our most pressing task is to find lasting equilibrium in our balance of payments. If we deal effectively with this problem, there is little reason for worry about the role of the dollar. If we do not, the dethronement of the dollar and our discomfiture in many foreign and domestic activities are a foregone conclusion. It is often overlooked that our whole political and economic position abroad is very closely intertwined with the strength of the dollar. I have no doubt at all in my mind that, once the American people understand fully what is at stake, they will show the will and ability to preserve the dollar as the keystone of the whole international financial system.