Inflation and the Defense of the Dollar*

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A year ago I spoke of the difficulties of 1966 and expressed the hope that in 1967 the stresses and strains would be less severe, and the problems less perplexing, than in the year we had just lived through. That hope was only partially fulfilled. In domestic banking matters the year, while not without its problems and challenges, was far more manageable than 1966. But in the international financial sphere the late fall of 1967 brought new crises of almost unprecedented severity. The crises appear to have been surmounted, through a forceful United States balance-of-payments program designed to underline the firm determination of the United States to defend the fixed relationship of the dollar to gold at $35 per ounce coupled with an impressive show of solidarity among the major industrial countries in recognition of their mutual interest in preserving the existing world financial structure. But, while we have made an excellent start, a great deal remains to be done before we can say that we have grappled effectively with this nagging balance-of-payments problem and that we have laid the necessary foundations for restoring unquestioned faith in the dollar, both here and abroad.

Perhaps the critical developments of November and December have served a very useful purpose in one regard if they have convinced more Americans than before that our record of persistent balance-of-payments deficits constitutes a problem that must be dealt with in a comprehensive and conclusive fashion. During recent years we have had frequent assurances of our need and determination to reduce or eliminate the deficit, and we have had a good many programs to attack specific elements in our payments problem. But, as gains were made on one or another front, new problems continually opened up and we made no progress overall. Moreover, the whole payments problem remained distant and esoteric to the great majority of Americans.

It was of course the devaluation of sterling which, not unexpectedly, triggered the violent onslaught against the dollar as the basis of the international monetary system. This attack took the form of a huge rise in speculative purchases of gold on the London market. Fear of just such a sequence of events had been a major motive for the various cooperative actions to defend sterling undertaken by the principal industrial nations over the past three or four years. And even in the final crisis there was no lack of willingness to provide enough international credit to back up a strong effort to preserve the former parity. The decision to devalue was a deliberate one on the part of the British government. Naturally it was up to the British to make a judgment, after due consideration of their domestic problems and the probable world reaction, as to whether devaluation was necessary or desirable, or both. But there is no doubt whatever that it was a highly disturbing move from the standpoint of world financial stability.

There are, of course, worlds of difference between the position of sterling and the position of the dollar. The dollar is vastly stronger as the currency of the world's largest and technologically most advanced economic unit —a nation with a huge excess of total foreign assets over its foreign liabilities. Nevertheless, the experience of sterling should serve as a salutary warning that a country whose currency is widely used for reserve purposes has

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some special aspects of vulnerability, and thus some special responsibility for even more scrupulous financial behavior than those countries whose currencies are less widely used internationally.

Although individuals are bound to differ somewhat in their judgment with respect to the particular features of the President's balance-of-payments program, the program as a whole deserves the nation's full support, both because the Administration now seems determined to conquer this hitherto intractable problem and because there is an evident desire to spread the burden of remedial measures as widely as possible rather than concentrating it on only a few shoulders. I can well understand the initial reluctance of some to accept a program of controls on the free flow of international capital and on spending abroad by American tourists, for this seems a violation of the very trends we have been trying so hard to nurture since World War II. But it seems to me that this reluctance overlooks two facts of great importance: (1) We are in a war economy, with military expenditures accounting for much of our balance-of-payments deficit as well as for much of our Federal budget deficit. "Business as usual", or even "travel as usual", is not consistent with the needs of a war economy. (2) The payments crisis had reached a point where immediate and dramatic action was essential to break the back of a violent and concerted attack on the dollar. And the consequences of failure to defend the dollar as the keystone of the international monetary structure would have been far more disruptive of international payments flows than any of the measures proposed in the program. International confidence in the continued ability and willingness of the United States to sell gold at the $35 price is, of course, crucial to the dollar's role as a reserve currency. The gold reserve requirement on Federal Reserve notes should be eliminated immediately, as proposed by the President last week.

I have mentioned the probable salutary effect of the crisis in alerting Americans to the need for forceful action. At the same time, I can see a risk that some Americans may mistake a necessary remedial crash program for a permanent cure. Interference with the free movement of capital and with tourist spending is certainly neither a desirable nor a practicable long-run solution of the problem. For this we must look mainly to a stronger trade surplus, which means improving our competitiveness in the world and avoiding an overheated economy that pulls in excessive imports. We should also take a more critical look at Government outlays abroad, especially military outlays, to make sure that their heavy economic cost is still justified in the light of political and military conditions of today. Foreign aid is in a different category, for genuinely productive expenditures in less developed countries are called for not only for moral and humanitarian reasons but also because they will contribute to a sounder world structure, political and economic, from which the United States will clearly benefit. This does not mean, however, that aid outlays should not also be subject to careful review to make sure that they really are soundly programmed. And I believe we should continue to press the major European industrial nations to give more effective recognition to their own responsibilities for help to the less developed areas. Moreover, countries with balance-of-payments surpluses must be mindful of their own responsibilities to follow fiscal, monetary, trade, and capital export policies which contribute to international equilibrium.

Mention of the vital importance of our competitive position in the world leads us squarely to an examination of how well or how poorly the United States has lived up to one of its major economic goals, i.e., cost and price stability. During the early sixties the record was quite creditable, for we enjoyed a much more stable cost-price structure than did most of the other leading industrial countries—and as a result we were making considerable progress toward a smaller overall payments deficit. All this changed radically for the worse after the Vietnam fighting accelerated in mid-1965. A rapid burgeoning of Federal defense outlays, coupled with a failure of fiscal policy to meet this increase through higher taxes, was largely responsible for upsetting the earlier record of cost-price stability, and inflationary pressures became quite severe in the overheated economy of 1966. Higher prices and high profits in that boom year, coupled with low unemployment and scarcities of skilled labor, in turn laid the groundwork for wage demands—and wage settlements—far in excess of national average productivity gains. Thus, our country was caught up in the familiar inflationary spiral in which cost-push and demand-pull are mutually reinforcing. In much of 1967 there was some letup on the demand-pull side (although none on the side of excessive wage increases), but more recently, as the business expansion has resumed speed, both elements are again operating with great force.

I am acutely troubled by the evidence on all sides that many of our citizens, while recognizing that a rather sizable pace of inflation—say at a 3 to 4 per cent rate—is undesirable, nonetheless regard it as inevitable. This view has found expression recently in speculative excesses in stocks, real estate, and corporate acquisitions. I hardly think it necessary to dwell on the dangers and inequities of inflation before this audience. Bankers are characteristically much more alert to them than is the public at large. But somehow a way must be found to bring these risks and injustices more forcefully to the attention of those who are in the strongest position to do something about it—and here I am thinking especially of leaders in labor, business, and government.

Cost-price stability and the closely related goal of payments equilibrium are, of course, not our only major national economic goals. Others are maximum sustainable economic growth and high use of resources, particularly of manpower resources. But I suspect that as a nation we have encouraged more rapid increases in aggregate demand than have been consistent with reasonable wage and price stability. In saying this, I am not belittling the goal of high resource utilization—quite the contrary. But I would stress the importance of reducing unemployment through structural improvements in the labor force and in job markets. For example, close attention must be given to better education and job training and to elimination of discriminatory practices in employment and union membership.

In recent years we have witnessed a profound change of public psychology with respect to economic growth and cyclical swings. There is much more confidence in the Government's ability to avoid recessions by means of various stimulative measures in the event of need. The counterpart of this should be a widespread acceptance of public policy measures designed to avoid inflation; but here we seem to face some kind of cultural lag. There is grudging recognition that monetary policy has to pay attention to inflationary as well as recessionary dangers. However, the past two years' experience suggests that the American people and their elected representatives are still a long way from accepting fiscal policy as a means of promoting economic stability in a time of inflation. Perhaps we should have been warned that this might be the case when in the early sixties even a tax *cut* to promote economic growth took some two years to come to fruition. Now, after two and a half years of rapidly expanding Federal expenditures, we have not yet used a tax increase to apply suitable brakes to the economy.

A few years ago many economists, as well as many of us in the Federal Reserve, were hopeful that fiscal policy might become a much more flexible instrument—although it could never be as flexible as monetary policy—so that a suitable "mix" of fiscal and monetary policy could be developed to meet whatever specific problems might occur. To some extent, this was actually accomplished at the time of the 1964 tax cut, when monetary policy was thereby enabled to be firmer than it could otherwise have been, with consequent benefits to our balance of payments. However, it has emphatically not been accomplished in the reverse direction since mid-1965, with the result that monetary policy has had to bear most of the burden when a public policy of restraint has been called for. What this could mean in terms of rapid interest rate increases and fears concerning credit availability was vividly demonstrated in the summer of 1966.

In the last few months, it has become clear that a key reason tax rate changes are a less flexible instrument than had been hoped is that legislators are unwilling to consider restrictive tax measures without also considering the possibilities of reducing Federal expenditures. In general this is as it should be, and economy in Federal spending is especially desirable in the present setting. But, in my view, reductions in Federal spending that would be large enough to deal with our present problems are simply not feasible. Under current circumstances, characterized by rapidly rising prices and accelerating business activity, a tax increase along the lines proposed by the President is essential to achieve fiscal restraint on the scale needed. Without such an increase, we run the risk of increased price pressures, more trouble for our balance of payments, and a recurrence of the mid-1966 credit conditions. I am hopeful that the sheer necessity of a tax rise will bring it into being without further delay.

While it is true that long-term interest rates have moved back to or beyond the peak levels of the summer of 1966, fortunately banking conditions are now quite different from those prevailing at that time. Since then bank liquidity has grown very appreciably, and I have the impression that loan demands, while substantial, have been rather less than most bankers had expected. Doubtless this is due in part to the record volume of offerings in the bond market which prevailed through 1967. The general public has also added a good deal to its liquid assets in the past year or so. The Federal Reserve System has been criticized for permitting bank credit to grow in 1967 at a rate of about 11 per cent, and I confess that we in the System have felt some concern on this score for several months. However, very unsettled conditions in the financial markets, the uncertain outlook for a tax increase, worries over the sterling situation, and the massive financing requirements of the Treasury all posed strong constraints on monetary policy until late in the year. Moreover, a somewhat higher than average growth of bank credit was to be expected after the unusually severe liquidity squeeze of 1966. It should also be noted that banks accounted for an increased share of total credit growth in 1967, and the unusually rapid pace of bank credit expansion was not matched by an equivalent rate of expansion of total credit.

Bank credit grew much more slowly on average in the last four months of 1967 than in the first eight months, and the slowdown was most pronounced in November and December. While the vagaries of seasonal adjustments and Treasury financing schedules make analysis of the actual statistics unusually difficult, the general tendency toward more modest bank credit growth seems clear, and it is most welcome. Obviously monetary policy is not seeking a cessation of bank credit expansion, but merely a pace more in keeping with the economy's potential for sustainable growth.

As we look ahead to the new year, the gravest question in the economic sphere is whether we can reduce the inflationary tendencies that are now so painfully apparent. Let me stress again that price stability is not only urgently needed to protect the value of the dollar at home. It is also most urgently needed to maintain and improve our competitive position in world markets. Our success in riding out the recent gold crisis is no cause for complacency. The Administration's new balance-of-payments program has to be buttressed, and eventually supplanted by more permanent remedies, including above all the elimination of inflationary pressures. Success will call for a concerted attack by appropriate public policies, especially a tax increase coupled with economies in Federal spending, strengthening of efforts to discourage inflationary wage and price increases, and maintenance of an appropriately firm monetary policy. But the degree of success that these public policies can achieve will depend very largely on the extent to which they are backed by a cooperative attitude on the part of labor, business, and the general public. The stakes are high enough so that such cooperation should be forthcoming without hesitation. I trust that the country's bankers will use their position of influence in the business and financial community to support this many-pronged attack on the greatest present threat to sustainable economic growth and survival of our international financial system.