The Challenge to the Dollar in a Changing World*

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In the past few months Americans have felt a sense of national emergency such as they have not experienced since World War II. Worst of all, crises have occurred on several fronts at once—in our military and political stance in the Far East, in our efforts to make democracy at home a meaningful way of life for all Americans regardless of color, and in confidence in the dollar as the world's most important reserve and trading currency. Of course to a considerable extent all three crises are related. However, I propose to concentrate my attention today on the crisis of the dollar—to sketch briefly how it occurred, what steps have been taken to meet it, what misleading and dangerous proposed remedies must be rejected, and what kind of measures we must take to maintain the dollar as the key currency of the international financial structure. I hasten to add that my solicitude for the dollar is not based on some mystical worship of our currency as such, but rather on a recognition of what a vital role it now plays in the world and of what a tragedy it would be for the future course of international trade and investment, as well as for our domestic economy, if the dollar were no longer to command the world's confidence.

For too long we have tended to take for granted the dollar's impregnable position, based as it has been on the tremendous strength of the United States economy and on our dominant world role in the early postwar years. So great was this reservoir of strength that we could run huge balance-of-payments deficits year in and year out for ten years, aggregating some $27 billion, and still the dollar retained much of its earlier reputation. Americans were often told that these steady deficits were undermining the dollar, but somehow they couldn't quite believe it—at least not enough to do something really effective about it. To be sure there were frequent official statements of determination to move toward equilibrium. And temporizing measures were adopted from time to time, designed mainly to check outward capital flows while more fundamental remedies were being worked out. For a while, until the Vietnam escalation of mid-1965, we were making considerable progress toward a larger trade surplus and reduced military outlays abroad; but that event put a quick stop to the improvement, brought a sharp jump in foreign military expenditures, and set in train inflationary tendencies that are still accelerating and that have already been instrumental in cutting our trade surplus to a dangerously low level.

In the political, military, and economic spheres we appeared still to be working on the assumption that we could take on substantial commitments throughout the world without paying close attention to our ability to finance such spending through exports and other earnings. This may have been valid enough right after World War II, but certainly did not remain so. The fact is that in the intervening twenty years the spectacular recovery of Europe and Japan had radically reduced our dominance as an exporter and that our annual outlays abroad, such as those for direct investment and tourism, had grown to a very large size. Small wonder that in these circumstances payments equilibrium remained as elusive as ever.

We had only to look to the United Kingdom to see how costly it could be to disregard the inexorable pressures of the balance of payments. In their case continual financial crises reflected essentially an unwillingness to recognize the full implications of the vital need for internal discipline and increased productive efficiency. Although our much greater economic strength is one of several major differences between this country and the United Kingdom, the November devaluation of sterling flashed a clear warning for the United States that we cannot ignore.

It had long been apparent to many of us that the fate of sterling and of the gold market were very closely linked in terms of market psychology and that sterling devaluation could easily trigger a severe run on gold. Such a major breakdown in the exchange-parity network was bound to

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lessen confidence in all other currencies and especially to raise new doubts as to the relationship between gold and the dollar.

As expected, a violent eruption in the London gold market occurred immediately after the devaluation of sterling. It was effectively countered at first by a statement issued in Frankfurt of solidarity of the major central banks and of their determination to defend the existing exchange structure with all means at their command. Another flare-up in December was calmed only after a similar statement and an assurance that the United States intended to take effective steps to bring its payments much closer to balance. The latter promise was reinforced by the President's balance-of-payments program announced on January 1. But while this had an important calming effect for several weeks, there was a growing feeling among close observers of the gold market that the gold pool—which meant in large part the United States—could no longer afford to continue to feed in monetary gold on the scale required to prevent the London price from exceeding $35.20. It had become more and more obvious that the major countries would not and should not deplete their monetary gold stocks further to supply a huge demand of individual and corporate gold buyers all over the world, especially when citizens of the United States, the United Kingdom, and several other countries had long been forbidden to own gold. All these pressures came to a head in the record market flare-up of mid-March, to which the temporary closing of the London market with the accompanying termination of the gold pool was the only reasonable answer. In my judgment it would have been far better if these actions had come some months earlier. With reaffirmation in the March 17 Washington communiqué of international support for the $35 official price, coupled with establishment of the so-called "two-tier system" and recognition of future supplies of special drawing rights (SDR's) as a new reserve asset, the worst exchange market fears quickly subsided. The market has remained generally quiet since that time, although an underlying feeling of deep concern persists because needed fundamental measures have not been taken.

In that hectic weekend of March 17, before the Washington communiqué was released, American travelers all over the world had for the first time the traumatic experience of seeing the world really question the soundness of the once unquestioned dollar. For a day or two, dollar traveler's checks and dollar currency often proved impossible to change into local foreign currencies, except perhaps at a sharp discount. For those Americans involved, this experience may have done more than any other recent event to awaken them to the seriousness of our payments problem.

The two-tier system adopted in March in essence represented a decision to accept the inevitable consequences of a distorted gold supply-and-demand position by separating the circuit of monetary gold transactions from all trading in gold as a commodity or speculative vehicle. Those who doubt whether it is viable should, I believe, bear in mind that, before the London market was reopened in 1954, free prices for gold far above $35 often prevailed in local markets in other countries without casting any doubt on the firmness of the official $35 price. In October 1960, after the run-up to $40 an ounce in the London gold market, there was a deliberate tactical decision by the American authorities to prevent the London price from going above $35.20, which was roughly the United States official selling price plus shipping charges to London. The decision was almost universally supported by opinion abroad, and this international backing was formalized with the organization of the gold pool in 1961. However, we should remember that it was never an essential feature of the gold exchange standard. The pool had been a substantial net buyer of gold over its entire life up to the time of the sterling devaluation of last November. But when the cost involved very large inroads into monetary stocks, the time had come to terminate it.

The question "Is the two-tier system viable?" merely masks a more fundamental question, namely, "Will the United States at long last take the steps needed to bring its international payments somewhere near equilibrium?" If not, we face dire consequences, and not because of the two-tier arrangement or of a fault in the gold exchange standard itself. No international monetary system can be devised that is strong enough to withstand persistent abuse by the world's major industrial nations. By the same token it is utterly misleading to suggest that we have viable alternatives, such as raising the price of gold or embargoing gold payments, to doing what must be done with our balance of payments. Either of these moves would, in my judgment, have disastrous results in and of themselves. Yet neither one would relieve us of the burden of adjusting our international payments. It is a sad commentary on the present state of affairs that such proposals have moved out of the academic area to open discussion in financial circles.

Increasing the price of gold would, temporarily at least, cause chaotic conditions in the exchange markets, with a consequent check to trade and investment flows that foster economic development. After the initial confusion there would be a period when each country would weigh the advantages and disadvantages of fixing a new rate for its own currency in terms of gold and the dollar, a rate that might or might not coincide with the view of the United States. We would then face the danger of a series of competitive devaluations, as countries sought to assure the safety of their trade balances. There would be a strong prospect for moves toward trade protectionism, capital restrictions, exchange controls, and other forms of retaliation. In the best of circumstances, it is difficult to see how we could preserve the present momentum toward attaining a more rational system of international liquidity centered on the SDR's and the various forms of international credit laboriously built up in the last twenty-five years. We would instead be taking a backward step by tying future reserve creation more or less permanently to the vagaries of world gold production.

And that is not all. A change in the gold price would constitute a gross breach of faith with all those monetary authorities who have held dollars as an important component of their monetary reserves. It could do irreparable damage to future confidence in the dollar as a reserve currency and perhaps also to future use of the dollar as the chief vehicle currency for world trade and investment. It would reward disproportionately and—economically speaking—irrationally the countries with large gold production or large gold hoards, public or private. From a selfish United States viewpoint, it would cause a major decline in our political influence. Finally, years would be needed to convince speculators that the new price could last. Since a revaluation of gold would produce very large windfall profits for gold-holding countries, and since it may be doubted that politicians would be slow to spend such profits, the speculators might have ground for thinking that continued inflation would before too long create the need for a new revaluation.

Just as bad, if not worse, would be a move by the United States to embargo further sales of gold for monetary purposes. In the past few years some Americans have advocated the use of a threat of embargo to force foreign acquiescence in our financial policies. I think it may be well to remind them that an embargo could prove fully as harmful to the United States as to our foreign partners. Cutting the dollar loose from gold would probably lead promptly to a chaotic system of floating rates in which all trade and credit operations would be severely handicapped and in which each country might feel forced to engage in competitive restrictions on trade and payments. Quite possibly the major European countries would then form a bloc adhering to their present parities in terms of gold, while another group of countries would adhere to the dollar. In this case the dollar might well float in relation to the European bloc, with highly adverse effects on trade and credit relationships similar to those resulting from a general condition of floating rates. In either case the European countries might decide to restrict severely American capital inflows, or American imports, or both.

More generally, it would be illusory to expect that a United States gold embargo would somehow lead to a worldwide demonetization of gold and thereby open the route to a new and more effective system of international payments. Because of their large stake in monetary gold, the European and certain other countries would probably look to gold as the ultimate means of payments settlement and, if any semblance of order in the exchange markets were ultimately to be restored, the United States would from time to time need to pay out gold in settlement of payments deficits. Meanwhile, moreover, inter-central-bank and intergovernmental credit facilities would have been severely damaged, if not totally immobilized, while the current bright prospect of opening up a new source of international liquidity in the form of special drawing rights on the International Monetary Fund would have suffered a serious, or even fatal, setback. The paradoxical consequence of a United States gold embargo, therefore, might be eventually to restore gold to unchallenged primacy in international settlements by undermining, if not actually destroying, all the other supplementary means of settling payments balances that have gradually developed since the Bretton Woods Agreements.

I hope no one, therefore, will look to either a gold embargo or a higher gold price as an acceptable escape route from the measures of internal discipline that are needed if we are to avoid chaos in international financial conditions. What are these measures to which we must look for a way out?

First and foremost, of course, we must slow and ultimately arrest the dangerous upward sweep of costs and prices that has been characteristic of the economy since the Vietnam escalation of mid-1965, but which has accelerated in the past nine months or so after a temporary lull in early 1967. No one can look with equanimity at the first-quarter 1968 rise in overall demand at an annual rate of 10 per cent, with two fifths of this increase merely resulting in a 4 per cent surge in prices. I recognize that there are a few sectors of the economy, particularly some manufacturing fields, where there is relatively little evidence of overheating. But these are clearly exceptional. Skilled labor is extremely scarce in most parts of the country, and the intolerable size of recent wage increases bears testimony not only to this labor scarcity but also to industry's ability and willingness to grant these increases and to labor's desire to offset the climb in the cost of living during the last couple of years. In the absence of adequate fiscal and monetary restraint, there is every reason to look for continuation of this condition of excessive demand and grossly excessive wage and price increases, which can set the stage for recession in which both wages and profits would shrink.

Besides sowing the seeds of future recession and producing a multitude of domestic inequities, the current inflation is doing untold damage to the United States balance of payments by sucking in imports at a very rapid pace and by making United States exports less and less competitive in world markets. The influence on imports has been spectacular in recent months. After leveling off in the first ten months of 1967, imports shot upward, and from October through March have been running 15 per cent above the same period a year earlier, far above the growth in our exports. This is in keeping with experience over a considerable period of years which shows that total imports are extremely responsive to major swings in gross national product.

Under the conditions I have outlined there is no conceivable excuse for a Federal budget operating at a deficit of $20 billion or more per annum. There is no mystery as to the kind of fiscal action that is vitally needed to meet this problem. An income tax surcharge of the magnitude proposed by the President, together with the strictest restraint in spending, would seem to be the minimum that is called for. It would undoubtedly have a pervasive cooling effect throughout our overheated economy. The effects of an income tax rise are bound to be spread more evenly than those, say, of a restrictive monetary policy. Unquestionably there are many types of spending that could be sharply reduced without loss to the nation, but in some areas, such as urban spending, substantial increases rather than cuts are necessary.

I find it impossible to explain satisfactorily to foreign holders of dollars why this obviously necessary fiscal step of increased taxes plus reduced spending has not yet been taken despite almost a year of discussion and strong endorsement by most economic experts. I can think of no more effective way of giving an enormous psychological boost to the dollar than by providing at long last this evidence of fiscal responsibility. Such an invaluable dividend would of course be over and above the obvious domestic benefits in the shape of a less hectic and less inflationary growth rate.

Monetary policy has been doing its part toward restraining excessive growth since last November. While it might be contended that the Federal Reserve started restraining some months too late, there were important inhibiting factors last summer and autumn, including the fear of damaging the prospects of tax legislation, the risk of pushing sterling over the brink, and the reluctance to make the Treasury's huge financing program any more difficult than necessary. In any event the tightening that has been accomplished since November, and more especially since February, has been very sizable. Our restrictive program made use of all three of the major credit policy instruments, i.e., open market operations, discount rate increases, and higher reserve requirements. Last month's discount rate increase was the third ½ per cent upward move since November, and the current rate of 5½ per cent is the highest discount rate in effect since 1929.

Naturally we are aware that a restrictive credit policy bears unevenly on various sectors of the economy, with housing and municipal financing usually feeling the pinch more than other sectors. The Federal Reserve has certainly had to move further and faster than would have been necessary if an appropriate fiscal program had been enacted. As credit tightens and interest rates move up to levels that are historically very high indeed, our financial institutions come under growing pressure and the process of disintermediation becomes clearly visible. The Federal Reserve System must remain on the alert to see that these pressures do not become too extreme, as they did in the summer of 1966. We have no wish to see repeated the highly nervous market atmosphere of that summer, nor have we any wish to see an end to the growth of bank credit.

The System's ultimate goal insofar as credit growth is concerned is a moderate rate of expansion in keeping with a sustainable noninflationary growth of the economy. Recent months have shown an encouraging slowdown in credit growth, but maintenance of firm restraint seems needed to keep this slower pace in the light of heavy and growing credit demand, including resumption of large Treasury borrowing. Fortunately the banks and thrift institutions are in a considerably better liquidity position than they were two years ago, and this should make much easier our efforts to avoid excessive market reaction.

Beyond the immediate need for strong support from fiscal policy to reduce the fever of our overheated economy, looms the need for a return to the conditions of price stability that characterized the earlier years of the current business expansion. One of the important reasons for price stability during that period was the record of matching wage and productivity gains. It has become fashionable to be contemptuous of the wage-price guideposts of that period, and to condemn them as unworkable. The truth, however, is quite clear: it is any substantial deviation from the principle of the guideposts that is unworkable. We must keep off the primrose path that leads to rigid wage, price, and dividend control or freeze; and this means all of us—government, business, and labor—must agree on some acceptable compromise that satisfies us that no one else is going to obtain undue advantage at our expense. A great virtue of the wage-price guideposts was that they promised to help all Americans understand the great difference between real gains and the mirage benefits of inflation-swollen current dollars. In a democratic society, that kind of understanding, together with freedom of labor and capital to respond to shifts in demand, is much to be preferred to a harness of direct controls.

To me these anti-inflationary measures of fiscal and monetary policies and of wage-price guideposts represent a prerequisite for balance-of-payments equilibrium. In this connection, I would like to say a word about strikes that have a major impact on our balance of payments. As one looks back to last year it becomes clear that the London and Liverpool dock strikes dealt a crushing blow to the pound sterling. In our own country, it has been distressing to see the hundreds of millions of dollars' cost to the balance of payments of the copper strike and the hedging against a possible steel strike. Surely the nation has a right to ask that leaders in both management and labor consider carefully the international payments effects of such strikes on the dollar's position.

There are many additional avenues to be explored, with a view to improving our balance of payments. For example, it may be that more could be done both by Government and by the sophisticated business community to increase the interest of small- and medium-sized American concerns in developing an export market. While the Government has done much to facilitate and encourage larger portfolio investment by foreigners in American securities, especially in American equities, more could probably be done in this area. Our stock market already has a very strong appeal throughout the world, but despite recent statutory action there are still too many technical barriers to the translation of this appeal into actual investment.

It goes without saying that the President's balance-of-payments program of January 1 should enjoy the full support of the nation, although most of us would have serious qualms about more than temporary reliance on restraints on the outward flow of American capital. I would remind you that the effort to slow the flow of direct investment should be viewed against the background of an unprecedentedly high level of direct investment outflow in 1965 and 1966. There is also much that surplus countries can do to aid our efforts at achieving international equilibrium both by their general economic policies and by their specific actions affecting the balance of payments, but primary responsibility falls on us.

Aside from our efforts to improve the trade surplus by stemming inflation, the most hopeful area for further balance-of-payments savings is that of Government expenditures abroad. I am not suggesting ill-considered cuts in foreign economic aid, for such outlays—subject of course to careful screening—are essential if we are to build the kind of prosperous and peaceful world economy that is vital to our own national well-being. As to Vietnam, there are many reasons for hoping for a satisfactory end to the hostilities. On the financial side, it would put an end to the tremendous drain on our balance of payments that now results, directly or indirectly, from our military outlays in that area. It would be too much to expect equilibrium in our international payments simply because of an end to the war, but it would certainly bring a major improvement.

But apart from the specific Vietnam problem, we must face squarely the question of whether the benefits arising from military and political commitments abroad outweigh their balance-of-payments cost. Some hard questions have to be answered, and answered promptly. For example, should not those European allies who stress the importance of having American troops in Europe assume a larger part of the cost? If they are unwilling to do so, are the benefits of maintaining these forces at our own expense worthwhile in view of the substantial burden placed on the dollar? More generally, we must bear in mind the fact that the costs of military and political commitments may include sacrifices in the form of even higher taxes at home, intensified direct controls over capital movements, and restrictions on tourism. Indeed, we have reached a critical point at which the financial consequences of military and political commitments must be weighed carefully whenever decisions are made to initiate or continue such commitments. I am not suggesting that financial considerations should receive top priority, but merely that the financial side deserves a lot more weight than it has had in the past. Further, and I think this needs the greatest possible emphasis, there is now a grave risk that continuation of our balance-of-payments deficit—by undermining the dollar internationally—may in itself endanger world stability and frustrate our ability to achieve our international economic, political, and military goals.

Fortunately, we are not faced with an acute exchange crisis at present. Nevertheless we must recognize that in a more fundamental sense the dollar is—and for some time will be—in a condition of crisis. This condition will persist until we can show real progress toward payments equilibrium. And, as I have tried to suggest, real progress is not an impossible task if we take the necessary measures to reduce economic overheating and to restore our competitive position in world trade. I fervently hope that we shall not need a recurrence of the black prospects of that mid-March weekend to make us take those sound and sensible steps that are clearly required to meet the challenge to the dollar in this rapidly changing world.