For release at 12 Noon
Eastern Standard Time
Thursday, February 6, 1964

THE ROLE OF A STABLE DOLLAR IN EXPANDING WORLD MARKETS

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

at the

Freedom Forum XXV

of the

National Education Program

Little Rock, Arkansas

February 6, 1964

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The American heritage of enterprise and innovation has brought us a vast accumulation of public and private wealth. And the richer we became, the more pervasive became our penchant for stability. As a nation, we now favor almost without question a stable society, a stable government, a stable economy, and a stable dollar.

But stability is not an unmixed blessing. The concept becomes immediately less appealing if we define it as lack of flexibility or lack of movement. We don't want stability if it is based on controls of prices, wages, or incomes. We want it if it is based on the free interplay of market forces. But the essence of a free market is fluctuation and expansion.

Thus, we want a stable dollar because we believe that this stability is consistent with the working of a free and expanding market economy.

Domestic Stability

Domestically, we measure the stability of the dollar in terms of its purchasing power over goods and services. We don't want the price of any individual good or service to remain unchanged; on the contrary, we want all individual prices, all individual incomes to be free to fluctuate in response to changes in the social usefulness of goods and personal services. But we want the average of all individual prices to remain reasonably stable, because only such stability provides us with a usable standard to evaluate changes in individual prices. In this way, stability of purchasing power helps us to profit from past experience and to plan our future actions.

In previous times, domestic stability of the dollar was frequently measured in terms of gold. As all of you know, today the dollar will officially buy 1/35th of one ounce of fine gold. But for domestic purposes, this arrangement is meaningless.

None of us is permitted to acquire monetary gold at that or any other price, and, in fact, none of us is permitted to hold any monetary gold at home or abroad, so that we have no reason to care whether or not we could sell it at that or at any other price. As long as the dollar's purchasing power in terms of total goods and services available to us does not change rapidly or persistently in one direction, the dollar fulfills its function as a stable currency for all domestic uses.

International Stability

Even in international transactions, gold is not actually used as a means of payment. U. S. businesses and individuals ordinarily pay foreigners in dollars and receive all sums due from foreigners in dollars; the only exceptions are a few payments that are made or received in foreign currencies. Even the U.S. Treasury, and the Federal Reserve, settle most of their foreign transactions in dollars. But from time to time an official transaction involves gold and it is at this point that gold still fulfills an important function in international finance.

All central banks keep at least part of their monetary reserves in the form of gold. And even those that keep the bulk of their reserves in foreign exchange, predominantly in dollar deposits or securities, usually convert at least part of their exchange receipts into gold whenever their holdings exceed some absolute amount or some traditional share in their total reserves.

The gold component of central bank reserves varies considerably, from more than 90 per cent in Switzerland to as little as 15 per cent in Japan. We need not discuss today the question of whether this gold preference is rational or not; whether the world would be better or worse off if reserves were held exclusively in gold or exclusively in foreign exchange. As long as both gold and dollars are universally used for monetary reserve purposes, the dollar must remain convertible into gold at a fixed rate, at least in transactions among central banks. This is the decisive reason why the U.S. Treasury must continue to sell gold freely at par to any foreign central bank for legitimate monetary purposes.

Foreign countries hold about $24 billion in gold and about $12 billion in U.S. dollars as part of their monetary reserves. Theoretically at least, any risk of instability in the dollar price of gold could induce those central banks increasingly to shift their dollar reserves to gold. In the absence of any defensive measures on our part this would mean that our own gold reserves would be reduced to less than $4 billion. Such a process would certainly impair confidence in the ability of the United States to maintain its international financial posture and thus perhaps also more generally its economic and political position of leadership in the free world.

But stability of the dollar in terms of gold is important not only because we have to maintain gold convertibility of foreign official dollar holdings in order to let the dollar continue to be a reserve currency for foreign central banks. It is even more important because our present international monetary system fixes the par values of all major currencies--pound sterling, Swiss and French franc, German mark as well as the dollar itself--in terms of gold. Hence, stable exchange rates between the dollar and the other leading currencies requires stability in terms of gold.

When economists speak of international stability of the dollar, they have primarily those exchange rates in mind. The experience of the 'thirties, when governments tried to get competitive advantages for their countries by tinkering with the exchange rates of their currencies, persuaded the men who assembled at Bretton Woods in 1944 to map the postwar reconstruction of our international monetary system that preservation of exchange stability should be a basic aim of the newly created International Monetary Fund.

Advantage of Stable Exchange Rates

The domestic economy's need for a stable unit of account is taken for granted. We can hardly imagine the myriads of economic calculations that a constantly fluctuating dollar would require and we are deeply concerned about the effect of moderate changes in the dollar's value on our efforts to sustain economic activity and economic growth. To a large degree, the international economy has just as great a need for a stable unit of account to facilitate country-to-country business transactions and to help maximize international trade and investment.

If exchange rates were to fluctuate outside of the narrow limits set by the Articles of Agreement of the International Monetary Fund, the resulting instability would hamper economic activity in two ways.

First, domestic prices of goods that are either imported or exported in large quantities, or compete with imported or exportable goods, would tend to fluctuate in sympathy with the exchange ratios that link the currency of one country with the currencies of its foreign suppliers and customers. In countries such as the Netherlands, where the sum of exports and imports is virtually equal to the country's Gross National Product, such fluctuations in prices of imported and exported goods would mean about equally large fluctuations in the entire domestic price level. Thus, instability in international transactions would be transmitted to domestic transactions.

Second, the uncertainty of predicting future exchange ratios would make it practically impossible to engage in international long-term credits, except at prohibitive interest rates. If the credits were denominated in the creditor's currency, the debtor would never know whether his future receipts in domestic currency would be large enough to enable him to repay the credit at the future exchange rate. And if the credit were denominated in the debtor's currency, the creditor would never know whether the repayment would match his original outlay in terms of his domestic currency.

At present, creditors and debtors usually denominate international credits in a stable "key currency" (mainly in dollars) whenever their domestic currencies are suspected of actual or potential instability. They can do so because they can also base their domestic calculations on dollars, as an internationally accepted measure and store of value. If the dollar were to fluctuate without limits in relation to the other major currencies, this method of using it -- or any other currency -- as a unit of account in international commerce would disappear. Such a change would particularly hamper long-term transactions, for which the risk of exchange fluctuations could not be covered by forward exchange operations.

Relatively stable international prices and a relatively stable unit of account for long-term credit transactions are both necessary conditions for steady growth in world trade. Thus, instability of the dollar in terms of gold, which would mean also instability in terms of the exchange rates of major foreign currencies, would preclude continued expansion of international markets for U.S. goods and services.

Expanding World Trade and the U.S. Economy

Some critics have rightly observed that international trade is far more important for virtually all other major countries than for the United States. Merchandise imports and exports together account for only 7 per cent of our Gross National Product, compared to 25-100 in other industrialized countries.

Nevertheless, expansion in foreign trade is vital for the United States: indirectly because of our political interest in a more complete economic integration of the free world and because a sharp contraction of world trade trends would weaken our Allies; directly, because of the role foreign trade plays in many of our basic industries, and especially in agriculture. Even though merchandise exports amount to barely 4 per cent of our Gross National Product, we are hardly indifferent to a $22 billion component in our economy.

An increase in our exports is particularly important under present conditions, when our total payments to foreigners exceed our total receipts from foreigners by several billion dollars a year. As long as this payments deficit continues, it acts as a brake on the domestic economy. The Federal Reserve has successfully, and in my opinion rightly, tried to offset the effect on our monetary system of the decline in our gold reserves connected with our payments deficit, and has added every year large amounts of U.S. Government securities to its portfolio, to replace the reduction in its gold reserves. In fact, roughly two-thirds of the net open market operations of the Federal Reserve were devoted to maintaining the status quo rather than to broadening the reserve basis for expansion.

It is true that some experts believe that our monetary policies could not have been much more expansionary, even in the absence of a payments deficit, without producing inflationary pressure. But, as you may know, I do not endorse this opinion. I feel that the only justification for the current credit posture in the United States in the face of continued underemployment and insufficient growth has been the payments situation.

I am glad to note that my views are shared by the distinguished economist who is generally regarded as the leader of the conservative neo-classical wing of the economic profession. Professor Gottfried Haberler, in his Presidential address to the American Economic Association last December, specifically stated that in his opinion our current underemployment could be remedied by more expansionary fiscal and monetary policies, if only our payments deficit were eliminated. Further growth in our exports is an indispensable part of any move toward restoration of our payments balance, and thus a necessary condition of greater monetary ease domestically.

Alleged Advantages of Fluctuating Exchange Rates

As you know, some critics do not agree with the belief that stable exchange rates are indispensable for a steady expansion of our economy. They would be willing to give up the stable par value of the dollar, both in terms of gold and in terms of foreign currencies, because they hope that this would put an end to our payments problem and thus make it possible for us to engage right away in the more expansionary policies needed to abolish underemployment; and more generally, that it would make U.S. domestic policies less dependent upon economic policies and trends in the rest of the world.

This is not the place to cover the whole controversy on flexible *versus* fixed exchange rates. But it seems self-evident to me that even with flexible exchange rates we should still be unable, in the long run, to spend abroad more than we take in through sales or borrowing abroad. In other words, reasonable balance in the international flow of our goods, services and capital funds, subject to normal variation in the time dimension, must always be an element in our domestic activities and policies.

It is true that a country can expand its exports (and reduce its imports) by devaluing its currency; this devaluation may be accomplished either by adopting a new and lower par value for its currency in terms of gold, or by cutting the tie of its currency to gold, and thus to other currencies, and permitting the exchange market to find a new (and lower) level of exchange rates free from government intervention.

Such a policy may be appropriate for a country whose share in world trade and production is small and whose currency is not extensively used in settlement of international transactions. And under conditions of fundamental disequilibrium, it may even be adopted by a major country. For instance, the devaluation of the British pound in 1949, of the French franc in 1958, and of the Canadian dollar in 1962 have helped those currencies to achieve more appropriate exchange relationships and thereby enabled their countries to regain balance in their international payments. But the United States could not successfully pursue such a course.

Foreign countries know that the United States still accounts for about half of the free world's industrial production, and remains an acknowledged leader in technological progress. They also know that our payments deficit does not stem from a deficit on trade account but from a net outflow of private and public capital in excess of our sizable trade surplus. Hence, they are fearful of the competitive power of U.S. industry and agriculture, and if the United States tried to gain an added competitive advantage by a dollar devaluation, they would simply devalue their own currencies to the same extent.

This is part of the price we must pay for world leadership. As long as the rest of the world looks to the dollar as its standard of value, we cannot unilaterally devalue the dollar in terms of other currencies. And we must remember that the international role of the dollar, while imposing upon us special responsibilities, also has its advantages for our economy. Our merchants can engage in international trade without having to weigh exchange risks and costs, since they can make and receive their payments in their domestic currency. And our money and capital markets are broader and easier because of the presence of $25 billion in foreign official and private funds deposited with U.S. banks or invested in U.S. money-market instruments.

New Methods of Adjustment to International Imbalance

The interrelations between the need for domestic expansion and for international balance at stable exchange rates make it necessary to rethink some of the policies traditionally followed to cure international imbalance.

Our economic text books usually state that a country suffering from a payments deficit should follow restrictive monetary and fiscal policies, and only a country experiencing a payments surplus could follow expansionary policies. They also state that a country should use expansionary measures when suffering from underemployment, and restrictive measures when suffering from overemployment.

This advice is perfectly valid in cases in which a country suffers at the same time from a payments deficit and over-full employment, or from a payments surplus and underemployment. But it obviously becomes self-contradictory whenever a country, like the United States today, suffers from a payments deficit, which would require restrictive measures; and simultaneously from underemployment, which would require expansionary measures. And a similar conflict, with signs reversed, faces countries like Germany or France, which have payments surpluses and domestic overemployment.

Obviously, we must find methods that would combine an expansionary effect on the domestic economy with a restrictive effect on the payments position, or vice versa.

Two such methods have recently been advocated.

First, it has been proposed that the United States combine an expansionary fiscal policy, which would add to disposable domestic incomes and thus alleviate domestic underemployment, with a restrictive monetary policy, which would raise interest rates, thereby attract funds from abroad, and in this way moderate the payments deficit. On the other hand, Germany and France should combine tight fiscal policies with easy monetary policies. But this new "mix" of fiscal and monetary policies seems to me to provide an uncertain answer at best to our problem.

Fiscal policy -- at least in the United States -- has not been flexible enough to be invoked in time to deal successfully with cyclical fluctuations in incomes and production. The action-delayed tax cut proposal alone is clear evidence of that lag.

Moreover, monetary policy cannot help but influence domestic uses of capital about as decisively as the international flow of capital. A rise in interest rates makes domestic as well as foreign potential debtors less willing to borrow: to that extent, it inhibits domestic investment and thereby counteracts the expansionary effects of a tax cut.

And, finally, the effect of unilateral changes in interest rates on international capital movements is by no means so unambiguous as the advocates of the "new mix" believe.

Obviously, such changes are ineffective whenever other major countries change their interest rates to the same extent, as they are likely to do. Also, flows of money-market funds react on the movement of forward exchange premiums and discounts as well as on changes in the so-called "uncovered" differences. And flows of risk capital depend more on the long-term prospects of economic growth and profitability than on short-run variations of interest rates; in particular, the highly important movements of equity capital, in the form of so-called direct investments or share purchases, are hardly at all influenced by short-run interest-rate considerations.

For these reasons, we can neither give up the use of monetary policy as a tool to achieve domestic policy goals, nor put on monetary policy all or most of the burden of balancing our international payments.

The second proposal is to stress special rather than general methods to combat the problem. For instance, the proposed interest equalization tax tries to discourage the outflow of funds and at the same time not to discourage the use of these funds for domestic investment. A tight monetary policy that would raise interest rates, say, by one per cent, may have the same effect on the outflow of funds as the proposed tax but, in contrast to that tax, would also discourage domestic borrowers. For the problem in reverse, we could envisage tax rebates for investment abroad in the case of countries that want to stimulate a capital outflow in order to reduce a payments surplus and also to reduce domestic inflationary pressures.

Tax rebates and tax imposition could also be used to encourage exports from a deficit country and to discourage them from a surplus country. And Government expenditures for defense and economic assistance abroad could be shared among the major countries of the free world in proportions that might vary in accordance with changes in the payments position of the participating countries.

All these methods share a common design to achieve expansionary rather than restrictive effects on economic activity. In this respect, they are diametrically opposed to policies relying on import barriers, exchange controls, and similar measures that interfere directly with market processes and therefore tend to hamper market expansion.

International Consultations and Cooperation

But the new methods of adjusting domestic economies to international imbalance can work only if they are adopted by both surplus and deficit countries. Otherwise, the actions of a country would risk being offset by contradictory actions of its trading partners.

Under traditional arrangements, it is the deficit country that has to bear the brunt of the adjustment. Surplus countries can let their reserves grow virtually without limit but deficit countries cannot let their reserves dwindle very far, and if they want to bolster their funds by borrowing abroad, they must accept any condition the creditor countries wish to impose.

One of the main lessons the world has slowly been learning is the mutuality of the responsibilities of surplus and deficit countries. The persistent and large deficit in U.S. international payments since 1958 has not only had a deflationary effect on the U.S. economy; it has also brought inflationary pressures to bear on the surplus countries of continental Europe. The traditional methods of adjustment have tended to aggravate rather than to remedy those deflationary and inflationary disturbances. Only a cooperative effort to employ new methods such as those we have just discussed can help restore balance without hurting the parties concerned.

The basis for such cooperation has already been established. The International Monetary Fund, the Organization for Economic Cooperation and Development, and other institutions link the United States continuously and closely with the other leading countries of the free world.

The International Monetary Fund and its ten major members, which participate in the so-called General Arrangements to Borrow that are designed to supplement the resources of the Fund, have recently begun extensive studies of the most urgent problems of international finance.

These studies should lead not only to a better realization of the pertinent economic facts and theories, but most importantly to better mutual understanding of proper policies. This understanding in turn should help us to dispel once and for all any lingering doubt, at home or abroad, about our ability to preserve the stability of the dollar in a climate of expanding domestic and international trade and investment.