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Statement by

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I am pleased to appear before this Committee to comment on recent developments in foreign exchange markets and their implications.

In assessing the exchange-rate arrangements that have prevailed since mid-March of this year, it is useful to recall a few historical facts. Starting in the mid-1960's, the balance of payments of the United States deteriorated with only minor interruptions. A trade surplus per year averaging more than \$5 billion in the mid-1960's vanished by 1969, and was converted to a deficit at an annual rate of over \$3 billion by the second quarter of 1971. For a time, particularly during 1968 and 1969, capital inflows offset the decline in the trade balance and kept the official settlements balance from reflecting the underlying deterioration. By the late spring of 1971, however, the growing weakness of our balance of payments was already widely recognized. A little later, a massive movement of dollars into foreign currencies finally forced the United States in August 1971 to suspend the convertibility of the dollar into gold and other reserve assets.

The actions taken by the United States that August culminated in a realignment of the par values of major currencies at

the Smithsonian meeting in December of 1971. No quick improvement of our trade position was anticipated in view of the lags with which exchange-rate changes affect international trade, and also because our economy was advancing with some rapidity at a time when the economies of our trading partners were generally sluggish. In fact, our foreign trade performance during 1972 turned out to be much poorer than had been expected, with the trade deficit soaring to about \$7 billion. By early February of this year, after some renewed disturbances in exchange markets, foreign governmental authorities agreed with our conclusion that the Smithsonian realignment had not gone far enough and that a further devaluation of the dollar was needed to restore equilibrium in international payments.

This second realignment of currency parities was agreed to on February 12. In contrast to the Smithsonian realignment, under which virtually all countries established new par values for their currencies, Italy and Japan now chose to float their currencies, thus joining the Canadian dollar, British pound, and Swiss franc -- all of which were already floating.

Once faith in a national currency is shaken, the process of rebuilding confidence is never an easy matter. The monetary

authorities of the leading countries were confident that the exchange-rate pattern established on February 12 was realistic and that it would in time restore equilibrium in world payments. Nevertheless, the dollar once more came under severe pressure in late February and early March. Countries still committed to maintaining par values for their currencies were therefore forced once again to purchase large amounts of dollars in the course of their intervention, and then ultimately to close their exchange markets.

The disorder that prevailed in currency markets during this crisis period prompted international discussions that resulted in a further extension of floating among the major currencies. Most countries within the European Economic Community -- West Germany, France, the Netherlands, Belgium, Luxembourg, and Denmark -- chose, however, to maintain exchange rates among their own currencies within narrow margins, but to permit them to fluctuate more or less freely against the dollar. This European bloc was soon joined formally by Sweden and Norway and informally by Austria.

After the mid-March Paris meeting of finance ministers and central bank governors, exchange markets reopened. In

the next few days the volume of activity was light, and exchange rates moved within a rather narrow range. Over the following weeks, markets continued to be calm as the volume of trading moved closer to normal levels. Fluctuations in market exchange rates differed little from those that had normally prevailed under the previous regime of fixed parities. In fact, the dollar did not move outside the range of 2-1/4 per cent on either side of the central rates established in the February-March period. Thus, during April and early May, the average dollar price of 10 major currencies (those of Japan, Canada, and 8 European nations) appeared to have stabilized at a level some 19 per cent above the exchange parities that prevailed in the spring of 1970 -- that is, prior to the Canadian float and the subsequent currency realignments.

In mid-May, however, the relative calm that characterized exchange markets during the preceding weeks ended abruptly. Movements of exchange rates became larger, and the dollar began to decline sharply further against the major European currencies. Over the six-week period from May 9 to June 20, the dollar price of the mark, the French franc, and the Swiss franc rose by 10, 7, and 6 per cent, respectively. The average appreciation during this period of the ten major currencies previously mentioned was

smaller -- about 4-1/2 per cent; the main reasons being that the dollar price of sterling rose little, while the Japanese and Canadian currencies remained quite stable, and the price of the Italian lira actually declined.

The causes of the widespread further depreciation of the dollar in this recent six-week period have been discussed extensively. I doubt if they can be identified with any great precision. My own impression is that the most important factor was the accumulating evidence that the moderate success which the United States had achieved in curbing inflation during 1972 was eroding. Other factors undoubtedly played their role -- among them, the tightening of monetary policies abroad, the new restrictive fiscal policy in Germany, the spread of uncertainty abroad about the ability of our government to handle economic problems effectively, and wild rumors that another devaluation of the dollar was contemplated. Not least important, there was a sharp speculative run-up in the market price of gold, which reflected, and in turn generated, a growing distrust of currencies generally. This development was bound to focus particularly on the dollar, in view of the world-wide fears caused by the sudden discovery that its stability could no longer be taken for granted.

There may be some economists who view the recent decline in the international value of the dollar with satisfaction. I am not one of them. When a currency depreciates, a nation's effort to curb inflation becomes more difficult. For in such a case, the prices of imported goods rise, and their rise is transmitted to domestic substitutes as well as to finished products based on imported raw materials. Meanwhile, exports are stimulated; and if direct controls are simultaneously being applied to domestic prices, as is now the case with us, some troublesome shortages may develop in domestic commodity markets. In contrast to the earlier devaluations, which were needed to restore equilibrium to our international transactions, the May-June depreciation is unfortunate. It certainly cannot be justified on any realistic evaluation of international price levels or underlying economic trends.

Nor is that all. To the extent that excessive depreciation of the dollar should persist, the United States would in time develop an undesirably large trade surplus. In other words, we would then be transferring real resources on cheap terms to the rest of the world instead of putting them to use here at home. Such a development, besides being senseless from our

viewpoint, could cause difficulties for other countries, most of which depend far more on foreign trade than does the United States. Still another consideration to bear in mind is that persistent depreciation of our currency would in time undermine confidence in the dollar's role as a transactions currency, and thereby weaken the international role of our highly developed financial system.

Although the decline in the international value of the dollar since mid-May is unwarranted by the condition of our economy or our balance of payments, there has as yet been no intervention by our government in the exchange markets. Those who are selling the dollar short -- whether out of a desire for safety or quick profits -- will probably be punished by the market itself. In any event, the central banks of the leading countries will not remain aloof indefinitely. The situation is being watched closely. As agreed at the March 16 meeting in Paris, we and the monetary authorities of other countries stand prepared to intervene to facilitate the maintenance of orderly conditions in exchange markets.

Under present circumstances, with many financial, commercial, and political issues still unresolved among the

nations of the world, the present exchange-rate arrangements -- which I hope will involve little central bank intervention -- are bound to continue. These arrangements have their advantages. The impact on exchange markets of speculative purchases and sales of currencies can be reflected in rate movements that are eventually self-limiting. In recent weeks, we have in fact been able to avoid the crisis atmosphere that would have emerged if the monetary authorities were still committed to maintaining a particular set of exchange rates through unlimited official intervention. There has been no need to close exchange markets to shut off massive international movements of funds. In addition, several countries have found that the present floating arrangements enable them to keep a firmer grasp on the expansion of their money supply and domestic indebtedness.

Limited experience is always an ambiguous teacher, but it can still generate strong opinions. Many of our businessmen and bankers now view floating exchange rates as a desirable development, or at least as necessary or entirely acceptable in current circumstances. Many regard the uncertainty associated with these arrangements as inconsequential, or as no

more serious in their business calculations than other sources of price or cost variation. Many believe that a return to a par value system will bring further episodic crises or new controls that would impede world commerce more than floating exchange rates. These attitudes contrast dramatically with the views held by most businessmen and financiers only a few years ago. Even some of my central bank colleagues -- who traditionally, as you know, have been the staunchest defenders of fixed exchange rates -- now seem to be accepting floating exchange rates with equanimity.

Thus, there is fairly broad agreement -- among businessmen, bankers, and political leaders -- that the present exchange-rate arrangements have been helpful or at least tolerable. Thoughtful and prudent men recognize, however, that the present arrangements have not been in operation very long, and I believe that not a few of the businessmen and bankers who were enthusiastic about floating exchange rates in April have developed doubts since then. Any judgments of the future based on recent experience must therefore be quite tentative.

For the longer run, thinking of a reformed international monetary system, I remain skeptical about the desirability of a general system of floating exchange rates. I hold this view even

though I recognize the usefulness of floating rates in particular situations, such as the present. Some reasons for my skepticism are as follows:

First, in my judgment, the floating exchange-rate system which has figured so heavily in academic discussions is a dream that will continue to elude us. Even for a country with as low a ratio of international trade to GNP as that of the United States, the repercussions of exchange-rate changes on the domestic economy can be substantial. Under a floating exchange-rate system, governments are always apt to be subject to political pressure by business, agricultural, and labor interests for protection against large movements of exchange rates -- which may mean new controls or central bank intervention or both. So-called "clean" floating is not a politically viable arrangement over the long run.

Second, a system of floating exchange rates may lead to political friction and competitive national economic policies. From time to time, suspicions will be generated that this or that country has been manipulating its exchange rate at the expense of the interests of its trading partners. In such an atmosphere, whether for defensive or retaliatory reasons, governments may impose controls on capital flows or on current

transactions. It is true, of course, that suspicion and political friction may be present under any type of exchange-rate regime. And we know from experience that governments often imposed controls on international transactions when they were trying to defend fixed exchange rates that were unrealistic. Nonetheless, I fear that such problems would be greater with widespread permanent floating of the major currencies.

Third, the uncertainties associated with floating exchange rates may lead in time to some erosion of international trade, particularly in the case of equipment purchases that require long-term financing and when profit margins are slim. These uncertainties may also weaken private foreign investment -- especially in long-term bond issues.

Fourth, exchange-rate fluctuations under a floating regime may add further to the difficulties that some governments already have in carrying out suitable fiscal and monetary policies. There is danger, for example, that a temporary exchange-rate depreciation will get translated into permanent price-level increases through upward revisions of nominal wages. Moreover, floating exchange rates may themselves become a tool of business-cycle policy, and thereby lead at times to neglect of appropriate domestic policies.

While I have such misgivings about floating exchange rates as the basis for a reformed international monetary system, I realize that international rules may be developed to minimize their undesirable effects. In any event, I do not approach the question of long-run reform in a dogmatic frame of mind. The objective of the negotiations currently under way should be to adopt that set of institutional arrangements which, in the balanced judgment of financial experts, is most likely to promote the orderly expansion of international economic transactions among countries -- each of which will be pursuing the goals of high employment, improvement in productivity, and general price stability. The exchange-rate regime is not an end in itself.

I also recognize that the Bretton Woods arrangements, despite their great contribution to the international economy of the post-war period, failed to achieve timely adjustments of exchange rates. In the future, exchange parities must not be allowed to become so rigid or unrealistic. Many changes take place in the world economy -- for example, in national rates of growth in productivity -- that require some change in currency parities. Furthermore, while we all hope that at least the major countries will pursue sound, noninflationary policies in the future,

we know that mistakes will at times be made. These mistakes, too, may modify the pattern of exchange rates that is appropriate for maintaining balance of payments equilibrium. Hence, I fully endorse the objective of developing an exchange-rate regime that will be more flexible than the Bretton Woods system.

The approach of our government to international monetary reform was outlined by Secretary Shultz last September in his address at the IMF meetings, and is embodied in the U.S. proposals to the Committee of Twenty. This approach assumes that in the new international monetary system most nations will maintain established parities for their exchange rates. A similar view was expressed by the Committee of Twenty in the communique issued at the close of their meeting this March. The communique stated that exchange rates must be a matter for international concern and consultation; that in the reformed system the exchange-rate regime should be based on stable but adjustable par values; but that floating rates could provide a useful technique in particular situations.

The U.S. approach to international monetary reform does not envision a par value regime of the Bretton Woods character. The U.S. proposals provide for rather prompt corrective actions,

including par value changes where they are deemed appropriate. The proposals recognize, moreover, that a realistic framework for a reformed international monetary system must permit a country to float its currency for a temporary -- and possibly for a prolonged -- period. In the latter case, however, internationally accepted rules of behavior would still need to be observed.

Under the U.S. plan, movements in a nation's reserves are assigned a central role in establishing the need for corrective action. We do not, however, propose a system of automatic responses to reserve movements. On the contrary, each country would retain a substantial degree of freedom in choosing the corrective measures that appear most appropriate in its circumstances.

An essential feature of the U.S. plan is that it would evenhandedly encourage adjustments by countries whose reserves were out of line, whether on the high or low side. The plan would operate on a principle analogous to that of workmen's compensation and no-fault accident insurance; in other words, remedial action would be expected of a country whose reserves either rose excessively or declined excessively, without attempting to allocate blame or fix responsibility for the remedial action on a "guilty" party.

Before concluding, I would like to comment briefly on the prospects for the U.S. balance of payments. For I believe that, as a result of the exchange-rate realignments of 1970-71 and early 1973, the outlook for our balance of payments has greatly improved. Altogether, by April of this year the dollar had been effectively devalued against other currencies by about 16 per cent since mid-1970, and by substantially more than that against some of our strongest competitors such as Japan and Germany. This is a large adjustment, and it has substantially improved the international competitiveness of U.S. goods.

The exchange-rate changes of recent years are already beginning to have perceptible effects on both our exports and our imports. So far this year, there has been a marked improvement in the trade balance. The trade deficit in the period from March through May, the latest three months for which data are available, was at an annual rate of about \$1.3 billion, compared to \$6.8 billion for 1972 as a whole. Much of this recent improvement reflects a bulge in agricultural exports which is likely to prove temporary, so that the underlying gain is not as large as the raw figures suggest. We should be prepared for some temporary setback during the months ahead. But there have been solid gains. The value of nonagricultural exports in the

March-May period was 18 per cent larger than it had been six months earlier. New foreign orders for machinery in the first quarter of this year were 16 per cent higher than in the third quarter of last year. Meanwhile, the growth of total imports appears to have moderated, although a sharp spurt did occur in May -- probably a result in large part of the recent rise in the prices of imported foods and raw materials.

Later this year and in 1974, we may expect to see further gains in our foreign trade balance, not only because of the cumulating effects of our strengthened competitive position, but also because business cycle conditions are likely to change in our favor. The growth of real output in the United States has begun to slow to a more moderate and sustainable rate, which should dampen the growth of our imports. On the other hand, economic activity abroad, which is the main determinant of our exports, is continuing to expand at a vigorous pace. The improvement in our trade balance this year is therefore likely to gather momentum in 1974 and 1975, by which time we should be experiencing a sizable trade surplus for the first time since the late 1960's.

The improvement in the trade balance may well be accompanied by some improvement in other international

transactions -- particularly capital movements. With the dollar so much cheaper than it was two or three years ago, foreign investors are likely to develop a greater interest in acquiring American assets -- business firms, real estate, or securities. There are already numerous indications of such a widening foreign interest. On the other hand, the higher prices that Americans must now pay for foreign currencies tend to diminish their incentive to build plants abroad or to acquire foreign securities.

This favorable outlook for the U. S. balance of trade and payments is, of course, contingent upon containing domestic inflationary pressures. I am greatly troubled by the high rates of inflation that we have experienced in recent months. No exchange-rate regime or international monetary system can work well if the major industrial nations, particularly the United States, fail to gain better control over inflation than we have as yet achieved.

A stable dollar is vital to the well-being of American workers and consumers. It is also essential to the continuing progress of our domestic and foreign business, to a healthier investment climate in our country, and to the maintenance of

our international political standing. I therefore hope that this influential Committee, while immediately concerned with the problem of floating currencies, will keep in mind the overriding importance of restoring stability to the domestic purchasing power of the dollar.
