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Statement by

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I appreciate this opportunity to appear before you on behalf of the Board of Governors to discuss recent developments in the international monetary system.

I should like to begin by sketching in the background of the events of the past few weeks. A careful look at the background will assist all of us in maintaining perspective on the dramatic happenings in the foreground.

The basic fact to keep in mind can be stated simply: on top of an underlying and long-lasting deficit in our balance of payments, there has been a massive flow of short-term funds from the United States to Europe within the past year.

I shall return later to a discussion of the underlying imbalance in our payments position. By itself, this imbalance is nowhere near large enough to have created a crisis. Let us first focus, therefore, on the substantial flow--perhaps I should say reflow--of short-term capital across the Atlantic.

Short-Term Capital Flow

The short-term capital that has moved from the United States to Europe in the past year largely represents funds that had shifted from Europe to the United States during 1969 when monetary policy was much tighter here than in Europe. At that time, while both fiscal and monetary policies in our country were aimed at combatting excess demand, Europe was in a more tranquil stage of economic expansion. American banks, finding their deposits running off as short-term market rates of interest rose above the Regulation Q ceilings, deemed it advantageous to borrow funds from their branches abroad in order to meet domestic demands for credit. The branches in turn bid for funds in the Eurodollar market, and the interest rates they offered were attractive enough to induce foreigners, mostly in Europe, to shift out of assets in their own currencies into dollars. The result was that upward pressure was exerted on interest rates in some European countries and foreign central banks experienced a reduction in their dollar reserves.

It is this process that was reversed over the past year.

Once excess demand for goods and services was brought under control in the United States, the Federal Reserve shifted its policies progressively away from severe restraint and toward moderate ease, in order to assure that the desired cooling off of demand conditions did not go so far as to create a cumulative recession. Meanwhile, many European countries experienced an intensification of economic activity combined with a strong acceleration of wage costs. As a result, monetary policies were tightened in Europe in the latter part of 1969 and in 1970.

In these circumstances, short-term interest rates fell in the United States relative to Europe. American banks found that they could now attract funds at home at lower cost than what they were paying in the Eurodollar market, and they therefore started to repay what they had earlier borrowed from their branches. Meanwhile, European borrowers--both private corporations and governmental entities--were finding that they could avoid domestic credit stringency and pay lower interest rates by borrowing in the Eurodollar market. The massive repayments of liabilities by U.S. banks to their branches were the result not only of a push from the United States, where monetary policy was easing, but also of a pull from Europe, where credit conditions remained tight.

Thus what we have been faced with in the past two years has been a disparity in the phasing of the business cycle in Europe and the United States. Given the existence of such a disparity, it is understandable that there has also been a disparity in monetary conditions, first one way and then the other. In a world of convertible currencies in which many business corporations and financial institutions command large sums, differences in monetary conditions can induce sizable movements of short-term capital. These swings in short-term capital have no doubt been facilitated by the existence of the Eurocurrency markets. But it would be a mistake to believe that the existence of these markets caused the flows. The cause lies in the difference in phasing of basic economic and monetary conditions.

The major pull on short-term funds came from Germany, where the central bank made especially strong efforts to restrain the availability of domestic credit but where private borrowers were quite free to seek loans abroad. There was thus a reciprocal interaction: decisions by U.S. banks to shift from more costly liabilities in the Eurodollar market to less costly liabilities at home released funds for lending to European companies; but the demand for funds by these companies put upward pressure on Eurodollar rates and increased the incentive for U.S. banks to repay their Eurodollar liabilities. In the process, dollars moved in large volume into foreign reserves and the efforts of foreign central banks to combat inflation were to some degree undermined.

One other aspect of this flow should be mentioned. The differential in interest rates between the United States and Europe, including the Eurodollar market, led a number of central banks to shift dollar reserves held in the United States to higher yielding deposits in the Eurodollar market. Whether they engaged in this practice directly or through the Bank for International Settlements, the result was to intensify the problem caused by the flow of short-term capital across the Atlantic. Such placements of central bank foreign exchange reserves in the Eurodollar market made funds available to European borrowers--thus tending to undermine tight money policies in Europe--and led to the creation of official dollar holdings abroad on top of the dollar reserves that originated in the U.S. balance-of-payments deficit.

Actions to Deal with the Capital Flow

As I have already noted, the flow of short-term funds abroad was a result of a U.S. push as well as a European pull. For our part, the U.S. monetary authorities took various actions designed to reduce or intercept the flow of short-term capital. The motivation for such actions was to moderate the U.S. balance-of-payments deficit and the attendant build-up of dollars in the hands of foreign central banks.

I shall merely identify, without discussing at length, the actions taken by the U.S. Government.

(1) The Federal Reserve's Eurodollar regulations, first adopted in 1969 in order to check the inflow from Europe, contained a feature--automatic downward adjustment of the reserve-free base--that provided some incentive for banks to hold on to their Eurodollar liabilities.

(2) In November 1970 the Federal Reserve raised the marginal reserve requirement on bank borrowings of Eurodollars above the reserve-free base from 10 to 20 per cent. This measure reminded banks that preservation of the reserve-free base might be of value to them.

(3) The Federal Reserve extended the automatic downward adjustment to reserve-free bases of banks on the so-called 3 per cent basis and gave these banks time to acquire Eurodollar liabilities.

(4) Federal Reserve open market purchases were conducted, insofar as practicable, in coupon issues rather than Treasury bills, so as to moderate downward pressure

on short-term interest rates without interfering with the basic objectives of monetary policy.

(5) Since mid-March, a moderate advance of short-term interest rates was tolerated by the Federal Reserve, mainly for domestic reasons, but partly also because it helped to narrow the gap between U.S. and European interest rates.

(6) The Treasury Department, in its debt management operations, placed more stress on issuing short-term securities, thereby avoiding upward pressure on long-term--but not on short-term--interest rates.

(7) The Export-Import Bank and the Treasury issued $3 billion of securities to foreign branches of American banks. These special issues intercepted funds that would otherwise have probably landed in foreign central banks.

Meanwhile, European central banks acted constructively to narrow the differential in interest rates. The central bank in Germany and in a number of other countries, motivated by varying combinations of domestic and external considerations, reduced their discount rates in early April. Short-term rates on market instruments also declined.

The Situation on the Eve of the Crisis

By early April a convergence of interest rates was well under way, and we had reason to believe that we had passed the period of maximum capital flow from the United States to Europe. In fact, our statistics show that in April the flow of dollars from our banks to Europe subsided markedly. Not only that, but plans were well advanced to check further creation of Eurodollars by foreign central banks and to assist, through the U.S. Treasury, the recycling of dollars from Europe to the United States.

Unhappily, this situation of relative calm in foreign exchange markets was disturbed by various news items, beginning with reports towards the end of April about a discussion among the Finance Ministers of the European Communities concerning a proposal for the EEC currencies to float together against the dollar. A little later, five economic research institutes of Germany issued simultaneous reports recommending that the Deutsche Mark be permitted to float or be revalued. And the German Economics Minister was reported to have characterized these recommendations as constructive. The background for these developments is quite clear: the intensification of inflationary pressures had given rise to a major political problem in Germany and exchange rate action came to be regarded by some prominent men of affairs as an appealing solution to this problem.

These events were sufficient to generate an enormous wave of speculation about a possible upward move of the D-mark and other currencies. Several European central banks ceased intervening in the exchange markets and, after a Brussels meeting on May 8-9 of the Common Market authorities, Germany and the Netherlands decided to let their currencies fluctuate beyond the customary margin, while Switzerland and Austria revalued, and Belgium adapted its dual-exchange market system to the new situation. France and Italy decided to leave their exchange policies unchanged.

The Present Situation

The options open to the German authorities appeared to be either to introduce controls on the inflow of capital or to take action in the exchange rate field. They chose the latter but agreed with their Common Market partners to deliberate by July 1 on appropriate measures to discourage inflows of capital and to neutralize their effects on the internal monetary situation.

How long the D-mark and the guilder will float is uncertain and is, of course, a matter for determination by the authorities of those countries in accordance with IMF rules.

It is much too early to evaluate the effects of the crisis. We do know that it has generated strong resentments both among European governments and toward the United States. Whether or in what ways these sentiments will affect the future behavior of nations remains to be seen. We can, however, draw some lessons for our own policies.

Lessons from the Crisis

As I have already stressed, the flow of dollars to Europe in the past year has to a major extent taken the form of short-term funds responding to differences in monetary conditions, which in turn reflected differences in business cycle phasing. Nevertheless, this flow came on top of a persistent deficit in our underlying balance of payments. Had such a persistent underlying deficit not existed, the recent crisis would not have been interpreted, as it was in some quarters, as a dollar crisis.

The underlying U.S. deficit, like the short-term capital flow, is attributable to actions and policies of other countries as well as to those of our own country. The United States cannot restore equilibrium to its balance of payments without acceptance or complementary actions abroad. But we must do what it is in our power to do, while we make efforts to persuade other countries to complement our actions.

What then can we do to improve the international position of the dollar? I see no real conflict between our domestic and our balance of payments objectives. The frequently suggested prescription of raising interest rates would not meet our lasting needs at home or abroad.

(1) The overriding need is to restore price stability even as the present slack in our economy is taken up. I believe, with growing conviction, that a cogent incomes policy is a necessary part of the effort to restore price stability.

(2) Until a better price performance makes it possible for us to rebuild a healthy trade surplus, we must be prepared to maintain our restraints on private capital outflow. I can think of nothing that would arouse greater resentment abroad and weaken the dollar more than an attitude of neglect that included dismantling or even relaxing our existing programs to restrain the outflow of U.S. capital.

(3) We need to persuade other nations to relax promptly the restrictions on their imports and on

investments abroad by their own citizens, besides undertaking a significantly larger contribution to the defense of the Free World.

(4) In the future, we must work with other nations to try to bring about smaller divergences of monetary policies. While many Europeans feel that the United States depended excessively on monetary ease in the past year, there are surely grounds for holding that the Europeans relied excessively on monetary stringency during this period. A more active use of fiscal policy by each major country in the interest of its own economy could, if found feasible, materially reduce divergences in monetary policies and thereby limit short-term movements of funds and payments imbalances.

(5) At the same time, measures can be adopted to offset the effects of those short-term capital flows that cannot be prevented. Such measures might include issues of securities by the U.S. Government abroad to absorb funds from the Eurodollar market, and the provision of improved investment outlets in the United States for foreign central bank reserves.

Conclusion

Let me say in closing that, despite recent events, I see no reason for gloom about our balance of payments as we look ahead.

First, our price performance is likely to be better than that of many other industrial countries, especially if we adopt a stronger incomes policy. This will permit us to regain competitive strength that we probably lost in the second half of the 1960's.

Second, our receipts of investment income from abroad have been rising rapidly. We expect this to continue even as rewards from investment at home, which affect both our capital and current accounts, loom larger.

Third, we have seen in recent years a large increase in foreign investment in the U.S. stock market. This too should continue, provided we maintain a strong and healthy economy and take measures to prevent recurrences of the sort of speculative crisis that has occurred recently.

Fourth, the continuing reduction of our troops in Vietnam is diminishing the military drain on our balance of payments.

Fifth, the bulk of the short-term capital outflow is now behind us. U.S. banks have reduced their liabilities to their branches from over $14 billion in early 1970 to about $2 billion presently. Thus even before our underlying payments position improves, our deficit on the official settlements basis should fall sharply from its rate of the last year or so.

These favorable prospects can be hastened, as I have suggested earlier, if they are accommodated to by other countries. The balance of payments is, by definition, a flow <u>between</u> countries or regions. The U.S. deficit is the rest of the world's surplus. The rest of the world must be prepared to see its surplus decrease if the U.S. deficit is to decrease. This simple arithmetic truism has important policy implications for our major trading partners as well as for us.

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