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Statement by

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before the

Committee on Banking and Currency

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The Board of Governors of the Federal Reserve System strongly supports enactment of the Par Value Modification Act. Prompt passage of this bill will fulfill an important commitment undertaken by the United States as part of the Smithsonian Agreement reached by the Group of Ten countries on December 18, 1971.

The Par Value Modification Act

The Par Value Modification Act proposes a new par value for the dollar in the International Monetary Fund. We will thus have a new official dollar price of gold: an ounce of gold will in the future be carried on the books at $38 instead of $35 as at present. The Act does not deal with the issue of convertibility, and therefore does not affect the present suspension of convertibility of dollars into gold or other international reserve assets.

The proposed change in the par value of the dollar will have several financial and accounting consequences. The value of the Treasury's gold and other reserve assets will be written up by 8.57 per cent, or about a billion dollars. The dollar value of subscriptions and contributions to several international financial organizations will need to be increased. And there will be an increase in the dollar value of certain Treasury and Federal Reserve liabilities connected with operations in foreign currencies.

The net result of the various financial and accounting adjustments, as the Secretary of the Treasury has informed this Committee, will improve somewhat the Treasury's cash position and leave both budgetary expenditures and the overall dollar assets and liabilities of the U.S. Government roughly unchanged.

The Federal Reserve System will be affected by the financial and accounting adjustments in two ways. First, the Treasury will be able to issue new gold certificates to the Federal Reserve Banks in an amount equal to the increment in the book value of the Treasury gold stock. To the extent that it does so, the Treasury's cash balance will rise. A subsequent return of its cash balance to previous levels would of itself result in an increase of bank reserves, but this increase could be offset--in whole or in part--by Federal Reserve open market operations.

The other effect on Federal Reserve transactions and accounts will occur in connection with settlement of commitments under the reciprocal currency arrangements with foreign central banks. Use of a "swap" arrangement by the Federal Reserve entails an obligation to deliver a specified amount of foreign currency at a future date. Similar commitments have been undertaken by the Treasury on its debt securities denominated in foreign currencies. At the present time, the Federal Reserve has outstanding foreign commitments of $2.86 billion. Inasmuch as the dollar prices of the affected currencies--namely, Swiss francs, Belgian francs, pounds sterling, and German marks--have risen since the swap drawings were made, there will be a cost to the Federal Reserve--presently estimated at less than $200 million--of liquidating these drawings.

The purpose of the swap transactions carried out in 1971, as in earlier years, was to defer or reduce declines in reserve assets that might otherwise have occurred. The losses to be taken when the swaps are settled will reduce the earnings of the Federal Reserve System that are turned over to the Treasury. But against this loss the Treasury may have a roughly offsetting profit on the gold and other reserve assets which it still holds because of the willingness of foreign central banks to accept Federal Reserve swap drawings instead of demanding reserve assets from the Treasury.

Need for Prompt Legislation

I have so far focused attention on the financial and accounting consequences of the Par Value Modification Act. If these were the sole results to be expected from the bill, there would be no need to rush its passage. But much more than this is involved.

As this Committee knows, the proposed change in the par value of the dollar was an integral part of the Smithsonian Agreement. Failure to pass promptly the Par Value Act could provoke a renewal of disorderly conditions in financial markets and place in jeopardy the Smithsonian Agreement itself. It is no exaggeration to state that the realignment of currencies which the Smithsonian Agreement achieved is absolutely essential to the reinvigoration of our foreign trade and the eventual restoration of equilibrium in our balance of payments.

Background of the Smithsonian Agreement

The international monetary crisis we experienced in 1971 was by far the most severe since World War II. It had its roots in events that stretch back over many years, during which a persistent deficit developed in the U. S. balance of payments. The crisis came to a head last summer when increasingly unfavorable reports on our foreign trade released a wave of speculation against the dollar that eventually engulfed foreign exchange markets. The speculation expressed a growing belief that there would soon have to be a substantial upward revaluation of at least some major currencies against the dollar--or, what comes to the same thing, that the dollar would need to depreciate in terms of other major currencies.

On August 15, the President announced a new policy for dealing decisively with the domestic problems of inflation, inadequate productivity, and unemployment, which were weakening confidence in the American economy. Recognizing that curbs on domestic inflation would not suffice to restore equilibrium in the balance of payments, the President sought also to achieve a realignment of currencies and better access to foreign markets for American producers. To set the stage for useful international negotiations, a temporary surcharge was therefore imposed on imports and the convertibility of dollars into gold or other reserve assets was suspended.

As expected, dollar prices of most of the major foreign currencies rose on the exchange markets. Foreign governments, although caught by surprise, soon sought in various ways to adjust to the new monetary and trade conditions. Some imposed restrictions on inflows of funds while permitting their exchange rates to appreciate in a controlled manner. Others resorted to rather comprehensive financial controls in an effort to maintain pre-August 15 exchange rates, at least for trade transactions. Only a few countries permitted their exchange rates to move more or less freely.

The pattern of exchange rates that evolved after August 15 thus failed to meet American objectives. Worse still, restrictions on international transactions were proliferating, with a few countries even imposing restrictions or subsidies on trade itself. Businessmen both here and abroad faced acute uncertainty regarding the exchange rates and governmental restrictions under which trade would be carried on in the future. This uncertainty aggravated recessionary forces already evident in Europe and Japan. It also affected adversely the profit expectations of American companies engaged in foreign operations or foreign trade, thereby inhibiting investment expenditures and economic expansion in the United States.

In these circumstances, the dangers were growing of a recession in world economic activity, of increasing recourse to restrictions on international transactions, of a division of the world economy into restrictive blocs, and of serious political frictions among friendly nations. Prompt resolution of the crisis was clearly necessary, and intensive international discussions therefore got under way in the autumn of 1971.

The settlement negotiated at the Smithsonian meeting of last December provided for an average appreciation of the currencies of the other Group of Ten countries against the dollar of about 12 per cent. Agreement was also reached on a widening of margins for exchange rate variation. Later, a number of other countries decided to revalue their currencies upward against the dollar, but most of the developing countries have elected to maintain their exchange rates against the dollar at the pre-August 15 levels.

Trade agreements were recognized by the participants in the Smithsonian Agreement as relevant to the achievement of lasting equilibrium in the international economy. Negotiations on trade matters of immediate concern to the United States, and which were under way at the time of the agreement, have since then been completed with Japan and the European Community--but not with Canada.

The new trade measures should improve the climate for certain U. S. exports. For the longer run, the prospects are now promising for widespread support of comprehensive multilateral negotiations on reducing barriers to trade in both industrial and agricultural products.

For its part in the settlement, the United States agreed to drop the import surcharge and related provisions of the investment tax credit, and to facilitate the realignment of exchange rates by proposing to Congress a change in the par value of the dollar in terms of gold.

Thus, the Par Value Modification Act is before you to honor a critical commitment made in behalf of the U. S. Government at the Smithsonian meeting. The American negotiators would have preferred to achieve the desired appreciation of foreign currencies without doing anything about the official dollar price of gold. Other countries, however, refused to countenance such a passive role by the United States in a multilateral adjustment of exchange rates.

Active participation by the United States in the exchange rate realignment was expected by other countries for various reasons. Some countries regarded it as politically or financially unacceptable to reduce the price of gold in terms of their own currencies--as would have been required if the exchange rate realignment had left the par value of the dollar in terms of gold unchanged. And virtually all countries took the position that no nation should be immune from changing its par value when its balance of payments is in disequilibrium. In our judgment, a negotiated realignment of exchange rates would have been unattainable if the United States had refused to consider a change in the par value of the dollar.

As already noted, the Par Value Modification Act proposes an increase in the official dollar price of gold from $35 to $38 an ounce, that is, by 8.57 per cent. This exact increase reflects a compromise outcome of the negotiations on the realignment of exchange rates. A price significantly higher than $38 per ounce was never seriously considered. An increase of less than eight and one-half per cent would have failed to bring forth a realignment of exchange rates as large as the readjustment that was finally accepted. The primary objective of the U. S. negotiators at the Smithsonian meeting was to achieve a substantial upward revaluation of the currencies of other industrial countries against the dollar, and this result was achieved.

It should be noted in passing that under the two-tier system for gold, agreed to in March 1968, the official price of monetary gold and the free market price of gold are effectively separated. For all practical purposes, gold in official reserves is now a different entity from gold that is bought and sold in free markets for industrial, artistic, or hoarding purposes. In particular, the market price of gold has no bearing on the change in the official price of gold proposed in the Par Value Modification Act.

Effects of the Smithsonian Agreement

Looking to the future, let me turn briefly to the probable effects of the Smithsonian Agreement. Since dollar prices of foreign currencies are now substantially higher than before, the growth of our imports will tend to slacken and domestic production will be stimulated. On the other hand, the lower price of dollars abroad will make it possible for our exporters to quote lower prices in terms of foreign currencies. Similarly, the lower price of dollars will tend to stimulate foreign investments and travel in the United States.

There is thus every reason to expect the realignment of exchange rates to bring about, in time, a substantial improvement in our foreign trade balance and in our overall balance of payments.

Just how large the improvement will be, and how long it will take for the full improvement to be realized, cannot be predicted with certainty. The experience of other countries indicates that large exchange-rate changes will produce large shifts in the balance of payments; but it also indicates that two years or so may need to elapse before the full extent of the favorable shift is realized.

While the Smithsonian realignment will have its largest effects on our exports and imports, there should also be favorable effects on other components of the balance of payments, including capital flows to and from the United States. Such capital flows have already been affected. The enormous outflow of speculative funds from the United States came to an end when the Smithsonian Agreement was announced. Since December 18, there has been a small net return flow of funds.

Besides serving to reinvigorate our foreign trade and otherwise improve the balance of payments, the Smithsonian Agreement has increased confidence both at home and abroad in the stability of the world economy. This confidence will be buttressed by passage of the Par Value Modification Act.

Unfinished Business

The Smithsonian Agreement provided not only for a realignment of exchange rates and other measures of immediate concern, but also "that discussions should be promptly undertaken, particularly in the framework of the IMF, to consider reform of the international monetary system over the longer-term." This unfinished business is most important. If we are to avoid a repetition of crises while preserving a monetary framework conducive to the healthy expansion of trade and investment, we must work with other countries to build a new and stronger international economic order.

In the area of exchange rates, the wider margins agreed to in December should prove helpful, especially in moderating short-term capital flows and thereby permitting somewhat greater scope for differences in interest rates among countries. For the longer run, procedures for changing par values will need to be flexible enough to prevent the buildup of large and persistent imbalances in trade and payments among countries.

A searching re-evaluation is also needed of the roles to be played by gold, reserve currencies, and special drawing rights in settling international accounts. Various proposals for modifying the operations of the International Monetary Fund require study and discussion. The circumstances under which the dollar may again be convertible into international reserve assets will have to be reviewed carefully. And determined new efforts will be required to reduce impediments to the international flow of goods, services, and capital.

The issues are many and complex. It will take time to resolve them. But the unfinished business of international monetary reform requires that we get on with the job without delay. Early action by the Congress on the bill before you will set the stage for much needed progress in both the international monetary and international trade areas.

Concluding Comment

I have discussed at some length the Smithsonian Agreement because it has given rise to the present hearing. But I cannot conclude this statement without warning that neither the Smithsonian Agreement, nor passage of the bill before you, nor any international monetary or trade reforms that may follow, can of themselves do more than move us toward the objectives of renewed vigor in foreign trade and equilibrium in the balance of payments.

To assure success in these objectives of foreign economic policy, we must have skillful and fully responsible management of monetary and fiscal affairs. The objectives of our foreign economic policy and of our domestic economic policy are interdependent. For the sake of both the one and the other we will need to concentrate on stepping up sharply the productivity of our resources and on regaining prosperity without inflation.