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Statement by

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Nine months have elapsed since last December when the finance ministers and central bank governors of the Group of Ten countries met at the Smithsonian Institution and reached an agreement on realigning the rates at which major currencies are to exchange for one another. During this period, exchange markets have alternated between calm and uneasiness.

The immediate reaction of the financial world to the Smithsonian Agreement was one of overwhelming approval. After the turn of the year, however, the earlier enthusiasm gave way to more cautious appraisal.

Many market participants expected a large return flow of capital to the United States to materialize right after the December meeting. This did not happen. A decline of interest rates in the United States relative to those abroad was partly responsible for inhibiting the reflow of funds. Another factor was the initial low level of foreign exchange rates within the wider exchange margins agreed to at the Smithsonian meeting. With the major European currencies below their central values, temporary holders of those currencies sensed a possibility of making a larger profit by delaying a shift back into dollars until the dollar

prices of foreign currencies approached closer to their upper limits. And once major European currencies strengthened within the margins, fears developed that some governments would fail to defend the Smithsonian exchange rates.

But as successive speculative episodes occurred in January, February, and early March, the foreign central banks intervened decisively. Their clear determination to uphold the new system of exchange rates had a reassuring effect on the market. Moreover, short-term market interest rates began rising somewhat in the United States while they declined abroad. This convergence of international interest rates helped to improve the atmosphere of foreign exchange markets. So too did prompt passage by the Congress of the Par Value Modification Act, known popularly as the gold bill. Confidence in the new system of exchange rates therefore improved and markets became more orderly.

Indeed, between mid-March and mid-June a sizable reflow of capital to the United States actually materialized. This reflow more than offset our continuing deficit on current account. Since the United States ran a surplus in its official settlements balance during this period, the dollar naturally strengthened in exchange markets.

This encouraging development ended abruptly in June as sterling came under increasing pressure. Today's hearing is

hardly the occasion to discuss Great Britain's problems, except to note that sharp and persistent wage and price advances weakened the market's confidence in the ability of Britain to continue to defend its new exchange rate. On June 23, after suffering a huge decline of monetary reserves, the British Government announced its decision to float the pound.

In the weeks following the British decision, exchange markets were again in turmoil and the dollar again weakened. Most of the major European currencies and the Japanese yen moved to their Smithsonian ceilings as market participants sought protection against the possibility of tighter foreign restrictions on capital imports, a float of Common Market currencies, or some combination of both. Speculative waves buffeted the markets daily, and several countries responded by adopting new restrictive measures on capital inflows. By Friday, July 14, the sterling crisis, besides causing a shift of \$2.6 billion from sterling into Common Market currencies, led to an additional flow of over \$6 billion from dollars into European currencies and the yen.

A period of relative calm was finally restored after mid-July and has been maintained since that time. On July 17-18, the Common Market finance ministers and central bank governors met in London and reaffirmed their determination to maintain the Smithsonian pattern of exchange rates while discussions were proceeding

on longer-term reform of the international monetary system. On July 19, the Federal Reserve System, acting in collaboration with the Treasury, resumed operations in the foreign exchange market. These two actions were entirely independent. Both played a major role in arresting disorderly speculation and renewing market confidence.

Officials of the Federal Reserve and the Treasury had been considering for some time the advisability of renewed operations in the exchange markets that would involve -- among other things -- a resumption of Federal Reserve swap drawings which were suspended on August 15, 1971. Once a governmental decision to reactivate the swap network was reached, the Federal Reserve was ready to move. The first of these exchange operations occurred on July 19 when the Federal Reserve Bank of New York made repeated offerings of sizable amounts of German marks on the New York market. I explained at the time that this operation was undertaken to help restore order in the foreign exchange markets, that the United States was simply doing its part in upholding the Smithsonian Agreement just as other countries were doing, and that the operation would continue on whatever scale and in whichever currencies seemed advisable. As this Committee doubtless knows, the American intervention in the exchange market was very favorably received by financial observers and participants both in the United States and abroad.

The New York Reserve Bank has recently intervened in the market for Belgian francs as well as for German marks. In all, the Bank has intervened in the exchange markets on nine occasions and in the process sold about \$32 million of foreign currencies. This amount, while relatively small, needs to be interpreted in the light of two major facts: first, the amount offered by the Bank for sale was much larger; second, in view of the extensive swap facilities outstanding, their reactivation meant that the amount that could at any time be offered for sale was vastly larger. The second of these facts has been a matter of general knowledge, and it was sufficient to make even reckless speculators stop and think. As the dollar strengthened on the exchanges, all sales of foreign currencies by the Federal Reserve that have taken place since July 19, whether from balances on hand or from swap drawings, were later fully covered by market purchases.

The Federal Reserve's foreign exchange operations started in 1962 and have been reported semiannually since then. The latest report, which describes operations through September 8, was released just a few days ago. With your permission, I would like to submit it for the record.

Let me call your attention now to a few salient facts concerning the swap facility -- that is, the network of reciprocal currency arrangements that the Federal Reserve maintains with foreign

central banks. This facility encompasses fourteen central banks and also the Bank for International Settlements. The total amount that the Federal Reserve can draw on these institutions under outstanding arrangements is \$11,730 million. By August 15, 1971, the amount actually drawn -- that is, the Federal Reserve's debt to foreign institutions -- had reached a peak of \$3,045 million. Since then, substantial repayments have taken place, and the outstanding debt stood at \$1,770 million on September 8 of this year.

Although profit considerations have never been the primary factor in the swap transactions, the Federal Reserve may either earn a profit or incur a loss in the course of using the swaps. A swap drawing by the Federal Reserve entails an obligation to deliver a specified amount of foreign currency at a future date. If the Federal Reserve acquires the currency needed for repayment of the swap at a dollar price that is lower than the price at which it was initially sold, a profit is made on the two transactions taken together. A loss results in the reverse case when the foreign currency appreciates between the time of the drawing and the time it is paid off and the required amount of foreign currency is therefore purchased at a higher price.

As already noted, the Federal Reserve's outstanding swap commitments on August 15, 1971 amounted to \$3,045 million. Inasmuch as the dollar prices of the affected currencies -- namely,

Swiss francs, Belgian francs, pounds sterling, and German marks -- have risen since then, the Federal Reserve has already incurred or will probably need to incur losses in liquidating these drawings. The total loss is presently estimated at about \$160 million.

Two related facts have a vital bearing on this loss figure. First, from the inception of the swap network in 1962 until August 15, 1971, the Federal Reserve had a cumulative profit on its foreign exchange transactions of \$25.6 million.

The second and more basic fact is that the expected Federal Reserve loss on foreign currency transactions undertaken prior to August 1971 is offset by the Treasury's incremental profit on gold account. Prior to the suspension of convertibility on August 15, 1971, foreign central banks taking in dollars could, under the Bretton Woods Agreement, convert such dollars into gold or other reserve assets. The swap transactions that were carried out in 1971 and earlier years served to defer or to reduce declines in reserve assets that would otherwise have occurred. Since gold was revalued in May of this year, the Treasury has profited substantially from the revaluation of the additional amount of gold that it now holds precisely because foreign central banks were willing to accept Federal Reserve swap drawings instead of demanding reserve assets from the Treasury.

All along, the primary purpose of the swap facilities that I have been discussing has been to serve as a first line of defense against disruptive speculation in exchange markets. Future foreign exchange operations by the Federal Reserve will continue to be guided by this objective. As in the past, operations in the currency of a particular country will be conducted only after full consultation with the central bank of that country.

In the new phase of operations, however, we shall not be confronted with the necessity of drawing on swap lines as an alternative to conversion by foreign central banks of dollars into gold or other reserve assets. In the new operations, market intervention will be on the Federal Reserve's initiative. It will be undertaken only to prevent or counteract disorderly market conditions and will be in such amounts and at such times as are judged likely to have a favorable market impact. Swap drawings will not be made for the purpose of providing medium- or longer-term financing of the U.S. payments deficit. Nor will they be used as a substitute for needed adjustments in basic economic policies.

Let me turn next to a brief discussion of recent balance-of-payments developments. The world payments situation continues to be plagued by large imbalances, despite the fact that the Smithsonian exchange rates are more appropriate than those that prevailed before August 1971. The U.S. deficit on current account and long-term

capital transactions -- sometimes called the "basic" deficit -- has continued to be disconcertingly large, reaching an annual rate of nearly \$11 billion in the first half of this year. Meanwhile, other countries have been experiencing large payments surpluses -- not only Japan and some industrial countries in Europe, but also many of the nonindustrial countries.

We knew, of course, at the time of the Smithsonian Agreement that it would probably take two or three years for exchange rate adjustments to work out their full remedial effects. We also knew that business recovery in Europe and Japan was lagging behind the recovery in the United States, and that this divergence of business-cycle phasing would of itself delay restoration of equilibrium in our balance of payments. Under the circumstances, it would be entirely premature to reach a pessimistic conclusion about the longer-run outlook for our international transactions. It should, however, be noted that the needed adjustments of payments imbalances, particularly in our merchandise trade, are taking place more slowly than had been hoped or anticipated.

One need not be a great optimist to argue that several forces are at last working in the direction of bringing about significant improvement in the over-all balance of our international payments. These include, first and foremost, the better performance of costs and prices in this country during the past year than in other industrial countries; second, the impact of the exchange rate

changes of last December, which in time should appreciably moderate the growth of our imports while stimulating the expansion of exports; third, the cyclical recovery now under way in Japan and Europe, which should increase the demand for our exports; and fourth, the strong expansion of our domestic economy, which should -- besides helping to attract foreign capital to this country -- make American investors more willing to put their dollars to work at home rather than abroad.

Still another encouraging fact is the growing awareness -- emphasized in the recent IMF report on international monetary reform -- that the status of international payments imbalances requires continuing review by both deficit and surplus countries.

Finally, I want to comment briefly on the prospects for international monetary reform. The governments represented at the Smithsonian conference recognized that the agreement they had reached represented only the first step in rebuilding monetary order. Although the Smithsonian meeting -- and conversations since that time -- have set the stage for realistic international negotiations, they have done no more than that. The uneasiness and turmoil that have characterized exchange markets in recent months, the violent movements of short-term capital from one currency into

another, the new capital controls which various governments established in reacting to these movements, the floating of the British pound -- all these indicate the urgent need for early rebuilding of the international monetary system.

Fortunately, it now appears that substantive negotiations will get under way promptly. The Committee of 20 in the International Monetary Fund will begin to function at the Fund-Bank meetings the week after next. The Deputies of the Committee of 20 should be able to meet frequently thereafter, canvass different approaches, and seek diligently to narrow the differences of view that presently prevail among national governments.

Many important issues will have to be resolved in the forthcoming negotiations. They include questions about the future monetary role of gold -- a subject in which this Subcommittee has indicated a special interest and on which Under Secretary Volcker testified earlier in the week. In general, I agree with the views that he has expressed. More specifically, I believe that the monetary role of gold will continue to diminish in the years ahead, while there will be a continuing increase in the importance of SDRs.

In discussing international monetary reform, we should guard against the tendency to be preoccupied with gold. Other issues deserve the greater part of our attention. Let me note some of them.

Ways need to be found, first of all, to assure a more prompt adjustment of payments imbalances than characterized the practical workings of the Bretton Woods System. Discussion of this objective and the means to attain it will in turn necessitate a thoroughgoing reexamination of the provisions of the IMF Articles of Agreement dealing with par values and exchange-rate flexibility.

Under the monetary system that prevailed before August 1971, there was a tendency to equate deficits with sin and surpluses with virtue. Moral as well as financial pressures were certainly much greater on deficit countries to reduce their deficits than on surplus countries to reduce surpluses. In fact, however, responsibility for payments imbalances can seldom be assigned unambiguously to individual countries. Moreover, the adjustment process is unlikely to work efficiently if surplus countries fail to participate actively in it. New means will therefore need to be devised for achieving a better division of responsibilities among surplus and deficit countries for initiating the correction of payments imbalances.

A number of vital issues will arise in connection with the convertibility of the dollar and future procedures for the settlement of payments imbalances. Decisions will need to be reached on the role of various reserve assets -- not only gold, but also SDRs and reserve currencies. Major changes may be called for in the procedures governing the creation, allocation, and use of SDRs. Understandings

will have to be reached about the desirability and feasibility of imposing limitations on the use of reserve currencies. Various proposals for the "consolidation" of reserve assets -- among them, the substitution of SDRs for reserve currencies or gold -- may need to be examined.

Moreover, since restrictive trading practices are a major factor influencing the balance-of-payments position of individual countries, it would be neither possible nor desirable to exclude the subject of trading arrangements from the forthcoming negotiations. As a specific example, some consideration will have to be given to ways of amending trade restrictions that impede payments adjustment when exchange rates are altered.

Still other issues will come up, particularly those bearing on volatile capital movements, the transition from our present interim arrangements to the new reformed system, and the organizational structure of the IMF.

There are bound to be significant differences in national views on the issues I have mentioned, and practical difficulties will intrude as efforts are made to resolve the differences. Nevertheless, we can be moderately optimistic about the outlook. All countries have a strong interest in devising new rules to govern international monetary arrangements. Disagreements among nations

exist, but they can be resolved once their representatives get down to the serious business of discussing them in a constructive and cooperative spirit.

The task confronting the conferees will be rendered more manageable if the major industrial countries, particularly the United States, meanwhile practice strict financial discipline. Indeed, I doubt if a viable international monetary system can be rebuilt without better control over inflation than we have as yet achieved. Fortunately, this need is increasingly understood in our country.

I look ahead to an extended period of challenging and rewarding negotiations on monetary and related trade issues. At the end of this process, we should have the foundations of a new and stronger international economic order.