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Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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The Board of Governors of the Federal Reserve System supports prompt enactment of S. 929, the bill to amend the Par Value Modification Act of 1972.

The bill proposes a new par value for the dollar in the International Monetary Fund. This proposed change will have several financial and accounting consequences. The value of the Treasury's reserve assets will be written up by 11.1 per cent, or about $1.4 billion. The dollar value of our subscriptions and contributions to several international financial institutions will need to be increased. In addition, 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 these financial and accounting adjustments will be to leave budgetary expenditures and the overall dollar assets and liabilities of the U.S. Government little changed.

The Federal Reserve System will be affected by these 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 increase in the book value of the Treasury gold stock. To the extent that the Treasury does so, its cash balance will rise. A subsequent return of the Treasury cash balance to previous levels would, of itself, result in an equivalent increase in bank reserves; but such an increase can be readily offset--in whole or in part--by Federal Reserve open market operations.

The other effect on the transactions and accounts of the Federal Reserve 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.

As of February 12, 1973, the Federal Reserve had outstanding swap drawings of $1.66 billion, almost all of which were originally undertaken prior to August 15, 1971. Inasmuch as the dollar prices of the affected currencies--Swiss francs, Belgian francs, and German marks--were further increased as a result of the currency realignment of February 12, there will be an additional cost to the Federal Reserve in liquidating these drawings. The cost attributable to the February 12th realignment is presently estimated at nearly $200 million. The total cost attributable to both the Smithsonian realignment and this February's realignment is estimated at less than $400 million.

The purpose of the swap transactions carried out prior to August 15, 1971 was to defer or reduce declines in reserve assets that would otherwise have occurred. The losses incurred at the time these swaps are settled reduce the earnings of the Federal Reserve System that are turned over to the Treasury. But against these losses the Treasury has a roughly offsetting profit on the gold and other reserve assets that it still holds because foreign central banks were willing to accept Federal Reserve swap drawings instead of demanding reserve assets from the Treasury.

The fundamental cause of the exchange market crisis that preceded the February 12th decision to propose a change in the par value of the dollar was the large and persistent deficit in the U. S. balance of payments and, as its counterpart, persistent surpluses of foreign countries. Our deficit of about 10 to 11 billion dollars on official reserve transactions in 1972 was less than the huge $30 billion deficit of 1971, but it was still enormous by any historical standard. As a consequence, the liabilities of the United States to foreign monetary authorities rose to $61 billion by the end of last year.

Against this background, it is not surprising that exchange markets were sensitive to recent economic developments. Publication of our November and December trade figures, which indicated that the trade deficit during 1972 would reach nearly $7 billion, had an unsettling effect on financial opinion. Recent sharp increases in wholesale prices coincided with doubts voiced in the public press about the effectiveness of Phase III. Financial sentiment may also have been adversely affected by the continuance of a large Federal budget deficit at a time of rapid economic expansion.

In late January, confidence in the stability of exchange markets deteriorated when the Italian Government adopted a two-tier market and the Swiss authorities decided to let their currency float. As excitement mounted in exchange markets, particularly in the case of the German mark, close consultation was maintained by our government with other governments. The Federal Reserve System and the Treasury undertook some intervention in German marks and Dutch guilders in a cooperative effort with other central banks to maintain order in exchange markets. Then, when large-scale speculation failed to diminish, the President decided on February 6 to take the lead in trying to find a resolution of the crisis by promptly exploring alternative courses of action with other countries. On Monday, February 12, Secretary Shultz announced that an agreement had been reached.

As you know, the President has proposed a devaluation of the dollar by 10 per cent--that is to say, the value of the dollar in terms of gold or SDR would decline by 10 per cent. Stated differently, our official price of gold would rise by 11.1 per cent or from $38.00 to $42.22 per ounce, and the price of SDR would likewise rise by 11.1 per cent or from $1.09 to $1.21. The bill you are now considering will give formal effect to the devaluation. It should be noted that the newly proposed official price of gold, like the old official price, is an accounting measure and must not be confused with the market price of gold.

The response of foreign countries to the proposed devaluation of the dollar has on the whole been favorable. A large number of countries have left unchanged the value of their currency in terms of gold, thereby allowing their currency to appreciate against the dollar by the full amount of the dollar devaluation. Many other countries have devalued part or all of the way with the dollar, but in most cases these actions appear to be consistent with their balance-of-payments situation. Countries with floating currencies--which now include Japan, the United Kingdom, Italy, Canada, and Switzerland--have so far intervened in their exchange markets on only a small scale. In view of the need to correct the existing pattern of payments imbalances, it is particularly encouraging that the Japanese yen has appreciated not only against the dollar, but also by a significant amount against other major currencies.

When these recent exchange-rate changes are taken together with those embodied in the Smithsonian realignment, it is clear that the U. S. competitive position has improved substantially. The balance-of-payments effects resulting from this improvement, however, will be fully felt only after a considerable lag. Indeed, in the months immediately ahead, the effect of the devaluation on the dollar value of imports is likely to be perverse. The reason is that dollar import prices go up quickly, while businesses and consumers will take time to cut back on the quantities that are imported.

The foreign trade figures just released for January show improvement. Nevertheless, there should be neither surprise nor anxiety if the trade deficit remains large in the next few months. Later this year, and more so in 1974, we can confidently expect our foreign trade and payments position to improve. The combination of the Smithsonian realignment and the recent exchange-rate changes have placed us squarely on the road back towards equilibrium in our balance of payments.

We must guard, however, against taking that improvement for granted. The deficit in our international transactions, while welcome in the early post-war years, has persisted since 1950. The few signs of improvement that have appeared now and then have proved evanescent. By now, the deficit in our balance of payments has seeped into the thinking of people concerned with finance around the entire world. The persistence of this deficit, its recent huge size, and the associated surpluses elsewhere have weakened the international monetary system, and have caused uncertainty to spread among traders. Restoration of confidence in the international financial order is essential. Indeed, confidence in our own economy will be strengthened if we set for our nation a firm and definite goal for the balance of payments--namely, to end the deficit within a period of two to three years.

The recent realignment of exchange rates, as I have already noted, has put us well on the road towards equilibrium in the balance of payments. To stay firmly on that road, we must make sure that our economic policies, taken as a whole, are realistically adjusted to our needs.

It cannot be emphasized too strongly that changes in exchange rates are not--and can never be--a substitute for sound domestic policies. The primary task of economic policy this year is to steer our expanding economy onto a noninflationary course. This goal is essential for domestic reasons, and it is no less vital for our international position. Unless our recent success in reducing the rate of inflation is extended, the improvement in the balance of payments which will result from the devaluation of the dollar may gradually be eroded away. Moreover, a vigorous effort to increase productivity and curb inflation is more than ever necessary, since Americans now have to pay more for their imported goods. With the prices of foodstuffs soaring and uneasiness about wages spreading, we must use all the tools in our arsenal--monetary policy, fiscal policy, and incomes policy--to achieve faster progress towards general price stability.

There is a second need that requires the attention of the Congress. The President has indicated that he will shortly be submitting new trade legislation. According to the Secretary of the Treasury, the President's recommendations will include authority to lower U. S. trade restrictions as part of a mutual reduction of trade barriers with other countries. They will also provide authority for raising U. S. barriers if that proves necessary to achieve fair access of our products into foreign markets, to provide safeguards against disruption of particular domestic markets, or to protect our international financial position against large and persistent deficits. If it should turn out that inadequate progress is being achieved in reducing the deficit in the U.S. balance of payments, this latter authority should be available for use; for we must leave no doubt about our determination to bring the long series of deficits in our balance of payments to a scheduled end. However, any deviation from a liberal commercial policy should be limited and strictly temporary, so that over the longer run we and other countries may continue to gain the benefits of a growing volume of international trade and investment.

There is a third need that we should keep in mind--namely, the importance of maintaining an environment that is conducive to private enterprise and investment. The recent upsurge of economic activity has made Americans seeking permanent investments more willing to put their dollars to work at home rather than abroad. It has also led to substantial foreign investment in American enterprises last year. Such foreign investment needs to be encouraged. Among other things, the proposal recently put forward by Congressman Mills for elimination of the withholding tax on interest and dividend payments to foreigners deserves serious study.

While we apply ourselves with zeal and diligence, as I trust we shall, to putting a halt to the deficits in our international accounts, we must simultaneously intensify our efforts to reform international monetary and trading relationships. The behavior of exchange markets since mid-January has poignantly demonstrated once again the urgent need for reaching early agreement on the framework of a new international monetary system. The United States Government has put forward a plan that promises to promote effective and more orderly adjustment of payments imbalances in the future. Other countries should be equally forthcoming in putting their views forward. The essential thing is to move at a faster pace toward agreement on a monetary system that will not be prone to recurring crises.

In conclusion, I want to share with you a sentiment I expressed last week to the Joint Economic Committee. I have recently felt a sense of concern developing across the nation about the ability of the United States to deal with its economic problems. This concern is understandable, for we live in troubled times and our problems are not simple. But I have every confidence in our nation's ability to resolve its problems as long as business, labor, and all branches of our government remain willing to work together toward the basic economic objective of prosperity without inflation.

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