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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on International Finance

of the

Committee on Banking and Currency

House of Representatives

March 7, 1973

The Board of Governors of the Federal Reserve System supports prompt enactment of H. R. 4536, 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 12 realignment is presently estimated at nearly $200 million. The total cost attributable to both the Smithsonian realignment and this February's realignment is presently 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 that are incurred at the time these swaps are settled reduce the earnings which the Federal Reserve System turns 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 was not surprising that exchange markets were sensitive to current 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. Excitement mounted rapidly in exchange markets, particularly in the case of the German mark. 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 immediate response of foreign governments to the proposed devaluation of the dollar was generally in accord with our expectations. A large number of countries left unchanged the value of their currency in terms of gold and SDR, thereby allowing their currency to appreciate against the dollar by the full amount of the dollar devaluation. Many other countries 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 situations. In view of the need to correct the existing pattern of payments imbalances, it was particularly encouraging that the Japanese yen appreciated not only against the dollar, but also by a significant amount against other major currencies.

In the week immediately following February 12, the mood in exchange markets was relatively calm. However, uneasiness soon returned to the markets and large speculative movements of capital again took place last week. On Thursday, March 1, the German central bank was forced to purchase over $2-1/2 billion in support of its new exchange rate; other European central banks also intervened in substantial amounts. In the face of this speculative onslaught, most exchange markets in Europe and Japan were closed down on Friday.

The Finance Ministers of the European Economic Community met to discuss this situation last Sunday. At that time they decided to leave foreign exchange markets closed this entire week, while further deliberations by finance ministers and central bankers were going forward. As you probably know, meetings have been scheduled on Friday of this week in Paris. The Government of the United States will be represented at these meetings, and I feel sure that a determined effort will be made on all sides to achieve a constructive resolution of the crisis.

In view of current uncertainties, the immediate objective shared by all countries is to restore confidence and order in financial markets.

Speedy passage of H. R. 4536 will remove one source of uncertainty. The Treasury, acting in the President's behalf, undertook a commitment in the negotiations leading to the February 12 realignment. Adoption of the bill that you are now considering will contribute to the restoration of confidence.

The United States can also help to restore confidence in international financial order by making sure that our policies, taken as a whole, are realistically adjusted to our needs. 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. A determined effort to increase productivity and curb inflation will also play an important role in eliminating the instabilities currently plaguing exchange markets.

At the same time, the restoration of confidence requires that we 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. It would be easy to dawdle away one, two, or more years on discussions of how to improve the monetary system. But the world cannot afford such a luxury. Whatever the difficulties, ways to resolve them must be found--and quickly. The essential thing is to move at a much faster pace toward rebuilding the monetary system so that it will not be prone to recurring crises.

When exchange markets gyrate, as they have been doing in recent days, it is easy to lose sight of underlying developments. The currency parities that resulted from the February 12 agreement appear to be basically sound. When these exchange-rate changes are taken together with the Smithsonian realignment, it is clear that the U. S. competitive position has improved substantially. Thus, although the deficit in our trade and payments will remain large during an initial period of a few months, we can confidently expect progress in reducing the deficit later this year, and more so in 1974. The two realignments together have placed us firmly on the road back towards equilibrium in our balance of payments.

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