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The Outlook for the Dollar

Remarks by

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Any evaluation of the international outlook for the dollar can best begin with an assessment of the inflationary problem here at home. As a result of the massive exchange rate adjustments that have taken place over the past several years, the international competitive position of the dollar has been much improved. But that gain will be in danger of erosion if we do not achieve effective control over the inflation that has been plaguing our economy. In a world of freely changing exchange rates, such as we have recently had, a failure to exercise reasonable discipline over the internal behavior of our economy is quickly and decisively communicated to foreign exchange markets.

So far this year, as we all know, our country has suffered an extraordinary upsurge in the price level -- the sharpest, by far, since the Korean War. This galloping inflation reflects a variety of special influences. There has been a worldwide economic boom superimposed on the boom in the United States. We have encountered critical shortages of basic materials. The needed expansion in industrial capacity had not been put in place because of the abnormally low level of profits between 1966 and 1971 and also because of numerous impediments to new investment on ecological grounds. Farm product prices escalated sharply as a result of crop failures in many countries last year. Fuel prices spurted upward, reflecting the developing shortages in the energy field. And the depreciation of the dollar in foreign exchange markets has served to boost prices of imported goods and to add to the demands pressing on our productive resources.

In view of these powerful special factors, and the cyclical expansion of our economy, a sharp advance in our price level would have been practically inevitable this year. But governmental policies have also not dealt vigorously enough with our underlying inflationary problem. Monetary policy began moving toward restraint in the spring of 1972. Yet, in retrospect, it appears that the degree of restraint should have been somewhat greater. This situation has now been fully corrected. Fiscal policy, despite energetic efforts to restrain expenditures, was not restrictive enough; the fiscal 1973 budget deficit of over $14 billion was clearly inappropriate at a time of rapidly advancing prosperity. Wage-price controls were eased suddenly last January, and, more important, the relaxation was widely interpreted to mean the virtual end of controls. And our governmental farm programs were too long aimed at limiting production -- a holdover from earlier times which was not fully corrected until early this year.

Once inflationary pressures become deeply entrenched, it takes time to eradicate them. For example, the rise we have had in consumer prices, and the strong continuing demand for labor, threaten an escalation in wage demands extending well into 1974. Already, wage rate advances are creeping up. With productivity gains tending to level off, larger increases in employee compensation will result in greater upward cost pressures on our price level. Thus, although the special factors affecting prices this year are likely to be on the wane, I am not hopeful that the rate of inflation can realistically be expected to fall below the 4-5 per cent range next year.

In this situation, public policy must aim at keeping the growth in aggregate monetary demand within moderate bounds. At the same time, however, our policies must not become so restrictive as to run the danger of plunging the economy into recession, thereby inevitably triggering corrective measures that may of themselves release new inflationary forces.

The problem of bringing inflation under control is worldwide. Other countries have been experiencing price rises and cost pressures as large or larger than ours. This worldwide inflation is most unfortunate, and it will require strong remedial action everywhere. But one fortuitous result of the fact that recent inflation rates abroad have tended to exceed our own is that we have not lost ground competitively, as we did during the late 1960's.

Moreover, the ability of American businessmen and farmers to compete against foreign producers has been vastly altered by the changes in exchange rate relationships that have taken place over the past few years. The two formal devaluations of the dollar, revaluation by some of our major competitors, and the floating of currencies that has been the general regime since March, have increased the average dollar price of the major foreign currencies by over 25 per cent since May 1970.

These drastic exchange rate changes are bound to have large effects upon all kinds of international transactions -- not only trade, but also tourism, other services, and both direct and portfolio investment. The changes will take time to work out their full effects, but we have already seen a very rapid improvement in the U.S. balance of payments this year. The improvement has been hastened by the boom abroad, which has generated strong demands for our goods, and by food shortages abroad at a time when we had large agricultural supplies available for export.

The U.S. trade balance has moved from a record deficit of $7 billion in 1972 to a deficit at an annual rate of $3-1/2 billion in the first half of this year, and the deficit appears to have vanished since then. Other elements of the balance of payments -- notably investment income and capital inflows -- have also registered improvement. Hence the combined deficit on current and long-term capital transactions (the so-called "basic balance") has greatly diminished -- from $10 billion in 1972 to an annual rate of $3-1/2 billion in the first half of this year, and to perhaps a $1 billion rate in the third quarter. On the official settlements basis, we actually had a small surplus in the second quarter of this year and a larger surplus in the third.

We can reasonably expect further improvement in the balance of payments in 1974. The trade balance should move into surplus, benefiting from continued strong demands abroad for our products, from readier availability of U.S. supplies for export, and from the cumulating effects of past exchange rate changes in stimulating export sales and limiting imports. The prospects for foreign investment in the United States have also greatly improved, while U. S. firms now have less incentive to invest abroad. In view of these prospective developments, the "basic balance" may well move into surplus next year for the first time since 1957.

Foreign exchange markets have begun to reflect a general recognition of the dramatic improvement that has recently occurred in our international economic position. The dollar strengthened materially in foreign exchange markets in August and it has remained quite steady since then. In recent days, the dollar has performed well in the face of terribly unsettling news. There is a consensus among economists that the dollar has by now been sufficiently devalued to assure the restoration of a satisfactory U.S. payments position. Indeed, the opinion is now widely held by informed observers that the dollar is actually undervalued. And there is ample reason to hope that the renewed strength of the dollar will be reflected during 1974 in some further reduction of U.S. indebtedness to foreign central banks.

While the floating exchange rates of recent months have been generally deemed necessary, our government and governments around the world hope to see greater stability soon restored to exchange markets. The major exchange rate adjustments that were needed are now behind us. There is a broad consensus that internationally agreed rules for exchange rate behavior are essential, but that restoration of exchange rate stability cannot be achieved without much better control of inflation, both here and in other countries. This is the paramount task to which economic policy in all advanced countries must now be dedicated.

In thinking about the outlook for the dollar, we must never lose sight of the fact that our economy is the strongest in the world, that our country is still richly endowed with natural resources, and that we enjoy a large measure of political and social stability. We certainly have the capability to do as well as any other country in controlling inflation. Our management of aggregate demand -- though it may be inadequate at times -- is better than that in most other countries, and it will become better still if the Congress makes progress -- as I am confident it will -- in improving its budgetary controls. What we need now more than anything else is to persevere in the fight against inflation.

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