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Statement by

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of the

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I am pleased to appear before this Committee to discuss recent developments in foreign exchange markets and in the balance of payments.

This year has been characterized by alternating periods of turbulence and stability in exchange markets. You will recall that, following several weeks of severe disturbance in exchange markets, the dollar was devalued for a second time on February 12. At that time, Italy and Japan chose to float their currencies, thus joining the Canadian dollar, British pound, and Swiss franc -- which were already floating. New pressures in exchange markets developed in late February and early March, and led to a further extension of floating among major currencies.

Over the next two months, the average dollar price of 10 major currencies (those of Japan, Canada, and 8 European nations) stabilized at a level some 20 per cent above the exchange parities that prevailed in the spring of 1970. In mid-May, however, the dollar again began to decline sharply, so that by July the average dollar price of these 10 currencies increased an additional 10 per cent.

This further substantial depreciation of the dollar did not seem consistent with international price levels or with longer-term prospects for our balance of trade or payments. Moreover, fluctuations of exchange rates from day to day and hour to hour had become more pronounced. In these circumstances, and after full consultation with the Treasury and representatives of other countries, the Federal Reserve began on July 10 to intervene in the exchange market. Through the month of October, the System sold a total of $512 million of European currencies, mainly German marks, drawing on the swap lines to finance this intervention. By the end of that month, enough marks, French francs, Belgian francs, and Dutch guilders were purchased in the market to repay in full these earlier swap drawings.

After our intervention in July and the release of favorable U.S. trade and payments figures, the dollar strengthened by about 3 per cent during the first weeks of August. There was little further change in the dollar's value until late October, at which time the announcement of a large trade surplus for September triggered another sharp advance. In recent weeks the dollar has strengthened further in relation to the major European currencies and the Japanese yen. The appreciation of the dollar against the yen would have been even greater if the Bank of Japan had not intervened in the market by making large sales of dollars. By the end of November, the average dollar price of the ten major currencies mentioned earlier had returned to the level that ruled between mid-March and mid-May; in other words, it was again some 20 per cent above the exchange parities prevailing in the spring of 1970 -- or slightly above the level in the week following the February 12th devaluation.

Some market observers have pointed to anticipations of the impact of oil restrictions by Arab countries as a factor contributing to these developments in recent weeks. Others have cited the stabilizing effects of official intervention by the Federal Reserve and other monetary authorities. There is no doubt in my mind, however, that the basic factor has been the decisive turnaround in the U.S. balance of payments. New evidence of this fundamental improvement in our payments position has been accumulating with each passing month.

Our exports have been rising at an extraordinary rate this year. Measured in current dollars, exports in the third quarter were 47 per cent above their level in the third quarter of 1972. Much of this increase is accounted for by rising prices.

But even in real terms, exports grew 23 per cent over this period. The big increase in our agricultural exports -- from an annual rate of $9-1/2 billion in the third quarter of 1972 to some $19 billion in the third quarter of this year -- has received a great deal of publicity. It is less often appreciated that non-agricultural exports, which account for about three-fourths of our total exports, have been expanding at extra-ordinarily rapid rates as well.

Part of the strong showing of exports is attributable to last year's poor harvests abroad and the current world-wide industrial boom. But the improvement also reflects a lesser rate of inflation in the United States than in other industrial countries and, far more important than this, the cumulating effects of the depreciation of the dollar since 1971.

The changes in our international competitiveness resulting from the depreciation of the dollar are having an effect on our imports as well as on our exports. In real terms, imports actually declined between the first and third quarters of this year, despite the strength of domestic demands.

The value of imports did increase at an annual rate of 14 per cent during that period, but only because of increases in their dollar price.

As a result of these developments, the trade balance has moved from a deficit of nearly $7 billion in 1972 to a surplus at an annual rate of $3 billion in the third quarter of this year. The trade balance continued to be in surplus at a substantial rate in October. It therefore now seems likely that the United States will have a trade surplus, albeit of modest size, for 1973 as a whole.

The balance of international flows of long-term private capital has also moved in our favor this year. Outflows of capital have moderated since the first quarter and are estimated to have slowed sharply in the third quarter. Prior to the recent decline in stock market prices, renewed confidence in the dollar helped to stimulate foreign purchases of American securities. Foreign direct investment in this country has also been substantial this year. These developments reflect, among other factors, the improved profitability of producing internationally traded goods within the United States relative to production abroad.

The basic balance -- that is, the aggregate of all current international transactions and long-term capital flows -- has been strengthening throughout this year. The improvement in the third quarter was dramatic enough to produce a large surplus -- the first quarterly surplus we have experienced since 1969. Net flows of short-term capital have also been favorable to the United States since the first quarter. As a result, the official settlements balance was actually in surplus during both the second and third quarters. Preliminary data for October and November suggest that the surplus has continued into the present quarter.

Short-term prospects for the balance of payments have become clouded, however, by recent developments in the oil situation. The price of our oil imports has risen spectacularly, from an average of $2.75 per barrel in the first quarter of 1973 to over $5.00 currently. The boycott by Arab producers has begun to reduce our petroleum imports and, if continued, would reduce our imports next year by some 3 million barrels per day below the amount that had been expected to be available. Even so, in view of the recent sharp price increases, our total payments for oil imports in 1974 would probably exceed by a substantial margin the $8 billion paid in 1973. Of course, if world trade in oil were to resume a more normal pattern at these astronomic prices, the cost of our oil imports would rise still more steeply. However, the net impact on our overall balance of payments would be substantially less or could even be favorable, since a good part of the increased payments for oil by the United States and other countries would find its way back to this country, directly or indirectly, in the form of increased exports, or capital inflows, or income receipts.

Whatever effects the oil shortage may have on our balance of trade and payments, a more immediate concern is the impact on domestic production and employment. A reduction in imports of crude oil and petroleum products by 3 million barrels per day amounts to a shortfall of more than 15 per cent from estimated demands for this source of energy. Only a small part of this shortfall could be made up during 1974 by increased domestic output of crude oil, or by substitution of other fuels for petroleum products. In the short-run, there are only limited possibilities for substituting other fuel for oil in industrial plants, or for altering techniques of production in ways that reduce dependence upon petroleum products.

The President's program to conserve fuel recognizes this basic fact, and is therefore oriented toward economizing end-product uses -- such as reduced consumption of gasoline in passenger cars, and reduced amounts of oil for heating homes and commercial and industrial buildings. To keep the oil shortage from generating major economic dislocations, our citizens will have to go to some trouble and put up for a time with various inconveniences. There is no practical alternative for the immediate future if seriously adverse effects on production and employment are to be avoided.

At best, a prolonged embargo on Arabian oil shipments to the United States will result in some economic dislocation next year. The demand for new cars, for tires and other auto parts, for suburban housing, for recreational vehicles, for restaurant meals and other travel-related expenditures will be adversely affected; commercial airlines will reduce their purchases of jet aircraft; and fewer motels and vacation homes will be constructed. These developments will be offset in part by larger activity in other trades -- ranging from coal to blankets and sweaters, and from drilling machinery to bicycles and buses. Our inflationary problem, meanwhile, will be aggravated by rising gas and oil prices.

The situation in which we find ourselves is obviously very difficult, but I believe it is manageable. The underlying strength and resilience of our economy must never be underestimated. Capital spending plans of business remain strong, and so are inventory demands for a host of materials and components that have been in short supply for many months. Our principal asset -- the resourcefulness of the American people -- remains entirely intact. As 1974 moves on, I would expect the domestic output of crude oil to gradually increase, electric utilities to shift to greater use of coal, auto manufacturers to concentrate more of their production on the smaller cars demanded by consumers, and other adjustments to be made in the thousands by ingenious businessmen across the land.

The longer-run economic implication of the cutoff of Arabian oil supplies should not leave us in any doubt. The United States can no longer afford to lose time in working towards an independent ability to meet its energy requirements. We must now move forward with determination on many fronts -- nuclear energy, solar energy, coal conversion, exploration for oil. Recent events should teach us that, even with a relaxation of the current boycott, we cannot remain so heavily dependent on oil supplies from foreign nations.

Some months will need to elapse before the long-run implications of the oil problem for our balance of payments clarify. So far at least, the restrictions on oil supply appear to have strengthened the world's confidence in the dollar. But even before the Middle East conflict erupted, the dollar was viewed with renewed esteem. The dollar is again a strong currency, and we can expect further support to our foreign trade and payments from the lagged effects of past exchange-rate changes.

Continued strength in the balance of payments will require, however, a satisfactory domestic price performance relative to other countries. A year or two ago our rate of inflation was substantially lower than that of other industrial countries. Unfortunately, a large part of this margin of competitive advantage has eroded in recent months. In October, the consumer price index was 0.8 per cent above September, and 7.9 per cent above October 1972. Clearly, the dangers of inflation remain very much with us. At the same time, as I have already noted, the oil shortage will cause shifts in the structure of industry and have adverse effects on overall production and employment. Economic policy in the months ahead thus faces the extremely difficult task of contributing to the objective of regaining price stability, while at the same time minimizing the risks of any extensive weakening in economic activity.

In the remainder of my comments this morning, I would like to share with you my impressions of the recent evolution of the world monetary system.

In the past several months, a large number of economic, political, and military events occurred that had potentially disruptive implications for exchange markets. Despite these disturbing events, orderly market conditions and general stability have prevailed. The official intervention that was undertaken has given us helpful experience in managing a system with exchange-rate flexibility in a way that preserves orderly markets without frustrating desirable adjustments. Although I remain skeptical of the long-run viability of a floating exchange rate regime, this experience supports the continuance of the present exchange-rate arrangements for the immediate future.

For the longer run, we must rely more heavily on rules of international law in the monetary area. Such a reform is the objective of the Committee of Twenty, which has been meeting periodically throughout 1973, and will continue its work into 1974. Considerable progress in clarifying issues has already been made, as evidenced by the Nairobi report of the Chairman of the Committee of Twenty and the associated First Outline of Reform presented by the Chairman of the Committee's Deputies. I expect further clarification and further convergence of national views in coming months.

But it is important to avoid unrealistic expectations. Some of the reform issues are extremely difficult, progress in reaching agreement will continue to be gradual, and new developments may cloud the situation -- as the energy issue has done in recent weeks.

Moreover, I have in recent months come to think of international monetary reform as an on-going, evolutionary process - not just as the final outcome of formal negotiations. In view of changing objective circumstances and continuing divergence in some official views, it is hardly practical to think of monetary reform in terms of a finished blueprint that is to be implemented in its entirety some morning after a final meeting of the world's finance ministers and central bank governors. Even while discussions continue in the Committee of Twenty and other forums, it is both possible and desirable to adjust some parts of our international financial machinery.

One such step in this evolutionary process has been the recent termination of the March 1968 agreement with regard to official gold transactions. That agreement, which established the so-called two-tier gold market, was born of the 1968 gold crisis. Developments in the private gold market were then threatening to undermine the international monetary system by draining it of gold -- which at the time was the world's principal reserve asset. To deal with this difficulty, the central banks of Belgium, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the United States agreed that they would no longer buy or sell gold in the private market.

In view of the suspension of convertibility of dollars into gold since August 1971, the 1968 agreement had become an anachronism. Its termination removes an obstacle to official sales of gold in the private market, and will thus permit greater flexibility of action in the future. Official sales of gold can be useful in preventing wide fluctuations in the gold market that at times generate instability in currency markets.

In due course, the United States and other countries will make decisions about possible sales in the gold market. In doing so, our government will comply fully with Article IV, Section 2 of the IMF Articles of Agreement. That Article states in essence that no member of the IMF shall sell gold below its official price or buy gold at a price above its official price. I am confident that most, if not all, foreign governments will also respect this Fund Article. Hence, while they may sell gold, which now fetches a price in the market that is far above the official price, they will not buy gold either from the market or from each other in the foreseeable future.

The termination of the 1968 agreement will make possible a further reduction in the role of gold in the international monetary system. With the establishment of the SDR facility, which was not available in 1968, we now have an alternative primary reserve asset. It has therefore become practical to consider steps that may gradually move gold out of official reserves.

Policy with regard to intervention in exchange markets is another area in which progress is beginning to be made in the evolution of the international monetary system. Under present exchange-rate arrangements, authorities of major countries are consulting and cooperating as they make decisions on intervention. This experience, and the experience to be gained in coming months, will be of great value in the effort to establish more formal exchange-rate arrangements for the longer-run future.

At the present time, with many currencies floating in relation to the dollar, official holdings of U.S. dollars will only be reduced through market intervention by foreign central banks. A substantial reduction of dollars presently held in foreign official reserves -- the reserve liabilities of the United States amount to some $70 billion -- is clearly desirable as a long-run objective. Progress in this direction has been most marked in the case of Japan, where dollar reserves have declined sharply in recent months. At the end of November, Japanese official reserves were reported to be some $6 billion below their level at the end of February. It would be desirable for other countries with excess reserves also to sell dollars gradually when market forces are serving to appreciate the dollar substantially against their currencies.

The controls imposed on capital flows may be a third area of international monetary arrangements where evolutionary steps can be taken. Starting with the measures adopted in 1963 and expanded in 1965, our government has administered a system of restraints on capital outflows in order to protect the balance of payments and avoid disturbance to international markets. These measures -- the interest equalization tax, the foreign direct investment regulations, and the voluntary foreign credit restraint guidelines -- have been adapted over the years to changing economic conditions, but it has been the objective to remove them when they were no longer necessary. Other countries have similarly imposed new controls, or tightened existing controls, to deal with capital flows considered to be temporary or reversible.

Early this year, the Administration announced its intention to phase out our controls by the end of 1974, but noted that the timing of liberalizing steps would depend on balance-of-payments developments. In view ot the recent strengthening of the balance of payments, it may be feasible for the agencies administering the controls -- the Treasury Department, the Department of Commerce, and the Federal Reserve System -- to move forward over the coming months with an orderly reduction of those restraints. Similarly, it may prove feasible for other countries to relax some of their earlier-imposed restraints on capital inflows.

In conclusion, I would like to note once again that the strengthening of our balance of payments and the restoration of confidence in the dollar in exchange markets stand out as this year's major economic achievements. These developments have served to bolster confidence in our nation's future at a time when we have been besieged with all sorts of unhappy economic and political news.

In fact, these foreign exchange developments have transformed the atmosphere in which international financial problems are being discussed. We no longer hear voices from abroad about inflation being exported from the United States. There is no longer so much complaining about a world flooded with dollars. Even complaints about the "dollar overhang" have become muted.

We must, of course, be careful and not exaggerate the extent of the dollar's recovery. There is much unfinished work ahead of us. Nonetheless, it is gratifying to be able to draw your attention to the improvement that has occurred in our balance of payments, and to advise you that the dollar is today a respected currency in financial circles both here and abroad.

Confidence in the dollar is essential both to a healthy domestic economy and to a successful evolution of the international monetary system. Looking to the future, we must strive to conduct all our economic policies -- domestic as well as international -- in such a manner that they will maintain, and indeed strengthen, that confidence.

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