

## MONETARY POLICY AND THE INTERNATIONAL ECONOMY

Free nations are closely tied together by commercial and financial relations, and the national income of each country depends to a large extent upon international developments. In order to make full use of its resources, a nation must exchange products in which it excels for products which are more efficiently produced abroad. It must attract foreign capital if its resources cannot be fully developed with its own savings. Similarly, it must send capital abroad if its savings exceed its own investment needs.

The monetary policy of every free economy must therefore pay serious attention to the interrelation between domestic and foreign events. There is, however, a fundamental difference between the domestic and the international aspects of monetary policy. Within its own borders, every nation has sovereign control of its system of money and credit, and the monetary authorities therefore have a unique position in influencing domestic economic developments. But sovereign monetary control does not extend beyond a nation's own borders, and the monetary authorities can affect happenings abroad only by indirection.

If, for example, the monetary authorities of one country succeed in curtailing the expansion of domestic credit in order to avoid inflationary developments, this step will directly affect domestic investment and thereby the size of the national income. The rest of the world, however, will feel only indirect repercussions; namely, insofar as the change in national income of the country affected will influence its imports and exports of commodities and of capital.

### International Effects of Monetary Policy

Monetary policy influences the economy primarily through the supply of credit. This influence can be brought to bear on the entire economy by changes in the rate of interest and in the liquidity position of credit institutions and the general public; it can be directed toward individual segments of the economy by selective credit controls.

Changes in interest rates and liquidity.--In times of international security, the currencies of all important nations can be freely exchanged. In such times, changes in interest rates and liquidity are very important in determining the international flow of short-term funds. In the present troubled times it is easy to forget that not so long ago the difference between short-term interest rates in New York, London, Paris, and Amsterdam was a decisive factor in the distribution of funds among those centers of international finance; it was therefore also an important factor in the liquidity of the banking systems of the United States, the United Kingdom, France, and the Netherlands.

Under present conditions it is unlikely that investors would switch their funds over night from one country to another in order to get a

slightly higher rate of return on their capital. In most countries capital transfers are subject to the approval of some government agency and, of even greater importance to their direction, are dictated more by political fears and hopes than by small differences in interest rates. Almost everywhere, people are subject to currency devaluation, capital levies, or exchange restrictions, not to speak of the danger of war or revolution. Hence, investors try to find a safe haven for their funds even if the interest rate there is substantially below rates prevailing elsewhere.

In times of severe international disturbances, therefore, the influence of changes in interest rates and liquidity on the international flow of investment funds is limited. In such times, however, both debtor and creditor countries pay particular attention to balance-of-payment problems, and the influence of monetary policy upon the balance of international payments often overshadows its purely domestic effects.

The dollar gap.---Most countries other than the United States are anxiously watching their current balance of dollar payments. The main reasons for this anxiety are twofold: most countries have smaller reserves than would be necessary in emergencies; they also have an unsatisfied demand for American goods, while the American demand for their own products is limited. This situation has become known as the dollar gap; namely, the persistent tendency of many countries to experience a deficit in their dollar balance of payments.

Monetary policies can do much to close that gap. A chronic deficit in a country's balance of payments suggests the presence of inflationary tendencies: the public has more money to spend than is needed to pay the existing prices for the goods and services currently produced. By eliminating excess purchasing power, the demand for foreign goods and services can be reduced until the international balance is in equilibrium. But there is a serious obstacle to such a policy: the structure of a country's economy may be such that before the demand for foreign goods has been sufficiently reduced, the demand for domestic goods will fall so sharply as to bring about a severe recession. For instance, the reduction of purchasing power in a highly industrialized country that depends upon imported foodstuffs may lead to serious unemployment in domestic industry long before there is any appreciable reduction in food imports. In such a case, a more fundamental change in the country's domestic economic structure or in its international economic relations may be necessary.

Early postwar efforts to reduce the dollar gap.---Immediately after the war, such changes were needed in virtually all countries that had suffered severe damage or enemy occupation. In those years, more reliance was placed on direct international aid, at first through UNRRA and then mainly through ECA, than on the indirect methods of monetary policy. By 1949, however, the importance of monetary factors had again been universally recognized. Inflation had been halted in most of the important nations, but different degrees of inflationary distortions persisted in the various countries, especially in those where severe domestic price and wage controls had added to the confusion. It was therefore necessary to reduce all these inconsistent price and wage levels, so to speak, to a new common denominator. It would obviously have been impossible to make further drastic changes in internal prices and wages so soon after stabilization and so it was necessary to change the international relations

of the various price levels. In other words, it became imperative to alter radically many international exchange rates, the most important of which was the rate between the dollar and the pound sterling.

The effects of the exchange adjustments of 1949.---You know that this was done in September 1949. From that time on, monetary policy has been able to resume its stabilizing role in international relations. At that time, many skeptical observers asserted that prices had lost their force to determine the flow of international trade. They were wrong: the price system started to work as well as it ever had as soon as it again got a chance to do so. Producers in Europe paid more attention to their traditional export markets after the artificial creation of new domestic purchasing power had been discontinued and the worst distortions in international price relations had been eliminated. Producers in the dollar area found in turn that they could not maintain their inflated export sales since the industries in the so-called soft-currency areas were able to undersell them.

In consequence, two events took place. Our export surplus dropped from 5.4 billion dollars in 1949 to an annual rate of 1.9 billion in the first eight months of 1950--a reduction by almost two-thirds. The resulting narrowing of the "dollar gap" made it possible for many countries to relax their direct controls, and this relaxation in turn increased the significance of monetary policy.

The example of Germany.---The countries that were most energetic in applying monetary measures and in repudiating wartime direct controls were the most successful in establishing domestic and international stability. For instance, such a policy was responsible for the almost miraculous progress achieved in Western Germany.

Germany suffered more than any other major industrial nation from the effects of its wartime inflation, suppressed by price and wage controls of unsurpassed severity. In 1948 the German Government, against the anguished protests of the adherents of direct controls, eliminated virtually all price controls and rationing and, at the same time, the German central banking system used its power firmly to avoid a return to the over-expansion of money and credit. Within little more than two years, Germany saw its industrial production rise from less than 50 to 114 per cent of prewar and its exports increase threefold. Between 1949 and the first eight months of 1950, its import surplus dropped from 1.1 billion dollars to an annual rate of 400 million dollars.

These developments would permit us to view the future of international economic relations in a very hopeful light if we could assume that further deterioration of political relations might be avoided.

The problem of convertibility of currencies.---In the international field, postwar monetary policy aims primarily at making the main currencies of the world again freely convertible into gold and dollars. As long as the international economic community cannot make use of exchangeable currencies, international trade is as seriously hampered as our domestic trade would be if we lost our common dollar standard. Prices obviously cannot fulfill their proper economic function in the international economy if it is impossible to tell accurately what a price expressed in the seller's currency means in terms of the purchaser's currency. For



instance, one pound sterling cannot at present be freely converted into \$2.80 although \$2.80 can be freely converted into one pound sterling. As long as this situation lasts, a commodity priced at one pound sterling will more readily find a buyer than one priced at \$2.80, even though at the official rate of exchange the two amounts are the same. The commodity priced at \$2.80 can be purchased by people who have dollars, but not by those who have sterling, while the commodity priced at one pound sterling can be bought by holders of either dollars or sterling. Under these conditions the currency asked in payment for a commodity is often more important than its price.

For this reason, the reestablishment of international convertibility of currencies is indispensable to the reestablishment of a free international economy based on the principle of the market mechanism. However, convertibility can be achieved only when the nondollar countries can reasonably expect their exports to earn about as many dollars as they need for buying essential American goods and services. Insofar as the monetary policies of the nondollar nations permit the expansion of exports, they contribute decisively to progress toward freedom in international economic relations, and thus to the achievement of one of the prime goals of our own international policy.

International effects of U. S. monetary policy.--Our economy is less dependent than most other economies on monetary conditions in other countries, but monetary developments here often determine economic development abroad. For example, the slight recession here in the first half of 1949, which made little impression on domestic consumption, considerably affected the international trade of some foreign countries. In the view of some observers, it even influenced the timing of the devaluation of the pound sterling and many other currencies in September 1949. Many countries have to rely upon vital imports from the United States, and upon their ability to earn the dollars needed for that purpose by means of exports. A recession that curtails our foreign purchases makes it more difficult for other countries to buy our foodstuffs, raw materials, and machinery, upon which their domestic welfare depends. On the other hand, any serious inflationary development in the United States tends to raise the prices of our domestic products faster than those of our imports. It thus tends to worsen the terms of trade of foreign countries that need our products, thereby endangering their economic stability. For instance, the rise in U. S. prices from 1946 to 1948 considerably increased the balance-of-payments difficulties many foreign countries were already having.

### Monetary Policy in the Present Emergency

Developments since the middle of 1950 have clearly shown the impact of international events on monetary conditions and policy in the United States.

Before the attack on South Korea, our most difficult postwar financial adjustments appeared to have been made. Now we must again build up our defenses against inflation. Rearmament will divert much of our manpower and material resources to the production of goods which, although vital to our survival, will not be available for purchase by civilian consumers. At the same time, the expanded defense activities will increase the purchasing power of the population. Either of these factors

could easily build up serious inflationary pressure. Monetary policy has special responsibilities to avoid inflationary disturbances at a time when economic instability might seriously impede defense against grave political and strategic dangers.

Monetary authorities must have regard for the effects of monetary policy on the management of our large public debt. The Treasury must constantly re-fund maturing issues, and it must be prepared to borrow additional money if receipts fall short of Government expenditures. A rise in interest rates makes these operations more costly, it is true; but inflation, with its increases in prices and wages, would cost the Government far more. Moreover, the effect of inflation on every member of the community, and the general disturbance created by a drop in the purchasing power of the dollar at home and abroad, would seriously hamper our defense effort.

U. S. anti-inflationary policy.---As soon as the danger of renewed inflation became apparent, the President, the Congress, and the monetary authorities took steps to counteract it.

The Defense Production Act and the executive orders issued by the President have given the Federal Reserve special powers to combat inflation in two strategic areas. The Federal Reserve is again regulating consumer installment credit, and for the first time in its history is regulating real estate credit for new construction. Restriction of real estate credit and consumer installment credit is intended to dampen the demand for new homes and for many durable consumer goods and thus help to make way for the diversion of strategic materials to armament production without inflation.

Even before passage of the Defense Production Act, the discount rate of the Federal Reserve Banks, unchanged since August 1948, was raised by one-fourth of a percentage point in August 1950. Also, the Federal Reserve System, jointly with the other agencies entrusted with the regulation of credit institutions, issued a formal request that these institutions abstain from any credit expansion that would interfere with the defense effort. The Federal Reserve Open Market Committee is directing its operations toward restraint of inflationary forces. The System continues to maintain an orderly market for Government securities, but it seeks to limit any increase in its holdings of Government securities and to offset purchases made in maintaining an orderly market by sales of other securities. These sales are to prevent an increase in bank reserves, which would provide the banks with additional funds for multiple credit expansion. The result of the System's operations has been a moderate rise in short-term interest rates, a development which in itself tends to discourage the extension of excessive credits.

International repercussions.---The recent rapid rise in effective demand in the United States deeply affected the international flow of goods and capital. The drop in our exports and the rise in our imports, which had been going on for some time, has been accelerated. In August, 1950, our imports exceeded exports for the first time in 13 years.

Moreover, a number of foreign countries have begun to take measures against the international spread of inflation. It is extremely encouraging to note that these measures do not primarily reintroduce direct controls, but are concentrating on the instruments of monetary policy.

Belgium, Germany, the Netherlands, and Sweden, in particular, have tightened reserve requirements or increased discount rates. At least three of these countries have experienced the harmful results of direct controls for so many years that they have become convinced of the superiority of monetary policy. Obviously, however, the situation would be very much confused if the United States itself were compelled to reimpose direct controls.

Prospects for the future.---The Federal Reserve System is prepared to take further action if inflationary tendencies continue. Quite recently, it has tightened its regulation of consumer instalment credit, and it has further limited the availability of reserves through its open market operations. For obvious reasons I cannot tell you anything about our plans for the future; however, I can give you the assurance that we shall carefully consider the use of any anti-inflationary weapon in our arsenal.

An inflationary increase in the supply of money stems chiefly from two sources: expansion of credit to the public, and expansion of credit to the Government due to a budget deficit. The efforts of the Federal Reserve System serve mainly the purpose of keeping the private credit situation in hand. The Government budget must be kept as nearly as possible on a pay-as-we-go basis by means of tax legislation. In addition, the refunding of maturing Government securities, as well as the flotation of any new issues that may become necessary because the yield of increased taxes may lag behind the rise in Government expenditures, should be so managed that the largest possible share of the debt is sold to the nonbank public.

### Monetary Policy or Direct Controls

Even with all of these deterrents in effect, it would be possible for private spending to increase further, especially in view of the public's large holdings of liquid assets. It would be equally possible for our presently planned level of defense expenditures to prove inadequate. In either eventuality, it would be necessary to impose even stricter monetary and credit controls and to raise our taxes still further. Otherwise, direct controls would have to be imposed.

From the point of view of a free economy, there can be no doubt that avoiding inflation by monetary and credit controls and increased taxes is far preferable to suppressing the symptoms of inflation by price and wage controls and rationing. Such a course, however, will need the whole-hearted cooperation of the public. Enacting higher taxes and imposing credit restrictions are highly unpopular measures. If too many people, while applauding anti-inflationary policies affecting the other fellow, oppose all those that would restrict their own dealings, direct controls may become unavoidable.

Price controls and rationing tend, at least in the first moment of their application, to give the impression that they hurt people less than strict credit controls and high taxes: they leave the money income untouched, and preserve the outer appearance of a stable price level. Actually, however, they undermine the market mechanism: prices cease to have economic meaning, money ceases to play its economic function, and ration points fixed by the Government tend to become the main motors of

economic activity. Such a development would be inconsistent with the principles of individual initiative on which our economic system is based, and should be only a last resort during an emergency in order to protect our system from greater danger.

However, if we can convince the public to support the anti-inflationary endeavors of our monetary and fiscal authorities, we can hope that our economy will bear the burden of the rearmament effort without suspending the price mechanism and thus impairing its efficiency. This burden will be a small price indeed to pay for the preservation of our freedom.