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INTERNATIONAL MONETARY SITUATION

Remarks of

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International Monetary Developments [1]

The subject for tonight's discussion encompasses recent international monetary developments and their implications for the inflation and recession dilemma facing the world today. I know this is an involved and fairly heavy subject for an after-dinner audience but it is one with which you should become acquainted because in my opinion international forces have been and are an important element influencing the economic and financial future of the United States.

To understand today's international monetary developments, it is useful to start with a backward look. August 15, 1971 marks a watershed in the evolution of the international monetary system. One can describe what happened then either in dramatic or in low key tones. It is not unreasonable to say that the Bretton Woods system broke down at that point. It has not been put back together again, nor has it been replaced with a comprehensive and coherent new system. Nevertheless important change--perhaps evolution toward a new coherent system--is taking place.

Let us begin therefore with a brief reminder of what led up to August 15, 1971, when by Presidential action, the long-standing

1/ The thoughts expressed in this paper are mine and should not be attributed to the Federal Reserve System nor any of my associates. Mr. Robert Solomon, Adviser to the Board, was of major help in developing this speech but is in no way responsible for the ideas or conclusions therein.

convertibility of the dollar into gold for official purposes was suspended. The background of this action was that the U.S. international accounts had deteriorated--largely as a result of the Vietnam inflation. From the end of World War II until the beginning of accelerated military spending in 1965, the United States had a surplus in its trade and other current transactions with the rest of the world. In fact the position had improved in the first half of the 1960's as our prices were relatively stable while prices in other countries rose. But beginning in the mid-1960's our price performance worsened, both absolutely and in relation to price changes in many other industrial countries.

This poor price performance, sparked by excess demand in 1966 and 1968-69, led to a fairly steady erosion of our trade balance. By 1968 and 1969 our trade surplus, which had averaged about $5-1/2 billion per year in the first half of the 1960's, fell to less than $1 billion per year. But, because of tight money in the United States and a resulting inflow of short-term funds via the Eurodollar market, the dollar was strong in those years and the over-all balance of payments masked the deteriorating trade position. The trade position improved temporarily in 1970 as a result of recession here and expansion in some of our major markets. As our economy recovered in 1971, our imports rose also and the trade balance fell into deficit--$2.7 billion for the year. This was our first trade deficit in many decades.

Meanwhile, the easing of U.S. monetary policy to deal with the recession led to a substantial reflow of the short-term funds that had come in during 1968-69. The result was an over-all balance of payments deficit (on the so-called official reserve transactions basis) of almost $10 billion in 1970, or five times the annual deficit average in the 20 years prior to 1970.

In these circumstances, speculative pressures increased turning into a run on the dollar in 1971--creating an over-all official settlements deficit of about $30 billion. It was this development, and a worsening trade deficit during the year, that triggered the suspension of convertibility in August.

Before carrying the narrative further let us observe that the inflation of the second half of the 1960's thus had lasting effects on the international monetary system as well as on our domestic economy. We are still trying to cope with those effects. Kermit Gordon, President of the Brookings Institution, was not exaggerating when he said recently that the most serious error in U.S. stabilization policy in the postwar period was the failure to enact a tax increase in 1966.

The suspension of convertibility of the dollar into gold was accompanied by a temporary surtax of 10 per cent on dutiable imports into the United States. It was clear to the world at large that the United States was seeking a realignment of exchange rates that would permit a restoration of our traditional trade surplus.

While no one, here or abroad, disagreed in principle with the legitimacy of this objective, its achievement involved considerable hard negotiations in the autumn and early winter of 1971. The finance ministers and central bank governors of the industrialized countries assembled time and again in well-publicized meetings. Technicians debated about elasticities of demand and about how large an "appropriate" U.S. surplus would be. Our European friends wanted the United States to make a "contribution" to the general realignment of exchange rates by raising the dollar price of gold, which had been unchanged since 1934. Through all this, foreign exchange markets were in turmoil and many countries imposed controls on capital inflows in order to limit upward market pressures on their exchange rates.

These problems appeared to be resolved with the Smithsonian agreement of December 18, 1971, which provided for devaluation of the dollar in terms of gold and an appreciation of a number of currencies--notably in Germany, Japan, and Switzerland--in terms of gold, while a third group of currencies--including the French franc and the British pound--simply stood still while the dollar devalued. On average the dollar was devalued by about 10 per cent against the other industrialized countries and by about 6 or 7 per cent against the world at large.

In addition to deciding an exchange rate realignment, suspension of the U.S. import surtax, and a widening of exchange rate margins from 1 to 2-1/4 per cent, the ministers and governors agreed that discussions should be promptly undertaken looking toward reform of the international monetary system over the longer run.

Post-Smithsonian Developments

It was generally recognized that the exchange rate realignment of the dollar against other currencies would not have an immediate effect in improving the U.S. trade position. In fact, the initial effects were expected to be perverse, for two reasons: 1) exchange rate changes normally involve immediate price effects but lagged volume effects (for example, while Americans found that the dollar price of foreign cars rose immediately, it took a while for them to respond to this increase relative to the price of home-produced cars); 2) in 1972 the United States was in an upward phase of the business cycle, while in some other industrial countries demand was starting to slacken off. Thus, in 1972, the U.S. trade balance deteriorated further, to a deficit of almost $7 billion. Beginning in the first quarter of 1973, the deficit was halved and by the third quarter of that year, the U.S. trade balance was back in growing surplus, buoyed especially by sales of agricultural products.

But, while 1972 was a year of relative calm on the international monetary front, at least compared with 1971, in early 1973 a bout of speculation against the dollar started again. This led in February 1973 to a round of quick negotiations and agreement on a further 10 per cent devaluation of the dollar.

The world had thus been subjected to the shock of two dollar devaluations within the space of 15 months. It would require a battery of psychologists to explain why markets did not settle down at that point, especially since, as I have already noted, the U.S. trade position was now improving rapidly. But a further outbreak of speculation occurred in March, requiring European central banks to buy dollars heavily in order to maintain their exchange rates. After a further series of crisis meetings of finance ministers and central bank governors, the major industrial countries cf Europe decided to let their currencies float; Japan had already gone onto a floating basis in February.

As far as the exchange rate regime is concerned, the March decision still stands. Major currencies are floating, though on a managed basis; that is, with intervention at the discretion of each country's monetary authorities and in accordance with a set of "guidelines for floating" agreed to in the International Monetary Fund.

The dollar took a further buffeting in the spring and summer of 1973, partly in reaction to political uncertainties in the United States. After it was announced in July 1973 that the United States would intervene in exchange markets at its initiative to support the dollar, the exchange rate rose. The outbreak of the Arab-Israeli War in October and the accompanying oil embargo led to a sharp rise in the international value of the dollar to an early 1974 peak, not far from the average rate to which the dollar had been devalued a year earlier.

These specific monetary developments occurred against the background of mounting world inflation in 1972-73. Simultaneous economic expansion--excessive in many cases--in most industrialized countries put heavy demand and price pressures on world raw materials. Meanwhile, poor harvests in Russia and elsewhere, plus other developments related to food, led to soaring prices of agricultural products. This in turn influenced wage demands in many countries, which found themselves faced with excess demand and a wage-price spiral. And when excess demand began to subside in 1974, the wage-price spiral continued and in some countries gathered further force.

In the midst of these disturbances, and influencing many of them, was the abrupt four-fold increase in oil prices in late 1973.

Impact of Quadrupling of Oil Prices

To say that the large increase in petroleum prices threw the world into confusion is an understatement. Apart from the effects of the embargo, which we can skip over for our purposes today, the oil-importing countries were faced with domestic and external problems for which they were not prepared. The higher oil price aggravated what was already a rapid rate of inflation. At the same time, this higher price exerted a depressive effect on economic activity similar to the effects of a new sales tax on petroleum. On the external side, a small group of oil-exporting countries--the OPEC group--were catapulted into a position to earn a surplus with the rest of the world of some $60 billion per year. The industrialized countries as a group, which were accustomed to a combined surplus on current transactions of some $12-14 billion were faced with a deficit of something like $40 billion per year. Developing countries, most of which quite properly were accustomed to incurring current deficits financed by development assistance and private capital inflows, suddenly faced a substantial enlargement of their deficits and were uncertain regarding the means to finance them.

Countries differ in their vulnerability to potential embargo and in the ultimate impact on their real income of higher oil prices. The United States produces almost two-thirds of the oil it consumes whereas Japan produces no oil.

Countries also differ in their dependence on oil for essential economic purposes. For example, in Japan 71 per cent of the energy used by industry consists of petroleum products, whereas in the United States, the comparable figure is only 20 per cent. Looking at it another way, more than half of Japan's total use of oil is in industry, whereas in the United States, industry accounts for only 21 per cent of our use of oil. Transportation is responsible for half of the use of oil in the United States, compared with 21 per cent in Japan, 25 per cent in Germany, and 33 per cent in the United Kingdom.

It is difficult to avoid the judgment that oil consumption is more easily compressible in the United States than elsewhere. But I am sure that an assemblage of motel owners or auto workers would quickly dispute this judgment. The fact is that our way of life has adjusted itself, for better or worse, to heavy use of petroleum and a reduction in that use involves painful disruption.

Although it is relatively less dependent on imported oil than other countries, the United States is a much more voracious user of petroleum products. Furthermore, with its domestic oil output falling and, until a year ago, its oil consumption rising rapidly, the United States was increasing its imports at a substantial rate. Thus in 1973 oil made up almost as large a share of total imports in the United States as it did in Japan (12.3 per cent against 14.9 per cent). At present prices, oil imports account for one-third of Japan's total imports and for one-fourth of ours. For other major countries the share ranges from 20 per cent in France to 25 per cent in Italy. Thus the major countries do not differ greatly in the potential impact of higher oil prices on their balance of payments positions, given the pattern of their oil consumption.

International payments imbalances are not a result only of oil costs. The increase in oil prices came at a time when a number of major countries were already experiencing balance of payments difficulties. Italy and Britain, in particular, were in substantial current account deficit in 1973, while Germany had a large and growing surplus. As a result, the problem of financing balance of payments deficits in 1974 differed among countries. Some had to finance the increased payment for oil on top of an already-existing deficit while others--notably Germany--had a surplus in 1974 despite higher payments for oil.

Although oil-importing countries face potential problems in financing balance of payments deficits that are unavoidable at present oil prices and with the existing pattern of oil consumption, the financing has proceeded remarkably smoothly thus far. Of their estimated cash surplus of $50-60 billion in 1974, the OPEC countries appear to have placed about one-fifth in the United States, mostly in liquid assets. At the same time, American banks loaned vast amounts abroad last year, with Japan the heaviest borrower. Thus we acted as an intermediary, receiving OPEC funds and lending them to other countries needing to finance deficits. The United Kingdom was also a recipient of oil funds. In addition, OPEC money flowed in large magnitude to the Eurocurrency markets, where a number of countries were able to borrow and use the proceeds to finance their enlarged deficits. And some individual countries--for example, France, the United Kingdom, Japan--negotiated direct loans from OPEC countries.

At the same time, the International Monetary Fund established an "oil facility," which borrowed more than $3 billion, primarily from OPEC countries, and loaned the proceeds mainly to developing countries but also to Italy. This facility will continue on an enlarged basis this year and the Organization for Economic Cooperation and Development (OECD) countries are in the process of setting up a "solidarity fund" which provides for mutual financing among this group of industrialized countries.

In general, the enormous payments imbalances that were created by the oil price hikes were financed in 1974 primarily by credit and investment flows. Few countries found it necessary to draw down their reserves to finance their deficits.

It is worth noting that to the extent that OPEC countries continue to have a large trade surplus, they are in effect delaying the impact of higher oil prices on the real income of the rest of the world. If OPEC countries were able to increase their imports immediately to the level of their magnified export receipts, there would be no financing problems between oil-exporting countries as a group and oil-importing countries as a group. The latter would be paying in goods and services for the more costly oil they are importing and that much less in goods and services would be left for their own domestic use. To the extent that the imports of OPEC countries lag behind their enlarged receipts, and a number of them have a limited capacity to absorb imports in the short run, we oil-importing countries in the aggregate face a financing problem, not an imposed real income reduction. However, the higher costs of oil and other products where energy is an important cost, has reduced nominal incomes available for other purchases.

A related point worth noting is that OPEC surpluses bring with them the means of their own financing in the aggregate. This is so because the financial proceeds of OPEC surpluses must be placed, in one form or another, in the rest of the world--that is, the oil-importing world. The financial problem therefore is to reshuffle these financial flows from OPEC countries among oil-consuming nations. Of course this involves the acquisition by OPEC countries of claims on the rest of the world--claims in the form of bank deposits, money market papers, bonds, stocks, and real property. To the extent that debts are created, the question of creditworthiness of individual borrowing countries begins to arise. In this connection, let me simply refer to Winston Churchill who once said, in connection with reparation problems after World War I, that debts between nations can be paid only in goods. While Churchill's claim to immortality does not rest on his economic and financial expertise, he was certainly correct about this matter. Its relevance to today is that OPEC countries can begin to cash in their claims on the rest of the world only when they increase their imports enough to develop a deficit in their current transactions with the rest of the world.

Nevertheless, the financing problem is a real one and adds to the risks of a cumulative world recession. While such a development is neither inevitable nor even likely, it is a remote possibility with which the U.S. and the rest of the nations must contend. The background factors for even considering this possibility include the debt pressure from oil payment borrowings, the domestic instabilities in several large industrial nations, the shaken confidence of consumers and businessmen, the expectations of inflation combined with recession, the impact from the taut monetary and credit policies pursued in many countries over the past year also, and in some cases the uncertainties of a fluctuating exchange rate picture.

One primary challenge to world financial stability arises from the debts to be created by nations borrowing to pay for oil imports. While recycling petrodollars will permit nations to continue their purchases of oil, one can legitimately wonder how long such debts can be amassed before strained credit positions or unwillingness to loan brings this cycle to an abrupt halt. At the same time the higher energy prices and their impact on prices of other goods can have a considerable dampening effect on consumer spending unless offset by higher wages, or other means such as reduced taxes. At recent levels of inflation, it is doubtful if consumers in some countries were able to sustain their real purchasing power; in the United States real wages have fallen in the past year and some contraction in consumer spending is underway. Thus a significant downward pressure has developed in most oil-consuming nations and with few exceptions has tilted their economies toward recession.

As demand-weakened inventories rose, industrial production declined, and unemployment increased materially in many countries.

Although unemployment compensation reduced the impact on the unemployed, there was a reinforcement of the weakening of demand and perhaps more importantly a severe shock to confidence. Consumers and businessmen both began to question the future and their confidence waned further as the recession deepened while prices continued upward. Expectations of further inflation accompanied with deeper recessions seem to be prevalent in many nations and governmental policies to extricate their nations from this dilemma appear to be lacking in both force and imagination.

Primary efforts to resist inflationary pressures took the form of stringent monetary restraint in virtually all major countries during 1973 and early 1974 and these efforts contributed to the downward trend of business. As credit became both tight and very expensive, businessmen began to reappraise both the cost of inventory holdings and of future capital spending. Consumers found installment credit less available and with their future incomes brought into question by the rising cost of living and higher unemployment, they too, pulled back from credit purchases.

As recessionist tendencies developed, monetary policies began to ease but the fear of continued double digit inflation restrained central bank efforts to reflate. Thus in many countries fiscal measures have been proposed as the primary tool to restimulate their economies, but tax reductions have indeterminate effects when consumers are uncertain about their futures. Meantime, the recessions are deepening.

Perhaps the greatest fear of the international pressures toward recessions is through the impact on export and import trade. Although nominal dollar trade data show tremendous increases for many nations during 1974, the real volumes of trade have started to decelerate and could be expected to contract materially if the recessions deepen. If current efforts to restimulate the economies of most major nations are successful by the end of 1975, the fall-off in real trade could be held to modest proportions. However, if such efforts are not successful or if they generate a perverse reaction by reinforcing fears of a further deterioration of currency values through inflation, then the decline in real trade could become significant and thereby aggravate the recessionary trends. While U.S. export and import trade is of a lower order of magnitude against our GNP than that of other large industrial nations, even our economy would be severely shaken by a strong downward move in foreign trade. For nations such as the U.K., and Italy, given their present problems, and heavy reliance upon foreign trade, such a development could have almost disastrous effects.

Another problem for world trade is the sharp shifts in relative exchange rates. With most currencies floating against each other, speculative or non-economic motivated capital flows, or unbalanced interest rate patterns, can cause major changes in rates. Prolonged movements in either direction have important implications for relative competitiveness of a country's goods in world trade and the cost of foreign goods imported into that country. Over the past six months, the U.S. dollar has declined considerably in terms of German marks and Swiss francs. To the extent that we export to those nations or compete with them in world markets, our products should become less expensive but imports of goods from those nations to the U.S. would become more expensive to our consumers. Such movements would dampen demand for foreign imports into the U.S., but should increase the demand for our goods shipped abroad. With recession underway in most major countries, there is a decrease in consumer demand including that for foreign products; exchange rate instabilities could aggravate that trend.

Obviously, the most severe case of cumulative and spreading recession would be a virtual cessation of trade. Such a future is not envisioned for the world in 1975 but the threat exists unless nations are cautious in their handling of exchange controls, trade barriers, and most importantly their efforts to reflate to stimulate recovery. Recent experience with double-digit inflation has conditioned peoples' attitudes toward reflation and may have so deeply ingrained their responses as to cause a negative reaction to such stimulation. In this event, reflation could cause further efforts to protect against inflation and frustrate recovery. With the present degree of idle resources, one could hope that stimulative fiscal actions could still be effective but central bank reflation must be handled with extreme care.

Where Do We Go From Here

Thus the international forces are of great concern to domestic progress in this interdependent world and economic trends in each country impact on the international monetary scene. Our review of the international forces raises legitimate questions on the future road we will travel. On recycling petrodollars, the actions of the International Monetary Fund's Interim Committee in enlarging and reemphasizing the IMF's facility gives hope for short-run credit availability, especially to the underdeveloped oil-consuming nations. The "solidarity fund" concept tentatively approved by the Group of Ten finance ministers, and central bank governors for action in the OECD, provides potential credits for the industrialized nations to borrow for oil consumption. But both of these are only short-run answers to a long-run problem, unless the price of oil is reduced or counter-balancing imports to oil-producing nations are sharply increased. Moreover, the total of both facilities is less than half a year's deficit for the oil-consuming nations. Left unresolved is the problem of credit responsibility for loans through the banking systems or from the recycling through government security issues and other financial instruments. Nevertheless, these facilities probably have bought at least another year of time.

Reform of the international monetary mechanism is another issue toward which we can hope that progress will develop in 1975. Tentative approval by the Interim Committee of the International Monetary Fund to eliminate obligatory payments in gold may further reduce gold's importance in the international arena. Similarly, the continued responsible use of Special Drawing Rights (SDR's) gives us hope that confidence in this unit will grow and its use as the centerpiece of monetary settlements will be confirmed. However, caution by the principal nations in the current floating environment both regarding exchange and trade controls is important to avoid aggravating recession and delaying ultimate reform.

To some people, these international matters are of only remote interest or concern for they are informed primarily about the domestic problems. I hope you are convinced that the international forces are of great importance to our domestic well being. While we seek answers to the domestic and international problems of recession and inflation, we should keep a close eye upon the international impact of our solutions and the relationship of our responses to those of other nations. In most of our economic, political, or even social concerns, we truly live in a closely connected world, not a closed domestic island.

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