

For Release on Delivery

(Approximately 12:00 Noon
Thursday, May 12, 1966)

The Money Scene

Remarks by J. Dewey Daane

Member, Board of Governors of the Federal Reserve System
Before the Investment Bankers Association's Spring Meeting

The Greenbrier

White Sulphur Springs, West Virginia

on Thursday, May 12, 1966

The Money Scene

In talking today on the subject of the money scene with such a large group of friends, whose mental agility and wisdom I know so well, I hope my remarks will be notable not for their notoriety but for their brevity, because you know me much too well for me to pontificate at length. At the same time, however, I am reminded of the legend about Carter Glass to the effect that he hated to make a speech except when it could be controversial. Without in any way attempting to make my own brief remarks controversial, I would like to talk with you today mainly about some of the issues on both the international and domestic money scenes as I see them.

The search for a new international money

On the international scene, which has absorbed much of my own time and energies this past year, there has been a continuing search for supplements to gold and dollars as the principal reserves in the international monetary system. This search, still in process, for agreed ways and means of deliberately creating, for the first time, an international money has indeed been an exciting one, and I would like to highlight for you both some of the areas of agreement and some of the remaining issues. While this search for a new international money has been going on, there has been a separate search under way in the international financial community for a better balance of payments adjustment process--for better ways and means that countries might adopt to correct their balance of payments disequilibria. Here, too, some of the sort of basic issues that arise along the way may deserve consideration.

As to the international money search, both the International Monetary Fund and the Group of Ten have been working diligently to explore the many problems involved. As you know, the Group of Ten is an offspring of the International Monetary Fund, a ten-country offspring self-designed to provide additional financial resources to the parent to the tune of up to some six billion dollars. In fact, under these arrangements more than nine hundred million dollars has already been provided by this group of major industrial countries. Representatives (the Deputies) of these ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, United States), plus Switzerland and the International Monetary Fund and other international financial institutions, have been meeting regularly since last fall in response to a Mandate from the Finance Ministers and Governors of these same countries, a Mandate asking the Deputies of the Ten to "determine and report to Ministers what basis of agreement can be reached on improvements needed in the international monetary system, including arrangements for the future creation of reserve assets, as and when needed, so as to permit adequate provision for the needs of the world economy."

Two questions may be raised at this point. First, why all of the effort and second, what progress has been made in finding agreement?

The why of the effort has been stated so many times it may sound repetitious. Simply stated, it is that the supply of new monetary gold and a shrinking additional supply of dollars will not meet the future

needs for world reserves. If one asks oneself what have been the sources of new international reserves over the last decade or so, the answer is that the rest of the world has depended to a very large extent on increases in holdings of dollars and on gold mainly acquired from the United States. In other words, the rest of the world has been dependent on balance of payments deficits in the United States for increases in international reserves. For a variety of reasons, which I need not develop in detail for this audience, it is both desirable and necessary that the U. S. balance of payments should return to equilibrium. For, while our balance of payments deficit has resulted in increasing liquidity for the rest of the world, it has at the same time reduced our own liquidity markedly--as our liabilities to the rest of the world have increased and our own assets in the form of gold have declined. The flow of gold from our country, of course, does not add net to world reserves but simply transfers ownership of existing gold in exchange for dollars that might otherwise have served as reserves. Meanwhile, the amount of new gold becoming available for additions to world reserves is not large enough, given the evident desires of countries to add to their reserves, and furthermore such new supplies of gold are unpredictable. Specifically, over the past six or seven years world reserves have grown annually by perhaps a little more than two billion dollars a year of which gold may have accounted for five or six hundred million dollars. Last year the contribution from new gold was only around 250 million dollars, obviously an amount insufficient to satisfy

the secular growth in reserve requirements of the world over time. Thus, while the future need for reserves is difficult to quantify, the likelihood of future need clearly exceeding growth of the stock in monetary gold and of reserve currency holdings, specifically dollars, leads to the decision to search for a new means of creating international reserves.

That search is now going on under the heading of contingency planning. In other words, the need to add to reserves is not felt to be immediate. At the same time, it is thought to be prudent to put in place, so to speak, a mechanism for reserve creation that can be activated as and when it is needed. As an analogy it can be thought of as putting together an airplane with the decision to fly it postponed to a later point in time. What progress has been made?

A first point on which a consensus is emerging is that contingency planning is clearly and firmly necessary. It is generally recognized--more clearly, I think, than when these discussions began--that the world must be assured that it is not beyond the capabilities of sovereign nations to agree on a means of mutually increasing reserves. This need emerges from a simple set of facts. Most countries gear their policies to achieving a growing level of reserves over time. And no country gears its policies to a secular decline in reserves. It follows inexorably that total reserves must grow unless some of these policy intentions are to be frustrated. But if some of them are frustrated, countries will change their policies, in an effort to

achieve rising reserves, in a way inimical to the interests of the rest of the international community. A second and closely related reason for the emergence of a consensus on the need for contingency planning is that the world must be assured that a true supplement to limited gold supplies can be found and put in place without disruption to existing international relationships.

Given this consensus, the main problems to be solved are concerned with the form of the new international assets to be created, their institutional setting, the way in which they will be made acceptable to monetary authorities, the way in which they will be utilized in financing surpluses and deficits, and the way in which the various countries of the world, in different stages of development, will share in this process of creating and using new reserve assets. Let me comment on some of these problems.

As regards the form of a new reserve asset, two types have been considered. On the one hand, a reserve unit, as it is called, could be created and held in the reserves of the monetary authorities. Such a unit would be directly transferable among such monetary authorities in a way very similar to the use of gold now. Some feel that the unit is more adaptable to the needs of the advanced countries, which are the major holders of gold.

The other form of reserve asset under consideration is a so-called drawing right on the International Monetary Fund. Such a drawing right (which might be looked upon as a checking account at

the IMF) would give countries the right to draw other currencies from the International Monetary Fund as needed to finance imbalances in their international payments. The economic effect of using either of these types of reserve asset would be rather similar, but at the same time each of them has distinctive advantages. A reserve unit, for example, appears more clearly as a supplement to gold. It would be freely transferable by countries holding it without the need to engage in transactions through an institution. Drawing rights represent an adaptation of a type of reserve asset already in existence; namely, gold tranche positions in the International Monetary Fund. The further development of this type of reserve asset would represent a clear evolution from what is already known and tested.

The member countries of the Group of Ten have shown a preference for one or the other of these forms of reserve asset. Consistent with the age old principle, well known to those so familiar with the Old White Club here at the Greenbrier, that "no bird ever flew on one wing", the United States has put forward a proposal which would provide the airplane with two wings, both units and drawing rights, in what we have called a "dual approach" to the problem of reserve creation.

An issue on which there has been somewhat less agreement concerns the way in which new units would be transferred in financing payments imbalances. Some proposals would link the use of the new unit to some other form of reserve--notably gold. The argument here is that if a new asset were linked to gold in use, it would be more acceptable

to receiving countries and would at the same time provide a greater incentive to deficit countries to correct their deficits. It is argued, on the other hand, that if a new reserve asset is to stand on its own feet as a true supplement to traditional forms of reserves, it ought to be usable independently of such other reserves and not provide any inducement to those kinds of shifts in reserve asset composition that would cause a shrinkage of total liquidity. Those who do not favor a link of the new reserve asset to gold, realize that, in the initial stages at least, some limitations will be necessary on the extent to which contributing countries can be obligated to accept the new asset. This could be accomplished by having the contributing countries agree that none of them would be obliged to hold the new asset above some sort of holding limit, with the right to redistribute the excess to other countries.

Another major issue concerns the way in which the various countries of the world would participate in the creation and distribution of new reserves. On the one hand, it is now generally acknowledged that all countries in the world, regardless of their stage of development, have a need for growing reserves over time. On the other hand, countries do differ greatly in the degree of development and in the extent to which they may need a supplement to gold and dollars in their own reserves. This raises the issue whether all countries should participate in reserve creation on the same basis, or whether the nature of their participation should be tailored to their particular

circumstances. Here again, the United States has put forward a proposal that attempts to recognize these diversities. We have proposed that a unit be created for the use of the major industrial countries (with some set aside for others to be allocated through the IMF) and that drawing rights in the Fund be established for all members of the Fund on a uniform basis.

I have tried to outline in very broad terms the nature of the issues with which the members of the Group of Ten are grappling. The negotiating process may seem slow. But when one realizes that what is involved here is a unique effort--to do, as I said earlier, what has never been done before--it is not terribly surprising that the pace of progress should be slow. The interests of the countries involved, although identical in some respects, are diverse in others. Some of the countries have been in surplus for a number of years and others in deficit; this fact itself inevitably colors attitudes. Some of the countries are large and others are small. Some have worldwide political and military responsibilities and others do not. Some have economies which are very dependent on external markets, whereas for others international transactions comprise a relatively small aspect of their total economic activity. For these and other reasons, it is understandable that the negotiations "to construct the airplane" are not easy. And beyond construction there is, of course, the issue of activation or, in other words, under what circumstances and how the first flight is to be triggered.

But despite these diverse interests, progress is being made, and the seeming slowness of progress may simply ensure a safer machine. On one of my recent trips abroad one of the stewardesses asked me why I was going over so often. In my own affable and artless way--with which you are familiar--I tried to explain to the young lady our efforts to create a new international money and she then asked "Do you think it will work?" I answered that I could not be sure because it did involve an uncharted and unprovable area, to which she in turn replied, "Well, they said we couldn't fly either". Conceding this, it seems to me that the time schedule calling for discussion and negotiation, both within and outside the Ten, is both appropriate and desirable.

The Deputies of the Group of Ten are scheduled to present a report to the Ministers and Governors late in the spring. The report will indicate the extent of agreement and presumably will also present the issues still outstanding. In time the discussions will be transferred to what is known as the second stage--in which a broader range of countries will participate in the discussions and negotiations.

The search for improvements in the adjustment process

As to the search for better ways and means to correct balance of payments disequilibria, this process of improving adjustment policies will, in all likelihood, prove to be even more time consuming. The smooth functioning of the adjustment mechanism is, in a very real sense,

an even more complex problem, with implications for the world economy perhaps even broader and more diffuse.

The forum for current international consideration of this problem is the so-called Working Party-3 of the Organization for Economic Co-operation and Development. Membership of this Working Party largely overlaps that of the Deputies of the Group of Ten and the Ministers and Governors of the Ten have expressed the hope that this Working Party might also make a report about the same time as the forthcoming one from the Deputies on reserve creation and monetary improvements.

The subject matter for Working Party-3's study and report--the adjustment process--refers, as I have indicated, to the policies that countries adopt, or sometimes fail to adopt, to correct balance of payments disequilibria. It is generally recognized that in some cases both deficit and surplus countries have been rather slow to adjust. If deficit countries are too slow to restore balance, an excessive burden can be placed on surplus countries, and in some circumstances this burden reveals itself in the form of inflationary pressures. On the other hand, if surplus countries are too slow to adjust, they absorb excessive amounts of reserves and deficit countries are driven to adopt measures that are in conflict with their own domestic objectives or with the freedom of international transactions. What is being investigated is whether the process of adjustment cannot be improved in a way that is conducive to the maintenance of steady growth and price

stability in all countries and with a generally free climate of international transactions.

What are the means by which countries can adjust imbalances in their payments?

First, they can use fiscal and monetary policies to influence aggregate demand. Deficit countries can restrict total demand and in the process reduce their imports and increase their exports. Surplus countries can stimulate aggregate demand and in the process increase their imports and reduce their exports. This is the traditional textbook prescription as handed down from the gold standard. And in some circumstances it is completely appropriate today. If the country in deficit is already suffering from excess demand at home, such policies would serve both internal and external objectives. Similarly, if the surplus country were suffering from inadequate demand, the prescribed policy would be consistent with both internal and external objectives.

We have seen in recent years, however, that countries in surplus may be suffering from excess demand at home, while countries in deficit may be experiencing inadequate domestic use of resources. In these circumstances the traditional textbook prescription doesn't work. For while possibly helping to correct the balance of payments, it aggravates the domestic problem. Payments imbalances often are caused by factors other than improper levels of aggregate demand.

The second prescribed means of adjustment of balance of payments found in the textbooks is to permit exchange rates to fluctuate freely,

as compared to the present fixed exchange rate system in which rate adjustments are permitted only in cases of "fundamental disequilibrium." In general, under this prescription, exchange rates of surplus countries would appreciate--thereby making their exports more expensive to foreigners and imports more attractive to their own citizens; while deficit countries would permit their exchange rates to depreciate, with the opposite effects on their trade. Without going into further detail, I need only to say that for a great number of reasons, this oversimplified prescription of fluctuating exchange rates is not generally accepted by Governments today--and, in my view, quite rightly. In fact, this has been ruled to be outside the framework of the Working Party-3 study.

Another, the third, means of adjustment would be through the use of direct restrictions on international transactions, such as import controls, exchange controls, and bans on capital movements. Such restrictions on trade and capital movements proliferated in the 1930's, and most countries came out of World War II with a panoply of such restrictions. Slowly and painfully, these restrictions have been relaxed in the post-war years, especially those on current transactions. It is generally believed that a world in which such restrictions are minimized is one in which the allocation of resources would be more conducive to economic growth and development.

Recently I had the privilege of attending a session of international economists, mainly academicians, at Princeton University on the subject

of the adjustment process. Starting from the premise that the fixed exchange rate system was a datum they explored, first, the possibilities of achieving adjustment via the co-ordination of aggregate demand policies in surplus and deficit countries and seemed to conclude that within realistic limits this would not suffice. As to the second alternative of direct controls these would be complete anathema to the economist group. Thus, they were all, or almost all, led back to the case for exchange rate fluctuations.

But this leads me instead to a fourth alternative means of balance of payments adjustment, one to which the United States has had recourse in recent years. This involves what I would call selective instruments of adjustment, which are designed to interfere as little as possible with private decisions regarding trade and capital movements, but which nevertheless attempt to exert a broad policy influence over these movements in the direction of balance of payments equilibrium.

The United States has experienced in recent years an excessive outflow of capital to the rest of the world. As a country with a current account surplus, it is quite proper that we should export capital. The problem has been that the capital outflow has tended to exceed our current account surplus after allowing for military expenditures and the external costs of aid. And for this excess outflow of capital there are many reasons. I shall not try to develop all of them, but let me mention the fact that we do have the largest,

the most developed, and the most accessible capital market in the world. And we have a highly developed and competitive banking system which can satisfy the borrowing needs of both American and foreign customers efficiently and at relatively low cost. Finally our corporations have been eager to build up their direct investments abroad on a large scale.

We have tried to cope with the excess capital outflow by the use of selective instruments, including the interest equalization tax and more recently the Voluntary Credit Restraint Programs applying to banks and other financial institutions and to corporate investors overseas. The application of these instruments is such that decisions on individual credits and investments remain completely at the discretion of the parties concerned.

I believe I have said enough to indicate that these selective controls are in fact different from the other types of balance of payments adjustment policies to which I referred. These selective instruments can never be regarded as a substitute for adequate fiscal and monetary policies. But as a supplement to such policies, they do in my judgment have great advantages over the other two forms of adjustment--floating exchange rates and direct controls over individual transactions.

As the adjustment process study goes forward, there is reason to hope that there will be a fair degree of agreement on the desirability of improving that process consistent with other important economic objectives. An important result of this study is likely to be an increasing realization that "it takes two to tango." In other words, the burden of adjustment should not fall only on countries in deficit, or only on countries in surplus. Rather, both surplus and deficit countries have important responsibilities in this regard.

We can also hope that there will emerge from this study a realization that, while improvements in the adjustment process are necessary and desirable, imbalances in international payments are inevitable in a dynamic world. There is nothing more stable than stagnation. In a world in which countries are growing vigorously, in which technology is advancing rapidly, in which new products and new techniques are continuously coming forward, in which international transactions are relatively free--in such a world we have to expect significant imbalances to show up in the total payments and receipts of individual countries. What is to be sought is not to prevent such imbalances but to prevent immobility in correcting them.

The domestic money scene

When we turn our attention to the major issues on the domestic money scene, the players and props change but the basic analytical framework can remain much the same. The principles involved in the international adjustment process have their direct application to domestic affairs. To be sure, the analogies between international and domestic processes are not always perfect but, if not pushed too far, I believe they can be quite helpful in putting what you may sometimes regard as the same trite old ideas in new perspectives. As a starting point, let me point out that we have a domestic "adjustment process" and it can be implemented through the same four policy channels that we have described a few minutes earlier as comprising the chief alternative channels of adjustment to international equilibrium. Domestically, just as internationally, these four channels can be labeled, respectively: (1) the adjustment of aggregate demand; (2) changes in the value of the currency; (3) the imposition of direct controls; and (4) the overlay of a supplemental fabric of selective instruments of adjustment.

Suppose we review these together briefly, one by one. First and foremost position must be given to policies to moderate the course of aggregate demand. Basically, these policies come down to monetary policy and fiscal policy. Each kind of policy has its own special attributes, its own ways of affecting demands, and its own side effects, not all of which are benign. You know these too

well for me to take time to detail them here. But what is not always fully appreciated is how much each kind of policy benefits from, and is reinforced by, appropriate and timely application of the other. In a phrase, good fiscal policy makes good monetary policy work better, and vice versa. This is one reason why I, right now, am still in favor of a moderate tax increase to balance our policy of aggregate demand restraint; ideally such a reinforcing tax increase could have come earlier this year. From the standpoint of our balance of payments position, too, the need for stronger aggregate demand restraint seems clear. Equilibrium in the U. S. payments balance is essential to the strength of the dollar, its continuing status as a reserve currency, and the accomplishment of international monetary reform. And my own view is that some firming by means of the tax and expenditure sides of fiscal policy could also be of major assistance in dealing with the current problems in the relationships among various kinds of savings intermediaries in the United States.

Given this potential for policy interaction, the coordination of monetary and fiscal policy is, in my judgment, invaluable. But such ideal coordination is not easy to achieve. Judgments of reasonable men can vary as to where we are in the business cycle, as to how "overheated" the economy is. Moreover, a whole panoply of political judgments and social values must also be brought into play. The end result is that coordination of intra-government demand policy can be almost as tricky--and occasionally as unnerving--as such adjustment of aggregate demand policies attempted internationally.

But suppose our aggregate demand control isn't enough. Then in the immediate instance, movements toward equilibrium would probably have to be made--as in fact they are being made--through depreciation of the value of the currency in terms of goods. Color this inflation--it is an economic affliction that is well nigh inevitable when aggregate demands exceed supply by a greater margin that can, or is being neutralized through the bite of tight fiscal and monetary policy. To you so intimately involved in dealing in fixed-value claims, the ills of inflation need no cataloging. The distortions and inequities it can create suit few persons' social preferences. But beyond these, there is the hard fact that inflation typically proves to be unsustainable--and the eventual and subsequent recession is a painful price that is extracted.

Some, worried about the damages threatened by inflation, would turn to the third channel of control--direct controls. This, for lack of a better term, I would label the "cork-in-the-bottle" approach to trying to hold down interest rates and effective demand. If applied at the right time and place, and with the right kind of public support, direct control undeniably can serve some policy objectives. There are times--like World War II or the Korean War--when such controls were obviously advantageous. But fundamentally direct controls have to be an anathema to anyone concerned with the market process. This is because the very essence of a direct control is to override--to contradict--the ordinary thrust of market forces. In the long run,

human controllers are not wise enough, nor market participants docile enough, to make a system of direct controls work well or indefinitely.

These kinds of positions can serve as reference marks in principle, by which policymakers can plot their long-range course. One cannot deny, however, that we sometimes come across navigational hazards that require some extra maneuvering to bypass without serious incident. As much as anything, these trouble spots grow out of market imperfections--including particularly the inability of private market participants to moderate short-run fluctuations that are out of track with longer run trends. A number of such imperfections have become so commonplace they are a part of our every-day language: "sticky prices," "surplus labor areas," "cost-push," "wage-price spiral," "market congestion," "credit rationing," "destabilizing international capital flows," and even that despairing moan that occasionally escapes the lips of a money position manager: "There's no more money anywhere!"

In such circumstances, public policy actions of a selective nature can sometimes provide some pragmatic assistance to the adjustment process that is proceeding under the more general influence of aggregate demand policies. One of the programs of greatest social benefit in this respect is the effort at basic education and vocational training of pockets of our population where lack of the labor skills most in demand in our automated society has given rise to long and enervating periods of unemployment. More in the headlines is the Administration's effort, via price and wage guideposts, to encourage

business and labor wage-price policies that would be conducive to sustainable, noninflationary prosperity. Minimum margin requirements on stock market credit are perhaps the oldest of our selective policy instruments. And then there is the whole voluntary foreign credit restraint program, designed to discourage excessive capital outflows during the period needed for more basic adjustment forces to do their work. I cannot end my illustrative list without referring to the kind of "jawbone" influence that is occasionally applied by officials--not excluding my colleagues and myself on the Board--to encourage an extra degree of prudence or consideration of long-run institutional and national interest in the decisions being taken in the financial marketplace. In the last few months you have heard us cautioning bankers to be prudent in bidding for time deposits, and to gird up their loins and start saying, "No," to demands for loans that can only be inflationary, even when it's a good customer that is doing the asking. And, given some snatches of casual market gossip I've heard in the last few days, I'm tempted to call another area of jawboning to your attention. To those of you who think you have figured out just exactly the margin of the Federal funds rate, or the bill rate over the discount rate that might impel the Federal Reserve to raise its rate I say, "Don't underestimate our discount officers!" Their administrative discipline on inappropriate bank borrowers gives the Fed a good measure of flexibility in its rate decisions, and you should not forget that.

In focusing attention on this illustrative group of selective instruments of adjustment--for both the balance of payments and the domestic economy--I want to emphasize the need to be wary of over-reliance upon them. They are not substitutes for good policies as to aggregate demands--indeed, they will break down unless supported by appropriate demand policies. But selective instruments of influence can sometimes be extremely valuable supplements to general monetary and fiscal policy--for they can smooth the adjustment process and save us from having to push policies of general demand restraint too far.

Insofar as the choice of these selective influences is concerned, hard-pressed policymakers--and perhaps some battered market participants--can sometimes come to regard them in a spirit very much akin to that expressed by that aging but effervescent Frenchman, Maurice Chevalier, when he was asked how it felt to reach the age of 75. He replied that, to be honest, it was distressing, uncomfortable--and sometimes, when a girl passed by, downright frustrating--but, considering the alternative, it was fine!

Considering the alternative, continuing to leaven a goodly mixture of monetary and fiscal policy with a judicious sprinkling of the selective instruments already at work may, in times like these, well be the best alternative that we can manage.