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Through the Money-Glass

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By J. Dewey Daane*

When I returned from a recent trip overseas, I found my five-year old daughter, Whitney, feeling somewhat under the weather. Trying to console her, I said, "Cheer up, Whitney. Next time I go to London and Paris, I'll just take you with me." In response, she looked up at me in disbelief and said, "London? Who wants to go to London, you dum-dum? I want to go to Florida." I can fault her for lack of respect (and I can assure you that I did!), but I certainly can't fault her judgment as to locale on this beautiful day here in typically sunny Florida!

I am sure that the title of my talk, "Through the Money-Glass," must have mystified at least some of you in this audience. But I can assure you that it was chosen deliberately not to obfuscate, but rather to light up and bring into sharper focus my major theme here today. For in recent months I have once again been impressed by the fact that the way we view our problems depends in no small part on the particular side of the looking-glass, or "money-glass"--which is what all of you and all of us at the Fed rely on--from which one views our problems. I think this is especially true of the problem areas in which I have spent much of my time during the past ten years or so, namely that of our balance of payments and of the functioning of the international monetary system.

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During those years, and I am sure earlier years as well, many voices have been raised calling essentially for a "do-nothing" policy with regard to the United States balance of payments. Most recently several good friends and distinguished economists have propounded the latest version in this series of do-nothing, or purely passive, approaches that have troubled policy makers intellectually and otherwise over the last ten years and have appropriated the term "benign neglect" to describe it. The benign neglect approach to our payments imbalance is not new; it has appeared in different forms and in different phases of the cycle during much of my experience as a monetary policy maker in the United States. Each time that it has appeared officials may have shared the yearning for release from constraints that it promises, but have rejected the basic theme and, in my judgment, properly so. For when we have examined the consequences of accepting the prescription propounded we know that we cannot and have had to reject it.

What is the current concept of benign neglect which its advocates argue also could only serve to produce useful reforms of the international monetary system? Like earlier do-nothing approaches, the benign neglect advocates seem to be saying this: don't pay any attention to the balance of payments and nothing adverse will happen; other countries will have to adjust by passively accepting dollars, willingly inflating, going out of their way to reduce trade barriers, or more readily appreciating their currencies. In the meantime, at home, American monetary, financial, and other policies should, in their words, "be exclusively guided by

internal policy objectives (high level of employment, growth, price stability or whatever they are).'' [Underscoring mine] In other words, this seems to say that no matter what our domestic objectives and policies are nothing bad can happen internationally!

The advocates of a passive or benign neglect approach for the United States believe that since other countries share with us an interest in maintaining the international monetary system, they will not react by adopting measures that would be destructive of the system. Restrictive reactions also are seen as unlikely because they may be the reverse of the usual sorts of controls. Restrictions on trade, for example, presumably would be directed toward exports rather than imports, and those on tourism directed toward limiting the amount that foreigners could spend in the country rather than the amounts that the country's residents could spend abroad.

As I have indicated, following the passive approach, the United States would have no particular objective with respect to balance-of-payments policies of other countries, and it would promise no action toward resolving balance-of-payments problems.

Some elements in this approach, put forward mainly by certain academicians, seem on the surface temptingly attractive. As one who shares your feelings about and fundamental distaste for controls, I can sympathize with those in this audience who might at first glance also find it appealing on that score. But I cannot let my sympathy run away with my best judgment. Successive groups of officials over

the past decade have rejected this thesis and officials currently, including myself, are just as strongly opposed.

Why have and do officials, both in the United States and in Europe, unanimously dismiss this approach? Just a month ago, for example, following a meeting of Working Party 3 of the Organization for Economic Cooperation and Development, attended by officials from leading industrial countries, the chairman of that group, Otmar Emminger, Vice President of the Bundesbank, reported to the press that in two days of closed meetings among the senior monetary officials of the U.S., Europe, and Japan "there was no trace of what is sometimes called benign neglect (of the payments deficit) in the statements of the U.S. officials. Quite the contrary, they are against passivism and so are we Europeans." Why this gulf in attitude between those advocates of passivism who have no operating responsibilities for the stability and functioning of the international monetary system and the senior governmental officials who do? As one of the latter, I find the weaknesses in the benign neglect approach very real, reflecting inadequate consideration of all the important implications and ramifications of such an approach. On the other side, the official side, of the money-glass the view must be broader and the relevant considerations are more numerous.

First, the thesis starts from the premise that one needs to look only at what others might "do to us" as a result of our adopting a purely passive attitude towards deficits in the U.S. balance of payments. But this ignores what we might be doing to ourselves by this passivity

about the role and standing of the dollar. Possible resultant instability in exchange markets and the international financial system would be no good for anyone interested in healthy long-run growth of trade, and even less so for the United States where we are in the beginning stages of a recovery that could be vulnerable to any additional uncertainties. Nor can we be oblivious to rapid growth in our short-term liabilities or the competitive position in our own and foreign markets.

Second, another and broader question can be raised as to the effect of a passive policy on the structure of international economic and political cooperation. In the financial area such cooperation has been the hallmark of the postwar period and has led to the strengthening of the system, most notably in the fruition of arrangements for Special Drawing Rights to provide a way to deliberately create needed reserve assets. In opting for passivity we certainly would lose our leadership role in working toward new international monetary arrangements. The risks in not working cooperatively toward a further strengthening of the international monetary system are substantial. In particular we would be incurring the risk that any changes in the system would be undertaken only in some unforeseen crisis period rather than as a result of calm and deliberate negotiations. We must have an atmosphere in which we can work cooperatively toward a strengthening of the international monetary system.

But the network of financial cooperation has served to underpin much more in terms of political and other relationships so vital to

world peace. While I do not accept the mirage that even in the limited context of international monetary relationships there might be little that could be "done to us," in any event our interests do not end here. There are many other not purely economic or financial issues in which international cooperation is crucial. Even more important are our political relationships with the rest of the free world. The possibility of a severe deterioration in our diplomatic and political relations abroad has been virtually ignored by the advocates of benign neglect.

Third, the do-nothing approach assumes that foreign central banks and governments have no options that would or should be unacceptable to the United States, primarily because of the foreign interest in maintaining a viable international monetary system. This, however, seems to me to beg the question. For my part I am sure that there are choices available to our foreign friends, choices outside of those tending to bring down the international monetary system. Thus I think other countries might very well find a way to avoid a dollar standard, turning more and more to restrictions on trade and capital with the European Community providing the principal vehicle for this range of choices and perhaps becoming more inward looking as a result. Other countries firmly believe that the U.S. deficit adds to their difficulties in maintaining independent monetary policies and restraining their inflationary pressures. The adverse psychological effect of our blithely turning to benign neglect could indeed provoke retaliation in both the narrower and broader context of foreign economic relations.

Fourth, and related to this last observation, an attitude of benign neglect would be most damaging in one very specific international endeavor. This is the effort to create an international reserve asset in the form of Special Drawing Rights. After long international negotiations, this international reserve instrument made its appearance in 1970, with an initial decision to create \$9.5 billion of SDR's over a three-year period. It was designed to provide the major element in the growth of international reserves and furnish the basis for a smoother working adjustment process. But if the United States were to make no effort to moderate the growth in foreign dollar reserves, over a period of years, the future of the SDR would not be promising. The result could well be a backward move for the entire international monetary system. The first truly international effort to cope with the world's needs for an ultimate monetary reserve asset on a worldwide basis, with the participation of all IMF member nations in a common endeavor, could be frustrated.

Fifth and finally, there seems to me implicit in the thinking of many who embrace a passive approach to our U.S. balance-of-payments problem the implication that we can ignore the international repercussions at least of domestic inflation and do not need to fight the battle of inflation quite as hard as we might otherwise do. Again, I would categorically reject this view. My own belief is that we must press even harder to achieve relatively greater price stability than other industrial countries of the world.

This does not mean that there are not responsibilities on both sides. At the risk of sounding like a broken record, I will repeat what has been said so many times, that surplus countries, too, have their responsibilities for achieving the sort of policy blending that will produce domestic stability with the least possible adverse impact internationally. Other countries as well as the United States have relied too much from time to time on monetary policy. Perhaps more needs to be done to devise ways to coordinate policies to affect international flows in ways supportive of rather than disturbing to national economies and the international monetary system.

Some of those who advise the U.S. to ignore its balance of payments have suggested that, "Well, after all, the U.S. has been following a passive policy with no untoward consequences." I would take sharp issue with this thesis. First, by way of background, let me note that the United States, through its demand management policies, temporarily accepted a growth rate much below our potential in the interest of halting a disruptive inflation inimical to sustainable long-term growth; while relative price stability has been and is a domestic objective, it is surely also a sine qua non for balance-of-payments improvement and we have not been oblivious of this aspect of an improved price performance. And again with a duality of benefit we have moved a considerable distance towards an incomes policy to reinforce our efforts to achieve price stability.

Second, we have deliberately directed ease toward the longer term rather than short term markets. The Treasury's debt management and the Federal Reserve's tailoring of open market operations have emphasized issuance of short debt and purchases of coupon issues. This is consistent with a convergence of interest rate movements internationally that can help to stabilize the international flows of short-term funds accounting for a large portion of both deficits and surpluses in some of the accounting measures of the balance of payments.

Third, we have attempted, by Export-Import Bank offerings and Treasury offerings of securities now totaling \$3 billion, to intercept outflows in the form of possible repayments of Eurodollars borrowed by

U.S. banks from overseas branches before these Eurodollars reached the hands of central banks abroad.

Fourth, we have maintained the capital controls programs virtually unchanged and have extended the interest equalization tax.

Fifth, Congress may well authorize the proposal for a Domestic International Sales Corporation (DISC), which I know has your support, and efforts are going forward to make U.S. export credit facilities more competitive.

Sixth and finally, looking ahead, it is my judgment that if the economy were to require further stimulus--and it is not clear now that it does--balance-of-payments considerations would call for such stimulus to come from the fiscal side and I would hope and expect that is where such stimulus would originate, specifically in the tax area.

Listening to this discourse, some of you undoubtedly would ask why, in the light of these measures, does our balance-of-payments performance continue to be unsatisfactory? Here I think it is necessary to distinguish between our basic balance^{1/} and the more transitory problem of short-term capital flows. Last year our basic deficit was in the neighborhood of \$2-1/2 - 3 billion. Obviously, this is not a satisfactory showing, although it is not significantly larger than the average of the past five years. And the U.S. current account surplus, excluding Government

^{1/}The basic balance may be defined as the balance on current and long-term capital account transactions.

grants, totaled some \$2.3 billion in 1970, at least a billion dollars or more higher than the 1968-69 average.

To further inveigh a bit against the prophets of gloom and doom re our basic balance, it can be noted that the basic balance-of-payments positions in Europe while not weak are not especially strong. A major part of the offsetting surpluses to our basic deficit is probably to be found in Canada and Japan. Continental European basic surpluses have been held down by U.S. restraints on long-term capital outflows, especially for direct investment. Even in Germany the current account surplus in 1970 was about half as much as in 1969. Wage and price movements in Europe now suggest a more rapid pace of inflation, both present and prospectively, relative to the United States. Thus it is possible to take a relatively optimistic view of our balance of payments provided we continue to make the efforts which I have noted and do not heed the sirens of benign neglect.

Those who look at the more exaggerated figures of our balance-of-payments deficit on an official settlements basis, which totaled around \$10 billion in 1970 (including SDR allocations), sometimes fail to recognize that in no small part this was an expected reversal of the short-term inflows of 1969. The average deficit on an official settlements basis for the 1968-70 period was about \$2 billion. The short-term capital flow problem, while it is a serious one both affecting the internal economies of the European countries and also having an adverse impact on the functioning of the international monetary system, is

fundamentally different from the basic balance-of-payments problem. It results from the acknowledged need and desire of countries in different cyclical situations to maintain monetary and interest rate policies keyed to their own domestic requirements. In 1970-71 this has meant substantial differentials between U.S. interest rates, which have been relatively low reflecting our need for economic stimulus, and interest rates in certain European countries which have been high, reflecting a desire for continued restraint in those countries.

In short, these divergent monetary policies have been the major source of the massive U.S. official settlements deficit in 1970. Even with available techniques for dealing with short-term capital flows, all nations must be prepared to ride out large swings in payments positions in such divergent cyclical situations. If an expansion of the U.S. economy this year is accompanied by a firming of U.S. money markets and there is an easing of monetary conditions in foreign financial centers, our U.S. official settlements deficit should be substantially reduced. Questions of the appropriate policy mix as between fiscal and monetary policy are relevant for all advanced countries, not merely for the United States.

Recognizing that there are no quick or easy answers to world balance-of-payments adjustment problems, we in the U.S. are carrying out our part of collective responsibility for an improved structure. Orderly growth with price stability in the United States is an essential underpinning to such improvement. The extremes of slack in, or overheating of, our

economy would offer no salvation for the balance of payments. A combination of orderly growth with relatively better price stability than others in the years ahead should move the United States along the desired path toward a stronger current and basic balance position.

At the same time, we are also conscious of the need to work cooperatively to improve the system's ability to adapt to and deal with short-term capital flows. This attitude was evidenced in the President's report on "U.S. Foreign Policy in the 1970's" in which he listed the objective of cooperation in the monetary sphere "to handle large-scale shifts of liquid capital without exchange crises or losses in the ability of individual nations to pursue their monetary policies." And the President called for "an intensive examination to determine whether there is need to reinforce the present techniques and procedures of international monetary cooperation to enable us better to cope with such movements." Examinations are in fact now going forward in a number of different forums, including the Working Party 3 of OECD and the Bank for International Settlements.

Admittedly, however, the U.S. basic balance remains unsatisfactory, reflecting serious deterioration in our trade surplus from the levels of the early 1960's. A primary cause of this past deterioration, pointed up in recent studies by our Reserve Board staff, was the inflationary boom of the late 1960's which is only now coming under control. Furthermore, as I have indicated, this deterioration shows up heavily in our trade with Japan and Canada, although European agricultural policies may

present the threat of further deterioration. Another major cause of our continuing unsatisfactory current account performance, of course, is our continuing large military defense burden, particularly relative to that borne by Europe and Japan. Despite their surpluses, many other developed countries still have restrictions limiting their imports from us. In a broader sense, countries with large current surpluses share our problem of having to make decisions and play their proper role in making the international system, namely the adjustment process, work more effectively. This applies not only in the trade restrictions area but in the area of foreign aid and capital outflows.

This brings me full circle in my remarks here this morning. I began by indicating that I did not believe that ignoring its balance of payments was the appropriate policy course for the United States today any more than it has been all along. I then pointed out that, contrary to the opinion of some, we have not been following such a so-called benign neglect policy but have been working individually and collectively in cooperation with other countries to deal with the world balance-of-payments adjustment problem and the short-term capital flows which magnified our apparent imbalance last year. And I hope that I indicated that in my view there is no reason to become so unduly discouraged by recent statistics as to abandon the long struggle we have carried on to move toward equilibrium in our balance of payments.

Lest I be accused, however, of neglect, benign or otherwise, of some of your own views revealed in your statement of policy less than a year

ago, let me close by saying that I find much to commend in that statement. The U.S. position on the desirability of keeping under examination the question of limited exchange rate flexibility is well known. Your call for an objective reassessment of U.S. balance-of-payments accounting has been heeded and an interagency group of experts has been at work on this subject. My use today of the "basic balance" concept reflects this continuing work. I personally share and warmly commend your feelings about the disadvantages of protectionism which you expounded in your last year's policy statement. With reference to the Export-Import Bank, the one specific proposal in your policy statement has been implemented, namely, that U.S. banks now have the option of using export paper as collateral in order to borrow from the Export-Import Bank or of selling the paper with recourse to the Ex-Im Bank. On DISC, your call for legislative action was not heeded despite Administration, notably Treasury, efforts supporting it. Again, on Private Export Funding Corporation (PEFCO) which you endorsed, this is, as you know, on its way into being and should be operating soon.

Finally I would be remiss here today if I did not take note of your policy statement of last year about the VFCR to the effect that it "continues to be a serious barrier to and restraint on the expansion of this nation's foreign trade and we recommend that the program be terminated as soon as possibleAt the very least, we urge that export credits be exempted."

As long as the VFCR has been in existence, the Board has watched its application carefully to ensure that the balance-of-payments gains were not achieved at excessive cost. In this constant review, the relationship between the restraint on lending to foreigners and U.S. export performance has been given special attention by the Board.

Last fall, looking toward the end of the year, when decisions are normally taken by the Government on possible continuation of the capital restraints programs and of possible changes in the levels of the restraints, the Board undertook a thorough study of the possible effect of the VFCR during 1970 on U.S. bank export financing and on U.S. exports. Developed with the cooperation of the Commerce Department, the survey led to our asking specific questions of banks that account for over nine-tenths of foreign lending, of exporters who were said to have been denied credit on behalf of foreign buyers, and of a cross-section of other exporters who might have sought financing for foreign customers. The inquiry revealed strikingly that the Program was not having any substantially adverse effect on U.S. exports.

In order to go into the export effects question further, the Board was interested in information that might show how much effort was being made by banks in carrying out the longstanding request in the VFCR Guidelines that, within their Guideline ceilings, banks give priority to credits that finance U.S. exports. In a separate inquiry, the Board learned that outstanding documented credit subject to VFCR ceilings and extended to foreigners to finance purchases from the United States

accounted for less than one-fifth of all outstanding bank credit under the Program. This fraction represents an average for widely differing bank situations and is subject to data limitations. But it may be taken as indicative of the performance of the U.S. banking community as a whole.

Clearly then I do not share the judgment of this group as to the costs of our own Federal Reserve VFCR program. Even more importantly, as I have already indicated, continuance of our capital control programs -- the VFCR along with the interest equalization tax and the foreign direct investment program administered by the Department of Commerce -- are an integral part of our policy of non-neglect of our balance of payments. But I would cheerfully concede that these programs alone cannot be effective unless we persist, as I am certain we will, in our efforts to contain inflation. As these efforts begin to produce results, then you in BAFT as well as we in the Fed and our foreign counterparts will find the answer is in the performance of our economy at home, and in particular the performance of our trade and current account. An appreciable increase in investment here in the United States, as the safest and most rewarding haven for short- and long-term funds, will provide offsets to our own outflows. More generally, as the rest of the balance of payments improves, we may then look forward to relaxing the capital controls program.

On this happy note, let me once again thank you for the privilege of being with this very fine group in this lovely setting.