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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at a meeting of the

Balance of Payments Group

of the

National Foreign Trade Council, Inc.

New York City

Thursday, January 4, 1979

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I appreciate the opportunity that your organization has provided for me to discuss before an audience of balance-of-payments specialists some personal thoughts on the evolution of events and policies in this area. The gist of my remarks, at which in proper economist style I shall arrive only after lengthy analysis, is that balance-of-payments discipline is coming to the United States, that this will make the dollar a better reserve currency and that it will make that reserve currency role both less important and less onerous to the United States.

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It would be quite wrong, of course, to suppose that growing consciousness of the balance of payments implies that at some point in the past the United States was totally oblivious of this sector of its economy. Benign neglect was never practiced in responsible quarters. President Kennedy's remark to the effect that his two prime concerns were the nuclear bomb and the balance of payments should suffice to lay that story to rest. But the evidence of mounting balance-of-payments consciousness is clearly before us. It comprises the recent actions of the Federal Reserve and the Treasury respectively, in the areas of interest rates and other monetary actions, foreign currency borrowing, and intervention. It encompasses also the nation's realization that economic growth had to slow down, and its mounting concern with inflation, even though domestic considerations are naturally preeminent. Fundamental policies must be in place if bridging actions are to be effective.

Numerous trends have contributed to exposing the United States to greater balance-of-payments discipline: The increasing share of foreign trade in the economy, the increasing openness of U.S. capital markets to foreign borrowers and lenders, the linkage of our capital markets to others through the Euro-dollar market, the accumulation of a large volume of dollar balances and other assets in the hands of foreigners, and the evident sensitivity of the dollar to balance-of-payments developments. Each of these factors deserves some comment.

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The Rise of the Foreign Trade Sector

U.S. imports, including invisibles, today represent about 10 per cent of GNP. This compares with 3.5 per cent in 1938 and 4.6 per cent in 1953. In quantitative terms, trade in merchandise and invisibles over these years has about trebled its role in the economy. In qualitative terms, U.S. dependence on foreign supplies has, of course, greatly increased. Oil is only one prominent example.

Since world trade has grown much faster in the postwar period than world GNP, the experience of the United States in becoming more open on current account is shared by many other countries, including leading trading nations like Germany and Japan. But for neither of these has the development been as spectacular as for the United States.

The United States has become more open also on capital account. Restrictions on capital movements, such as the interest equalization tax and the "voluntary foreign credit restraint program," no longer exist. Many new foreign borrowers have gained access to external capital markets, including the American. The international activity of American banks has greatly increased.

The Euro-dollar markets for deposits, loans, and bonds constitute a growing link between the United States and the rest of the world. The amounts lent and borrowed in those markets, to be sure, are funded very predominantly from outside the United States, and interest rates reflect very largely the level of interest rates

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in the United States. But there is also reciprocal interaction, with effects running in both directions.

Large dollar balances have accumulated in foreign hands which, in part, are liabilities of the United States, and, in part, those of the Euro-market. The magnitude of the Euro-balances is often overstated, owing to the double-counting of interbank deposits. Nevertheless, there is a significant volume of funds in the hands of nonbanks and of central banks that, to a degree, are mobile. There is also a growing stock of Euro-bonds denominated in dollars. All these are capable of influencing the demand for and supply of dollar assets, and the exchange rate of the dollar. The same applies, of course, although in generally lesser degree, to domestic dollar assets owned by U.S. residents -- theoretically they could all be sold for foreign currencies.

Still another international linkage is the apparent sensitivity of the dollar rate to the state of the U.S. balance of payments. This may well be a passing phenomenon. For the time being, however, the weight of the U.S. deficit in determining the exchange rate of the dollar, as compared with other major determinants such as relative rates of inflation and interest rates, seems to be considerable.

In former years -- during the inter-war period and the early postwar years -- the relative absence or low weight of the linkages I have listed served, to a degree, to shield the United States from strong balance-of-payments discipline. The growth of these links,

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all of which have helped to integrate the United States with the rest of the world, has contributed to a weakening of this shield.

In addition, there are further developments that, without bearing particularly on the linkage between the United States and the rest of the world, have nevertheless served to reduce the relative insulation from balance-of-payments discipline that the United States enjoyed in former years. The principal factors among these are the use made by the United States of the reserve currency role of the dollar, developments in the area of asset settlement of payments deficits, and recent experience with floating exchange rates.

Effects of Reserve Currency Role of Dollars

It is in the nature of a reserve currency that it shields the country issuing it in some degree against balance-of-payments discipline. When payments deficits can be met by issuing currency and allowing it to accumulate in the hands of foreign official holders, balance-of-payments discipline, for good or ill, is diminished. There is not the same pressure for balance-of-payments adjustment that is felt by countries that must settle their deficits with reserve assets.

Very different views have been taken of this characteristic of a reserve currency. General de Gaulle complained about the "exorbitant privilege" enjoyed by the United States in paying for its deficits in its own currency. On the other hand, proponents of flexible or at least adjustable exchange rates have pointed out that under fixed rates the

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reserve country is being deprived of one effective means of balance-of-payments adjustment -- a change in the exchange rate. Since other countries peg their currency to the reserve currency, it is they, not the reserve country, that determine the exchange value of the reserve currency. Proponents of strong expansionist policies, finally, have viewed the shield provided by the reserve currency as a fortunate circumstance to be taken full advantage of.

In retrospect, it appears to me that the United States made excessive use of the protection against balance-of-payments discipline afforded by the reserve role of the dollar. We became accustomed to payments deficits because they were easy to finance and, up to a point, even desirable in order to provide the world with liquidity. The evidence is in the increasingly inflationary condition of our economy. It is to be found also in successive devaluations under fixed rates and repeated declines of the dollar under floating rates. The deficits that were financed with dollars went beyond what the rest of the world was willing to accumulate at an unchanging dollar rate. These deficits, and the overexpansion and inflation that lie behind them, probably would have been substantially smaller had the United States been under continuous balance-of-payments discipline.

Reserve currency status does not, of course, convey complete immunity against balance-of-payments discipline so long as the reserve currency is convertible, i.e., is backed by asset settlement. Gold losses associated with payments deficits did exert restraint over

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U.S. policies, both during the last years of the Eisenhower Administration and in the early Kennedy days. But the United States worked hard to minimize the role of asset settlements. Suasion, swap arrangements, the gold pool and manipulation of the free market price of gold, all were designed to hold down U.S. gold losses. Eventually the gold window was closed altogether.

Asset settlement, even in the case of a reserve currency, therefore, is an important channel of balance-of-payments discipline. Under floating exchange rates, the analogue to asset settlement is intervention in exchange markets by the country whose currency is being supported, except as that intervention serves the purpose of countering disorder in a narrowly defined sense. The fact that the United States of late has been intervening vigorously and in a coordinated manner, and has mobilized very substantial resources for this purpose, indicates that the United States is not relying on the reserve role of the dollar, unbacked by asset settlement, to shield it from balance-of-payments discipline. The fact that the United States has been intervening to correct an unjustified exchange rate situation suggests further that the policy is not to rely on wide swings of floating exchange rates to provide protection against balance-of-payments discipline.

Floating exchange rates, of course, have been long advocated as the ultimate protection against balance-of-payments discipline for all countries. With a floating exchange rate, it was argued, each

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country could pursue the domestic policies it wanted. Differences in the degree of expansion and inflation would be taken care of by the exchange rate.

Experience with floating rates has not fully confirmed this prescription. Floating rates have had many advantages, as alternatives to controls, and as a vehicle for a rising volume of international trade and capital movements. But countries that believed they could escape balance-of-payments discipline by floating soon found out otherwise. Overshooting of exchange rates, accelerated inflation, vicious circles, and continuous narrowing of the room for fiscal and monetary maneuver have been the lot of countries that ignored their balance of payments. These consequences of floating have been more apparent in countries with high degrees of openness. The basic conclusion, however, applies also to the United States. Floating rates provide shelter from balance-of-payments discipline only in moderate degree.

Changing Views of Balance-of-Payments Discipline

My comments so far, reflecting my purely personal views, have probably made clear that I regard balance-of-payments discipline in general and for the United States in particular as beneficial. This is the result of the reading of history that I have presented. I am aware that the view is not universally shared in the economic profession. It needs, therefore, some buttressing.

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I should add that I am speaking of balance-of-payments discipline principally for deficit countries, and that this discipline involves primarily correction of excessively easy fiscal and monetary policies. It does not involve unlimited exchange rate depreciation as a means of achieving payments equilibrium. Balance-of-payments discipline for surplus countries is a different matter. They, too, should feel pressure to reach equilibrium, but this should not be accomplished by a degree of relaxation of fiscal and monetary restraints that would encourage inflation.

In a few circles, balance-of-payments discipline has indeed been a dirty word. Criticism of the gold standard has generally culminated in the charge that it imposed excessive balance-of-payments discipline. Historically, there is much to be said for that view. The gold standard is one extreme in a spectrum. The question is how far it is wise to move toward the opposite extreme.

As concerns the United States, it is noteworthy that the Employment Act did not list balance-of-payments equilibrium among U.S. economic objectives, which were broadly defined as high growth, full employment, and price stability. It is perhaps significant that the German counterpart of this Act does list external equilibrium as an objective, in addition to growth, full employment, and price stability. During the early 1960's, when the balance-of-payments problem was much in the foreground, some private groups

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aiming to specify U.S. economic goals examined the possibility of including payments equilibrium among the nation's economic objectives. Only in 1978, with the passage of the Humphrey-Hawkins (Full Employment and Balanced Growth) Act did an "improved trade balance" become a formal objective of national policy.

The case against balance-of-payments discipline is simple. Whatever a country wants to do is what is best for it. That way it maximizes social welfare. Anything that restrains its freedom of action necessarily means a loss of welfare.

A more jaundiced view of human nature suggests that rejection of balance-of-payments discipline involves an exaggeratedly optimistic view of national policy making. There is no assurance that every country is managing its affairs optimally, or that its policies are designed to maximize its welfare. More likely, they are designed to find the line of least resistance and the lowest common denominator of agreement. The optimistic view seems to see any particular country as managing its affairs competently and achieving its objectives in a stable fashion. Unfortunately, it seems, the rest of the world is unstable and, if balance-of-payments discipline were admitted, would prevent the country from carrying out its wise policies.

On balance, however, a more frequent case may be that a single country feeling balance-of-payments pressure is going off its tracks while other countries remain on theirs. A realistic appreciation of political

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processes and of the historical reluctance of many countries to live within their means would suggest that balance-of-payments discipline may be appropriate at many times and in many places.

Usually, moreover, policy thinking in a country is not monolithic, but runs along a spectrum from more to less conservative policies. Usually, there are defenders of the policies that would be called for by the state of the balance of payments, but frequently they are outvoted. Balance-of-payments discipline would strengthen their hand.

In the United States, this may have been the case at certain times in the past. At present, I believe that a consensus is building along policy lines consistent with the needs of our balance of payments. As I said earlier, these include not only those policies specifically addressed to the value of the dollar, but also those with respect to inflation and economic expansion.

Conclusion

If my analysis is correct that the demands of the balance of payments are increasingly heeded in U.S. policy making, one of the results undoubtedly would be to enhance the attractiveness of the dollar as a reserve asset. Less inflation, growth moderated to the level of our long-term potential,would strengthen the balance of payments and improve the position of our currency.

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These policies would also imply a reduction in the degree to which the United States has been relying on the reserve role of the dollar to copy with its balance-of-payments problem. The improvement in the balance of payments, the borrowing of foreign currencies, the greater role of asset settlement through intervention all point in that direction.

Diminished reliance on the reserve role of the dollar seems appropriate to me. U.S. experience has shown that, relied upon excessively, a reserve currency role can backfire. It has advantages when not used heavily and particularly when kept in reserve for difficult periods. As a steady diet, the resulting lack of balance-of-payments discipline runs a very serious risk of undermining the strength of the currency.

Recognition that the role of a reserve currency is no bed of roses is not, of course, confined to this side of the Atlantic. The countries whose currencies are most frequently nominated as candidates for reserve currency status, Germany and Switzerland, are making every effort to prevent this from coming about. The nature of their concerns is somewhat different from that of the United States, focusing on fear of disruption of capital markets, over-expansion of money supply, and extreme exchange rate fluctuations.

The absence of a willing candidate as a successor to the dollar seems to leave matters pretty much where they are at present. But if I am right about the greater acceptance of balance-of-payments discipline

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in the United States, the status quo has improved: The dollar should be a more attractive reserve asset precisely because that function is likely to be relied upon less heavily by the United States.

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