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POLICIES FOR THE 1980'S

Excerpts from remarks by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

to the

French-American Chamber of Commerce in the United States, Inc.

New York City

March 3, 1980

SUMMARY

1. The world faces severe tests that can be met only by international cooperation.
2. Financing of the payments deficits caused by the higher price of oil should be possible, but it will not be as relatively easy as it was after the first price increase in 1973-74.
3. The Euromarkets can contribute importantly to this financing, but these markets' expansion must be brought under better control. Close to \$40 billion of Eurodollars are now included in the Federal Reserve's redefined aggregates.
4. The international role of the dollar is likely to diminish over time, but willing and able successors have not appeared. Evolution of the world monetary system in the direction of a SDR-based system would be much preferable to a multi-currency reserve system. International cooperation will be needed to achieve this.
5. The oil problem also demands cooperation, both for any possible near-term emergency and for longer run conservation and substitution of energy sources. The United States in some respects faces a more difficult problem than other countries because of its diminishing availability of easily accessible domestic sources.

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**Henry C. Wallich
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**I am honored to be addressing the French-American
Chamber of Commerce on the subject "Policies for the 1980's."**

The Tests Ahead

**The 1980's will be a period during which our countries,
and the international economic and financial system that unites
them, will be severely tested. In the international sphere, the
principal tests, as I see them, will challenge our ability to
maintain a free and open international financial and trading
system, and to maintain an adequate flow of oil supplies. In
the domestic sphere, the principal tests will be those of our
ability to maintain economic growth and stability in the face**

of energy shortages and mounting costs and difficulties of all kinds. An essential condition of success in this endeavor will be ability to control the inflation that is now eating away at our productivity and at our social fabric.

Continued success in expanding world trade and finance can never be taken for granted. It is the result of international cooperation and a willingness to forego temporary national advantages for the sake of bigger national and international gains in the long run. The test before us challenges the survival power of this cooperation. Once before, during the 1930's, cooperation broke down. Individual countries sought to improve their condition at the expense of their neighbors, through trade restrictions and payments controls. Considerable parts of the world froze over financially. It became impossible to move money from one country to another without licenses that were not generally granted. Debtors, even if solvent, often could not pay their creditors. It was the ice age of international finance.

There is no compelling reason why the world should ever relapse into anything resembling the conditions of the 1930's. But in the face of skyrocketing oil prices the financial problems generated in large part by these prices will need to be dealt with, to control that ever-present risk. The financial burdens must be distributed in a manner that makes them bearable.

We need to be aware of the parameters of the situation and what they mean to borrowers.

1. The OPEC surplus will be more lasting than the 1973-74 created surplus.
2. The funds to finance the corresponding deficits are available from OPEC in the aggregate but they must be channeled where needed and where debt can be supported.
3. The non-oil developing countries will probably not be able to handle as large a rate of increase in their debt as in recent years, because debt already is high and the banks already have loaned a great deal.
4. Developing countries, therefore, must stress adjustment along with, and perhaps more than, financing of deficits.
5. A larger share of the OPEC-imposed deficit will, therefore, fall on the developed countries.

Financing will be relatively easier for the developed countries. OPEC funds not flowing into dollars will necessarily flow into other currencies, providing some automatic financing to the countries in question. Countries likely to receive OPEC investments directly or through the Euromarkets can ease the adjustment process by accepting deficits. If these countries tried to run surpluses, this would throw a greater burden of deficits on other countries.

The Euromarkets

The Euromarkets will be one area in which our ability to cooperate in financing OPEC-induced deficits will be conspicuously tested. The Euromarkets have performed an extremely valuable function by facilitating the recycling of OPEC funds and the financing of payments deficits through the world's large banks. But they are beginning to pose serious questions for the monetary authorities of the countries whose currencies principally are used in those markets. The Euromarkets allow the creation of dollars, D-mark, and other currencies outside the direct monetary control of the respective central banks. The creation of dollar loans and deposits, for instance, occurs both through U.S. banks' foreign branches and through the banks of other countries.

Creation of a substantial volume of dollar assets and liabilities has an impact, naturally, upon the exchange rate of the dollar and on interest rates in the United States and elsewhere on dollar-denominated assets.

The Federal Reserve has moved to take into account the creation of U.S. money by the Eurobanks. Some \$40 billion of Eurodollars have been included in the newly redefined monetary aggregates. The expansion of these Eurodollars, which has been far more rapid than that of dollars in the United States, will henceforward be taken into account in formulating U.S. monetary policy. To offset the rapid expansion of Eurodollars, the expansion of the domestic component of the aggregates will have to be somewhat slower if the Federal Reserve's overall money-supply targets are not to be exceeded and growth of the broadest aggregate is not to become excessive. For the time being, this effect is small, since the volume of Eurodollars is small relative to U.S. monetary aggregates, but in time it is likely to grow and gain importance.

Discussions are underway now dealing with possible means of subjecting the Euromarkets to some degree of control. There is widespread agreement on the need to

preserve the safety and soundness of the participating banks, and the consequent need to maintain or introduce adequate prudential controls. With respect to growth of the markets and the use of various national currencies, divergent interests of countries need to be reconciled. Countries that expect to be borrowers in the Euromarket naturally take a different view than countries in whose currencies assets and liabilities are being expanded. Countries that benefit from the presence of the market in their financial centers have interests different from the rest.

The Eurodollar market is an analog of the nonmember banking system in the United States which also is outside direct Federal Reserve control. Growth of the nonmember bank system has become a problem Congress is having to face. Growth of Euromarkets may eventually generate similar compulsions.

Role of the Dollar

The international role of the dollar will be an important feature of the international scene. There seems to be a growing feeling that this role, far from being an

enormous advantage, is becoming excessively burdensome to the United States. But there are no eager candidates to replace the dollar. Germany, Switzerland, and Japan, whose currencies all might serve in this role, show varying degrees of reluctance.

A return to gold, I believe, is unviable. The wide fluctuations in the price of this metal make clear that it cannot form a basis for stable relations among currencies, even if present high domestic rates of inflation did not make stable relations impossible. A basket of currencies, such as the SDR, seems the most logical way to reduce risk in the holding of official reserve balances. Eventually perhaps, it may become a medium for private financial assets and liabilities. An SDR solution would be far preferable to a multi-reserve currency system which may be the consequence of letting matters drift in this field.

Cooperation among countries at present can usefully be oriented toward creation of a substitution account in the International Monetary Fund. This account would absorb some official dollars and would move the SDR closer to becoming

an important world reserve medium. It is presently under discussion in the International Monetary Fund.

The Challenge of Oil

The supply of oil is a second major area in which international cooperation will be needed. Supply and demand are precariously balanced. We have recently seen how a slight imbalance, manifested in a substantial premium price in the spot market, can lead to a ratcheting of OPEC prices. We have seen also how the fear of rising prices and even more so shortages can give rise to inventory accumulation that in turn aggravates the price movement and the supply/demand imbalance. Cooperation among oil-importing countries to avoid a repetition of the recent scramble is urgent.

Cooperation would also be needed if through some political or technological accident supplies should be disrupted. Such situations might still be manageable if arrangements established under the International Energy Agency can be implemented smoothly. The consequences of a disorganized scramble among nations for inadequate oil supplies could be disastrous.

For the longer run, each country must act to conserve energy and to create substitute energy sources to replace imported oil. This, too, is a form of international cooperation. Any one country could perhaps rely on the efforts of others to keep adequate oil supplies available. But in the aggregate, this would be self-defeating.

The United States faces in some respects a more severe problem than other countries. From a position of self-sufficiency in oil, we have been moving toward rising imports as domestic production declined. Our efforts at conservation and substitution must cope with the double problems of rising demand and progressive exhaustion of easily accessible supplies. This must be accomplished in the face of a geographic and industrial structure posing particularly severe obstacles.

Domestic Policies to Support International Cooperation

Cooperation in common international problems will be helped if we deal effectively with domestic matters. During the 1980's, policies will have to be directed toward combating inflation, reducing unemployment, and increasing productivity

and growth. These are major challenges, and so far success has been far from satisfying, especially in the United States. Stronger and stabler domestic economies will contribute to the growth of the world economy and to the solution of international problems.

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