THE AMERICAN DOLLAR AND THE WORLD ECONOMY

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by

Monroe Kimbrel, President
Federal Reserve Bank of Atlanta

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The once prestigious American dollar has lost its former place of eminence among world currencies. Just three months ago, President Nixon, in effect, proclaimed to the world that the dollar could no longer carry the burdens to which it had long been accustomed. As a result, the world monetary system, which had depended upon a strong dollar, came crashing down, after having served the world for twenty-five years.

Americans, as well as the rest of the world, are perplexed by this turn of events. Many are wondering what happened to bring about this dramatic weakness of the dollar and how this is related to our current pattern of economic stagnation, high inflation, and high unemployment. Perhaps more importantly, many are beginning to wonder what will happen next in international economic affairs. The answers are complicated.

International trade and finance involve technicalities and complexities understood only by professionals and not always by them. Without entering into the somewhat mysterious and controversial details, the fundamental causes of the international economic predicament now engulfing the United States and the rest of the world can be briefly stated:

1. We have shown enormous self-conceit in trying to spread at very high cost, both militarily and otherwise, our own political and cultural ideals throughout the world.

2. Partly as a result of this, we have mismanaged our fiscal affairs, incurring large deficits when our economy was fully employed and creating inflationary pressures that have allowed the dollar to decline in domestic purchasing power to less than half its value forty years ago.
3. Inflationary pressures have widened the gap between productivity and business costs, especially of labor, and we have failed to effectively deal with this problem.

In consequence, we have flooded the world with dollars and priced ourselves out of a good part of the international trade market. The increasing oversupply of dollars exposed a number of serious weaknesses in the international monetary system that added to our difficulties.

Events came to a head when the accelerating outflow of dollars to the rest of the world over the last year resulted in intense pressures on the dollar in foreign exchange markets. Increasingly, European financial men appeared convinced that the U. S. would not take adequate steps to avert a dollar devaluation. Because attitudes play such an important part in the short-run value of any currency, apprehensions among world financiers intensified the very weaknesses that frightened them. Speculation against the dollar mounted steadily. The situation had reached a point where international difficulties could no longer be papered over.

While the drastic Presidential actions taken in mid-August were inevitable because of the deteriorating situation, they, of course, have not resolved all of our difficulties. This is underscored by the very slow progress made since then in international financial negotiations. But we have indicated a willingness to finally come to grips with the problems confronting us and to work out a more equitable and better functioning set of international economic relationships.

A substantial part of our current problems are hang-over headaches from our long inflationary binge since 1965. The rapid troop build-up in Vietnam, in addition to an already fully employed economy, created excessive demand pressures. Large budget deficits intensified these pressures and placed an overwhelming burden on monetary policy to maintain stability in the economy. Finally, in late 1969, monetary and fiscal policies had begun to control these prolonged excessive demand pressures. More recently, however, a kind of inflation has emerged that has not responded to the classic prescriptions for control. It may be described as a cost-push inflation, in large part a product of extravagant wage contract terms imposed by labor leaders on business concerns under the threat or the impact of industrywide strikes. While these wage contracts were an effort by labor unions to catch up losses in real wages resulting from past inflation, these wage deals, nevertheless, have contributed to higher prices and higher unemployment.

The existence of high unemployment and continued inflation has certainly complicated the task of monetary and fiscal policies in trying to achieve domestic economic goals. But both the demand pull and the cost-push inflation have weakened our competitive position by pushing prices for American goods above goods produced abroad. Rising labor costs in the U. S. may also have encouraged large U. S. corporations to increase their investments abroad to hold the line on costs.

Thus, it should be clear that failure to adequately handle our domestic economic affairs had serious international repercussions as well. These repercussions have contributed in greater or lesser degree to the recurring international financial crises over the last decade. In dealing with these crises, we should have learned several lessons about how to better mesh international and domestic economic developments. If these lessons are ignored, we can expect some of our present difficulties to linger or reappear in more intense form.

The popular view has been that when international policy needs conflict with domestic economic goals we could somehow muddle through international problems without a great deal of loss. International transactions may not play as large a role in the U. S. economy as they do in other nations, but their importance is nevertheless significant.

From mid-1970, attempts to stimulate growth in output and employment with a still high rate of inflation were undoubtedly frustrated in part by a high rate of imports. Yet these imports were a symptom of a much more fundamental cause: the cumulative effects of a high rate of inflation during the latter part of the 1960's had made U. S. producers increasingly less competitive with foreign producers. Reducing imports through quotas or other means without restoring U. S. competitiveness would only have dealt with symptoms while aggravating inflationary pressures.

The August 15 actions in the international area and the responses of foreign governments will have widespread effects upon American consumers and businessmen.

American consumers must now pay higher prices for the variety of foreign goods that we import, such as cars and televisions. These higher prices may have the effect of marginally reducing the real standard of living of many Americans.

In contrast, a number of American businesses competing with foreign imports will gain temporary advantages, since the price competition from foreign producers will be less severe. But unless these companies increase productivity, such advantages soon may be dissipated. Other American businesses may find their costs rising as a result of the higher prices they must pay for imported foreign components.

Many large American corporations and banks with extensive overseas operations are already finding that the wide array of foreign exchange controls are hampering their operations. Consequently, these controls may reduce foreign earnings of the corporations and banks, as well as earnings of private Americans who have invested in foreign stocks and other foreign securities.

We should have learned that no nation can deal with its international difficulties alone. No actions taken by this country to deal with its balance of payments deficit can succeed if other nations pursue policies designed to maintain lasting surpluses.

One such matter is the question of equitable sharing of defense and economic aid expenses. A currency realignment of the right proportions, if permitted by other countries could restore a significantly large surplus in the U. S. balance of merchandise trade and services. Then, offshore dollar defense expenditures and dollar aid outlays might continue to be carried by this country without incurring continued large U. S. balance of payments deficits.

Everything considered, however, it might be politically less onerous for our trading partners to accept a larger share of the defense and aid costs rather than to impose upon their own industries the competitive disadvantages implicit in a large U. S. merchandise trade surplus.

All one can be sure of is the virtual impossibility of restoring equilibrium to the U. S. balance of payments unless agreements are made to achieve either a large U. S. surplus on merchandise trade and services or a more equitable sharing of the costs of defense and economic aid.

On the other hand, if we expect the cooperation of other nations, we must exercise responsibility in restraining inflation in such a way as to minimize any adverse impact of our own economy upon other nations. Our dominant size in the world economy and massive influence on the economies of other nations make this responsibility particularly acute. In other words, we cannot pursue a policy of "benign neglect" toward the rest of the world.

Through growing and frequent central bank consultation, the use of central bank swap networks, the creation of special drawing rights, and other developments, we have made significant advances in dealing with many international monetary problems. But we should have learned that these international problems cannot be solved solely by financial policies.

There has been a tendency to rely far too heavily upon monetary policy to achieve both domestic goals and international equilibrium, while applying international tax, trade, and investment policies in a piecemeal and often haphazard fashion.

Past policies, in fact, may have significantly delayed needed international adjustments. Consequently, the international adjustments necessary now are likely to be <u>more</u> difficult and painful as a result of such delays.

The Administration's move to bring about these adjustments by unilaterally closing the gold window and applying a 10-percent import surtax is fraught with risk. One danger is that foreign governments may respond somewhat emotionally, perhaps by erecting trade barriers to U. S. products and investment in retaliation for our actions.

Most U. S. officials and businessmen are convinced that the maintenance of trade barriers has adversely affected U. S. merchandise trade performance in addition to the burden of our own past inflationary excesses. Of course, we too, have resorted to trade barriers. In fact, such barriers may have contributed to some extent to our present inflationary problems.

In the interest of building a better international economic system for the future, the present need for sweeping realignments in currency values may thus provide a unique opportunity for progress in reducing nontariff barriers to trade and barriers to free investment flows.

In the present world of rapid change, some difficulties have resulted from our failure to develop new policies to keep abreast of these changes. The Eurodollar market is a prime illustration. During the 1960's, this market grew much more rapidly than the capacity of policymakers and economists to fully understand it, and this failure to understand partially contributed to the aggravation of international monetary problems earlier this year.

In placing restrictions on international trade and investment, policymakers may not have given sufficient consideration to the benefits received from the increasing economic integration brought about by international trade and investment flows.

Shifts in investment patterns by multinational corporations searching for production at lowest cost sites improve the efficiency of their operations. Countries receiving such investment enjoy a stimulus to economic growth, while American shareholders in these companies benefit from increased profits. Moreover, consumers in the United States and foreign countries benefit from the better quality and lower cost of the goods produced by these corporations.

If nations are to achieve a sound and workable international payments system, our horizons must be broadened and, ideally, the economic and financial policies of individual nations developed jointly.

At the same time, these policies should be flexible enough to permit the maximum benefits from free enterprise operating on an international scale, just as we derive benefits from free enterprise operating within our individual countries. These benefits include greater variety, better quality, and lower prices on goods available to Americans and, at the same time, maximum returns on investments of American citizens and businesses. This means keeping restrictions on international trade, payments, and investments to a minimum.

The disarray in international financial markets, resulting from the new U. S. initiatives and from the events of recent months that made those initiatives necessary, creates both promising and threatening possibilities. If the parties to the negotiations are prepared to be flexible in hammering out new arrangements with an eye to the long-term needs of the international economic system, we have a once-in-a-generation opportunity to make changes that will benefit everyone. On the other hand, if the negotiations are stymied by adamant insistence upon short-run national interests so that the talks drag on in an atmosphere of growing frustration and acrimony, then the progress of the past 25 years toward freer movement of goods, capital, and people could be undone. One may devoutly hope that all involved are aware of the alternatives and will move responsibly.

In summary, there is an excess in the supply of dollars held by foreigners above the amount they require to pay for purchases from us. A moderate devaluation would temporarily favor exports over imports. But it is not a permanent solution. Correction of our adverse balance of payments and preservation of the dollar as an important international currency must be done by ourselves, not by others.

Competitiveness in world markets depends upon:

1. Bringing labor costs into line with productivity;
2. Increasing the rate of productivity gain by upgrading the labor force;
3. Providing the labor force with more and better capital equipment; and
4. Rededicating ourselves to the task of restraining inflation.

As U. S. competitiveness improves, the surplus dollars held abroad will be sent home in purchase of our exports.

If we fail to pursue policies calculated to bring about equilibrium in our economic relationships with the rest of the world, we can look forward to a rather bleak set of alternatives. We can expect to see the world economy broken up into currency and trading blocs, with increasing restrictions placed on international trade and investment. Such a breakdown can be expected to generate increasing economic inefficiency for all nations. This inefficiency will be reflected in slower economic growth, lower profits, lower returns on investment, and increasing inflationary pressures. These are alternatives we, in cooperation with other nations, must strive to avoid.