THE AMERICAN DOLLAR AND THE WORLD ECONOMY

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by

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The once prestigious American dollar has lost its former place of eminence among world currencies. Just a few 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 international monetary system, which had depended upon a strong dollar, came crashing down, after having served the world for twenty-five years. The drastic Presidential actions taken in mid-August and the international financial turmoil that followed created severe shocks around the world.

Americans, as well as others, have been perplexed by this turn of events. Many have wondered what happened to bring about this dramatic weakness of the dollar and how this is related to problems of economic stagnation, inflation, and high unemployment. 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 that has engulfed 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 mismanaged our fiscal affairs, incurring large budget deficits when our economy was fully employed and creating inflationary pressures

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that have allowed the dollar to decline in domestic purchasing power to less than half its value forty years ago.

3. Inflationary pressures widened the gap between productivity and business costs, especially of labor, and we failed to effectively deal with this problem.

As a result, we 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.

In more concrete terms, a substantial part of international economic problems are hangover headaches from the long inflationary binge that began in 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, by late 1969, monetary and fiscal policies had begun to control these prolonged excessive demand pressures. At that time, however, a worrisome cost-push inflation began to emerge. This cost-push inflation resulted in large part from excessive wage contract terms extracted from business concerns under the threat or the occurrence 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 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

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inflation 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.

But it would be sterile to dwell overmuch on the negative aspects of these economic problems. Despite the turmoil of the past year, we have received a splendid opportunity for helping to construct an improved framework for our economic interrelationships with the rest of the world. Just a few days before Christmas, the United States reached an accord with other major industrial countries that should be viewed as significant progress in the right direction.

As part of the accord, other nations agreed to a realignment of their currencies against the dollar in exchange for removal of the 10-percent surcharge on imports and of the "Buy American" feature of the recently enacted investment tax credit. In addition, the Administration promised to ask Congress to devalue the dollar by raising the price of gold from $35 to $38 per ounce. In return, our major trading partners have shown a willingness to engage in a fundamental renegotiation of trade problems, with a view toward significantly reducing world-wide barriers to trade.

However, while the December accord represented a significant first step in resolving our international economic problems, a number of thorny issues remain to be resolved. In addition to trade barriers, these

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issues include, among others, the future creation and transfer of international reserves, capital controls, and the flow of international investment. In dealing with these problems, we should keep in mind several lessons from the past if we are to better mesh international and domestic economic goals. If these lessons are ignored, we can expect some of our present difficulties to linger or reappear in more intense form.

For example, 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 persistent 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 and other types of trade barriers without restoring U. S. competitiveness would only have dealt with symptoms while aggravating inflationary pressures. Those who would still try to control imports through such measures should realize that their costs are likely to far outweigh their benefits.

The new exchange rate realignments, in which the prices of major foreign currencies were raised against the dollar, 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

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

The new exchange rate realignment may also encourage some shift of investment from other countries to the U. S. The stock market already appears to be receiving a renewed infusion of foreign funds.

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. Thus, without the currency realignment negotiated with other countries, it would have been impossible to achieve a better balance in our international transactions. Even now, the opportunity to eliminate our balance of payments deficit could still be frustrated through restrictions on trade and investment. These are matters which still require arduous negotiations. A more equitable sharing of mutual defense and economic aid expenses by our major trading partners can also contribute to a better payments equilibrium.

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

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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, as recent events demonstrate, we should have learned that international economic 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.

Excessive reliance on monetary policies in the past, in fact, may have significantly delayed needed international adjustments. Consequently, the international adjustments necessary now are likely to be more difficult and painful as a result of such delays.

Thus, the new exchange rate realignments should be considered only as a first step in the building of a better international economic system for the future. We will also need to make progress with other nations in reducing nontariff barriers to trade and barriers to free investment flows.

Some of our difficulties have resulted from our failure to develop new policies to keep abreast of rapid changes in economic life. 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

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the aggravation of international monetary problems early last year.

In placing restrictions on international trade and investment, policy-makers 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. There is increasing evidence that these multinational corporations are also major contributors to employment growth in this country.

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 new U. S. initiatives for international economic reform create

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both promising and threatening possibilities. If the parties to the forthcoming 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. The devaluation of the dollar through exchange rate realignments should 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 to purchase our exports of goods and services.

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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.

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