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THE INTERNATIONAL FINANCIAL OUTLOOK

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Some of you may remember that I was at your convention last year in Las Vegas and that, ungraciously perhaps, I argued there against increasing the official gold price above what it has long been--namely, \$35 per ounce. I argued as persuasively as I could for adoption of the so-called special drawing rights plan, which would make possible a steady, noninflationary increase in international liquidity or reserves and a continued growth in world trade. As many of you know, the special drawing rights plan was adopted a few months ago by the member countries of the International Monetary Fund. It has become a part of the constitution of the Fund, although not, I hasten to add, because I argued in Las Vegas that it should.

One of the bits of advice my father left me with was never to speak of a halter in the house of the hanged, so perhaps I should not have reminded you that the special drawing rights plan was adopted. Possibly I can be forgiven for reminding you, since adoption of the plan was for many an event of far-reaching significance. It was widely hailed as such at the annual meetings of the twin institutions of Bretton Woods, the Fund and the International Bank for Reconstruction and Development or World Bank, which were held in Washington at the end of September.

At these meetings, Fund member countries gave approval to the actual creation of \$9.5 billion of special drawing rights over the three years 1970-72. Very soon then, within a few months, the western world will have begun

supplying international reserves in an eminently sensible way. And for those government officials responsible for the plan, officials of the United States and other leading industrial countries, an immense labor of several years will have ended. We should be quite clear; reforming the international monetary system is anything but easy.

It would not surprise me if many of the government officials responsible for the special drawing rights plan were longing for retirement; or if not retirement, then an easy year or two. But an easy year or two is not in prospect. A workable solution for the international liquidity problem has been managed. There is still the adjustment problem, however, and managing a solution for it will prove no easier than managing a solution for the liquidity problem.

But manage we surely must. If the past is any guide, then in the future the delicate equilibrium of the international economy is going to be upset again and again, whether by fortuitous events or by mistakes of economic policy. The countries of the western world are going to have to adjust--and by adjusting, restore equilibrium in the international economy. How, though, should these countries adjust? This is the question for which, as the various currency crises of the past few years have made all too obvious, government officials must find an economically and politically acceptable answer.

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There is much to be said for keeping exchange rates from fluctuating much, if at all--when possible, that is. What is most important, international trade is thereby encouraged; so is international investment. Economic efficiency is increased. But of course if exchange rates are fixed, then

balance of payments deficits and their necessary counterparts, offsetting balance of payments surpluses, are possible. Or should I have said inevitable? This is the rub.

There are, however, deficits and deficits; and surpluses and surpluses. There are fleeting or transitory deficits and surpluses which, as most experts would argue, should be ignored; and there are more lasting or chronic deficits and surpluses which, however much we might want to, cannot be ignored. That there are two kinds of deficits (and surpluses) was recognized at Bretton Woods. The Fund was created to make short-term loans to member countries, loans to be used to finance short-term or transitory deficits. It was created so that member countries would not have to adjust to such deficits, whether by deliberately increasing unemployment rates, or by changing their exchange rates or in some other way. If countries were to adjust to all deficits, fleeting and lasting, by changing exchange rates, international trade and investment would not be much encouraged. Nor would economic efficiency be much increased.

Over recent years, foreign exchange speculators have become more numerous. And speculators can be a serious threat. They can convert small losses of international reserves into large losses. As has been amply demonstrated in recent years, they can make ignoring short-term deficits rather difficult. This is why official credit facilities, or credit lines--among them, the Federal Reserve System's reciprocal swap lines with other central banks--have been increased. The amount of international reserves that any of the governments or central banks of the leading industrial countries of the western world can borrow today is truly impressive. The increase of official credit facilities has made the continued ignoring of short-term deficits

possible, and shows that there are deficits (and surpluses) which, so far as governments are concerned, should be ignored.

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Sad but true, there are also deficits which cannot be ignored-- deficits which, having been caused by fundamental economic changes, lasting in their effects, give promise of running on too long and exhausting available supplies of international reserves. Obviously, no country can go on indefinitely paying out its own reserves; nor can a country go on indefinitely borrowing reserves. But then how should countries with lasting or chronic deficits adjust? What should they do?

And what about countries with lasting or chronic surpluses? How should they adjust? This might seem a strange question to be asking, since there is no inevitable end to the accumulation of reserves. But in a smoothly functioning international monetary system, chronic surplus countries also have to adjust.

Forty or fifty years ago the answers to my questions would have been easy. How should a chronic deficit country adjust? By adopting a deflationary policy. By deliberately increasing unemployment and, if possible, forcing a decrease in the overall price level. In theory, a deflationary policy can eliminate a balance of payments deficit, if held to long enough and provided that the country doing the deflating does not bulk too terribly large in the world economy. With an increase in unemployment, imports decrease; and with the overall price level holding steady or decreasing, exports increase.

And how should a chronic surplus country adjust? By adopting an inflationary policy. By deliberately decreasing unemployment and forcing an increase in the overall price level.

But these, as I have said, are the answers of forty or fifty years ago. Today it is not realistic to prescribe deflationary policies for chronic deficit countries. Most if not all of the countries of the western world have taken continuing full employment as a basic economic objective, and over the postwar period have shown a marked unwillingness to increase unemployment very much. And today it is unrealistic to prescribe inflationary policies for chronic surplus countries, since price stability is, as it has long been, a basic economic objective. Over the postwar period chronic surplus countries have shown a marked unwillingness to deliberately increase their overall price levels.

My judgment is that we cannot count on the countries of the western world sacrificing domestic objectives--full employment and price stability--to keep their international accounts in balance. Nor is it clear that they should. Certainly full employment is eminently desirable; and of course so is price stability.

Countries can perhaps be counted on to make small sacrifices of domestic objectives. They have even in the recent past. There is, however, no assurance that the making of sacrifices sufficiently small to be tolerable will be good enough. Small policy adjustments may not restore international equilibrium. Also, I can imagine foreign exchange speculators being unconvinced by tolerably small sacrifices, or by small policy adjustments. And however much official credit facilities are increased in the future, unconvinced speculators could well remain capable of creating great uncertainty about exchange rates. And it is no good having fixed exchange rates, about which, however, there is great and continuing uncertainty that they will be maintained.

Let me be quite clear; I am not condoning inflation, whether in the U.S., where what happens is very much my concern, or in any other country. Inflation is a domestic evil, to be avoided if at all possible. But countries do differ in their tolerance for inflation; this, I believe, is a fact of economic life. And mistakes in setting economic policy--inflation-producing mistakes--will likely be made in the future, as they have in the past. As a practical matter then the issue is what to do once there has been some inflation in an important trading country; and what I have suggested is that it is unrealistic, and probably wrong, to prescribe extreme deflation or a reversal of price increases. This is what would be required to eliminate an inflation-induced chronic payments deficit. Unless of course other countries were willing to adopt inflationary policies. But, as I have also suggested, they cannot be counted on to do this.

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There is another way of dealing with chronic international account imbalances, a way I hesitate to even mention. Surplus countries might ease existing restrictions on international trade and investment; and deficit countries might make existing restrictions more stringent and, if necessary, impose new restrictions.

But clearly this is not the way to eliminate chronic deficits and surpluses. We may want to encourage countries with chronic surpluses to ease restrictions. A world-wide easing of restrictions would be highly desirable. For many years the U.S. has been striving, along with various other countries, for precisely this.

Deficit countries should not be encouraged, however, to make existing restrictions more stringent or, heaven forbid, impose new ones.

Economic efficiency requires that they not do so. It makes sense when possible to maintain fixed exchange rates, but not by imposing more stringent or new restrictions on trade and investment. The advantage of fixed exchange rates is that economic efficiency is increased. Increased economic efficiency results, however, only if nationals of various countries are able to trade with each other, and if investments can be made across political boundaries.

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The way to eliminate chronic balance of payments deficits and surpluses would appear then to be by adjusting exchange rates. In saying this, I might seem to be contradicting what I said before--namely, that fixed exchange rates, by encouraging international trade and investment, increases economic efficiency. On occasion, however, something has to be done. And it is better, I believe, to adjust exchange rates than it is to change restrictions on international trade and investment. Countries are not going to sacrifice domestic objectives to the necessary extent. Nor should they. The choice is therefore between adjusting exchange rates and having countries in chronic deficit impose more stringent or new restrictions on international trade and investment, and so invite retaliation from countries not in chronic deficit. The choice, if I may put it differently, is between adjusting exchange rates and having the countries of the western world become more and more isolated, each from the others, and maybe not only economically but politically as well. As I am sure you will agree, this is not a pleasant prospect.

Now, admittedly, Fund member countries have all along been free to adjust their exchange rates, if only in appropriate circumstances and in consultation with Fund officials. The constitution of the Fund is crystal

clear. A country in fundamental balance of payments disequilibrium--in chronic deficit, that is, or surplus--can change the official dollar price of its currency. It can change its official currency parity. A country in chronic deficit can lower its parity; it can depreciate its currency. And a country in chronic surplus can raise its parity or, in other words, appreciate its currency.

But if the experts who gathered at Bretton Woods provided for exchange rate adjustments, what is all the fuss about? Why have I spoken of an unsolved adjustment problem? Why indeed? The answer is easy enough: through the postwar period countries have also shown a marked unwillingness to adjust exchange rates. Adjustments have been made; there have been currency depreciations and, less frequently, currency appreciations. Still, there has been this unwillingness. I would remind you that on occasion the decision to change the official parity has been delayed rather a long time.

I believe it fair to say that adjusting exchange rates has proved quite difficult, sometimes for political reasons. What the western world needs therefore is a relatively easy way of adjusting rates, a way which ensures, to the greatest extent possible, that appropriate exchange rate adjustments will actually be made.

The experts who gathered at Bretton Woods may not have envisaged relatively infrequent and large adjustments in exchange rates. This, however, is what we have had. The typical exchange rate adjustment of the postwar period has been considerable. Recall the British adjustment of November 1967; the pound parity was lowered by 14 per cent. And recall the French adjustment of last August; the franc parity was lowered by 11 per cent.

This may be the difficulty, that we have grown accustomed to a

country delaying and then making a relatively large adjustment in exchange rates. Making several relatively small adjustments, and without great delay, might prove easier, however, and less disruptive than waiting and then making a single relatively large adjustment. Many experts think so. I am not an expert, but I do too.

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There are experts who favor automatic or non-discretionary exchange rate adjustments. Some would have the western world's governments adopt an inflexible rule, a rule which would force relatively small and frequent adjustments of rates. There is not the time to go into why, but I am rather leary of adopting any inflexible exchange rate rule, just as I am of adopting any inflexible rule for adjustment of domestic monetary policy. Adopting an inflexible exchange rate adjustment rule may in the end prove desirable. I have not closed my mind to this possibility. But I am not one of those who believes that our only hope is making exchange rate adjustments automatic or non-discretionary. It is enough to have flexible management of exchange rates.

What governments might reasonably do, it seems to me, is agree informally on when exchange rate adjustments should be made, and on how large and frequent the adjustments should be. They might agree on conditions which, when satisfied, would indicate the desirability of exchange rate adjustment. They might agree on what has been referred to as a presumptive rule, which would not, however, force adjustments. No country would be bound to adjust. A particular country might be asked, however, in appropriate circumstances, why it has not adjusted its parity or exchange rates.

We should not, I think, underestimate what the prospect of being asked to explain might accomplish. There is a certain force in moral suasion--

the urging of your peers. In the sometimes barely comprehensible language of central banking, the process has come to be called multilateral surveillance.

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Let me philosophize with you a moment in closing. It seems to me there is an obvious human desire to view our social and economic relationships as a series of problems, each of which can be divided neatly into a beginning, a middle, and an end. Unfortunately, these problems can seldom be isolated with any degree of precision--most lack identifiable beginnings, and few have predictable ends--yet we continue to try to think of them as so many separate packages.

Gradually, though, I think we are becoming aware that structure and process are the things we should be concerned about. The simple problem/solution approach at best buys a little time. Unless we devise structures that provide the mechanisms for regular and orderly adjustment to change, and develop the managerial processes to go with them, we will continue to lurch from one crisis to another.

We do have a successful prototype in American industry. Those of you who read last year's best seller, The American Challenge, by Servan-Schreiber, will recall that he credits the extraordinary success of the American corporations to the way they are organized--their structure--and the way they react--their management processes. The organization and management processes of public institutions, whatever their province may be, has to be this good.

Structure and management must go hand in hand. The structure must be the appropriate one; but without a commitment to a managerial process which permits management to deal with change, the structure is useless. And maybe

worse than that, for the appearance of order and rationality conveyed by a charter may really serve as a rug under which the shortcomings of the organization can be swept.

For example, the Bretton Woods Agreement created a structure that in most respects is an admirable one. Certainly it anticipated the necessity for periodic readjustment of parities, and outlined the mechanisms for adjustment. Yet pressures for readjustment of certain exchange relationships have had to virtually become explosive before the process could become effective. Generals, domestic political considerations, have dictated the management process with distressing regularity.

I can, I think, anticipate the criticism that given the political realities of the countries involved, no alternatives existed; nor is there any real reason to expect the future will be different. But if I may borrow from the eminent diplomat and historian, George Kennan: history does not forgive us our mistakes simply because they can be explained by domestic political considerations. As he said, "A nation which excuses its own failures by the sacred untouchableness of its habits can excuse itself into complete disaster." Nor is this any less true for a group of nations than for a single nation.

Fortunately, I think, there are signs we can avoid a monetary apocalypse. Major central banks now confer in a number of institutional ways. Management processes, if you please, are improving. Less clear is the progress toward inter-government cooperation, but the speed with which SDR's were ratified by the constitutional governments in the International Monetary Fund is a good sign. Ultimately, of course, governments must be willing to impose upon themselves the internal discipline of domestic

policies that will reflect their membership in an economic community that is now world wide. Balance of payments positions, international aid, cooperative currency arrangements--the list is a long one, but we must not despair simply because of its length and complexities. There is not the slightest reason to believe time alone will reduce or eliminate the necessity to deal in a forthright way with any of these sources of disequilibrium.

Let me end by anticipating another criticism--that our democratic, free societies are becoming over-managed. As former Secretary of Defense Robert McNamara has said, the truth is that our societies are under-managed. "The real threat to democracy comes from under-management, not from over-management. Democracy cannot survive unless we continue to develop our political structure and processes."

If I may quote former Secretary McNamara again: "The under-organization, the under-management of a society is not the respect of liberty. It is simply to let some force other than reason shape reality. That force may be unbridled emotion. It may be greed, it may be aggressiveness, it may be hatred, it may be ignorance, it may be inertia, it may be anything other than reason. But whatever it is, if it is not reason that rules man, then man falls short of his potential."