INTERNATIONAL FINANCIAL OUTLOOK

Remarks by

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Nearly 30 years ago, Herblock of the Washington Post drew a famous cartoon depicting the negotiations that were to result in the Bretton Woods Agreement. The cartoon showed a long conference table heaped high with papers and two exhausted diplomats, one saying to the other, "Okay, let's start over again. Now if you have three apples and I have two oranges . . ."

The exchange market turmoil of the past few months is once again pressuring negotiators to try to reconcile the irreconcilable. The Group of Twenty, with representation from all members of the International Monetary Fund, is busily beavering away on a proposed framework for the reform of the international monetary system in hopes of presenting its findings at the annual International Monetary Fund meeting in Nairobi this fall. Meanwhile, other experts in capitals around the world are gearing up for the trade negotiations scheduled to begin in Tokyo this September. There is an air of urgency in all this activity, and at the same time an undeniable air of uncertainty as well, since the potential exists in any tough bargaining either for productive agreements, or endless recriminations.

On the issue of international monetary reform, the agenda is full of tough problems. It's clear that any new agreement is going to have to provide for greater flexibility in exchange rates than was practiced under the old Bretton Woods Agreement. Indeed, the rules will presumably have to be designed to accommodate floating exchange rates, since regimes of this sort have become too numerous to suppress or ignore. Then there is the question of eventual convertibility of the dollar into reserve assets, and the necessary preconditions to achieve this. Among those preconditions, surely, are 1) some concrete evidence that past exchange rate changes are bringing the

U.S. balance of payments into surplus; 2) that the excess liquidity in the system at the moment (often referred to as the "dollar overhang") has been at least partially funded or reabsorbed; and 3) that some method has been found for dealing with disruptive short-term capital movements.

Despite the complexity of the issues involved, I have strong hopes that meaningful progress can be made in resolving differing views on international monetary reform, partly because a good deal of "reform" has in practice already taken place. To be sure, last February's second devaluation of the dollar did not produce the hoped-for stability in international financial markets. On the contrary, it made abundantly clear that one cannot tamper with the value of a reserve currency at frequent intervals, and expect the holders of dollar reserves to stand still for yet another change. As a result, the world is trying to have its cake and eat it too, as exemplified in the wonderful phrase the IMF Governors' Committee agreed on to describe their aspirations -- a regime based on "stable but adjustable par values." In practice, when the official foreign exchange markets reopened in March, the world was de facto faced with a variety of floating exchange rates.

Now firm supporters of fixed exchange rate parities still argue that world trade and investment will be held back by a system that tolerates floating exchange rates. My own impression, however, is that businessmen, bankers, foreign exchange dealers, and investors are adapting to the current situation without too much difficulty. A few months without a crisis certainly doesn't prove the viability of present arrangements, as we learned to our regret last year. But at least the present calm may help to dispell the undeserved black eye given the so-called floating system that existed during the interregnum from August to December in 1971.

In some respects, of course, the present situation with its many uncertainties is analogous to the period between the closing of the gold window in August 1971 and the Smithsonian Agreement the following December. However, in other important respects I believe that the situation today is considerably more stable. In the first place, in 1971 we experienced the traumatic breakdown of a system that had lasted for more than 20 years. This spring, having already survived one devaluation of the dollar and having witnessed the floating of several major currencies, we were more prepared to take change in our stride.

In the second place, in the fall of 1971 we were faced with the monumental task of attempting to find some reasonable realignment for exchange rates that had become substantially distorted over many years. Today, much of the necessary adjustment has already taken place.

If there is a threat to international monetary stability at the moment, it seems to me to lie in the excess liquidity that exists within the system. Vast sums of money, reacting to rumor or to speculative opportunities, are available to move from one currency to another, driving exchange rates out of line with underlying balance of payments needs. These large capital flows also interfere with the monetary authorities' ability to control money supplies in a manner appropriate for the domestic economy. Indeed, the proliferation of controls on capital movements in the last 18 months is testimony to the absence of any mutually acceptable means for controlling or sterilizing such flows. In these circumstances, I am not convinced that floating rates can by themselves absorb or deflect currency speculation in the manner for which they're given credit in the textbooks -- resort to certain types of controls is perhaps as inevitable at the moment with floating rates as it would be in a fixed parity system.

A different aspect of the current situation that seems to cause some worry is the possibility that floating exchange rates, or joint floats against the dollar, are harbingers of a world that is breaking up into competing currency blocs. As I see it though, the tendency for the world to align itself into currency areas is a natural outgrowth of the changed structure of the world economy. The effects of this new structure on trade and financial relationships will be dictated more by the degree of economic cooperation and harmony among countries generally than by the particular form of currency links they adopt. Outward oriented policies by currency blocs are just as conducive to growth in world trade and investment as are such policies undertaken by individual countries.

Other observers of the current scene are distressed by the fact that ostensibly "floating" rates are not being wholly determined by market forces. Central banks have retained the right to intervene in foreign exchange markets when they feel it is necessary. This has given rise to charges of "dirty floats" which, coupled with a fear of world trading blocs, has led some to express concern that we are heading into an era of competitive exchange rate devaluations and trade controls.

While such a scenario can't be ruled out, I think we do ourselves a disservice in failing to make more discriminating use of the term "dirty float". Official intervention to maintain orderly market conditions or to prevent speculative flows of funds from distorting fundamentally viable exchange rates seems to me perfectly appropriate and indeed desirable. I regard a "dirty" float as one in which the authorities purposely attempt to achieve or maintain a basically undervalued exchange rate. This was the case in the 1930's when country after country attempted to "export its unemployment." More recently, countries have at times tried to maintain undervalued currencies in an effort to preserve export markets, even in the face of full employment and inflationary pressures at home. Because of the strong temptations to misbehave in this way, I believe the most pressing issue of international monetary reform at the present time is the devising of rules that will identify and bring to account cases of dirty floating, in the restricted and pernicious sense that I have defined the term. To be effective, such rules will have to have the broad support of the leading industrial nations, and this is no mean task.

Whatever the eventual design of a reformed international system, it seems clear that the dollar will play a somewhat lesser role than in the past. This is neither good nor bad in itself, but simply a reflection of the changes in real economic relationships that have already taken place. The attempts by the Common Market to move toward a European "central bank" as a step toward monetary union seem quite natural, especially in light of the recent instability in the dollar. By intervening in each other's currencies rather than the dollar to maintain a joint float, part of their previous reliance on the dollar as an intervention currency has already been displaced. And it's probably not unreasonable to expect a reduced scope for the dollar as a reserve currency as well. At the same time, I think Dr. Emminger of the German Central Bank is quite right when he said recently that the dollar should continue in some pivotal role whatever the final design of a reformed system. Whether or not it will be able to shoulder this role will depend in large part on the strength of the dollar at home.

Negotiations on international monetary reform are not being conducted in a vacuum; the negotiators are very much aware of the trade talks waiting in the wings. In fact, the outcome of the current negotiations with the Common Market on concessions due the United States as a result of the entry of the

United Kingdom, Ireland and Denmark will give some indication of how cooperative we can expect the Common Market to be in this area. Although we have heard the usual remarks about the threat to the Common Agricultural Policy posed by the tough negotiating stance taken by the United States, some members of the Common Market have taken a more conciliatory stance.

In this context, it's worth noting that the Common Market Commission in Brussels has commented favorably upon President Nixon's proposed trade legislation. And for what it's worth, I would like to add my support as well for that legislation. It is of great importance, particularly to our European trading partners, that U.S. negotiators have the authority to make firm trading commitments, as contemplated in the trade bill. Although the bill itself would give the President the authority to raise as well as lower tariffs and quotas, the Administration has taken pains to present the bill as the basis for trade liberalization rather than restriction. If the legislation is enacted and used in fashion intended, it will symbolize U.S. leadership in expanding the world economy, and make a significant contribution to the success of the GATT negotiations.

The breakdown of the old monetary system was an acknowledgment of the many structural changes that have occurred in the world. The old system was based on the dominance of the United States both as the leading economic power and as custodian of the international currency. The United States is no longer the dominant economy in the industrial world: instead, we must learn to live with powerful equals. The realities imposed by the economic power of Japan and the enlarged Common Market will have to be recognized in all future negotiations on monetary and trade reform.

It is because of these great changes in economic relationships between nations that I feel the formulation of a new international monetary system cannot be hurried. In this regard, I agree with Bob Roosa, former Under Secretary of the Treasury, who recently stressed the importance of taking time to analyze the impact of changes that have already taken place, particularly in view of the rate at which these changes have occurred in recent years. My own belief is that we have time now to do a thorough and thoughtful job, provided we rather quickly devise some "rules of the road" to guide our present patchwork "system" over the inevitable bumps in the path ahead.