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Some Observations on Monetary Matters

Address by

William McChesney Martin, Jr.,

Chairman, Board of Governors of the Federal Reserve System,

at the

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of
The Stonier Graduate School of Banking

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No activity is more important than education, and no part of education is more absorbing than that in which all of you here have been engaged: fostering understanding of the world of business and finance and the nature of the economic process--the process by which people make their living.

Those of you who have participated as students and as teachers in the vital undertaking of The Stonier Graduate School of Banking deserve the commendation--and the admiration--of us all. You have mine, without reservation.

I might also say you have my envy for having had so inspiring a setting for your work at this distinguished university in which, over the two centuries since its founding in 1766, many generations have worked in utmost dedication to preserve and advance the cause of the liberal arts.

That, and the fact that Rutgers University is an institution older than the American Republic itself, tempts me to reach back in time and dwell upon the glory that was Greece in the Age of Pericles and the grandeur that was Rome in--and beyond--the Age of Augustus.

But recent experience has taught me to be wary. If I should venture to compare our life and learning today with that of Greece in the 5th Century, B. C., or that of Rome in or after the 1st Century B. C. or A. D., I am sure there would be some who--no matter what I said about differences as well as similarities--would interpret my remarks as a prediction that we will be overrun by barbarians--and in a matter of minutes, at that. Nor will I venture comparisons with historic periods in the American past. If I should so much as mention the year 1814, for example, I daresay there would be some to accuse me of advocating that the City of Washington be put to the torch again.

But I am not discouraged by that. Instead, I am heartened by the capacity for sober understanding that has been evidenced to me in recent days by many thoughtful men and women, throughout our country. So I'd like to talk to you today, neither as prophet nor advocate, but simply as one who hopes that some observations by a fellow student may have some value, however small, for the studies that you have been pursuing.

In your careers in this school of banking, I am sure you have discovered, as I too have done, that it is more than merely possible for reasonable men to disagree on the correct course for monetary policy to follow at any given time to best discharge all of its responsibilities.

In monetary policy as in all other matters, judgments must necessarily be based on incomplete information: the data available reflect at best the situation of yesterday, and more frequently of last week, last month, last quarter. Even if our information were completely current, there would always be some uncertainty about its meaning for the future, even with such aids as surveys of spending intentions. Interpretation would be handicapped by our inability to comprehend all pertinent relations among the innumerable elements of our economy--and by the ambiguity of many of those elements themselves. A slight rise in prices may be a momentary flurry that will soon reverse itself in the absence of any action, or it may be the first sign of inflationary pressure that will generate a dangerous spiral unless offset by firm policies.

The practical impossibility of obtaining fully up-to-date or complete information to act upon, of building an operational theory that would incorporate all the variables to be found in a modern economy in all their interrelations, and of excluding errors of evaluation--all these factors help to explain why central banking remains an art rather than a science, although intensive research is advancing our ability to measure and understand economic behavior.

It is doubtful, however, that anyone will ever be able to devise formulas that can provide infallible guides to monetary action. For example, the same data can have very different significance under different circumstances. In 1958, when the United States began to show a large deficit in its international accounts, that deficit should certainly not have been given the same weight as in early 1965, when the persistence of a large deficit over more than seven years was threatening the maintenance of international confidence in the stability of the dollar. When price fluctuations have for some time been mild and without clear trend, a given rise in the price level is not as ominous as when the increase has been going on for some time and is showing a tendency toward acceleration.

These problems, incidentally, seem to me to show not only that central banking is an art rather than a science but also that, as an art, it is the art of the middle way. At all times, the central banker needs to be aware of the risk that the country might slide into either inflation or deflation. At all times he will be subject to criticism that he is leaning too far to one side or the other, and he will be urged to do the exact opposite of what he is doing at the moment. Hence, he will always be in the middle, in more than one sense of the word.

In the United States, our internal economic activity is so much larger than our international business that--until recently--many observers have tended to regard our balance of international payments as an almost negligible consideration. But those who did not know it earlier have come to know now that even the United States cannot live in isolation from the rest of the world, since the flow of funds to and from foreign countries is inextricably connected with the flow of funds within our economy. In other words, sustained economic growth requires not only domestic financial stability--which means neither an insufficient nor an excessive supply of credit and money--but also international financial stability, which has special requirements of its own.

On the domestic front, the 1960's have thus far been a period of almost continuous progress, and, as I have sought recently to stress, we ought to be bending every effort--and taking every precaution--to keep it that way. But, as I have also sought recently to stress, continuation on our upward course can be assured only if monetary disturbances are avoided in international as well as in domestic accounts. And it has been in the international sector that monetary policy--like U. S. financial policy in general--has recently been faced with its most urgent and difficult problems.

Whatever may have been the case in the past, I suspect that never again will the United States be able to ignore its balance of payments in formulating domestic economic policies. There is no once-for-all solution either to the problem of maintaining balance in our internal economic expansion or to the problem of maintaining balance in our external payments. Constant effort is required.

The Federal Reserve has not been unmindful of these problems. In an effort to discourage capital outflows to other countries, the System began very gradually to lessen monetary ease as soon as recovery from the recession of 1960-61 enabled such action. But the System has continuously proceeded with great care, lest in trying to reduce the spill-over of funds abroad, it deprive the domestic economy of funds needed to finance expansion.

Since President Kennedy's balance of payments message in July 1963, the general operations of monetary policy have been supplemented by selective actions aimed at curbing flows of capital from the United States to foreign countries. At first, these actions were taken exclusively in the field of taxation, in the form of the Interest Equalization Tax on long-term non-export credits to residents of developed countries other than Canada. As you know, this tax initially was applied only to lenders other than banks. Then the Interest Equalization Tax was extended to banks under the so-called

Gore Amendment following President Johnson's balance of payments message in February 1965. This message also led to the institution of the voluntary foreign credit restraint efforts for which the Federal Reserve, after consultation with the Treasury, has been issuing guidelines for banks and for other financial institutions.

Compliance with these guidelines has provided the Federal Reserve with somewhat more leeway to make day-to-day adjustments in monetary policy than might otherwise have been the case.

I do not know--and neither does anyone else--whether in the period ahead the present posture of monetary policy will prove to be exactly right, or will need some further firming or some easing; that will depend on the way events develop, for the simple reason that monetary policy must always be adapted to meet changing circumstances. In any event, it should be clear that the use of selective measures to improve our international payments position has not made the prudent use of general monetary policies any less essential for the preservation of stability in our economic system.

It should be equally clear, however, that while our circumstances require a reduction of the recent massive volume of capital outflow they do not require, even now, that we eliminate capital outflows altogether. There are sound reasons for that: as the country with the highest per capita income in the world, the United States is likely to have a larger flow of savings and better developed capital markets than less affluent societies; and as the country with the world's largest stock of capital equipment and most advanced tools of modern technology, the United States is likely to have a less urgent demand for investment than countries that are still trying to catch up with the latest developments. Accordingly, we should be able to maintain payments equilibrium in the face of a capital outflow, and therefore in the face of some lasting differential between credit conditions in this country and most others. Such a differential is, in fact, inherent in the preeminent position of the United States in the world economy.

It now appears that, under the initial impact of the voluntary restraint program and related temporary measures, our international accounts have actually been about in equilibrium for the past three or four months. Interest rates in some foreign countries, especially in the so-called Euro-dollar market, have been under some upward pressure, but there has been no lack of investment funds abroad. It does not seem unreasonable to expect that, over time, a relation between the levels of interest rates and other credit conditions among the major industrial countries can be established that would hold U. S. capital outflows, even without selective measures, to amounts compatible with international payments balance without any threat to continued expansion of domestic economic activity and of international commerce.

Clearly, the task will be the simpler, and success the surer, the more that central banks of the major countries are willing to cooperate in such an effort. We shall not surrender our ability to follow monetary policies that are appropriate according to our own judgment, and neither will any other country. But we have shown our willingness to consult on the proper aims of balance of payments policies so as to avert the danger of mutually inconsistent actions--which were the bane of the interwar period.

The last few years have seen the steady growth of international financial cooperation. The Federal Reserve has initiated a network of mutual currency arrangements under which 11 countries can receive from us, and are willing to make available to us, short-term accommodation in case of need in a total amount of $2.6 billion. The Federal Reserve also participates in periodic meetings with central bankers of the major European countries, and with those of our sister republics in the Western Hemisphere. Together with the consultations within the framework of the International Monetary Fund and the Organization for Economic Cooperation and Development--which Federal Reserve officials attend as members of the U. S. delegations--these meetings provide an unprecedented opportunity for working together in the common interest of the free world.

Most recently, a study group set up by the 10 major members of the International Monetary Fund, in which again Federal Reserve representatives play a part, has been concerned with plans to improve our international payments system. I do not know what will be the final outcome of these endeavors. But it may not be amiss for me to say something now about the broad principles that ought to guide us as we give consideration to proposed changes in international monetary arrangements. This whole question is intimately intertwined with the problem of the U. S. balance of payments and with the results of its improvement.

Change, development, progress are the law of life. There is no reason for any of us to insist on maintenance of the status quo. Although the present international monetary system has served the world very well, it, like all institutions, must evolve and adapt to changing circumstances.

The formal justification for the current intergovernmental examination of proposals to change international monetary arrangements is that a major source of new reserves will disappear as the

U. S. balance of payments moves from substantial deficit toward surplus. Ever since the end of World War II, the United States has supplied the rest of the world with more dollars than were needed to make current payments to this country. In the earlier years, this excess supply of dollars--which went out in the form of U. S. purchases abroad, Marshall Plan and other aid, military outlays and private capital flows--was a welcome addition to the reserves of other countries. More recently, since the late 1950's, these additions to foreign reserves have been excessive. In other words, our balance of payments deficit has been too large and too long-lasting. It has become the sword of Damocles over both our domestic expansion and the international payments mechanism.

Elimination of the deficit in our balance of payments--an objective to which the entire U. S. Government is firmly committed--will certainly deprive the rest of the world of an automatic supply of reserves. And there has been a widening area of agreement that gold production alone is neither so large nor so predictably available to monetary authorities as to provide for the needed growth in international reserves over time. Thus an end to U. S. deficits may well call for some supplementary means of supplying countries with reserves.

It would be a mistake, however, to think that European initiatives toward the creation of new reserve assets are purely a response to the prospect of an end to U. S. deficits. We must recognize that the motivation runs deeper. If we are to act intelligently and in a spirit of international cooperation we must fully understand the attitudes of other countries, and especially the viewpoints of the large industrial countries. I do not wish to imply that there is a unified view abroad, even in Continental Europe, on the international monetary system. There are broad differences among countries and perhaps even among officials of individual countries. Nevertheless a common thread of opinion runs through the fabric of European monetary thinking and I shall try first to point it up and then to make some comments about it.

First of all, there is a widespread view in Europe that the deficit in the U. S. balance of payments must be curbed. This view is expressed in different ways at different times. Some of our European friends have at times attributed Europe's inflation to the inflow of dollars. Others have complained about excessive U. S. investment in their countries, a process by which Americans are said to acquire factories and other productive facilities in Europe while the monetary authorities of the countries concerned acquire dollars in the form of U. S. Treasury bills or bank accounts. Still others have complained that they hold more dollars than they wish but are not really free to convert dollar receipts into gold for fear of shaking confidence or jeopardizing their relations with us.

Related to these expressions of dissatisfaction with our balance of payments is, in some countries, a deeper dissatisfaction with the existing monetary system in which the U. S. dollar serves not only as a national currency, but also as an international medium of exchange and store of value. The status of the dollar as a reserve currency is regarded by some European observers as a source of special advantage for the United States, since in contrast with other countries, we create new international money when we have a deficit. Others in Europe complain that the amount of new reserves created as a consequence of U. S. deficits does not necessarily correspond to the reserve needs of other countries; what they seek is a more systematic means of creating international reserves.

I turn now to some comments on these European attitudes. Just as there is a range of opinion in Europe on these matters, there is also a diversity of views among Americans. Some of our countrymen believe that in the present system we have the best of all possible worlds; others go so far as to blame most of the ills of our economy in recent years on the international monetary system.

We can all agree with the European view that the U. S. balance of payments must be brought back to equilibrium as soon as possible; indeed, the President's message of February 10 is a clear and unequivocal statement of this agreement.

We do not accept the view that the U. S. deficit is responsible for inflation in Europe. Most Americans who have studied the matter, and many Europeans also, see the causes of European inflation right in Europe. By the same token, we do not accept the view that our balance of payments deficits are caused by forces outside the control of the United States. We fully accept our responsibility to demonstrate our ability to manage our own affairs in a way which will justify confidence in our currency.

As to American investment in Europe, I would say that insofar as this is a problem, it is quite independent both of the U. S. balance of payments situation and of the nature of the international monetary system. Those who complain about U. S. direct investment would probably complain about it just as loudly if U. S. payments were in balance; those who welcome it, do so regardless of the state of our balance of payments.

Whatever the differing attitudes of countries regarding the composition of their reserves between gold and foreign exchange, it is a fact of financial life that all countries use reserve currencies-- especially the dollar--in their exchange markets. Thus countries in balance of payments surplus inevitably find their dollar balances increasing; the monetary authorities of countries in deficit must sell dollars in their exchange markets to support their exchange rates. This almost universal use of dollars by monetary authorities is a reflection of the widespread employment of the dollar by private traders and financial institutions, even in transactions that do not involve the United States. The use of the dollar as a reserve is closely related to its function as a medium of exchange, and reflects as well the predominant position of the U. S. economy and the ready convertibility of dollars into gold at the established price of $35 per ounce. Certainly any proposal for changing the international monetary system must respect these functions performed by dollars and must avoid the introduction of incentives to convert dollar holdings into gold.

Whether other countries do or do not wish to continue to use the dollar as a reserve currency is of course up to them. The United States does not insist that other nations accumulate dollars to meet their reserve needs. Nor does the United States claim that the amount of dollars that flow abroad as a result of our balance of payments position necessarily or automatically corresponds to the needs of the rest of the world for currency reserves. In this connection we at the Federal Reserve can well understand those who say in effect that international money will not manage itself.

Though we try to understand the attitudes of some of our more critical friends in Europe, and though we do not insist on maintenance of the status quo, we are casting a careful eye on the various proposals for new forms of reserve creation. In their anxiety to curb the ability of the United States to incur balance of payments deficits, some of our friends would turn back the clock of monetary history toward an excessive reliance on gold. Such a system, whatever its specific technical form, would impose on the world too restrictive a monetary climate, which could inhibit international trade and economic growth.

The international monetary system must be flexible rather than rigid. It must be adaptable to the differing and, over time, changing needs of the various countries. It would be a great mistake to act as if all countries were alike in their size, structures, policies, and values. Any change in the monetary system must recognize the great diversity that exists among countries, even among the major industrial countries. And any such change must be an evolutionary one, preserving and building upon the valuable elements of the existing system.

In particular, any change in the international payments system must respect the monetary sovereignty of individual countries. I have stressed that monetary policy in the United States cannot be formulated in isolation from the world beyond our borders; we must reconcile domestic and balance of payments objectives in pursuing the art of central banking. But as long as nations remain as independent entities, with separate power of decision over economic policies, monetary policy too must remain in national hands. And, within the context of international financial cooperation, the right of each country to make bilateral arrangements should be preserved. It is notable, in all these connections, that membership in the International Monetary Fund, and participation in supplying and using the Fund's resources, is quite consistent with the retention of monetary sovereignty.

The central role that the International Monetary Fund now fills makes it a natural repository for any new monetary functions that may merit consideration. Gold tranche positions in the Fund, which are usable virtually on demand by countries in deficit, are already widely regarded as reserve assets. If and when the need is felt for additional reserve assets, there is much to be said for adapting the Fund mechansim to this purpose and building upon its tested and respected institutional framework. To rely on such an evolution of the International Monetary Fund, rather than to establish a rival center in the international monetary field, would help to assure that any innovations undertaken would contribute to world prosperity without disturbing market processes, violating national sovereignty, or disrupting international cooperation.

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