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International Responsibilities of the Federal Reserve

Remarks of Wm. McC. Martin, Jr.

Chairman, Board of Governors of the Federal Reserve System,

at the

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of

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International Responsibilities of the Federal Reserve

It is indeed a pleasure for me to be here tonight. This is the more so because it gives me the privilege, as head of our American central banking system, of acknowledging the heritage that is ours from British banking, from British economic and financial genius, and, in particular, from the mother of central banking--the Bank of England. Without this heritage, the Federal Reserve System would be far less well equipped to do its part in meeting the complex problems that confront us today.

The position the United States occupies as a world trader, investor, and banker obliges the Federal Reserve, just as it does our Government as a whole, to consider carefully the effects of our policy actions both on the economic health of other countries and on the international position of the dollar. Internationally, our objective is to foster progress towards payments equilibrium, to sustain continued confidence in the dollar, and to do what monetary policy can to promote the orderly expansion of world commerce. Multilateral, nondiscriminatory trade and convertibility of currencies, free of exchange controls, is our ultimate goal.

In recent years, these objectives have led us, first, to seek ways of helping to correct our own payments deficit without retarding the needed growth of our domestic economy; and second, to take our part in fostering the international cooperation of central banks and governments in order to improve the working of the international payments mechanism.

Growth without inflation

The most important contribution of United States monetary policy in the past 15 years toward solving the U. S. payments problem has been the effort to resist inflationary forces without sacrificing economic growth. The founding father of the "new" economics, the late Lord Keynes, was a supporter of efforts of that kind. Twice I had the privilege of discussing with him the problem of postwar monetary policy, first during and then immediately after World War II.

In our first discussion, he maintained that the central postwar monetary problem would be the task of averting deflation--a hardship all too frequent in the history of transition from war to peace. In our second discussion, he agreed that the prospect following World War II was different; that the main danger would not be deflation but rather inflation and that the Western World would succeed in attaining steadily rising standards of living only to the extent that it could cope effectively and consistently with this danger.

Both followers and opponents of the "new" economics do Keynes a grave injustice when they attribute to him an inflationary bias. Keynes was far too wise, and far too conscious of the realities of economic and financial life, to underestimate the pernicious influence of inflation on what in modern times have been universal goals of economic and financial policy: optimal output, employment, and economic growth.

Sometimes I think that the harm of inflation is less easily understood by people in my own country than it is here in Britain, where international trade is, and always has been, so important for economic life. The courageous actions of the British people this past year are ample proof that such an understanding does exist here.

Developments in the sixties

In the first half of the sixties, the United States enjoyed an unusually long period of uninterrupted growth and rising employment domestically, due, I believe, to the absence until 1965 of the kinds of internal imbalances that are associated with inflationary pressures and that eventually generate a downturn if they are not corrected in time. During those same years, however, the United States continued to experience large deficits in its international payments, one reason for which was an unusual expansion in foreign lending and investment.

In that period our primary domestic need was to attain a fuller utilization of our manpower and capital resources, and this need made it desirable for us to permit such an increase in the supply of credit as would help us to keep moving toward this goal. To cope with the problem of our balance of payments deficit at the same time that our general policies were conducive to monetary expansion, our Government found it necessary to take various special measures to reserve more credit for domestic use.

Since autumn of 1965, in contrast to the preceding period, the U. S. domestic economy has experienced substantially full utilization of resources. But the excessively rapid increase in business capital expenditures, and the abrupt and large rise in Government expenditures associated with hostilities in Vietnam outpaced our capacity to provide the labor and machinery needed to meet all demands: the consequences were, as usual, a surge of inflationary pressures.

In this situation, the domestic objectives of Federal Reserve policy converged more closely with our continuing objectives with regard to the payments balance and the international standing of the dollar. Accordingly, the main stress of Federal Reserve policy was redirected from monetary ease toward putting a brake on the expansion of bank credit to both domestic and foreign borrowers.

In the absence of greater fiscal restraint, monetary policy had to bear the brunt of the task of checking the inflationary pressures emerging in an economy operating at full capacity. Interest rates, responding to the force of intensive credit demand and increasing monetary restraint, rose sharply, to the highest levels in postwar years. Necessarily, this created difficulties, internationally as well as domestically. For example, when American banks pulled funds from the Euro-dollar market on a big scale last summer, that flow undoubtedly added to the pressures then developing on sterling, contrary to our wishes.

Towards the end of last year, even though the inflationary updrift in costs and prices had not completely subsided, a lessening of aggregate demand pressures became increasingly evident. It became possible and desirable to relieve the tautness of domestic money market conditions so that bank credit expansion might resume, and the Federal Reserve did so--not unmindful of the potentials this might hold for international as well as domestic flows of funds. Thus monetary policy once more showed its ability to adapt flexibly to developments in the economy as they occur. As is so often the case, uncertainties attend the economic future. And in these circumstances, given the budget projections just released, the President's request for a tax increase is a prudent proposal, and it has my full support.

International monetary cooperation

As I mentioned earlier, a second way in which the Federal Reserve has been recognizing our economy's role in world commerce has been through efforts to further international monetary cooperation. I am glad to say that there is no longer any need to stress either the importance or the fruitfulness of such cooperation in making for "good neighbor" policies in monetary matters.

In the continuous expansion of international commerce there are always risks of imbalances developing in international payments. Such imbalances, sometimes aggravated by disturbing political and economic events, can create serious temporary difficulties in foreign exchange and in international money, credit, and capital markets.

In coping with problems of these kinds, my colleagues and I at the Federal Reserve, like our counterparts in the Bank of England, are continuously engaged in cooperative study and discussion with other central banks on problems of world concern. One result of this cooperative endeavor has been the development of a network of reciprocal currency arrangements. The purpose of this network is to keep exchange markets orderly by preventing those temporary, reversible, and--especially--those speculative flows of funds from causing unnecessary and psychologically harmful fluctuations in exchange rates or in monetary reserves. We are especially happy that these reciprocal arrangements have been useful to the Bank of England in repelling speculative attacks on sterling.

The short-term character of drawings under the arrangements makes it impossible for them to be regarded or used as alternatives to drawing facilities at the International Monetary Fund on more than a temporary basis, or as alternatives to new methods of providing international liquidity. Hence, our reciprocal currency arrangements were never intended to replace, but merely to complement more general international monetary arrangements. Moreover, as I hardly need say, the existence of this network does not in any way lessen the need for restoring and maintaining reasonable payments equilibrium internationally. On the contrary, we know that the network can go on working smoothly only if the participating nations make solid progress toward that goal.

International payments reform

The present international payments system, like all human institutions, has its weaknesses--but it also has great strength. We hear much about the alleged lack of balance of payments discipline and about uncertainties concerning the role of gold. But occasional sickness makes more interesting news than long stretches of good health. And the weaknesses of the present system may be attributable in part to the intrinsic nature of international financial relations rather than to particular forms of international financial organization.

Balance of payments discipline.--It is sometimes asserted that the present international payments system makes it possible for the United States to avoid, or at least to postpone indefinitely, the correction of its large and persistent payments deficit. While I disagree with this assertion, I do fully agree that the United States balance of payments deficit has been too large and has persisted too long. Significant progress has been made in reducing that deficit, but much remains to be done.

It would be a mistake, however, to think that the United States has not been subject to balance of payments discipline in recent years. It is a striking fact--apparently not widely realized as yet--that over the past 3-1/2 years as a whole our payments deficit has practically all been financed by the reduction of our reserves: that is, through sales of gold and drawings on the International Monetary Fund--not differently in substance from the way any other country might finance its deficit.

The international role of the dollar.--In contrast to the leveling off of foreign official dollar reserves in recent years, foreign private holdings of dollars have continued to rise. This fact encourages me to offer some observations about the international role of reserve currencies--though for reasons of brevity and convenience I shall confine my references to the dollar, profoundly aware though I am of the seniority of sterling.

Outside the United States, the dollar has long been widely used by traders and bankers in settlement of international transactions and by monetary authorities as a vehicle currency and a reserve asset. In consequence, the dollar is actively traded in exchange markets throughout the world. Monetary authorities in most countries maintain the exchange market values of their currencies by buying or selling dollars. A country in balance of payments surplus inevitably finds its dollar holdings increasing; conversely, the monetary authorities of countries in deficit sell dollars in their exchange markets to support their exchange rates.

These are practical facts of life. They are firmly built into behavior patterns and institutional arrangements in the international monetary sphere, and it is difficult to believe that they will change, whatever innovations may be introduced into the international monetary system.

Accordingly, it should be expected that many countries around the world will continue to find it useful and profitable to hold a substantial part of their reserves in the form of dollar balances. We in the United States believe that it is a matter for individual countries to decide whether or not to hold dollars in their reserves at all, and whether or not to accumulate dollars when their reserves increase. But we are naturally sensitive about proposed innovations in the international monetary system that would place obstacles in the way of their doing so, or would actually give countries a positive incentive to switch their reserves out of dollars.

The role of gold.--This does not mean, however, that we expect gold no longer to play a role in international commerce and finance. On the contrary, we expect gold to continue serving the international payments system as a reserve asset and also to continue serving commerce as a useful commodity.

Sometimes gold is held as a speculative investment. A part of this hoarding possibly reflects anticipations that the holder's own particular national currency might depreciate, but a part undoubtedly reflects anticipations that an increase might occur in the price of gold in dollars and other currencies.

Gold, as we all know, is a scarce metal and there are those who say that its scarcity could be remedied by increasing its official price. They often point to the unchanged price of gold since the thirties in support of an increase. But they are viewing gold as a commodity rather than as a measure of monetary value and a monetary reserve asset. The price of gold--like the price of a currency convertible into gold--need no more move with the commodity price level than any other standard or unit of measure needs to move over time just because the objects to be measured get larger. Those most vocal about gold as a monetary asset should stop thinking of gold as a commodity whose price must move with the general price level.

I would like to state categorically that, in my opinion, an increase in the price of gold is completely unacceptable. This position is shared, with strong conviction, not only by the U. S. Government but also, I believe, by almost all governments and central banks throughout the world.

A supplement to world monetary reserves.--The world can no longer count on growth in monetary reserves in the form of foreign exchange, as in the past. And the gap can hardly be filled with the newly mined gold left after meeting private demand for industrial use, even if private demand for hoarding should recede significantly. Consequently, most experts on international monetary organization agree that steps should now be taken to avert the risk of future inadequacy of international monetary reserves.

What is required is a way through international agreement to supplement or reinforce gold and reserve currencies in meeting monetary reserve needs. The difficulties may be great, but surely they are not insurmountable. By removing present uncertainties, an agreement on new international arrangements for the growth in monetary reserves can be expected greatly to enhance the prospects for healthy expansion of world trade and finance.

Essentials of international monetary reform.--In spite of all its real or alleged weaknesses, our international payments system has proved able to perform creditably during a period of unparalleled economic well-being and yet of change and stress.

The past successes of our international payments system show, in my judgment, that our efforts to improve it can, and should, be based on this experience. We should make maximum use of existing institutions--gold, at the established price, and the International Monetary Fund as the source of supplementary reserves.

The International Monetary Fund is an enduring monument to the representatives of many countries who labored at Bretton Woods nearly 23 years ago. Whatever form our international monetary system may take, the Fund will, and must, remain its pivot. This conviction has been one point on which all members of the Group of Ten seem to have reached a consensus in the recent report of their Deputies, and with which every single nation outside of the Group is likely to agree.

It seems to me only natural, therefore, to entrust to the Fund the provision of any new reserve supplement that might be needed in the future. I hope that the studies and discussions now under way among the Fund Executive Directors and the Group of Ten will result in positive and constructive action without undue delay.

Transition and adaptation

Our international monetary system appears today to be in a stage of transition and adaptation to the many changes that have occurred in the past two decades. One major change since Bretton

Woods is that Western Europe has recovered and has redeveloped great economic strength. The resurgent prosperity of Western Europe is a phenomenon that we Americans have admired and have welcomed heartily. One of its results is a lesser dependence on the United States, and this too we welcome. It is only natural that the monetary authorities of Western Europe should seek to modify the international monetary system so that the strength of their economies will be reflected in a corresponding influence on international monetary affairs. Their greater strength can well enable them to assume greater responsibility for world payments stability.

A second striking change is the emergence into political independence of many countries that at the time of Bretton Woods lacked independent monetary status. These countries have now achieved autonomy in financial and economic matters, and it is understandable that they, along with other developing countries, are insistent on having a proper share in the working of the international monetary system.

These fundamental changes help to explain, I believe, the ferment that is so evident in international monetary matters. I welcome this ferment. But I would like to enter a word of caution. In our zeal to correct any deficiencies in the international monetary system or to adapt it to changing circumstances, we must not overcorrect or overadapt.

The Federal Reserve System is based on the proposition that "money will not manage itself," and that responsible men--mindful that they serve as trustees for the currency of a nation--can and will manage it soundly. The many recent proposals for adaptation of the international monetary system may reflect a growing belief that the same proposition may be applicable internationally.

The world, we all recognize, is made up of a great diversity of nations. Countries differ profoundly in their size, in their industrial and financial structure, in their degree of dependence on foreign transactions, in the speed of reaction of their policy-making machinery, and in many other ways. The international monetary system must be adaptable enough to accommodate the various and changing characteristics of its members.

As a central banker, I believe that the principles of good monetary management can be soundly applied on an international basis. As an adviser to our representatives in the Fund, I know how well the Fund has played its role in postwar years. Hence, I am convinced that a reform of our international payments system based on the Fund will be most likely to contribute to the orderly growth of world commerce and thus to a steady advance in the standards of life in all countries.

That is the goal that all of us seek. It will be attained only if in each country there is the resolve to so conduct the affairs of the nation as to sustain--as well as stimulate--vigor in our domestic economies, and to restore and maintain balance in our international accounts. Without this, our best efforts to improve the international payments system, to enhance the usefulness of the Fund, and even to supplement existing reserve assets in case of need, will have been in vain.

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