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The U.S. Dollar at Home and Abroad

Remarks of Wm. McC. Martin, Jr.,  
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before the

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Tonight I should like to speak to you about the role of the U. S. dollar at home and abroad--about the interrelations between a sound economy and a sound balance of payments, about the link between a sound international monetary system and the economic welfare of all people, consumers, workers, and producers--including, needless to say, producers of iron and steel.

The United States dollar, for which the Federal Reserve System accepts a special responsibility, serves as much more than a domestic currency. It is also an international currency, a keystone of international trade and finance fulfilling on a worldwide basis two traditional functions of money: a means of payment and a store of value.

#### The Role of the Federal Reserve

Let me at the outset point up the role and responsibility of the Federal Reserve System. The power to "coin money" and "regulate the value thereof" which the Constitution vests in the Congress was delegated under the Federal Reserve Act of 1913 to the Federal Reserve System.

Since the Constitution was written, "coin" has been supplemented and swamped in amount by paper currency and then by deposits in banks. By now, four-fifths of the money supply over which the Federal Reserve exercises its functions is in the form of deposits, and only about one-fifth in the form of currency and coin. At present coin as such makes up only 3 per cent of the money supply.

More profound than the change in the composition of what is used as money has been the development of the techniques of central banking. Instead of taking the time to trace this development, let me summarize for you how the Federal Reserve performs its functions today. The basic means by which the Federal Reserve exerts its influence is the requirement that member banks--which account for more than 80 per cent of the total assets of all commercial banks--maintain reserves equal to specified proportions of their deposits. These required reserves are held mainly in the form of deposits at the Federal Reserve Banks. The Federal Reserve is able to regulate the volume of member bank reserves by altering the magnitude of its own assets and liabilities. The volume of bank reserves, in turn, more or less determines the ability of the commercial banking system to expand its assets--that is, lend to businesses, consumers and governments--and to incur liabilities in the form of deposits of consumers, businesses and governments. And the scale of lending and investing activities that the commercial banks are able to undertake influences the cost and availability of credit and the supply of money throughout the economy.

I do not wish to imply that what I have just described is a finely-tuned precision instrument. It is far from that: there are many slippages between a change in the bank reserves supplied by the Federal Reserve and a change in commercial bank assets and liabilities and then, at the end of a long series of complex linkages including effects on nonbank financial institutions and securities markets, a change in spending for goods and services. But, in general, it should

suffice to assert that the instruments of Federal Reserve policy make possible affirmative governmental influence over the lending and deposit-creating activities of commercial banks and, thus, in turn, on interest rates and other credit conditions that have an important bearing on private spending.

The major objectives guiding monetary policy are no different from those that guide fiscal policy. They are summed up in the Employment Act of 1946, as currently interpreted: to encourage a steadily-growing, actively and productively employed economy with reasonable price stability. In recent years another major policy consideration has been added: to help restore and maintain a strong balance of payments and therefore a sound dollar abroad as well as at home. Fiscal policy pursues these objectives through the direct effects of government spending and through the influence of the tax system on private incomes and spending. Monetary policy aims at these objectives through its impact on financial conditions--notably the volume and cost of credit and money--and thus on private spending decisions.

#### The Role of the Dollar

Given this general orientation of Federal Reserve policy instruments and objectives, we may go on to observe that the currency over which the Federal Reserve exercises its stewardship, the U. S. dollar, is much more than a domestic currency. The domestic use of dollars is understood by all of us. We define our money as the means of payment used within our borders. A New Yorker pays for a car produced in Michigan by transferring dollars, usually through a check written on his local bank and ultimately deposited in the bank of the auto maker..

What is less well-known is that the dollar plays a similar role abroad. When a German importer purchases machinery in France that transaction will ordinarily be accompanied by a transfer of dollars from a German bank to a French bank. Even if the specific transaction were invoiced in francs, the German importer's bank would ordinarily acquire francs by paying out dollars to a French bank.

Since the end of World War II, the U. S. dollar has come to be used very widely throughout the world as an international currency. This fact can be underscored by noting that private traders and bankers abroad hold a total of over 20 billion of dollar balances in the form of deposits in U. S. banks and holdings of short-term government and other securities in the United States. In addition, they hold substantial dollar balances in foreign banks--in the so-called Euro-dollar market.

In addition to the dollar's use abroad by private traders, investors and bankers--even in transactions in which no American is involved--the dollar is also used in important ways by foreign central banks. The major market for foreign exchange in Germany is a market in which the dollar is traded against marks. And so it is in almost every country. This means that when the central banks of foreign countries operate in their own foreign exchange markets, they do so by taking in or paying out dollars against their own currencies.

Thus when a country--except for those that use sterling or francs as an international currency--has a surplus in its balance of payments, that surplus shows up in the first instance as an inflow

of dollars to that country's central bank. This can happen--it should be stressed--even when the United States' balance of payments is itself in surplus. And when a country is in deficit its central bank will be paying out dollars to its foreign exchange market to satisfy the needs for excess payments abroad inherent in the notion of a balance of payments deficit.

The use of the dollar in these ways by private merchants, investors, commercial banks, and central banks, is referred to as the dollar's role as a "vehicle currency." This use of dollars did not come about through formal decision or legislative action anywhere. It simply arose out of the convenience and needs of international commerce, and the underlying strength of the U. S. economy and its resources.

But the vehicle currency use of the dollar is only part of the story. Up to now, I have been describing the dollar's role as an international means of payment. But as I mentioned in the beginning, money has two traditional functions--as a means of payment and as a store of value.

Central banks throughout the world find it useful--indeed essential--to maintain working balances in dollars, as the vehicle currency, just as you and I keep a balance in our checking accounts to facilitate our transactions. But it further suits the convenience of many countries to keep not only working balances but also a substantial part of their international reserves in the form of dollar assets. In other words, many countries use the dollar not only as an international means of payments--a vehicle currency--but also as a store of value--a reserve currency.

Countries, like individuals, need "rainy day" balances--that is, funds on which they can draw at times when their receipts from abroad may fall short of their payments. Such reserves presently can take only three forms: gold, a foreign currency, or a reserve position in the International Monetary Fund. Soon an additional reserve asset--Special Drawing Rights--will be available, as a supplement to other reserves. At the end of 1968, the official reserves of all countries together--amounting in total to more than \$75 billion--consisted of 51 per cent in gold, 40 per cent in foreign exchange and 9 per cent in reserve positions in the IMF. And a large proportion of foreign exchange--that is, national currencies held by other countries as reserves--is in the form of dollars.

The fact that the U. S. dollar is the principal vehicle and reserve currency is not a matter of coincidence or accident. Dollars became useful and convenient to hold because they could buy attractive goods; because large and efficient financial markets are available for investing dollars and earning interest on them; because the United States stands ready to convert dollars into gold and gold into dollars for foreign governments and central banks, and the United States has by far the largest gold reserve in the world; and, as a further point, because there have been relatively few periods of doubt about the dollar price of gold.

Since the national currency of the United States is used in this way as money--in fact, serving both the major functions of money--the United States is in effect a bank to the rest of the world. And it behooves us, for that and other reasons, to take whatever steps are needed to assure one and all that our credit--our money--is good.

Inflation in the United States

Today it is clear--as clear as at any time in our history--that we cannot retain confidence in the dollar among either Americans or foreigners unless we conduct our economic and financial affairs in such a way as to merit confidence.

That we do so, now and henceforth, is all the more essential because we have faltered for more than 3 years--the period since the sharp step-up of our commitments to the Vietnam War--with the result that our economy has become overheated, our manpower resources have been strained, and our costs and prices have moved up with dismaying rapidity.

It would be idle to dwell again on the mistakes of these recent years. The adoption in mid-1968 of fiscal measures to raise taxes and restrain government expenditures was perhaps 2 years late, with the result that the budget deficit reached the staggering total of \$25 billion in fiscal year 1968 at the very time when inflationary pressures were cumulating. Nor would I wish to overlook the error of an overhasty--although only temporary--relaxation of monetary restraint by the Federal Reserve last summer.

At the present time both fiscal and monetary policy have, appropriately, taken a restrictive stance. But we cannot expect instantaneous results. We are dealing with a heritage of many errors, of private as well as of public origin, and out of them all have come cost and price increases that are continuing to generate still further cost and price increases, the whole of which--importantly--has become deeply imbedded in business and consumer consciousness and expectations.



After several years of rapidly rising prices, it is only natural that many spending decisions are motivated now by the fear that prices will be even higher next year, or by the conviction that inflation will bail out even the most marginal undertaking. After all, the price component of our national product has moved up with increasing rapidity from an average rate of less than 1-1/2 per cent a year in the early 1960's, to 2 per cent in 1965, 2-1/2 per cent in 1966, 3 per cent in 1967, close to 4 per cent last year, and 4.3 per cent in the first quarter of this year. Public skepticism about the government's ability to "do something" about prices has its roots in this dismal record.

I have recited these facts out of realism--but certainly not despair. Much of our heritage of errors has already been corrected in recent months. Monetary and fiscal policy are now working in the same direction and reinforcing each other. I believe that we are, at long last, making some headway in dealing with inflation, in advancing toward what I have described as the goal of "disinflation without deflation." Progress has been slow, but that should be understandable after so much inflationary momentum has been generated by delay in getting the nation's finances in order. From here on, patience, perserverance and persistence will be necessary--and considerable fortitude as well--to pursue steadfastly economic stabilization policies that bring inflation under control, and to continue those policies as long as needed to ensure that a resurgence of excess demand and upward cost and price pressures does not recur to plague us again.

Of course, this is not a problem for government alone: labor and management in every field of endeavor, and consumers as well, have a role to play and also a responsibility, for at stake is the opportunity of restoring a sound base for healthy further domestic growth, and of restoring a stronger base for equilibrium in our balance of payments also.

Let all of us keep firmly in mind that in commerce Americans are in competition not only with each other but also with the world. They are in competition not only in design, quality and promotion but also in prices. They are in competition not only as sellers but also as buyers.

Meeting the competition within the world market place requires of Americans initiative, imagination, inventiveness, enterprise, managerial skill and self-discipline, both in our private and our governmental processes. The way out of our troubles is not to draw into our shells, not to fence ourselves in, but to summon our strength, to launch out, to engage in the competitive fray and give it our best.

Doing so means that in domestic and foreign markets alike we are going to have to come up with the right goods and services, at the right places, in the right times, with the right prices.

We cannot afford to be priced out of the market by the wage-price spiral: in our private enterprise, employers must remember they are competing with other employers over the world for sales and profits, and employees must remember they are competing with other workers over the world for jobs as well as wages.

Neither can we afford to be priced out of the market by currency inflation: as I have said, in our governmental processes we must be doubly sure that budgetary and monetary operations reinforce rather than undermine the value of our currency, and thus reinforce rather than undermine our international competitive position.

To take an opposite course, and attempt to protect ourselves by barriers against competitive products from abroad would be self-defeating in two ways: it would invite similar action by other countries and it would dampen the spur provided by foreign competition to better quality, higher productivity and lower prices for American products.

#### U. S. Balance of Payments

This brings me to the U. S. balance of payments.

The inflation of demand and prices that we have experienced over the past 4 years has had an inevitable effect on U. S. foreign trade. Demands by consumers, businesses and governments together in excess of what our economy could supply have naturally spilled over to foreign-produced goods, and our imports have advanced very rapidly--by more than 50 per cent between 1965 and 1968. As a result our traditional export surplus, which averaged \$5-1/2 billion in 1963-65, has dwindled and almost disappeared in 1968. Our current balance on goods and services, although still in surplus, has been reduced correspondingly.

Fortunately for the international position of the dollar, this marked deterioration in the so-called current account of our balance of payments has been compensated--in fact, recently over-compensated--

by an improvement in our capital accounts with the rest of the world. As the result of various influences--governmental balance of payments programs, an apparent shift in the preferences of foreign equity investors toward the U. S. stock market, and rising interest rates and tight money conditions here--the United States has recently become a net importer of private capital from the rest of the world.

Consequently the dollar has been strong in foreign exchange markets and our balance of payments statistics have registered a surplus on the so-called official settlements basis.

Paradoxically, the worsening of our international trade position is not currently reflected in any weakness in the dollar internationally. Lest we take too much comfort from this situation, let me hasten to make two observations about the present unusual structure of our balance of payments. First, the large inflow of foreign capital that we experienced in 1968 and the first quarter of 1969 cannot be regarded as sustainable at anything like its recent rate. Neither the governmental program restraining capital outflows of U. S. corporations nor the tight money that attracted unusually large inflows of foreign short-term funds to the United States through the Euro-dollar market can be counted on to produce results of similar magnitude over time. Second, even if the large capital inflow were sustainable, it would not be desirable on its recent scale. The richest country in the world ought to be providing private capital to the rest of the world, not absorbing it.

Clearly, a more sustainable and appropriate structure in the U. S. balance of payments would involve a restoration of a sizable surplus in our trade with the rest of the world, and a lesser dependence on unusual capital inflows.

What is called for to start us on the road to a better foreign trade position is precisely what is called for to restore stability at home: a cooling off of excess demand and a consequent deceleration of the price-wage spiral. Thus both domestic and international considerations give rise to the same prescription for U. S. fiscal and monetary policies--resolute restraint that will help us to disinflate and get the economy back on a growth path that is non-inflationary.

#### World Reserves and the U. S. Balance of Payments

I noted a moment ago that the United States balance of payments has been in overall surplus over the past year, on an official settlements basis. The counterpart of this surplus has been a significant reduction in the official reserves of other countries--particularly countries in Continental Europe. Over the 12 months ending in March 1969, the total international reserves of industrial countries other than the United States fell about \$2-1/2 billion or more than 6 per cent, whereas normally most countries expect to see their reserves increase over time as their trade and other international transactions grow.

The past year's experience, even if it resulted from unusual circumstances and even if there are doubts regarding its sustainability, illustrates concretely and dramatically a basic assumption

underlying the development of the plan for Special Drawing Rights in the International Monetary Fund. This assumption is that if the United States is in balance or in surplus, the world will find itself without an adequate source of needed growth in international reserves.

As we look to the future we must expect the United States to continue to strive for an overall balance in its official settlements position with the rest of the world. Furthermore, it is well known that both France and the United Kingdom are aiming for payments surpluses, in order to repay debts and to restore their depleted reserves. And the less-developed countries as a group appear to increase their reserves fairly steadily year by year. It is a matter of simple arithmetic that if the United States is to be in balance, if the United Kingdom and France are to achieve surpluses, if the less-developed countries are to continue to accumulate reserves, then either the other developed countries must lose reserves steadily or a source of new reserve creation must be established.

It is unlikely that the other developed countries are willing or able to tolerate a steady reduction in reserves. Indeed we have seen indications in recent months that such reductions in reserves are resisted. It follows that the need for new reserves is a strong one. And the Special Drawing Rights in the International Monetary Fund are ideally suited for this purpose.

One can go further and say that activation of Special Drawing Rights will help to facilitate an improvement in the pattern of international payments positions. The desired adjustments by

Britain and France, to which I have referred, plus maintenance of a balanced position by the United States, can hardly be expected to be realized if other countries must, as part of the process, suffer significant declines in reserves.

### The Role of Gold

Having discussed world reserves and their relationship to balance of payments adjustment, let me say a few words about gold. Gold is the largest component of world reserves, as I noted earlier. Gold can be expected to continue to be a major element in world reserves. Similarly the role of the dollar as a reserve currency will no doubt continue. But neither gold nor dollars can be counted on to contribute significantly to the needed growth in world reserves. This is why Special Drawing Rights were conceived.

Establishment of the two-tier gold system in March 1968 succeeded in insulating official gold reserves from private transactions in gold. The two-tier system has worked very well and there is no reason why it cannot continue to do so. The remaining problems in this area are certainly amenable to practical solutions.

With the establishment of the two-tier system, and improvement in the U. S. reserve position, talk about the official price of gold has subsided greatly. This is a healthy sign. I want to reassert what I said in a talk some 15 months ago--that an increase in the official price of gold is neither necessary nor desirable as a means of improving the workings of the international monetary system. It is unnecessary because Special Drawing Rights can provide for growth

in world reserves in an equitable, systematic, and noninflationary manner. It is undesirable for many reasons, not the least of which is that it would turn back the clock of monetary history. I have no doubt that the present era in international monetary affairs will be viewed by historians as one in which individual nations managed to reconcile their sovereignty with their obvious interdependence by unprecedented progress in international cooperation. Such monetary cooperation takes place in many forums--the International Monetary Fund, the Organization for Economic Cooperation and Development, the Bank for International Settlements and numerous other bodies where groups of country representatives consult.

International cooperation is subject to occasional setbacks and failures--which can also be said of policy formation within individual countries. But this in no way lessens its importance. International cooperation is the counterpart among nations of governmental authority within nations. The alternative to cooperation is chaos.

#### Concluding Comment

To me, it seems clear that the mainspring of economic progress and prosperity has always been the energy, skill and enterprise of people striving for better things for themselves, their families and their communities.



The responsibility of governments is to provide conditions and a climate of opportunity that give scope and encouragement to the common exercise of these qualities in an atmosphere of freedom.

We in the United States have kept at the center of our economic life the market system, the most reliable arrangement mankind has devised for bringing human effort to bear--voluntarily, rather than by compulsion--to the task of achieving a higher living standard for all.

The advantages of a market system, where supply capacities and demand wants and needs are matched in open markets, cannot be measured in economic terms alone. In addition to the advantages of efficiency in the use of economic resources, there are vast gains in terms of personal liberty. Powers of decision are dispersed among the millions affected, instead of being centralized in a few persons in authority.

Today, in every phase of American life, we are up against a challenge to prove that a free society can have enough wisdom, self-discipline and cohesion to advance the common good in an orderly, sustainable fashion. I am confident that the American people have those qualities, and in awareness of their interdependence with the rest of the world, will exercise them to achieve greater and finer things than we have even dreamed of as yet. And, in doing so, we will find new faith both in our system and in ourselves.