Monetary Policy and International Payments *

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The task of the Federal Reserve, like that of all parts of our Government, is (in the words of the Employment Act of 1946) "to foster and promote free competitive enterprise" as well as "to promote maximum employment, production, and purchasing power". These four purposes may well be summarized under the single heading of orderly and vigorous economic growth.

The Federal Reserve has recently been criticized for neglecting these goals in favor of another—the achievement of balance in our international payments. Other critics of the Federal Reserve, however, charge us with neglecting the international payments problem and with concentrating too much on domestic goals. Both criticisms overlook what seems to me an obvious fact, namely, that our domestic and international objectives are inextricably interrelated. We simply do not have a choice of pursuing one to the virtual exclusion of the other. Both must be achieved together, or we risk achieving neither.

Thus, our domestic economic growth will be stimulated when our external payments problem is resolved. And our payments situation will be eased when the pace of our domestic growth has been accelerated. With more rapid growth, the United States will become more attractive to foreign and domestic investors, and this will improve our payments balance by reducing the large net outflow of investment funds.

In particular, accelerated growth will presumably lead to larger internal investment and credit demand, and so to some gradual rise in interest rates, not through the fiat of restrictive monetary policy, but through the influence of market forces. With rising credit demand pressing on the availability of credit and saving, the flow of funds from the United States to foreign money markets will be more

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limited. In addition, a closer alignment of interest rates internationally can be expected to result and this will help to reduce the risk of disturbing flows of volatile funds between major markets.

Similarly, the maintenance of reasonable stability in average prices, with progressive gains in productivity, is more than a basis for sustained domestic growth. It is also a necessary prerequisite for improving the international competitive position of our export industries and our industries competing with imports, and thus for increasing our trade surplus so that it can cover a larger part of our international commitments. This is not to deny that prices and costs of some of our individual industries may be out of line with those of foreign producers. There are doubtless industries where grievous competitive problems exist for international reasons, and in these cases a strong enterprise economy expects the necessary adjustments to be made through the efforts of such industries themselves.

Even if our country did not suffer from an international payments deficit, our Government would still have to pursue the twin goals of orderly and vigorous economic growth and over-all price stability. The payments deficit provides merely another circumstance that the Federal Reserve must consider if it is to make an effective contribution to the fulfilment of the goals set by the Employment Act.

INTERNATIONAL ROLE OF THE DOLLAR

In reaching our decisions on domestic monetary policy then, the Federal Reserve cannot ignore our international financial problems. There might be countries or times in which there could be enough leeway to do so. But the United States is not such a country and the present is not such a time.

The United States at present is the financial leader of the free world, and the United States dollar is the main international currency of the free world. As long as this leadership exists, we are obliged to keep our policies compatible with the maintenance of the existing international payments system.

The increase in the volume of world trade and finance since World War II has led to an unprecedented integration of the world economy. This economy has become ever more closely bound together by ties of trade, investment, communication, transport, science, and literature. Financially, the world economy has become coordinated by an international payments system in which the dollar serves both as a major monetary reserve asset and as the most important international means of payment. And the reliance that the world has come to place on the dollar requires that the dollar be always convertible into all major currencies, without restriction and at stable rates, based on a fixed gold parity.

It is in the light of the special international role of the United States and its currency, and therefore of the responsibilities of the Federal Reserve, that a Federal Reserve concern with maintenance of our gold stock, our balance of payments, and stability of the dollar exchange rate must be understood.

Above all, we must always have in mind that the role of the dollar in the international payments system is founded upon freedom from exchange restrictions. Whatever temporary advantage might be gained for our payments deficit by controls over capital movement or other international transactions would be more than offset by the damage such controls would do to the use of the dollar internationally.

ROLE OF THE UNITED STATES GOLD STOCK

A persistent decline in our gold stock is harmful to the United States economy for two reasons: First, it endangers our international liquidity position, i.e., our continuing ability to convert on demand any amount of dollars held either by foreigners or by United States residents into any other currency they may need to settle international transactions. Second, because of our long-established domestic reserve requirements, a declining gold stock fosters uneasiness about a curtailed Federal Reserve flexibility to pursue domestic monetary policies otherwise regarded as appropriate and desirable.

Sometimes it is suggested that the decline in our gold stock could be avoided if we gave up our policy of selling gold freely to foreign monetary authorities for monetary or international settlement purposes. But a decline in our gold stock stems from the deficit in our international payments rather than from our gold policy.

A payments deficit initially means an accumulation of dollars in the hands of foreigners, as virtually all of their commercial or financial transactions with residents of the United States are settled in dollars. If foreign corporations or individuals choose not to hold dollars, they convert them into their own or into other foreign currencies; in either case, the dollars fall eventually into the hands of one foreign central bank or another.

If in turn the foreign central bank acquiring dollars chose not to enlarge its dollar holdings, and if it could not convert its dollar receipts into gold, it would present dollars to us for redemption into its own currency. Once United States holdings of that currency, including credit availabilities, were exhausted, we could acquire the cur rency only by selling gold. If the United States declined to sell gold in such circumstances, foreign private recipients of dollars could no longer count on converting dollars at par into their own or other foreign currencies.

Thus, a gold embargo would terminate the convertibility of the dollar at fixed values, not just into gold, but into any foreign currency. This would obviously be the end of the dollar as a currency that bankers, merchants, or investors could freely use to settle their international obligations.

Since there is a statutory linkage between gold and our domestic money supply, through the minimum gold certificate reserve requirements of the Federal Reserve Act, consideration must also be given to the effect of changes in the United States gold stock on the gold certificate reserve ratio of the Federal Reserve Banks. At present, this ratio still exceeds the required minimum of 25 per cent both against Federal Reserve Bank deposits and against Federal Reserve notes. Should it fall below that minimum, the Board of Governors would have full authority to suspend the Reserve Bank gold certificate reserve requirements.

Some interest has been expressed in the mechanics of suspending these requirements. Let me summarize them at this point in briefest form. Upon action to suspend requirements, the Board of Governors would have to establish a tax on the Reserve Banks graduated upward with the size of their reserve deficiencies. The tax could be very small for as long as the reserve deficiencies were confined to the reserves against deposits and the first 5 percentage points of any deficiencies against Federal Reserve notes. If the reserve deficiencies should penetrate below 20 per cent of Federal Reserve notes outstanding, the tax would undergo a fairly steep graduation in accordance with statutory specifications.

The Federal Reserve Act further specifies that, should the reserve deficiencies fall below the 25 per cent requirement against notes, the amount of the tax must be added to Reserve Bank discount rates. But, if the reserve deficiencies were confined to reserves against Reserve Bank deposits, the required penalty tax could be nominal and no addition to Reserve Bank discount rates would be necessary.

It is perhaps easier to talk about this subject just now when the gold stock has shown no change for two months. But our progress this year in rectifying our international payments disequilibrium has fallen short of our target, in part because of a rise in our imports of $1½ billion. Hence, we must now intensify our efforts to re-establish payments balance. And until we have regained equilibrium, we shall have to be prepared to settle some part of any deficits experienced through sales of gold.

Nevertheless, any decline in our gold stock large enough to bring its level significantly below the gold certificate reserve requirement of the Federal Reserve could raise further questions about maintenance of dollar convertibility. And it could also lead to heavy pressures on the United States monetary authorities to take strong deflationary action that might be adverse to the domestic economy or, alternatively, to pressures on Congress to devalue the dollar, a subject to which I return later. It is of utmost importance, therefore, to shorten as much as possible the period in which further large decline in our gold stock will occur and to hasten the arrival of a period in which our gold stock may from time to time increase.

The point I should like most to emphasize here is the following: No question exists or can arise as to whether we shall pay for the debts or liabilities we have incurred in the form of foreign dollar holdings, for that we most certainly must do—down through the last bar of gold, if that be necessary. What is in question is how we best manage our affairs so that we shall not incur debts or liabilities that we could not pay.

BALANCE OF PAYMENTS

To maintain the credit-worthiness of the United States, to support confidence in the dollar, to check the decline in our gold stock, to bring our international payments and receipts into balance without interfering with the convertibility of the dollar—these objectives are all synonymous one with another. We in the Federal Reserve are concerned about the balance of payments because it is vital that the full faith and credit of the United States not be questioned.

Our international payments deficit this year was less than ½ of 1 per cent of our gross national product. That deficit did not represent a decline in our international wealth because the rise in our foreign assets exceeded the drop in our net monetary reserves. Yet the deficit was of vital concern in that it extended by one more a series of large deficits, a series that has now persisted for five years.

A payments deficit means either a decline in United States gold or foreign exchange reserves, or an increase in United States short-term liabilities to foreigners. In either case, it worsens the ratio of reserves to liabilities; in other words, it weakens the nation's international liquidity position.

The United States, as the free world's leading international banker, can fulfill its role only if it keeps the confidence of its depositors. No banker can suffer a continuous decline in his cash-deposit ratio without courting danger of a run.

The best method to combat a payments deficit is to improve the competitive position of our export industries and our industries competing with imports. This method can be effective only in the long run, but in the long run it is bound to be effective. And its accomplishment will have an expansive rather than contractive influence on our domestic economy as a whole.

DOLLAR EXCHANGE RATE

Some economists have argued forcefully that as a general principle a country, suffering at the same time from external deficit and from domestic unemployment, should devalue its currency, either by a shift to a floating rate or by a change in its gold parity. But if there ever is any merit to that argument, say in the case of countries whose currencies are not extensively used in international transactions, it is not applicable to the United States. This is so because the United States, as the world's leading banker, is responsible for a large part of the monetary reserves of foreign countries and for the great bulk of the international working balances of foreign bankers, traders, and investors. We have accepted these balances in good faith and, as I said earlier, we must stand behind them.

Whatever other consequences would follow from a devaluation of the dollar, I am convinced that it would immediately spell the end of the dollar as an international currency and the beginning of a retreat from the present world role of the United States that would produce far-reaching political as well as economic effects. It would, in my judgment, invite the disintegration of existing relationships among the free nations that are essential for the maintenance and extension of world prosperity and even world peace.

It has sometimes been suggested that we could maintain the dollar as an international currency simply by giving a gold value guarantee to some or all foreign holders of liquid dollar assets. At first glance, it might seem a good idea for a foreign central bank or a foreign investor to own an asset that would be not only as good as, but actually better than, gold: a kind of interest-bearing gold. But I do not think that the suggestion for a gold value guarantee is realistic.

First, if foreign holders of dollars did not trust our repeated assurance that we would not devalue the dollar, they would hardly trust our assurance that, if we devalued the dollar contrary to our previous assurance, we would do it in such a way that some or all foreign holders would be treated better than domestic holders.

Second, I do not think it would be possible to limit effectively a gold value guarantee to the dollars held by some or all foreign holders; and, if it were possible to make an effective distinction between foreign and domestic holders, this would amount to unjustified discrimination against domestic holders. In my judgment, neither Congress nor public opinion would tolerate any such discrimination.

In spite of our international payments deficit, the United States has refrained from drastically cutting Government expenditures abroad for defense or for economic aid, and from curtailing the freedom of capital movements. To have done otherwise would have undermined our position of economic and political leadership of the free world. So would any failure on our part to maintain the established par value of the dollar.

ROLE OF THE FEDERAL RESERVE

Within the limitations set by the international role of the dollar, what can the Federal Reserve do to achieve its domestic policy goals together with contributing to the achievement of international balance?

My friends sometimes accuse me of being a chronic optimist. But I believe that we can find ways of furthering our domestic economic aims while, at the same time, we are making progress in overcoming our payments problem internationally. And I believe that these ways will contribute better to sustainable economic growth than would flooding the economy with money.

Indeed, my present feeling is that the domestic liquidity of our banks and our economy in general is now so high that still further monetary stimulus would do little if any good—and might do actual harm—even if we did not have to consider our payments situation at all. This means that, if any additional governmental action is needed in the financial field in order to give fresh expansive impulse to the economy, it would probably have to come from the fiscal side. The part played by monetary policy, from both an internal and an external point of view, would then be mainly supplementary and defensive.

In this context, monetary policy would have to be on guard against two dangers: first, the danger that too rapid domestic monetary expansion would eventually produce rising domestic costs and prices as well as unwise speculation and in this way curtail exports and overstimulate imports; and, second, the danger that too easy domestic credit availability and too low borrowing costs would encourage capital outflows.

For the past few years, monetary policy has already contributed to the needed stability of the domestic price level, while prices in some other important industrial nations have been under steady upward pressure. In specific terms, Federal Reserve policy has been seeking to maintain a condition of credit availability that would be adequate for domestic needs while avoiding any serious deterioration of credit standards or any widespread speculative reliance on credit financing and at the same time limiting the spillover of credit funds—short term and long term—into foreign markets.

Nevertheless, our monetary policy has remained easier through this economic cycle than during previous cycles because that has seemed to be needed in a domestic situation of lagging longer term growth and a less-than-robust cyclical expansion. In balancing the scope and the limitations of our monetary policy, however, I am convinced that, within limits imposed by human imperfection, the Federal Reserve has paid neither too much nor too little attention to our international payments problem.

As I mentioned at the outset, criticism of our policy through this economic cycle has been about equally divided between two groups. The first complains that we have violated the classical principle of an international payments standard based on fixed exchange rates by failing to contract our money supply in the wake of a decline in our gold reserves. The second complains that we have neglected our duties to the domestic economy by permitting the decline in our monetary reserves to have some impact on our money markets, especially on short-term interest rates.

If all criticism had come from one side only, I would still believe it unjustified. But the very fact that criticism comes from both sides inclines me even more strongly to the comforting thought that we have been keeping to the golden mean.

FOREIGN CURRENCY OPERATIONS

The Federal Reserve has not been content to limit its participation in solving the country's payments problem to its traditional tools of monetary policy. It has felt a particular need to set up defenses against speculative attacks on the dollar pending an orderly correction of our payments disequilibrium. And it has felt a more general need to cooperate directly with foreign central banks in efforts to reinforce the international payments structure. Recognition of these needs underlies the decision that we took just a year ago to participate on Federal Reserve account in foreign currency operations.

Since the Treasury also engages in similar operations, Federal Reserve activities have had to be, and will continue to be, conducted in cooperation with those of the Treasury. Smooth coordination has been facilitated by the fact that the instructions of both agencies are carried out through the same staff members of the Federal Reserve Bank of New York, headed by Mr. Charles A. Coombs, Vice President in charge of the Foreign Department of that Bank and Special Manager for Foreign Currency Operations of the Federal Open Market Committee. At the same time, both the Board of Governors and the Federal Reserve Bank of New York have endeavored to maintain close contact with the central banks of foreign countries, bilaterally as well as through regular meetings of the Organization for Economic Cooperation and Development in Paris and the Bank for International Settlements in Basle.

The most important foreign currency activity of the System thus far has been the conclusion of reciprocal currency arrangements with leading foreign central banks and the Bank for International Settlements. Under these arrangements, the System acquires, or reaches agreement that it can acquire on call, specified amounts of foreign currencies against a resale contract, usually for three months. Concurrently, the foreign central bank acquires, or can acquire on call, an equivalent amount of dollars under resale contract for the same period.

In these contracts, both parties are protected during the active period of a swap arrangement against loss in terms of its own currency from any devaluation or revaluation of the other party's currency. These arrangements, of course, are subject to extension or renewal by agreement. Interest rates paid on the deposit or investment of funds acquired through swaps are set at equal levels for both parties, in the neighborhood of the current rate for United States Treasury bills, so that, as long as neither party utilizes any of its currency holdings, there is no gain or loss of income for either.

So far, agreements have involved a total approximating $1 billion. For the most part, they are stand-by arrangements. Only a small fraction of actual currency drawings has been utilized for market operations. And a large part of amounts so utilized has been reacquired, and used for repayment of the swap drawings.

In entering into swap arrangements, the Federal Reserve has had three needs in view. First, in the short run, swap arrangements can provide the System with foreign exchange that can be sold in the market to counter speculative attacks on the dollar or to cushion market disturbances that threaten to become disorderly.

Second, swap arrangements can provide the Federal Reserve with resources for avoiding undesired changes in our gold stock that may result when foreign central banks accumulate dollars in excess of the amounts they wish to hold, especially if these accumulations seem likely to reverse themselves in a foreseeable period.

Third, when the United States balance of payments has returned to equilibrium, swap arrangements with other central banks may be mutually advantageous as a supplement to outright foreign currency holdings in furthering a longer run increase in world liquidity, should this be needed to accommodate future expansion of the volume of world trade and finance.

CONCLUDING REMARKS

As long as the United States balance of payments is in over-all deficit, and we are therefore losing rather than gaining monetary reserves, on balance, the Federal Reserve cannot expect to accumulate outright large amounts of foreign exchange. Meanwhile, System holdings of foreign currencies will necessarily be limited to relatively small amounts, swollen on occasion by swaps.

But over the longer run, the System may find it useful to increase gradually its foreign currency holdings and operations. This development could be modified, of course, by further changes in the institutional framework of our international payments system. For this reason, the Board's staff, in cooperation with the staffs of the Treasury and other interested agencies of the Government, is carefully scrutinizing the various recent proposals designed to adapt, strengthen, or reform this framework.

Whatever the fate of these reform proposals, it seems likely that Federal Reserve operations in the international field will need to be continued for the foreseeable future. The Federal Reserve's involvement in foreign exchange problems is the inevitable consequence of its role as the central bank responsible for the stability of the world's leading currency. Such a responsibility necessarily carries with it the responsibility for helping to preserve and improve the existing international monetary system, thus to contribute to the stability and prosperity of the free world.