THE DOLLAR AND THE INTERNATIONAL MONETARY SYSTEM

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"Free Enterprise was born with man and shall survive as long as man survives."

—A. D. Shroff

1899-1965

Founder-President

Forum of Free Enterprise

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The sharp depreciation of the dollar in foreign exchange markets since September 1977 has been the subject of considerable concern in the United States and across the world. There are ample reasons for this concern.

When the value of the dollar declines in terms of foreign currencies, the Americans who work, visit, or buy abroad are at once affected adversely. And as the rise in the price of imports spreads to domestic commodities and makes itself felt in retail outlets, the entire public feels the effects of a depreciating dollar. The depreciation of the dollar in foreign exchange markets has thus intensified the economic troubles wrought by inflation — a disease from which the United States, along with much of the rest of the world, has long been suffering.

In view of the vital role that the dollar has come to play in international trade and finance, its value is highly important also to the rest of the world. To begin with, the dollar is the currency in which a major part of international commerce is carried out. Contracts for international trade in primary commodities — of which oil is an outstanding example — are preponderantly denominated in dollars. Contracts for manufactured commodities moving across national boundary lines are also frequently expressed in dollars. That is no less true of Israel than of Japan, Europe, and the rest of the world.

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The dollar is not only the major currency in which international trading is invoiced. The dollar is also the principal currency used in international capital markets. It is the currency on which central banks primarily rely when they intervene in foreign exchange markets. Perhaps most important of all, the dollar is a store of value for practically every central bank, for multinational corporations generally, and for people of wealth and means around the world as well as the American public.

In view of the vital role of the dollar in international trade and finance, it is natural for the business world to expect the dollar to be a stable international currency--that is, a currency whose average value against other major currencies will fluctuate within only narrow limits from day to day, from week to week, and perhaps even from year to year. When the dollar fails to behave in this fashion, when doubts arise about its stability, a troublesome dimension of uncertainty is added to international trade and investment.

I therefore have no hesitation in saying that at this juncture of history the international monetary system requires a reasonably stable dollar in foreign exchange markets taken as a whole. As the leading international currency, the dollar needs to be respected around the world. Once its integrity is in doubt, hesitation tends to spread among businessmen and financiers wherever dollars or dollar-denominated assets are held.

In an effort to throw some light on the circumstances surrounding the international position of the dollar, I shall discuss with you briefly the following questions: First, how has the dollar actually performed in foreign exchange markets? Second, why has the dollar depreciated so much recently? Third, what are the prospects for some improvement in the dollar's international value? Fourth, how can a more stable international monetary system be achieved in the years immediately ahead?

Let us then turn to the first question: How has the dollar actually performed in foreign exchange markets? The answer depends, of course, on the time period considered.

For many decades the international monetary system was tied to gold, and the value of the dollar was entirely stable against most major currencies. But since 1971, when convertibility of dollars into gold was abandoned, and even more since the worldwide shift to floating exchange rates in 1973, the external value of the dollar has undergone large variations—particularly in relation to other major currencies.

Thus, between early April and early July of 1973, the average value of the dollar relative to the currencies of the ten major industrial countries fell 11 per cent. It then rose 21 per cent until mid-January 1974, fell 11 per cent between that date and mid-May, rose 7 per cent by early September, fell again 10 per cent until early March of 1975, and rose once again until early June of 1976 by 16 per cent. The decline that began at that time reached over 20 per cent toward the end of last month.

These are large fluctuations by almost any yardstick. And the fluctuations of the dollar, of course, have been larger still in relation to individual currencies—especially the German mark, the Swiss franc, and the Japanese yen. From the beginning of 1977 until late October 1978, the value of the dollar declined about one-fourth in terms of the mark and about two-fifths in terms of the yen and also the Swiss franc.

This brings me to the second question: Why has the dollar depreciated so much over the past two years—especially since the early fall of 1977? There can be no simple or single answer to this question. In addition to the American public, there are many millions of people abroad who hold dollars or dollar-denominated assets, and the total amount of these outstanding assets staggers the imagination. Those who seek to hold, acquire, or part with dollars have countless business, financial, or personal reasons for so doing. Nevertheless, several facts of major significance do stand out.

First, the dollar plummeted in international markets despite massive intervention by the major central banks. In the aggregate, central banks purchased over $40 billion since the beginning of 1977. This enormous support of the dollar was helpful in correcting the disorderly conditions that kept recurring in foreign exchange markets, but it had little or no permanent effect on the underlying trend of the dollar.

Second, short-term market interest rates turned upward in the United States early in 1977, while they moved down in European money markets and in Japan. By mid-1977, interest rates were lower in Germany, Switzerland, and the Netherlands than in the United States. This reversal of interest-rate differentials has become larger since then, and it has spread to other money markets including that of Japan. But the higher short-term rates failed to attract much foreign capital to the United States. On the contrary, private capital moved out on balance in substantial amounts during 1977 and in the early months of this year.

Third, since massive central-bank support and appreciably higher short-term interest rates failed to stem the depreciation of the dollar, powerful influences were obviously dragging down its value. The deterioration in America's foreign trade, the quickening of its inflation rate, and the failure of American policy makers to take effective measures to deal with both difficulties—these were the factors that attracted wide attention and counted most in the dollar's decline.

The decline of the foreign trade balance of the United States, especially in manufactured goods, reached dimensions that exceeded even pessimistic expectations. A surplus of $ 9 billion on the overall trade account in 1975 was followed by a deficit of $ 9 billon in 1976 and a deficit of $ 31 billion in 1977. The deterioration was not confined to the merchandise trade with any one country or region. On the contrary, it occurred on a worldwide scale. For example, the trade deficit with the OPEC group came to $ 16 billion in 1976, but reached $ 23 billion in 1977. In the case of Japan, the deficit moved from $ 5 billion to $ 8 billion. In the case of Western Europe, the traditional trade surplus shrank from $ 9 billion to $ 6 billion. Moreover, the trade deficit this year has been running on an overall basis even higher than last year's unprecedented total, and it has become embarrassingly large for manufactured products.

As knowledge of this widening trade deficit spread around the world, confidence in the external value of the dollar naturally diminished. Experienced market participants reasoned that the dollar would have to depreciate before equilibrium in America's foreign trade could be restored. Expectations of this sort led to some outflow of capital. Meanwhile, unfavourable expectations were nourished for a time by pronouncements out of Washington, at times even by high officials, that depreciation of the dollar was a good thing—that it would serve to augment American exports, to diminish imports, and thus strengthen the ongoing domestic expansion in production and employment. Such rhetoric tended to propel further the outflow of capital, and the depreciation that followed served to confirm pessimistic market expectations. Yet, these expectations would not have escalated as they in fact did if inflation in the United States had not taken a serious turn for the worse.

In 1974, when the hectic boom of the American economy culminated, the consumer price level rose 12 per cent. During the next two years considerable slack existed in the economy, and the inflation rate receded sharply—to 7 per cent in 1975 and to less than 5 per cent in 1976. But as the economy surged forward again, the inflation rate moved up to almost 7 per cent during 1977, and it rose still further—to an annual rate of over 9 per cent—through September of this year. When a country's currency buys less and less of domestic goods or services, as was now the case with the dollar, participants in the foreign exchange market are apt to reason that its value in terms of other currencies must also decline —unless, of course, the trend of inflation is generally similar elsewhere. That, however, was not the prevailing situation.

On the contrary, while the inflation rate was quickening in the United States, it was diminishing in most other industrial countries. By the second quarter of this year, the rate of increase in the consumer price level of the United States exceeded that of Germany, Japan, Switzerland, Australia, the Low Countries, Austria, and the Scandinavian group. Even the inflation rate of Great Britain, which once served as a conspicuous example to the world of what needed avoiding, had come down to the American level and according to some measures was below it.

It is in the nature of markets to project recent trends into the future and at times to do so on an exaggerated scale. Certainly, the depreciation of the dollar has far exceeded what could have been expected on the basis of relative price trends alone. Insofar as this development indicated unfavourable market expectations about America's inflation and foreign trade in the future, the economic policies pursued by the United States have not been blameless. If they have been puzzling at times to Americans, they have been quite bewildering to many others. Business and financial observers everywhere kept wondering why effective measures were not being taken by the United States to reduce reliance on foreign oil, why some exports were being sacrificed in the interest of promoting moral rectitude, why the federal government's deficit was expanding at a time of economic resurgence, why the money supply was increasing so rapidly, why America's enormous financial resources were not being boldly used in international markets to protect its currency, and why the American government was taking steps that were practically bound to raise prices—such as increasing the minimum wage, raising payroll taxes, raising agricultural price supports, imposing import quotas on shoes and television sets, and otherwise checking imports of steel. With doubts on all these scores being keenly felt by market observers and participants, it is hardly surprising that the dollar slumped far more than the price performance of the United States relative to other countries might have suggested.

If the dollar, being the world's foremost currency, should continue to depreciate, the concern felt around the world by government officials, businessmen and ordinary citizens will become more acute. There is already much fear in countries whose currency has sharply appreciated against the dollar that their export industries may suffer sufficiently to cause general economic stagnation. Certainly, if hesitation about spending or investing decisions should spread, the somewhat fragile international economic recovery that is now under way would be weakened. And if events took such an unfortunate turn, the American economy could not escape damage. Not only would the dollar's depreciation further intensify inflation, thereby threatening the continuance of domestic prosperity, but American exports—which have been disconcertingly sluggish—might become weaker still. I need hardly add that in such a world, protectionist practices would tend to multiply and thus add to international economic and political troubles.

The third question that I posed at the beginning of this address—namely, the prospect for some improvement in the dollar's external value—is therefore of great significance to the international economy. I am well aware of the widespread pessimism about the dollar both in my country and abroad. Besides pointing to deficiencies of economic policy, critics dwell on America's languishing productivity, its inadequate capital investment, the slackening of research and product development, and the lack of vigorous enterprise or imagination in cultivating export markets. There is doubtless some merit in much of this questioning and criticism; but it nevertheless conveys a seriously distorted picture of the American economy and prospects for the dollar. Let me draw your attention to several facts.

First of all, the United States has made more rapid strides in recovering from the recent international recession than any other industrial country. Since March 1975, the American economy has created over 10 million new jobs, and these have been preponderantly jobs in private industry. The volume of employment relative to the total population of working age is now at the highest level in our nation's history. The unemployment rate has dropped sharply. As far as skilled labour is concerned, the economy is already close to full employment. Clearly, the American economy has not yet lost its dynamism or resilience; but the very vigour of its recent expansion, which outdistanced the performance of the industrial countries, has been responsible for much of the deterioration of America's trade balance.

Second, as was bound to happen, the rapid growth that characterized the American economy in the earlier stages of the expansion is now abating. The physical volume of production rose at an annual rate of 4 per cent in the first three quarters of this year in contrast to an increase of 6.3 per cent during the corresponding period last year. Employment this September was nearly 4 million above a year ago, but it was hardly larger than three months ago. The average length of the workweek has actually declined a little since April. And while the rate of expansion of the American economy has been slowing down, other major industrial countries—Germany, Japan, France, Italy, and the United Kingdom—have been gradually recovering from last year's semi-recession. Both Germany and Japan, moreover, are now moving toward more expansive economic policies that promise to sustain and extend their current recovery.

The convergence of growth rates of the major industrial countries that appears to be under way should prove beneficial to the trade balance of the United States, since it will tend to lead to a lower rate of expansion of American imports at the very time when American exports may be moving up at a faster pace. The reduction in the trade deficit of the United States since the early months of this year may already reflect such a development besides some response to the dollar's past depreciation.

Third, the conventional theory that a depreciating currency is beneficial to a nation's foreign trade and its general economic activity has lost its earlier appeal within the government of the United States. Practically every official intimately involved in making economic policy now recognizes that whatever merit may attach in some circumstances to the conventional theory, it is a dangerous guide to the economic policy of a country whose currency is the centerpiece of the international monetary system.

Since December of last year, when President Carter declared unequivocally that the United States has a "responsibility to protect the integrity of the dollar," the government has taken various steps with a view to strengthening the dollar's international position. Swap arrangements with foreign central banks have been pursued more vigorously in the interest of correcting disorderly conditions in foreign exchange markets. The discount rate has been raised repeatedly and it now stands at the highest level in Federal Reserve history. Monthly sales of gold have been undertaken by the Treasury. Technical regulations by the Federal Reserve System have been modified to facilitate borrowing abroad. An energy bill designed to promote oil conservation has been passed by the Congress. The administration has developed a programme for enlarging direct assistance to American exports and for reducing domestic barriers to exports. Moreover, having reached the conclusion that inflation is now the nation's principal economic problem, the President has announced a new policy of seeking to moderate wage and price increases.

Fourth, while these measures may be regarded as coming late and as being inadequate, it is important to recognize that the dangers attaching to the dollar's depreciation are now fully understood in the United States. American economic policy has been evolving along directions that cope with the problem, and this evolution will probably continue—as the emphatic monetary actions taken last week clearly suggest.

In fact, a highly significant change in political attitudes has emerged in the United States in the past few months. The recent tax revolt of California citizens is a symptom of the disenchantment of a large section of the American public, especially of the middle class, with governmental trends. There is a growing feeling across the country that inflation is weakening the national economy, that capital investment requires encouragement, and that the economic situation can be improved by cutting back on government spending, by lowering taxes, and by reducing the burdens imposed by government regulation. Of late, politicians of both major parties have been vying with one another in proclaiming inflation as the nation's Number One problem, and in urging more conservative fiscal policies. Despite their political skills, trade union leaders have failed to persuade the present Congress that their market power needs strengthening. The tax bill just passed by the Congress breaks with the tradition of granting large tax reductions only to low-income groups. Instead, it goes some distance in lightening the tax burden on the middle class, on corporations, and even on the upper-income groups. And the new mood of fiscal conservatism has already left some imprint on the federal budget deficit projected for this and the next year.

This dramatic change in the American political scene favours capital investment—particularly in risky ventures. It favours improvement in productivity, better control over inflation, and also larger foreign investments in the United States. True, the shift in the political scene is such a recent development that no one can be sure how far it will go or how lasting it will prove. The proponents of larger government spending and easier credit are still a powerful political force. The budget deficit is still a powerful inflationary influence. The growth of the money supply is still exceeding the Federal Reserve's targets. The relentless push by trade unions for sharp wage increases is still continuing. President Carter's new programme for curbing inflation still remains to be tested; it is by no means clear that even the modest goals that he has set can be achieved without much more effective budgetary restraint and some bold redirection of structural policies.

This uncertainty about the prospects for bringing down America's rate of inflation in the near future inevitably clouds the outlook for the dollar in international markets. But I need hardly remind you that the disease of inflation is not confined to the United States. Even now, there are some signs that the inflation rate may once again be quickening in other industrial countries. Other dangers to the dollar —such as diversification of reserve assets by central banks or abandonment of dollar pricing by OPEC—appear to me to be exaggerated. Disappointing though the performance of the dollar has been, good substitutes for the dollar are hardly available for most official holders, nor for that matter for many private holders. It is highly unlikely that any of the major central banks will attempt an appreciable degree of reserve diversification. And as far as the OPEC group is concerned, its members are well aware that any move on their part that weakens the dollar may seriously damage their own economic and political interests.

On balance, I see no escape from the conclusion that doubts about the dollar's future are likely to persist until there is convincing evidence that the United States is making some progress, first and foremost, in curbing inflation, and second, in correcting the enormous deficit in its current account with other countries. But I am also inclined to believe that there is a basis for a more positive attitude toward the dollar than has recently prevailed. Its emergence may be delayed, but it will in time—perhaps even soon—again lead to a large flow of capital into the United States.

I have left for last the most difficult question—namely, what needs to be done to achieve a more stable international monetary system in the years immediately ahead. I believe, as I have already indicated, that at this stage of world economic evolution the United States has the primary responsibility to promote a stable international monetary system. It must nevertheless be kept in mind that the instability of individual currencies around the world—whether it be the dollar, the yen, or any other—cannot be solely attributed to shortcomings of American performance.

The turbulence that has characterized exchange markets since 1973 reflects a very disturbed international environment. During these years, individual countries experienced high and widely divergent rates of inflation, the price of oil quintupled, a severe recession in economic activity occurred on a worldwide scale and, more recently, economic recovery has proceeded at widely different rates in individual countries. In view of the massive disturbances that rocked the international economy in the past few years, it is hardly surprising that enormous trade imbalances developed and that foreign exchange markets became highly unstable. If the Bretton Woods system had not collapsed in 1973, it probably would have collapsed only a little later. If the United States is not free from blame, neither are other countries around the world.

In the interest of international monetary order, as well as for its own sake, the United States will need to strive harder than it yet has to achieve a stable domestic price level and to reduce its reliance on foreign oil. However, in the absence of a rigid exchange rate system—something that did not exist even under the Bretton Woods regime—the dollar will fluctuate against other currencies because of developments that are outside American control. The most that can be expected of the United States is that its affairs be conducted in such manner that the **average** value of the dollar against other currencies will fluctuate within only narrow limits. But even if that happened, the value of the dollar against individual currencies—the mark, the French franc, the yen, et cetera—could still move over a wide range in response, among other factors, to differences in national inflation rates. Clearly, a more stable international system requires appropriate financial conduct by many countries. It can be promoted by the United States; it cannot be achieved by the United States alone.

If a more stable international economy is to be achieved, individual countries—particularly the industrial countries—will need to marshall the will to live by strict rules of responsible financial behaviour. Countries whose external position has been persistently weak—and whose currency therefore is under a cloud in foreign exchange markets—will need to practice stern financial discipline. Unless they conduct monetary and fiscal policies in a manner that promises to curb domestic inflation and to reduce international deficits, lack of confidence in their economic management will inevitably be reflected in the exchange value of their currency. When loose financial practices prevail, turmoil in foreign exchange markets cannot be avoided.

Countries that run persistent surpluses in their balance of payments also have a vital role in promoting stability of the international monetary system. Not a little of the turbulence that has characterized international finance since 1973 is due to the enormous and abrupt increase in the price of oil by the OPEC cartel. Of late, the more influential members of OPEC have come to recognize that the world has not yet adjusted to the revolution they caused in the price of energy. The forbearance that OPEC has recently practiced with regard to the price of oil is one of many signs that its members now appreciate the fact that they have become a large factor in international finance, and that their self-interest requires the avoidance of new shocks to the international economy.

Countries outside the OPEC cartel that have been experiencing persistent surpluses in the international current accounts also need to contribute to international monetary order. These countries have at times been urged by others to seek faster economic expansion even at the risk of re-igniting the fires of inflation. I deplore such counsel. I do believe, however, that it is neihter in the interest of the international monetary system nor of the surplus countries themselves to resist the appreciation of their currency that is called for by underlying economic forces—such as the stability of their price level, or the attractiveness of their investment climate, relative to that of other countries. And insofar as the surplus countries can achieve faster growth of their domestic economies without releasing new forces of inflation, it would clearly be desirable both in their national interest and in the interest of the international economy that they do so.

If these principles of responsible behaviour were generally observed by individual nations, the international monetary system would surely gain in stability and facilitate the orderly conduct and expansion of international economic transactions. There can be no assurance, however, that principles of right financial conduct will be followed by all or even by most nations. On the contrary, the history of the world across the centuries, no less than recent economic history, records case after case of financial misbehaviour and political mismanagement.

If we are to make progress in the future toward a stronger and more stable international economy, individual countries will therefore need to recognize their interdependence more fully than they yet have. By this I mean that they will need to work toward more co-operative decision making, and beyond that to a rule of law in international monetary affairs. Fortunately, we have in the International Monetary Fund an institution that is well suited to guide the international economy toward the establishment of a rule of law in monetary affairs.

In recent years the IMF has achieved considerable success in getting countries that sought its financial assistance to adopt more responsible economic policies. The requirements have varied from case to case, but they have generally included some limitation on domestic credit expansion, on bank lending to the public sector, and on foreign borrowings of certain maturities. Countries that have implemented IMF programmes have found that their ability to get additional financing from commercial banks or in other ways is appreciably improved. This experience in turn is serving to reduce reluctance to apply for IMF assistance. And the fact that the United Kingdom and Italy, in addition to numerous developing nations, have recently accepted the conditions laid down by the IMF has greatly added to its prestige.

Under the amended Articles of Agreement that now define its authority, the IMF has the power to exercise firm surveillance over the exchange rate policies of its members and to proclaim specific principles for their guidance. It is highly important that the Fund make full use of its new authority: that it start at once to monitor exchange rate movements whether or not they appear to be excessive; that it seek compliance with the principles of appropriate conduct that have been laid down; and that it evaluate the appropriateness of intervention by individual central banks. I also hope that the Fund may see fit to reform its operating procedures so that its lending resources, for the most part, are made available only when borrowing countries agree to firm conditions of financial rectitude.

Full use of the new and enlarged authority of the IMF has become, I believe, an essential requirement for a stable international monetary system. But if the IMF is to exercise effectively its new authority, national governments will need to support a strong IMF. Early action on establishing a Council at the ministerial level is desirable, so that the IMF can speak with a stronger voice to its member nations. Countries that are in fundamental disequilibrium will need to resist the temptation to circumvent the Fund's authority by seeking bilateral official credits or by exerting political pressure to ignore or bend or weaken the Fund's principles and procedures. Countries that do not need to borrow from the Fund, whether because they are running a surplus in their international accounts or for other reasons, will have to learn that it is to their own long-run interest as well as that of the international economy to take seriously the IMF's pronouncements about their financial conduct. If some European countries or the nations of any other region proceed to establish a monetary union with a view to minimizing exchange rate fluctuations among themselves, it would be highly desirable that their scheme of organization provide a role for the IMF. Unless that is done, forces may be released that unwittingly diminish the IMF's prestige and authority.

The amended Articles of Agreement that give new powers to the IMF also impose on it heavy responsibilities. More than ever, the IMF will need to conduct its business in ways that command the full respect of its members. It can do so only by treating all countries—whether they are large or small, whether they are developed or developing, whether they are running a surplus or a deficit in their international accounts—in a conscientious and yet thoroughly objective manner.

These are difficult but not impossible requirements. National pride, if not lesser political motives, may often limit and at times frustrate the IMF's authority. But the fact that two major industrial countries, the United Kingdom and Italy, after searching for all sorts of easier ways, found it expedient to accept the stern conditions laid down by the IMF gives some basis for confidence that a rule of law will eventually prevail in international monetary arrangements.

I began this address by emphasizing the responsibility that the United States has to maintain a reasonably stable dollar. Let me close by stating that the United States in particular must give strong support to the IMF—as it in fact has done in recent years. Under no circumstances should the United States, any more than Italy or Mexico or Israel, expect to receive preferential treatment from the IMF. Neither the United States, nor any other country need fear the counsel of the IMF or the conditions that it may at some time in the future lay down before it will extend financial assistance. Countries that conduct their financial affairs prudently will rarely, if ever, become subject to guidance or pressure from the IMF. But when a country mismanages its finances or runs into bad luck, it should be comforting to know that the IMF is likely to prove a constructive ally in the restoration of its economic health.

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"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

—**Eugene Black**

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