

## The U. S. Balance of Payments: Freedom or Controls

### I.

In the last two years the U.S. balance of payments and the international position of the dollar have undergone sharp and somewhat paradoxical changes. It will be recalled that the bad showing of the balance of payments in the last quarter of 1967 — a record deficit of \$6.8 billion (annual rate) — led to a run on the dollar. The Administration panicked and in a dramatic New Year's address President Johnson proposed, and partly put into effect, drastic controls. Capital export restrictions and certain other controls were severely tightened by executive order but fortunately other measures — an unprecedented tourist tax, border taxes on imports, etc. — were rejected by the Congress. In April 1968 at the height of the crisis the international gold pool through which the central banks of the leading countries, the United States carrying the main burden, had been feeding the gold speculators, was closed down and the two-tier gold market was established.

Later in 1968 the picture unexpectedly improved. Huge amounts of capital flowed into the United States, attracted by high interest rates and a booming stock market and spurred by the collapse of the French franc as one of the world's strongest currencies and the invasion of Czechoslovakia. Thus in 1968, for the first time in 11 years, the U.S. balance of payments showed a small surplus both on the liquidity and official reserve transaction basis. But the traditional surplus on trade account disappeared and the overall improvement was clearly of a precarious nature. For the richest country in the world importing capital on a large scale is obviously an unnatural and unsustainable phenomenon.

The expected deterioration of the balance of payments recurred with a vengeance in 1969. In the first quarter the deficit was \$6.7 billion and in the second quarter of this year the liquidity deficit

climbed to \$15.4 billion (annual rate), more than twice as large as the previous record; in the third quarter of 1969 it was still at the second highest level of \$10 billion (annual rate). It is true, on the official reserve basis the picture was better, but in the third quarter of 1969 after 5 quarterly surpluses there was again an official reserve deficit of \$3.7 billion. Moreover, the trade balance as well as the balance of goods and services are still in deplorable shape, although the third quarter brought a slight improvement which will probably continue as the economy cools off.

The paradoxical thing is that the unprecedented deterioration of the external balance in 1969 has not even caused a ripple in the exchange market as far as the dollar is concerned. The last two acute crises that shook the international monetary system in the spring and again autumn of 1969 led to the devaluation of the French franc in August and the upvaluation of the DM in October, but left the dollar entirely unscathed. This is in sharp contrast to the impact of the much smaller deficit late in 1967 and early in 1968.

What is the explanation? The decisive factor is, I believe, that the events of last year, the departure of General de Gaulle and the demise of the French franc, as well as the occupation of Czechoslovakia have created a feeling of insecurity in Europe and by contrast revived confidence in the United States and the dollar. This as well as the insulation of the monetary gold stock from the private gold market and from gold speculation has brought it home to the Europeans and others that the world is practically on the dollar standard whether they like it or not (1).

The fact that since the end of 1967 as a consequence of the huge flows of private capital to the United States *official* liquid dollar holdings abroad have declined substantially (from \$15.65 billion to about \$10 billion middle 1969) has surely helped to reassure foreign central banks. But they must have been fully aware all along that there may easily occur a shift back into official balances whenever

(1) After this was written I learned that no one less than M. Jacques Rueff has reached the conclusion that a rise in the price of gold has become "obsolete and uninteresting" because the world is now on the "dollar standard". The termination of the gold pool, the *de facto* inconvertibility of the dollar into gold and the decision to create SDR's have put an end to the gold standard and put the dollar in the saddle. For the intrepid champion of gold this must have been an agonizing reappraisal. But it is typical of this realist never to close his eyes before the facts, however distasteful they may be, and never to engage in wishful thinking. (See *Le Monde*, Paris, November 29, 1969).

private holders decide to reduce their dollar holdings. Such a shift seems to have started in the third quarter of 1969.

What does it mean to say that the world is on the dollar standard? If it were literally true, as it was in the early postwar years, it would mean that the dollar is routinely accepted as international reserve and that other countries are ready, if necessary, to accumulate dollars without limit, so that the United States need never worry about its balance of payments. This surely is not the case; there are limits to the willingness of foreign central banks to accumulate dollars. For example, if our inflation continued or accelerated, there certainly would be trouble. I shall return briefly to that contingency later.

But assume that our inflation is checked or at least reduced to a rate which is not higher than that of the most disciplined countries abroad; assume furthermore that we still had a moderate deficit. That this is not a wholly unrealistic assumption is suggested by the fact that over a longer period, 5 years, 10 years or longer, the dollar has lost less in purchasing power than any other major currency, the German mark and Swiss franc *not* excepted.

What could other countries do if they did not want to accumulate more dollars? They know that if large blocks of dollars were presented by foreign central banks for conversion into gold, the gold window would simply be shut down. So they are left with two options: They could inflate sufficiently or let their currency float up, in order to get rid of their surplus — and of our deficit. Either solution would be acceptable from the American standpoint. It is sometimes said that other countries have still another option: They could introduce controls. But that would not only be a violation of the IMF Charter but would also be irrational because it would make things worse: It would increase the other countries' surplus — and our deficit! What they could do, however, is to reduce their tariffs and eliminate import restrictions. This would be acceptable from the American standpoint.

But now let me leave the dollar for a moment — I shall return to it later — and let me look at the international monetary system as a whole.

## 2.

In the last few years we have seen a series of foreign exchange crises involving almost all major currencies. Each crisis was preceded by massive capital flows and some culminated in exchange rate changes, or some substitute for such a change such as border tax adjustment. Moreover, each crisis was accompanied by the imposition or tightening of controls, notably in France and the United Kingdom. Only a few of these controls were later removed.

Everybody agrees that this is not a satisfactory state of affairs and that we need a better method of balance of payments adjustment than the one we have. And most experts, even many who only a year ago were staunch supporters of the system of fixed and rigid exchanges, now believe that some flexibility of exchange rate adjustment is badly needed, that the present system of occasional large depreciations and appreciations, the so-called adjustable peg, is unsatisfactory. I shall not discuss in this paper the various types of flexibility that have been proposed — unlimited flexibility, crawling peg, wider band, upward crawl, automatic crawl, discretionary frequent adjustment of rates in small steps, etc. I confine myself to saying that the choice with which we are confronted is not between (a) really fixed exchanges with fully convertible currencies without controls and (b) some sort of flexibility. The real choice is between (a) a messy, disorderly method of changing exchange rates openly or in disguised form, punctuated by violent crises with massive speculation and accompanied by more and more controls and (b) an orderly smooth adjustment which largely or entirely avoids controls and reduces speculation to a minimum.

In support of the assertion that flexibility reduces speculation, let me recall one dramatic episode of the upvaluation of the German mark. Before the German election billions of dollars flowed into Germany. On September 24, four days before the election, the exchange market was closed. On Monday, September 29, the day after the election the market was reopened with the exchange rate unchanged. In a few hours huge sums poured into Germany. The market was closed again and the decision was reached to let the mark float. The next morning, Tuesday, September 30, when the market was opened, the exchange value of the mark shot up, and

lo and behold the speculation had practically vanished. It simply became too risky to speculate. Even more interesting, the speculation was *not* revived, at least not on a substantial scale, when a little later a more or less open debate was conducted in the press on the question whether the mark should be restabilized at the level of 6, 8 or 10 per cent above the former parity.

It is too early to say whether the new rate, 9.3 per cent above the old one, will turn out to be right. The appreciation may well prove to be insufficient; for it should not be forgotten that the *effective* appreciation of the DM was much less than 9.3 per cent because the "Ersatz" (substitute) revaluation of November 1968 in the form of border tax adjustment was rescinded when the real appreciation went into effect and the appreciation had been anticipated in the forward market. Two things are certain, however: First, the whole operation was a hell of a way to change an exchange rate; it was most unfortunate to make the exchange rate of a major currency a political football. Second, as far as discouraging massive speculation is concerned, the floating system was a great success; it fully confirmed or surpassed the most sanguine expectations of the most ardent advocates of flexibility.

## 3.

Since the war, world trade has been growing by leaps and bounds and the economies of the Western countries are so closely linked by trade and payments that commodity flows and capital movements have become very sensitive to price and interest differentials. This is, of course, as it should be and it is a matter of justified self-congratulation for the managers of the international monetary system. But it also implies that smooth balance of payments adjustment at fixed exchange rates with full convertibility (in other words, without controls) would require far-reaching harmonization and mutual adjustment of monetary, fiscal and wage policy. This is the situation which we enjoy inside the United States. Balance of payments adjustment between the various regions of the country works so smoothly and automatically that few people are aware that there exists such a thing as a regional balance of payments. Monetary and fiscal policies are automatically harmonized

and the wage push is the same everywhere in the United States (2). Among sovereign countries such close mutual adjustment and harmonization of policies simply does not exist nowadays, not even among the members of the European Common Market as recent events have shown. The situation was different before 1914 under the rule of the gold standard, because in those days maintenance of external convertibility was the overriding objective of monetary policy and wages were not as rigid as they are now. Today, the overriding policy objectives are full employment, growth and in some countries price stability. Unfortunately, different countries put different priorities and weights on these various objectives and some are more successful than others in carrying out their intentions. This is especially true of reconciling the objective of price stability with that of full employment and growth.

For these reasons, it is so important to find a method of smooth and flexible exchange adjustment. Let us, however, be on our guard against certain simplifications and exaggerations. Exchange flexibility does not mean that every currency should fluctuate in terms of every other. Many small countries will undoubtedly peg their currencies to that of some large neighbor and groups of countries may form fixed currency blocs.

## 4.

I now return to the special position of the dollar. It is now generally recognized that the dollar is in a unique position, for the dollar is the world's foremost reserve currency, the intervention currency which all other countries use to maintain the par value of their currencies at the agreed level, it is the international unit of account, and last but not least the dollar is by far the most important international investment and transactions currency used by private banks, corporations and individuals all over the world.

It is now generally recognized that because of the unique position of the dollar the United States could not devalue the dollar unilaterally nor could it let the dollar float vis-à-vis other currencies even if it wanted to. If the United States decided to devalue the dollar by, say, 10 per cent in terms of gold, or to suspend gold payments and let the dollar float (in terms of gold), practically all other

(2) There are other factors which help to bring about smooth interregional adjustment, but those mentioned in the text seem to me of decisive importance.

countries would go along and continue to peg their currencies to the dollar so that the dollar would not float in terms of other currencies.

But how, it may be asked, could the United States then ever enjoy the benefits of a floating rate? The answer is that the decision to introduce flexibility must be taken by others. Does that not imply a serious handicap for the United States, if it is agreed that exchange flexibility is a desirable state of affairs? By no means; the United States would automatically enjoy the benefits of flexibility when other currencies are made flexible vis-à-vis the dollar. And what if they refuse to let their currencies float? Suppose a surplus country refused to let its currency appreciate. Then it would have to accumulate dollars; that is their business and not ours. Either course would be acceptable from the American standpoint. As explained earlier, it would make no sense for a surplus country to impose controls. It could, however, eliminate existing controls and import restrictions.

Suppose a deficit country refused to depreciate. Then it would run out of dollars (or gold), and if it still refused to devalue or to let its currency float, it would have to introduce controls. This would indeed hurt us along with others including the offender himself. That cannot be helped, but we can console ourselves with the thought that for the United States trade is less important than for almost anybody else, so that bad policy elsewhere would hurt others, including the offender himself, much more than it would hurt us.

However, if we check inflation and give the world a stable, reliable and desirable reserve medium, we may be reasonably sure that most countries will play ball and behave rationally in their own interest. What else could they do? They cannot, to repeat, get gold in large quantities from us or from anybody else and dollars are better than gold especially with high interest. The creation of SDR's will make the dollar standard even more acceptable.

But what if we do not stop inflation? Then there will be trouble and recriminations. But even then other countries could not get gold, so they may put up with a dollar that loses purchasing power, provided inflation is not too rapid, especially since high interest rates caused by inflation would afford some compensation. Any country that does not want to inflate as much as we do and to accumulate dollars will have to let its currency appreciate in terms of dollars.

I could spin out this rather morbid subject of what would happen if we went on having inflation of 5 or more per cent per year. It may be impossible to foresee precisely other countries' reactions. But one thing is certain, even in that unfortunate case nobody can force us either to create a serious depression or to impose tight controls. Let us hope that inflation will be checked so that we need not find out what would happen if inflation goes on.

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