The Euro-Dollar and the Internationalization of United States Monetary Policy (*)

The last two years have seen a series of monetary crises which have led a number of observers to the opinion that the international monetary system, as we have known it, is on its last legs. The crisis in sterling in November 1967, the gold crisis of March 1968, and the French-Deutschemark confrontation of November 1968 have excited financial writers, central bankers and Treasury officials, plus a few hoarders, even though they did not reach deeply into the daily lives of businesses and households. The questions on not a few lips are whether the system is about to undergo a major revision, and whether, in that process, a good many institutions which have performed with remarkable efficiency in the last few years, may not come unstuck. I do not think so. I have not been thinking so for the 10 years since Robert Triffin first started to cry "Wolf" in his *Gold and the Dollar Crisis*. I could be wrong. It is well to recall the story of the young diplomat who went to his older colleague in 1939 and asked "What shall I tell all these people who ask whether there will be a war?" "Tell them no", said the diplomat. "People have been asking me this question for 40 years, I have always said no, and I was wrong only once".

The essence of the international monetary problem is that it may not be possible to keep the gold standard or the gold exchange standard when various countries have policies which are not in harmony. If all countries, for example, want to add to reserves each year, their needs can only be met if reserves are increasing at an appropriate rate. This is the basis for the reform of the system which would add substantial amounts of reserves each year in the form of Special Drawing Rights, as agreed at the 1967 Rio de Janeiro

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meeting of the International Monetary Fund. Or some countries may prefer price stability to full employment, and others employment to price stability, with the result that they follow different price paths. This concern leads a great number of academic economists to recommend the abandonment of fixed exchange rates, and substitution for them either of freely flexible exchange rates, or, to discourage speculation in foreign exchange, limited flexibility in the form of a slowly moving parity, called the crawling, or creeping, or sliding peg. Most scholars recommend either a major increase in liquidity or a system of exchange-rate flexibility; a few, like the London *Economist*, seem to press for both. At the risk of being reactionary, or at any rate out of the main stream of thought, I support a gradual evolution of the present system in the direction of internationalization of the dollar standard not with coordinated macro-economic policies in different countries, but coordinated fiscal policies, and a single monetary policy which affects all countries, joined together by means of a single international short-term capital market, the Euro-dollar market.

It is, of course, true that the system is under strain when the major participants in it all want surpluses in their balances of payments and gold production is limited. The system has worked well from 1950 to 1963 because the United States provided liquidity to the market by lending dollars abroad. Liquidity is something which can be earned by saving in liquid form, or acquired through borrowing. The individual, firm or country seeking liquidity borrows long and, if it accepts the liquidity in the form of dollars, lends short, i.e., holds dollars on deposit. It pays the difference in interest rates at which it borrows and lends and acquires liquidity. The lending institution — bank, savings institution, insurance company or country — lends long and incurs a short-term liability. It provides liquidity to the market and earns the difference between the long-term rate received and the short-term rate paid. When domestic financial institutions undertake financial intermediation which provides liquidity, it is regarded as normal by all but the Populists who somehow feel that banking institutions are swindling the gullible. When a country undertakes it, however, almost everyone objects. President de Gaulle and Jacques Rueff take the role of the Populists, who claim that the United States is getting something for nothing. And even the President, Secretary of the Treasury, Chief of the Balance of Payments Division of the Office of Business Economics

of the Department of Commerce, all object that the United States is in deficit because it is lending long and borrowing short. To my mind, this is not a deficit in any meaningful sense but international financial intermediation, a useful economic function which supplies liquidity to the world when and as needed.

Some part of the function of supplying liquidity to the world can, and should, speedily be taken over by the Special Drawing Rights, or paper gold, agreed upon in principle in Rio de Janeiro in November 1967 and needed to supplement or replace gold in the central banking systems of the world. But not all. Liquidity is needed by countries under two circumstances: on trend, as when the Germans, French, Italians, Japanese say they want to build up their international reserves to some pre-determined number, just a little bigger than the present figure; and in a crisis when various actors in the monetary system scramble for liquidity. Under the U.S. National Banking System which survived from 1863 to 1913, the fixed supply of money provided by the National Bank Act was satisfactory except in crisis. Since the money supply could not expand quickly under strain, crisis turned into panic, as in 1893 or 1907. The Federal Reserve System was designed with rediscount facilities to handle just this sort of crisis liquidity. In Britain, the practice was to suspend the Bank Act when trouble hit. In Walter Bagehot's terms, the remedy was to discount at a penalty rate, but to discount freely.

In the international monetary system of today, crisis liquidity is handled by the swap network which has grown up since the Basle Agreement of March 1961, which responded to the attack on the pound following the upward revaluation of the mark and the guilder. In due course, when there are sufficient consensus and experience of the Basle-Agreement sort, this swap network can be consolidated into an international central bank, which will stand over the national central banks as they in turn undergird and support their national banking systems. It would be premature to move now to such an institution. National opinion is still too much in the Bretton Woods mentality in which lending in crisis is limited by quotas scaled to accord with volumes of trade, rather than in the unlimited amounts, for but limited periods, needed to meet the requirements of financial flows. At the moment, the larger amounts of Basle-Agreement scale are forthcoming only on the basis of conditions agreed to on each separate occasion, with some countries occasionally dropping out.

An international financial *community* which will accept the size and character of the mutual obligations needed to undergird the system and cope with crises is almost but not quite built.

In addition to trend and crisis liquidity needed by countries, I want to see the system provided with machinery for dispensing liquidity internationally to private, as well as public, actors on the international financial scene. It is important, that is, to sustain an international capital market in which credit-worthy national governments, local governments, and agencies of government, and private firms can borrow through the sale of bonds, term loans, bank credits, and so on. The Bretton Woods mentality did not set much store by international capital markets. Trade was to be kept unrestricted, but there was no objection to controls over capital movements. In my judgement this was a mistake. Amalgamation of markets brings specialization in financial function, efficiency, reduced costs and benefits to saver and borrower alike. It is not enough to provide capital to developing countries through governments and semi-official agencies like the International Bank for Reconstruction and Development. In the long run, it is desirable for the developing countries to reestablish their credit and have access to a flourishing international capital market.

Such a market cannot exist, however, if balance-of-payments disequilibrium is defined to include lending long and borrowing short. This financial intermediation can be overdone, of course. But in the way the United States keeps its books, any lending long and borrowing short, a normal banking function, is regarded as disequilibrium, or at least as a deficit, and a matter for concern. The fact that the United States balance of payments has tended to produce a " deficit " on the liquidity basis of $2 to $3 billion each year (save 1957) since 1951 suggests that this is about the amount of liquidity world markets have wanted. Since 1963 the United States has sought to detach itself from the world capital market with the Interest Equalization Tax, the Gore amendment, Voluntary Credit Restraint Program, Mandatory Program, closing the Canada gap, the pension gap, etc. So long as foreigners are free to sell their United States securities and buy Euro-dollar securities issued abroad, however, the world capital market is to some extent joined. It is difficult, to an extent approaching the impossible, to control capital movements without a major program of foreign exchange controls. Effective restriction by piecemeal devices is not only well nigh impossible;

it is undesirable, and restriction could be readily eliminated if our unrealistic definition of balance-of-payments equilibrium were abandoned. A dissertation at Cornell makes the point that the British balance of payments was in deficit every year from 1900 to 1913, on the definition of balance used by the Department of Commerce, this in a period which is generally regarded as the golden age of international finance.

Liquidity is then a need, as Triffin recognized as early as 1958, but it need not be provided by gold, and it is undesirable to have it provided only by gold and SDR's or SDR's alone. In addition to trend liquidity, we need crisis liquidity and market liquidity. The present definition of balance-of-payments equilibrium stands in the way of market liquidity now, but it is the definition which is dysfunctional, not the workings of the international capital market.

Before going on to flexible exchange rates, let me say a word about gold. I oppose a rise in the price of gold for several reasons: the resultant gains would be arbitrary in their impact on holdings and new production; there is great difficulty of selecting the right price increase so as not to increase hoarding hoping for another rise, or to produce total dishoarding, as in 1934 when we had the " Golden Avalanche ", a repetition of which today would be seriously inflationary; and changing the price of gold hastens the day of demonetization by making it clear to all that gold is not intrinsically valuable but only a poker chip, which can be revalued at will. Gold is en route to demonetization with copper, nickel, silver, not to mention wampum and clam shells. There is no need to hurry to achieve the result, not because of any esteem for the magic metal, but because it is impossible to see where violent rocking of the boat would lead. Demonetization is nonetheless inevitable. The basis of national money is national credit. We approach the day when the basis of international money is international credit. The two-price system adopted in such haste in March a year ago has advanced the day of demonetization, although it did not quite achieve it. $35 for old gold, and whatever the market will pay for new gold is a viable system, more viable than I believed possible a year ago. But it leads not to $70 an ounce for monetary gold, but to the two-price system such as existed so long for silver. Almost everybody except William Jennings Bryan and Key Pitman understood that silver was a commodity, not money; in time this will also be understood about gold.

The failure to match desired surpluses in international reserves with additions to reserves is a failure of the international system. The second major gap in convergence in the system has been the failure of countries to achieve the course of incomes and prices necessary to produce adjustment in a system of fixed exchange rates. Deflation serious enough to produce unemployment has been universally excluded as a weapon of international adjustment. This leaves inflation by the surplus countries as the only available weapon. Where surplus countries prefer price stability to full employment, as in Germany, or have such high rates of increase in productivity that the most that expansion seems to be able to do is to prevent prices from falling, as in Italy and Japan, these countries will register consistent surpluses on balance-of-payments account. One way to produce price stability and balance-of-payments equilibrium is to revalue the currency upward, but this runs into opposition from export and import-competing interests. In Germany, it should be noted, the argument over whether the Deutschemark should be revalued runs between the savings-bank interests who have vivid recollection of the inflation of 1923 and the repressed inflation of World War II, and the export and import-competing interests, mainly the Ruhr and farmers.

Too often the issue over flexible exchange rates is posed theoretically in terms of target and policy variables. It is a fairly new precept of economics that one must have as many policy variables as one has target variables. To express this in terms of the old math, the number of equations must equal the number of unknowns, or one can kill two birds with one stone, only by lining up the birds with great care for a carom shot — itself another weapon in addition to the stone. With monetary policy and fiscal policy, two policy variables, one cannot hope to achieve three targets: price stability, economic growth (or full employment), and balance-of-payments equilibrium. The answer is to add another policy variable: exchange-rate policy. The formula then becomes use monetary and fiscal policy in some mixture for price stability and growth, and exchange-rate variation to achieve balance-of-payments equilibrium.

The difficulty with this reasoning, of course, is that it presupposes a single country operating in a world of fixed exchange rates. When the number of countries is two, the system becomes unstuck. Each country cannot be free to vary its exchange rate, since one country's exchange rate is the reciprocal of the others. It is sometimes said that there must be one country which has no control over its exchange rate while *all* others are free to fix whatever rate they choose. This is extrapolation from the two-country case, one country maintaining control over its rate and the other losing it. Such extrapolation may be legitimate if the United States is the country which gives up control over its rate, because it is such a large part of the world. But suppose the country which lets its rate be set by others is small, like Bermuda. Setting the rate of the pound, the dollar, the Deutschemark, the lira or the French franc on the Bermuda pound is notionally possible, but the rates that count are evidently the pound-dollar, franc-dollar, i.e. the crossrates, and these must be fixed jointly, not separately. The additional policy variable of exchange-rate flexibility is an illusion. Exchange rates must be jointly set, whether under a fixed or a flexible rate system, unless some major country is prepared to give up all control over its rate. In this case, the rate may become another target, rather than a policy variable, being forced so low in a world of inflation as to make the country absorb unwanted inflation from abroad, or pushed up in overvaluation and made to contribute to deflation in a world of existing deflation. Completely flexible exchange rates offer no hiding place for monetary authorities in search of a world of simplicity.

I shall not comment at length on the possibility of destabilizing speculation in exchange under the flexible exchange rate system. Those who favor exchange rates free to fluctuate and freed of all intervention by the authorities assume that speculation will be informed, abundant and stabilizing, in fact anticipating where the rate is likely to go and moving directly there. Others with the experience of the 1920's and 1930's in mind are fearful of destabilizing speculation in which the funds flow to or from a currency in excess amount, driving it way up or way down. In one case, speculation is a negative feedback mechanism, like an automatic pilot, keeping the rate on course; on the other, it tracks from side to side. I suggest that neither proponent is universally correct, but that in the foreign exchanges, as in the stock market, speculation is generally stabilizing but sometimes destabilizing.

The new technique for beating destabilizing speculation in the foreign exchange is the so-called crawling peg. This is a wide band plus a gradually moving parity. The wide band about a fixed exchange rate has been a reform advocated by those who were dis-

turbed by the " one-way option " offered to speculators by a currency under attack. It might be devalued and the speculators who sold it would gain. A narrow band of permissible rate fluctuation meant that the rate cannot rise much. By widening the band from ½ percent either side of parity or three-quarters percent to something like 3 or 5 percent, a speculator who guessed wrong and sold at the lower end of the band might have to suffer a loss of 6 to 10 percent when the currency moved to the other limit. The wide band is merely a constrained flexible exchange rate.

The crawling peg has a wide band plus a moving parity. In some versions the parity can change by ½ percent per month or 6 percent a year. In others, the monetary authorities have no discretion, but parity is automatically fixed by a moving average of the 12 most recent monthly averages. In this case the parity can decline in any month by 1/12th the width of the band. Whatever the technique adopted, the idea is to get some motion into exchange rates, while containing destabilizing speculation.

One must admire the ingenuity of the economists who have played with these devices, but one can question whether they have asked the right question. They seem to be repairman, finding problem after problem in the operation of the system, and repairing it piecemeal, rather than addressing the main question of the system's design. The central question is whether management of the world economy is too complex, now that commodity and factor markets have been joined by cheap transport and communication, so that we must turn back to national rather than international solutions of questions of economic policy. The fluctuating exchange rate system — whether crawling, walking or galloping — is one designed to break up the world market for goods and factors, in contrast with the fixed-exchange-rate system which operates on the principle of one market, one price, and one money.

Admittedly we have tried to maintain the fixed exchange rate system by controls over capital, tied loans, injunctions to government to purchase at home, plus protectionist controls in textiles, oil, cheese and similar sensitive commodities. But these are aberrations, rather than part of the system. It may be that the coordination of national policies needed to run the system is too great, and we must fall back on the second-best position of breaking up the world market by means of fluctuating exchange rates. If the world market must be broken up because we are incapable of producing the needed

coordinated, common or harmonized policies to run it, it is better to do it with general measures which are impersonal, such as flexible exchange rates, rather than by the visible hand of controls, which picks and chooses in an invidious way. But I am not yet ready to concede that the task of running world policies is too difficult. The great success achieved since World War II in expanding and opening up the world economy leads me to think that it is possible, even in a world where emphasis is shifting somewhat from international to domestic problems, so to coordinate overall policies in separate countries as to march along in harmony.

One market implies one price which implies one money. And one money implies one monetary policy. I contend that the world has not been on the gold standard or even the gold-exchange standard since the war, but on the dollar standard. The dollar has been the world unit of account, for reckoning prices and incomes; the world's standard of deferred payment, for the issuance of long-term bonds; the store of value, for foreign-exchange reserves until we panicked over the balance of payments in 1960; and the world's medium of exchange. Economies of scale come from using one money for international transactions. To measure international securities, the prices of international goods, foreign exchange reserves, etc., in a single money facilitates international economic intercourse. The system of fluctuating exchange rates whether changing daily as in the freely flexible system, or gradually under the crawling peg, inhibits international trade and payments because of the added risk of loss through changes in the rate at which payment for the good, or repayment of the loan is made.

The major difficulty with the system is not economic but political. The efficient economic institution which is too closely identified with a particular country can serve the international community only with difficulty. World-wide resistance to the international corporation, because it is primarily a United States firm, or to the dominant international technology because it is American in the 1960's (or because it was British in the 1860's), belong to the same basic human reactions. But the answer to them, as to the use of the dollar as the world's money, is to internationalize the institution.

When I first came to this conclusion, my inclination was to convert the Federal Open-Market Committee of the Federal Reserve System into an Atlantic Open-Market Committee. It seemed evident that it was desirable to evolve one common monetary policy which

would serve the needs of growth of the system as a whole. Employment policies could be served with domestic fiscal policies. The balance of payments of the other members of the system, though not of the United States, could be affected by changing their individual discount rates. The reason that the United States could not affect its balance of payments very much is that changes in the United States rate affect the level of interest rates throughout the system, not the difference between the New York rate and those in Europe, whereas changes in other separate rates affect the differential, not the level. This asymmetry is the consequence, of course, of the great size of the United States capital market. Other countries would have three targets and three policy variables (employment, price stability and the balance of payments as targets; the level of world interest rates, domestic fiscal policy, and the interest differential as policies). The United States would have two targets, growth and price stability, and two policy variables, the level of world interest rates and domestic fiscal policy. The balance of payments would have to be abandoned as a target, as it could be if we understood international financial intermediation, and as the British balance of payments was during the period prior to World War I when it was the financial center of the world system. The balance of payments of the United States would be the opposite of the sum of the separate balances of the rest of the world.

The Atlantic Open-Market Committee, I thought, could be rather like the Federal Open-Market Committee with certain permanent members — the United States, Germany, Britain, France, perhaps in the place of Washington and New York, and the others rotating, as Boston, Philadelphia, Richmond and the others do now. It seems wrong to have the Federal Open-Market Committee make monetary policy for the North Atlantic Committee without Europe being represented. This is what happens today; at the end of last year when the New York bank raised its discount rate, Belgium, France, the Netherlands followed. *The New York Times* interpreted this as a wave of tight money. A correct interpretation is that the world capital market is one capital market (with a few exceptions such as Britain where financiers are unwilling or not allowed to take exchange risk in dollars), and the increase in interest rates in the United States, which dominates the market, pulls up rates throughout its length and breadth and requires other central banks to bring their discount rates into line.

On mature political reflection — in which, be it noted, I am no expert and function as the rankest amateur — I have decided that Germany, France, Britain, Italy *et al* do not like to be regarded as the 14th Federal Reserve district on a par with Kansas City, Minneapolis, Dallas and San Francisco, any more than Canada likes to think of itself as the 13th. A more antiseptic political institution is needed. I think it can be found in the Euro-dollar market.

There is no need to remind you what the Euro-dollar market consists in. It is a pool of dollars in Europe, largely but by no means solely in London, which is available for borrowing by anyone outside of the United States willing to take the exchange risk, and anyone in the United States with an adequate credit standing and willing to pay the rates for large amounts of money. More importantly, it is the link among the money markets of the major financial powers which brings their rates into line. It provides liquidity to money markets in trouble, as in Italy in 1963-64, and frustration to other markets, such as the German, which seek to adopt an independent (tighter) monetary policy but only succeed in driving their borrowers out to acquire Euro-dollar funds.

Of great importance to this developing institutional pattern which I applaud, it has come to frustrate, in a degree, the operation of an independent monetary policy in the United States. The Federal Reserve System tried to tighten monetary conditions in July 1966 when the economy was heating up and nearing the boil, and Congress was uninterested in increasing the income-tax schedule. As reserves were needed in the United States, they were acquired from abroad. One could contend either that monetary policy was ineffective in halting inflation, or that it worked well on the balance of payments, or both. But from then on, the United States as well as the countries of Europe had to take into account the state of the Euro-dollar market, along with domestic monetary conditions.

As a substitute for the Atlantic Open-Market Committee, I suggest that Atlantic monetary policy, with Japan as an honorary Atlantic country as she is in the Organization for Economic Cooperation and Development, be carried out through open-market operations in the Euro-dollar market. Such operations have taken place in 1967 and 1968 at the year-end to counteract the temporary tightness induced by German bank window-dressing. The Federal Reserve Bank of New York and the Swiss National Bank on those occasions pumped some dollars into the Euro-dollar market to replace

those that had been withdrawn. This rudimentary operation could develop with time into a major weapon of monetary policy world wide. With the money supply of the United States close to $200 billion, and only $20 billion in the Euro-dollar market, some growth is needed before the tail can wag the dog. But the Euro-dollar market is developing an existence of its own, independent of national authorities, and hence free of the political overtones which are implicit in the original suggestion of converting a Federal Reserve institution into an Atlantic one. The Euro-dollar market is a dollar market, to be sure, but it is European. Subject to the banking regulations of no country, and to no inspections, evolved like Topsy to a considerable extent by accident, and not the result of planning by economists, it represents a flexible, supple instrument for the provision of liquidity, and for reducing it, an instrument which is *politikfrei*, free of national politics.

All countries must think out together what the world level of interest rates should be in the interest of growth and cyclical stability, and then separate countries can establish differentials from such a level for balance-of-payments reasons. Until the Euro-dollar market grows still further and becomes independent of the New York money market, rather than of an extension of it as it started out, the capacity of the United States to affect its balance of payments by independent action will not exist: a change in the rate in New York will be a change in the level. But these changes in the short run should be decided internationally and put into effect through open-market operations in the Euro-dollar market. Perhaps in due course the Bank of International Settlements will have developed into an international central bank for the conduct of such policies, as well as a lender of last resort for national central banks. The system is developing in this direction.

This is a fixed-exchange-rate system. But this does not mean that all rates are fixed for all time. Countries should try to stay in line with the world in prices, incomes, and so on, but when they get thoroughly out of line the only thing to do is to devalue or revalue and make a new start to keep rates stable. Rate changes should not be made in the midst of crisis. It is better to anticipate the need, or to finance the crisis with the help of the swap network or the ultimately agreed-upon international central bank, and then to change the rate on some dark night when things are quiet. I quite understand why President de Gaulle would resist a change in the

value of the French franc in the midst of crisis, and before his economists had a clear idea of where costs and prices will settle down after the disturbing wage increases of the *accord de Grenelle* of June.

The fixed-rate system is the most liberal, the most open, the most international. It may be that we lack the consensus or community necessary to run it. Perhaps. There are those who think that the world ought to be organized into monetary blocs — the EEC, sterling and the dollar, with fixed rates within them, and fluctuating rates between them. This solution is too contrived, too Cartesian and logical for my taste. The division of the world into blocs violates my political preference for *laissez faire* in trade, services and factor movements, especially of capital, and of labor from those countries which have passed through the Malthusian barrier and begun family limitation. If anything, fixed rates among the dollar, sterling, French franc, mark, lira, etc. should be set at equilibrium rates, with freedom for countries within the " blocs ", which would lose their cohesion under this dispensation, to change their rate. For Canada to adopt a flexible exchange rate is interesting and perhaps useful, without disruption for the world economy. But the key currencies should be fixed in relation to one another, if policies can be sufficiently harmonized.

Even if the major capital markets of London, Paris, Frankfurt, New York become fused into one market for short-term capital and top-grade bonds, other capital markets will be only loosely joined, as witness the spread in mortgage rates between the East and West coasts in the United States. But the world continues to shrink. Just as the lifting of Regulation Q in New York affected the savings and loan associations in California in 1966, so one day — not too far away — the mortgage markets of Japan, Southern Europe and the United States may be joined through the Euro-dollar market. In a world of joined markets, we need joined policies. If policies remain separate, we must — to my great regret — separate our markets.

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