Cooling Off the Money Crisis

By HENDRIK S. HOUTHAKKER

Paradoxical though it may seem, the adoption of floating rates by all the major trading countries is likely to bring a greater degree of tranquility to the international monetary system than it has seen for several years. The long series of monetary upheavals that started with the devaluation of the pound in 1967 may at last be coming to an end.

This optimistic prognosis is not based merely on the fact that, with floating rates nearly universal, any further change will have to be in the direction of less flexibility of exchange rates. In fact, it is by no means obvious that the floating exchange rates will be subject to much fluctuation; the U.S.-Canadian dollar exchange has hardly moved at all since the Canadian dollar was floated nearly three years ago. Other floating currencies, especially the pound, have shown somewhat more volatility, but the exchange rate between the U.S. dollar and the six continental currencies is more likely to follow the U.S.-Canadian pattern.

There are three main reasons for expecting that international monetary affairs will gradually move from the front page to the financial page of our daily newspapers. The first reason is that the defenders of fixed exchange rates should by now have realized the futility of their last-ditch fight and may find some merit in floating after all. Except for Canada, which has a long history of floating, four other countries that adopted floating rates during the last few months (Britain, Switzerland, Italy and Japan) did so reluctantly, but having tried it, they liked it. Britain's only regret appears to be that it did not adopt floating 15 years ago, in which case its recent history might well have been less depressing. The other three, for reasons of their own, will probably find it difficult to go back to a fixed rate, although in the case of Japan the float is so "dirty" that it probably would not make much difference if it did. Among the six most recent converts, Germany and Holland already had some previous experience with floating rates, while Belgium had been running a dual rate system. It is mainly M. Giscard d'Estaing who now has to eat his golden words.

Improved Competitive Position

The second reason for expecting greater tranquility is the greatly improved competitive position of the United States. Until a few weeks ago it looked as if we had not gained any trade benefits from the devaluation of 1971. Now that the December trade figures have been revised and the January trade figures have shown further improvement, there are indications that we may have turned the corner. The large trade deficit of 1972 resulted from a sharp increase in imports combined with initial sluggishness in our exports. From the middle of 1972, however, our exports have shown new vigor, and in January they were running at an unprecedented annual rate of nearly $60 billion. One should not give too much weight to one month's figures, but the upward trend is unmistakable.

It is too early to say how much of the gain in exports is due to our devaluation and superior domestic price performance, how much to improved economic conditions abroad, and how much to special circumstances such as the world-wide grain shortage. All of these factors have probably played a part, but since they may be with us for some time, the outlook for our exports is favorable. The rise in the value of our imports reflects partly the strong recovery in our economy, partly the higher cost of imports due to devaluation. Our growth rate will probably taper off somewhat and the devaluation effect is of a once-and-for-all nature, though of course repeated this year. On balance we are likely to see a significantly smaller trade deficit in 1973, accompanied by some improvements in other items of the balance of payments.

The third reason is that the dollar has come through all these crises stronger than ever. Its exchange value in terms of other currencies has been reduced, but no substitute for its predominant role in world finance has so far appeared, and none is on the horizon as long as the members of the European Economic Community cannot agree among themselves. All the brave talk about dethroning the dollar, for instance, by going back to gold, has come to nothing.

If the expectation of an improved U.S. balance of payments is realized it also means that we can now begin to de-emphasize the policy of "benign neglect" which we have been pursuing for the last four years, and which has been crowned with considerable success. This policy, first formulated by a Republican pre-election task force in 1968 under the chairmanship of Professor Gottfried Haberler of Harvard, was aimed at forcing a depreciation of our overvalued dollar. At that time there was no possibility of devaluing the dollar unilaterally, since several other countries had made it clear they would devalue by an equal amount, thus nullifying our move. These countries therefore had to be persuaded by a continuing accumulation of inconvertible dollar balances.

It was not an easy policy to carry through; for one thing, it could not be publicly explained and therefore was widely misunderstood not only abroad but also by several influential newspapers in the U.S. It put a considerable strain on the international monetary system, and even so results were slow in coming.

The drastic actions taken by John Connally while he was Secretary of the Treasury were a departure from the tactics, though not the strategy, of benign neglect. His successor, George Shultz, wisely returned to the previous approach; thus reports of last week's meeting in Paris quoted him as responding to European pressures for higher U.S. interest rates by saying that our interest rates are determined by domestic considerations. Such statements are the essence of benign neglect, and so was the announcement that we will phase out our capital control programs by the end of 1974. At the same time it appears that by avoiding his predecessor's strongarm methods, Secretary Shultz has preserved international harmony.

Secretary Shultz' Proposal

From this rather sanguine interpretation of recent events it should not be inferred, however, that the millennium is now at hand. Although recent experience with floating rates has been favorable, they may raise more serious problems in the longer run. Importers, exporters and bankers can probably live with them, since they can generally hedge their exchange risks, but the effect on direct investment may not be so innocuous. There is at present also a huge volume of "hot money" whose movement may at times be destabilizing. Consequently the search for a more stable international monetary system should not be abandoned; to arrive at such a system was indeed a second purpose of the strategy of benign neglect. Secretary Shultz made a fair and comprehensive proposal to this effect at the IMF meeting last September, but until last week it apparently created little enthusiasm among other countries. This proposal was intended to preserve the good features of the Bretton Woods system while making it more responsive to changing economic conditions. Now that the fixed-rate diehards have at last had to admit defeat, the prospects for durable reform may have suddenly improved, and the pressure for reform will become overwhelming if universal floating rates turn out to be unmanageable. But whether or not floating rates will last, we are now much closer to international economic equilibrium than we have been for a long time. Provided we continue to pursue a responsible fiscal policy and keep our monetary policy on a more even keel, we may have confidence in the maintenance of an open world economy.

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