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THE DOLLAR AND THE POLICY MIX: 1971

ROBERT A. MUNDELL

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
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The author, Robert A. Mundell, is Professor of Economics at the University of Chicago. He has written many articles in the field of international finance and several books, including most recently, Man and Economics (*1968*), International Economics (*1968*), Monetary Problems of the International Economy (*with A. Swoboda, 1969*), *and* Monetary Theory: Inflation, Interest and Growth in the World Economy (*1971*).

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FRITZ MACHLUP, *Director*
International Finance Section

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THE DEFICIT AND THE DOLLAR

A decade ago Professor Rueff characterized the American balance-of-payments deficit as a "deficit without tears." He meant that the United States could buy expensive-to-make (European) resources with cheap-to-print dollars. The international use of the dollar granted what General de Gaulle called an "exorbitant privilege," an automatic access to credit analogous to free emergency overdraft facilities, adding an extra dimension to American power. Other countries had adopted the dollar because it had become the unit of account, the currency of settlement, the intervention currency, the dominant vehicle currency, and a major reserve asset of the international monetary system. Unlike the United States, other countries had to *earn* reserves by running balance-of-payments surpluses. In the 1960s the United States did shed some tears over the deficit, but they were largely of the crocodile variety.

In 1970 and early 1971 the deficit has been much larger than usual and a source of great embarrassment to the United States. Its tears have showered the Bundesbank with liquidity, although some of the problem has been eased, apparently, by forward operations and mopping-up special sales of short-term securities by the Treasury. The short-run weakness of the dollar hides its long-run strength, which is based on the dominating power of the American economy. But the temporary difficulties of the short run represent hurdles that have to be jumped, and the weakness of the dollar today could cause very important long-run changes in the international monetary system.

Is the deficit a menace to the dollar? Fritz Machlup could anatomize the word "menace" and find twenty-five meanings for it. It could be a menace to the gold stock in the short run. If the gold window is shut, the deficit might threaten the role of the United States as the world's financial leader. The rest of the world could conceivably set up its own system and exclude the United States, or the system could break up into "optimum-currency areas." If, on the other hand, the deficit increases and foreign countries swallow or spend the dollars, the resulting increased world money supply would aggravate world inflation and threaten confidence in currencies, including the dollar. If the European countries one by one changed their exchange rates, they would sacrifice some of the financial integration that has been a major contribution of the dollar, upsetting the stability of expectations, and further promote the "dollarization" of the world economy. Similarly, if other countries

adopted flexible rates, the dollar's strength would increase, because of its unchallengeable liquidity properties, in comparison with the currencies of the smaller countries. Finally, if the Europeans formed a currency coalition against the dollar or created a new sovereign currency, a two-bloc system would reveal the need for explicit coordination of policies to accommodate the financial interests of the two blocs. But the dollar bloc would still be larger than the Eurobloc even if the latter included the United Kingdom. Its transactions domain would encompass well over 60 per cent of the world's transactions, so huge is the domestic dollar domain. A European currency represents no direct threat to the United States, except that it would curtail the dollarization of Europe. It would promote European integration and the competition from a friendly rival might inspire the United States to a better economic performance.

Should the United States ignore its balance of payments and govern its policy solely by the needs of internal balance? A change from the present system is not cheap. America would give up substantial international power (which would be good or bad depending on one's appraisal of her current and expected future use of it). A "passive" policy or "benign neglect" is a trap.

The menace to the dollar, however, does not lie in the international sphere as much as in the inflation and unemployment policies of the United States. Inflation is neither necessary for, nor conducive to, full employment. We shall argue later that inflation causes unemployment.

In the meantime the American depression of 1969-71 will have created a loss in output foregone approaching $100 billion, an incredible waste for the entire world and perhaps the most serious factor undermining world confidence in the economic leadership of the United States.

The best defense of the dollar involves policies to restore the American economy to full capacity, and stop, or at least reduce, inflation. The purpose of this essay is to show that restoration of equilibrium requires a change in the American policy mix. The current policy mix leads to more inflation and unemployment. The correct policy mix will save billions of dollars in output. In introducing the correct policy mix and getting back to full employment the United States will prevent the tears of the deficit from flooding the rest of the world with too much liquidity.

In this first section, I consider the cause of the deficit and the reasons why it should not be neglected by a "passive" balance-of-payments policy. In the second section, I put the case against the present policy mix and show that it will cost the United States $100 billion in foregone output before the recession is over; loose money and sagging interest rates will not solve American problems. In the third section, I show why a tax reduc-

tion will lead to increased employment, output, and growth and, if combined with sufficient monetary restraint, will stop the inflation and bring the deficit down to levels the rest of the world can tolerate.

Two Explanations of the Deficit

"The" deficit is the increase in dollar liabilities of the United States plus gold and SDR losses. It has been the major source of reserve growth of the rest of the world for a decade. The deficits averaged about $1 billion annually in 1950-57, about $3 billion in 1958-64, and in recent years have been over $7 billion. In 1970 the deficit was $9.8 billion.

The two official measures of the balance of payments, the liquidity (Lederer) and the official-settlements (Bernstein) measure, differ in their treatment of changes in short-term capital holdings of foreign commercial banks. If dollar liabilities to foreign *commercial* banks increase, the liquidity, but not the official-settlements, deficit rises. If the liabilities are accumulated by other *central* banks, both the liquidity and the official deficit increase.

The two measures of the deficit alternate over the business cycle. Foreign commercial banks support the dollar during American booms when interest rates are high as they move funds into the Eurodollar market, while foreign central banks have to support the dollar when interest rates are low and commercial banks move out of the market. The liquidity deficit was high in 1969, but the official measure was in surplus. The official deficit was high in 1970 and will be high in 1971 as long as American interest rates are low and the American economy is more depressed than those abroad.

Even if the dollar had no special status as an international currency, the tremendous size of the American economy would give its balance of payments special significance. The chronic character of the deficit has its origin in the global role of the dollar, which itself is due to the great economic influence of the giant economy. The United States produces financial assets the rest of the world wants to accumulate and that demand is likely to grow as long as the United States is a stable political power.

The rest of the world tolerates the dollar standard because there are only less satisfactory alternatives to it at the present time. Commercial banks and multinational corporations use the dollar abroad as the settlement currency for commercial transactions (vehicle currency). American banks can branch abroad to do what they are forbidden to do at home and dollar deposits in branches of American banks, as well as foreign banks, have grown to tens of billions of dollars serving American and other multinational corporations. The new international banking groups

like Orion use the dollar as the dominant currency. Commercial banking has leapt into the vacuum left by the official banks and created, in effect, a new world currency and central bank. The international corporations use both American branches and national banks, but the major international currency for multinational corporations is overwhelmingly the dollar, which now accounts for perhaps one-fifth of the deposits of foreign banks. Superimposed on this huge private demand for the use of dollars are the official demands of national central banks, which are still important despite the increasing domination of great commercial banks.

A legal detail enhances the international position of the dollar—worth mentioning here only because it would assume importance if the advocates of a passive balance-of-payments policy have their way. In 1949, the U.S. Secretary of the Treasury wrote a letter to the Managing-Director of the IMF affirming that the United States was freely buying and selling gold under the provisions of Article IV-4-b of the Bretton Woods Charter, which exempts a country from provisions of Article IV-4-a requiring it to peg the exchange rates of other members to within one per cent of par value. In 1959 a by-law further enthroned the dollar by formally establishing the key-currency principle, by which a single convertible currency can be pegged in lieu of that of every member. Naturally the dollar was continued as the intervention currency by most countries (except those in the sterling, franc, and escudo areas), and adopted as master currency under the European Monetary Agreement. Only the United States adopted Article IV-4-b, so the dollar is the only currency "freely convertible into gold" for foreign central banks, and the United States is therefore the only country exempt from the need to intervene in the exchange markets. At least since 1968, American gold convertibility has become a bit of a myth, but the risk of the United States formally closing the gold window and changing the system inhibits outright challenge to it. The United States has had no need to close the window, because other countries have not come to it.

Theories of the deficit have grown with its size. Robert Z. Aliber has made a useful distinction between demand theories and supply theories. The demand theory is that the rest of the world wants the dollars it gets and will always follow policies to get the dollars it wants. The supply theory is that the world has to take the excess dollars the United States supplies and that if other countries try to inflate their surpluses away the United States will just feed them more dollars. There is a third theory that is general. The general theory is that the deficit is the outcome of both demand and supply forces and that the initiative for a change in the deficit comes sometimes from demand (as when foreign liquidity ratios are low) and sometimes from supply (as when American

monetary expansion accelerates). The general theory is correct, because both blades of the scissors do the cutting. It is a tautology, however, because both supply and demand can be broken down into voluntary and involuntary components. A theory should explain what Fritz Machlup has called the "involuntary demand" for dollars. The special theories illuminate the difference between the two measures of the deficit.

The difference between the demand theory and the supply theory helps to explain the cyclical variations in the liquidity and official deficits. The liquidity deficit is high when the commercial holding demand for dollars is strong and the official deficit is high when the official American supply of dollars is strong. Thus, during recessions the official deficit is high whereas during booms the liquidity deficit is high, because demand abroad is strong and interest rates are high. The analogy to shifts in the accounts of American banks between demand and time deposits over the cycle is apparent.

The procyclical variation of interest rates in the United States causes, after allowance for cycles abroad, a procyclical movement of the capital account which is usually associated with an anticyclical fluctuation of the trade-balance surplus. This appears to have been the historical pattern for the United States whenever it was not offset by cycles in the rest of the world. The capital account has dominated the trade balance procyclically and led to American payments surpluses in booms and deficits in depressions (the post-devaluation years, 1936-40, are an exception). Because the demand for money is procyclically strong, it is associated with an excess supply of securities or goods, leading to a surplus on capital account, the trade balance, or both. The money goes where the action is.

Inflation and the International Demand for Dollars

World inflation increases the demand for dollars because of a *depreciation demand*. This is true for both internal and external use of dollars. A neutral inflation throughout the world thus increases the nominal value of the deficit, though not necessarily its real value, which depends partly on alternatives to the use of dollars.

Analysis of inflation originating in the United States (as when American monetary growth accelerated in the summer of 1965) is slightly more complicated. American monetary acceleration in the face of weak demand abroad creates an excess supply of dollars that fall into the hands of central banks abroad, creating initially unwanted surpluses, but eventually lead to worldwide inflation. Rising prices in the world as a whole increase both the commercial and official demand for dollars to compensate for the decline in the liquidity value (purchasing power) of the outstanding stock. The world demand for dollars depends on the money

value of global transactions, and general price increases raise both the supply and the demand for dollars.

It sounds paradoxical to say that inflation increases the demand for dollars, but the difficulty is unravelled once the *real holding demand* is separated from the *nominal holding demand*, and the stock of reserves is distinguished from the *flows* replenishing those stocks. I have elaborated on this in my *Monetary Theory: Inflation, Interest and Growth in the World Economy* (1971), especially chapter XIV on "International Liquidity and Inflation," but it is worth reiteration here that foreign countries can be illiquid even during a raging world inflation. The greater the rise in world prices—especially of internationally-traded goods—the greater the erosion of liquidity. To preserve the reserves/imports ratio, nominal reserves have to rise with the rate of inflation even though the reserve expansion itself is the source of the inflation. Assume world reserves are $80 billion. Then, if the world inflation rate is 5 per cent and dollars are the only source of reserves, the deficit would have to be $4 billion just to allow other countries to maintain their customary conventional international-liquidity ratio. The conventional liquidity ratio is reached when the ratio of imports to reserves is equal to the ratio of GNP to money, which for most countries implies reserve holdings of about three to four months' imports.

Inflation and the American deficit represent a source of seigniorage for the United States that is analogous to a tax on foreign dollar balances, the rate of the tax being the inflation rate, and its base the real value of existing reserve balances. If the United States gains seigniorage from inflation (because foreigners pay part of the tax) but lose because they pollute the home monetary environment, the gains and losses lead to a theory of an optimum balance-of-payments deficit. This enables the United States to exploit the fact that part of the incidence of the inflation tax is borne abroad, which, for low rates of inflation, exceeds the welfare cost of the inflation to residents of the United States and leads to a concept of optimum inflation rate and optimum balance of payments. (See my "The Optimum Balance of Payments Deficit," paper presented to the Conference on Monetary Policy in Open Economies, Paris, March 1971. The proceedings of this conference will be published in a book edited by Emil Claassen and Pascal Salin of the Jean-Baptiste Say Seminar, University Dauphine, Paris.)

Loose Money and the Deficit

The American deficit increased during the 1969-71 recession, and monetary policy, judged by the level of *real* short-term interest rates, has been extremely easy. For several months the United States has been

pumping the economy full of liquidity in the hope of starting a revival, but the appetite for liquidity has increased as memories of the 1966 and 1969 squeeze linger. The influx of dollars into central banks abroad in 1970 and early 1971 approaches tolerance thresholds in some countries and forward support for the dollar has been thought necessary by the Federal Reserve. At the same time there has been a weakness in real demand in several countries and unemployment rates have risen.

At the Copenhagen IMF meetings in September 1970, the Managing Director asked the United States to accept some reserve losses to cover the deficit. This opens the way for some gold conversions by major countries. Although in principle the United States could use foreign-exchange holdings, IMF drawings, and Basle arrangements to finance the deficit, the credit already provided to the United States by dollar accumulation is an alternative to these sources. Gold conversions are disintermediatory, if not automatically offset by American sterilization operations. Since disintermediation is desirable when there is excess liquidity, the United States could accept some gold losses if it were not allowed to lead to a panic. The purpose of a gold reserve after all is not just deterrent—to have some to lose—but to be willing to lose some when its opportunity cost rises.

Gold losses not offset by credit expansion would tighten the American money market and eliminate the loose-money problem that arises when short-term rates go below either the expected rate of inflation or the anticipated capital losses on bonds. Not much help is given to the domestic recovery program by forcing dollars into an unreceptive money market after interest rates have got below 4 per cent (with a 4-per-cent expected inflation rate) and while there is an expectation of rising long-term interest rates. At that point savers prefer to stay out of the bond market until the expected fall in bond prices has materialized; a liquidity trap thus emerges at a short-term money rate of interest equal to the expected short-term rate of inflation. Further monetary expansion after that point merely leads to expectation of further inflation and rising nominal interest rates. The demand for bank loans will recover only when confidence in recovery is assured and inventories have been run down.

The belief that easy money promotes expansion rather than inflation at home is a gross exaggeration. There is, of course, an international route through which accelerated monetary expansion can help revive demand. Expansionary monetary policy in the United States feeds liquidity abroad and stimulates American exports, as foreign countries try to reduce their surpluses by competitive inflation. Some gains can be expected through this route, but its international risks are very high. To the extent that the slump in employment becomes worldwide, it would be less harmful *if*—

and the "if" needs emphasis—it did not *pari passu* aggravate inflationary expectations. The present is of course the best time for other surplus countries to lower trade restrictions and buy more American goods, reciprocating the easy-money advantages provided to Europe by the United States when major European economies were depressed in 1967. But rising unemployment is not confined to the United States alone and a relaxation of trade restrictions is not politically easier in Europe or Japan than in the United States. The United States cannot, therefore, rely much on stimulating exports by stuffing central banks abroad with dollar reserves, forcing them to inflate unwillingly or even revalue their exchange rates outside the framework of an explicit cooperative solution. There is already an overdose of monetary expansion in the Western world. Increased American monetary expansion begets more foreign monetary expansion, leading to more world inflation, not more real expansion.

The phenomenon of inflation makes interest-rate theory more complicated, because it becomes necessary to distinguish between the real and nominal interest rate, and also the natural and market interest rate. The natural interest rate changes with a change in the shortage of capital. The (real) market interest rate rises and falls with the level of employment over the business cycle. Short- and long-term interest rates follow a concertina pattern over the business cycle, because of expectations. Real and money interest rates diverge with increased expectations of inflation.

It is sufficient for most policy purposes to distinguish four main factors leading to a rise in interest rates. Interest rates rise when there is (1) an increased shortage of capital, (2) a strengthening of the domestic economy, (3) expectations of accelerated monetary expansion and inflation, and (4) monetary restriction caused by open-market sales of securities with unchanged expectations. What is needed is higher real interest rates engineered by prompt budgetary expansion. In the meantime, monetary glut should be prevented both to forestall a renewal of inflationary expectations and to protect the balance of payments.

Passive Policy and the Dollar-Standard Solution

The rest of the world cannot force financial discipline on the United States short of bringing on a crisis or organizing its own system without America. The position of other countries would not be helped if they forced a change in the system by pressing dollar conversions to the point where the Treasury closed the gold window; the 1965 revolt against the dollar was unsuccessful because the alternative of the gold standard did not in 1965 seem preferable to the dollar standard. A solution to the

international-stabilization problem has to be compatible with stability of the American economy.

The announcement of a passive balance-of-payments policy has a legal kick, and would create a credibility gap about American involvement in the international system. If the United States closed the gold window, she would relinquish the privileges of Article IV-4-b and instead become legally required to keep exchange rates of other IMF members within one per cent of parity. A new intervention system would have to be developed to replace the provisions of the 1959 by-law, referred to above. If it fails to support the dollar and "goes it alone" it gives up the status and privileges of a convertible currency and opens the way for the rest of the world to use the IMF to create a new international monetary system without the United States.

I do not want to exaggerate the importance of these legal complications. The Fund has in the past found ways of accommodating aberrant legal behavior ever since its first brush with France in 1948, and since May 1970 the Canadian dollar has been flexible. It is unlikely that the IMF would be used as a means of retaliating against the United States. Nevertheless, unilateral action is not a correct posture for a world leader whose role should be exemplary.

But the disadvantages of a passive policy do not rest on legal issues. A go-it-alone policy has the ring of neomercantilism. For a decade the United States has pledged its commitment to keep the dollar as good as gold and reiterated its commitment to the international system. To adopt a "take-it-or-leave-it" posture with respect to the dollar in 1971 is to invite a backlash and enhance the gulf between Europe and America. Monetary isolationism would bring in its wake isolationism in trade and surrender American influence on the evolving world system, and it would do so for benefits that have never been adequately explained or defended.

The benefits of a passive policy for the United States are almost nil. There are no economic costs to a balance-of-payments policy that can be escaped by avoiding its discipline, unless one sees the answer in more American inflation masquerading as expansion. No additional resources are acquired by giving up concern for the balance of payments, nor is American policy likely to improve as a result of ignoring its balance of payments. One can hardly argue that balance-of-payments policy has caused excess unemployment, at any rate since 1931-34. American policy would not have been better served by a more rapid monetary expansion over the past few years.

The fact is there is no conflict between the external goal of a more acceptable balance-of-payments deficit and the American and worldwide