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SOME POSTWAR POLICY OPTIONS

Remarks of

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This is a most pleasant occasion. The topic "When Peace Comes" is both hopeful and exciting in its promise for the future. I found it relaxing to stop worrying about day-to-day events in order to examine some basic problems that may have to be faced in the future. As I understand the purpose of today's seminar, it is to look beyond immediate worries in order to develop analytical concepts useful in projecting economic promises and performance in the period well beyond the next six months or year.

A bonus in peering ahead was my sudden recognition that sometime in the year 1970, less than two years from now, the U.S. economy will be turning out goods and services at an annual rate of over one trillion dollars.

I want to discuss only two of the many welcome questions raised by this seminar's topic, "When Peace Comes":

(1) What sort of monetary policy--or, as a corollary, what type of interest rates--might appear useful for the first postpeace year?

(2) Is a desirable policy achievable? Or, what basic domestic and international forces might make it difficult to achieve?

The briefest answer is that more credit than is now available and lower interest rates should be both useful and efficient for the immediate postwar type of economy. The achievement of such policy objectives will depend on the path that prices, wages, and monetary and fiscal policy take between now and then. The important fact though is there appear to be no insurmountable barriers to the adoption of such a policy goal.

As an aside, I have assumed that this conference is primarily concerned with the underlying relationships expected in some Year P, the first postpeace year. What year that will be is uncertain because we don't know how long negotiations will take nor what the resulting speed and degree of demobilization will be. For convenience I have thought of Year P as 1970. However, the analysis would still apply if the first postpeace year were either earlier or later.

Similarly I have not attempted to forecast interim policy. I have thought of Year P as one in which most of the war's impact on the economy will have faded away. I assume our current problems--too large a budget deficit, too rapid rises in prices, too much Federal demand for financing will have been solved. If they have not been, major adjustments in the analysis might be necessary to account for any remaining disequilibria.

Private Investment

My projection for 1970 as Year P shows large and growing requirements for both domestic gross private investment and net exports. Their dollar total should be at least 25 per cent higher than either the latest quarter or the average of the past two years. Perhaps more significantly, gross private investment may be expected to rise from the current rate of 14-3/4 per cent of the GNP to a rate of 16 per cent.

Each of the three basic sectors of private domestic investment should partake in this expansion.

Many have been concerned with the viability of recent rates of investment in plant and equipment. Certainly they have been extremely high--at record-breaking levels--for the past three years. On the other hand, with an expanding economy, continued rapid improvements in technology, and growing wage costs, demand appears adequate for these expenditures to continue to run in the neighborhood of 10.5 per cent of the GNP.

The value of residential construction (given adequate financing) should rise by more than 50 per cent compared to 1966-67. I say this even though I believe that most observers overestimate the number of new housing starts required in the next three to four years.

Since investment in business inventories in normal periods is primarily related to growth in the economy, I would expect inventories to expand in the vicinity of $8 billion a year.

A fourth sector of the investment sphere is the transfer of resources abroad through net exports of goods and services. Our knowledge and ability to project in this sphere is minimal. The amount of required investment will be directly related to the role the U.S. wants to play internationally. With our military commitments, the world need for aid, plus that for direct private investment abroad, a net non-military export goal of $10 to $12 billion a year would seem small rather than large. My later remarks are pertinent to the question of whether such a level is possible.

Public Investment

Because it depends on thousands of political decisions, forecasting public investment is far more difficult. I see no indication that this demand will decline. On the contrary, I guess that it will grow even more rapidly than private demand. Certainly the needs for investment brought about by the increasing pollution of our air and water, the continued deterioration of our cities, our growing needs for recreation, as well as the rapid expansion of higher education, medical care, and similar community activities all point to greater, not lower, needs for public investment.

Monetary Policy

Most economists would probably agree that these large investment requirements could be met more easily and efficiently in an economy characterized by comparative monetary ease and with considerably lower interest rates than we are now experiencing. At lower interest rates, individuals, firms, and local governments could finance more of their needs directly in private financial markets. More decisions would be decentralized. The achievement of those needs which seem to be rising in our national scale of values--housing, slum clearance, transportation, hospitals, schools, colleges--would be enhanced if there were lower interest rates with funds more easily available.

Granted the desirability of such a monetary policy, are there any obvious factors standing in the way of its fulfillment? On the domestic side the answer seems clearly to be no. Easier money and lower interest rates should be possible in the first postpeace year. Whether the correct policy mix needed to obtain it will be selected is, of course, an entirely different matter.

Examining the possible flow of funds needed to finance the large investment of Year P, we find no need for significant deviations from relationships experienced in recent years. The amounts needed for each market can be reached through a continuation of recent trends. While mortgage requirements are above recent levels as would be expected from the sharp expected spurt in housing, the general distribution of funds would come close to that of many postwar periods.

Differences from the past are well within ranges that could be offset rather easily by minor shifts in fiscal policy. The war's end will see a sizable peace dividend available for government programs. As Vietnam expenditures are phased out, revenue surpluses should develop sufficient to expand current programs, add new ones, or alter the deficit.

Because the projected financial flows are close to balance, rather minor shifts in Federal borrowing should bring about an equilibrium at considerably lower interest rates. In addition, if the Federal Government increases its grants and direct lending it will reduce the burden on the financial markets by lowering the amount of funds recipients would otherwise have to borrow in the market.

In the first postwar year, as in recent ones, fiscal policy will be a major determinant of the height of interest rates and the general availability of credit.

International Monetary Policy

The idea that there are no obvious domestic impediments to easier money now visible for the postwar year and that an easier money policy could result from a proper fiscal package is understandable, explainable, and probably acceptable to most of you. Can the same statement be made on the international side? Is there something basic in international financial relationships which would make it difficult to achieve the type of monetary policy we would choose for domestic reasons?

Again my general answer is <u>no</u>. International financial forces should not require higher interest rates than are desirable for domestic reasons. I must admit though that the analysis in this sphere is far more complex. We lack the data, the concepts, and the models that are the equivalent of those available for the domestic economy. In addition, traditions, emotions, conflicting aims, and misunderstandings tremendously complicate analysis.

Since international questions are so important and since the lack of understanding is great, I will spend the rest of my time on it. I will take a single abstract hypothetical problem and try to show its various policy possibilities as simply as I can.

Gold

First let me point out that the required analysis has little or nothing to do with gold. Most discussion and much analysis intermingles and confuses two rather separate problems: that of confidence and stability in our international exchanges with the much more difficult problem of balance of payments adjustment. The gold problem is mainly one of confidence and reserve stability. It may but need not be related to the problem of how a country adjusts its balance of payments when they are in either deficit or surplus. I intend to talk only of the second or adjustment problem.

Good discussions of the adjustment problem are fewer than they should be because so many concerned with the balance of payments have spent so much of their time in the past 10 years fighting the brush fires associated with the problems of stability and gold. Perhaps as a result of the Washington-Stockholm conferences in March, gold will more and more assume the role of comparative unimportance to which most modern economists have wanted to relegate it.

As I see it, these two conferences were extremely important because, among other things, they make it possible to separate the problem of stability from that of adjustment. Each of these problems may now be faced up to logically and separately. The two-tier gold system and its semi-demonetization of gold is a recognition of and a solution to one of the problems that arises naturally in an exchange system based on several types of reserves. Such difficulties are exacerbated when a reserve serves multiple purposes as does gold by being both a commodity and a monetary reserve.

More importantly the conferences seem to me a public recognition by the major countries of what many economists have preached for years--that there is no necessary relationship between the price of gold and the world's balance of payments problems. The conferences may also be interpreted as a significant reaffirmation of the determination of the major countries not to allow fear or market speculators to dominate logical unified international financial policies.

Interest Rates and International Adjustment

For our discussion of balance of payments adjustment, let's pick as simple a problem as possible. Let's assume that in Year P, the United States successfully adopts the best possible mixture of policies to meet our domestic goals. The index of wholesale prices of industrial commodities is constant. Growth of real GNP is close to 4.5 per cent a year. Unemployment is at its structural minimum.

What would happen? What would be gained; and what lost if monetary policy were now used in an attempt to adjust the balance of payments?

First one might ask how there could be a balance of payments problem when the domestic economy was in ideal balance. The answer is that there is no necessary relationship between the post-Vietnam situation which will exist in the domestic economy and the resulting international balance. Our Year P balance of payments will depend on where our domestic prices stabilize relative to those in foreign countries. It will be influenced by accumulated deficits, longer term liabilities, and backlogs resulting from current policies. Even assuming all controls and special taxes will be removed, a backlog will remain of potential investments, lending, and travel held back by prior restrictions. Equilibrium will also depend on whether foreigners wish to increase or decrease the dollars they hold for transactions or reserve purposes.

Most important will be decisions as to the Government's postwar military and aid commitments. Many people believe that our recent annual totals of net lending abroad by the U.S. Government, grants for economic aid, and net military expenditures abroad of $7 billion--under 1 per cent of GNP--should be our minimum target for the future. Many observers believe that to perform its proper role, given our size, income, and importance of the dollar, the U.S. nonmilitary net export balance, which averaged $8 billion in 1966 and 1967, ought to run between $10 and $12 billion.

Since predicting where we might or should end up is at this point almost entirely guesswork, I shall not attempt it. Instead, I'll pick an entirely arbitrary example. Let's assume that in our postwar world with ideal domestic conditions, we decide we want to increase our net balance on nonmilitary goods and services and private capital movements by $3 billion per year. It doesn't matter whether this is to give more aid, reduce a deficit, or keep more troops overseas.

How could monetary or interest rate policy help to bring about the desired adjustment? Through what channels would it work? What sort of relationships seem to exist between domestic changes and those in the balance of payments? What other possibilities of adjustment exist in addition to domestic monetary or fiscal policies?

Higher Interest Rates and Tighter Money

There are three separate channels through which higher interest rates may influence the balance of payments.

(1) The first is through the form and location at which people hold their assets and liabilities.

(2) The second is through reducing the level of income and production.

(3) The third is through reducing the price level below the point it would otherwise reach.

It is clear that higher interest rates may act and react through each channel simultaneously. For ease of exposition, however, let's examine each separately.

The Direct Effect of Differential Interest Rates

Surprisingly our actual knowledge of impacts is probably least in the area where the expected effects of changing interest rates on the balance of payments are most traditional while the controversy over its effects may be greatest. It seems obvious that higher interest rates ought to improve the balance of payments by attracting more money and reducing U.S. lending abroad. Liabilities held by foreigners are shifted from central banks to private banks or individuals. Assets held abroad by U.S. banks and investors increase less than they otherwise would have. Our reserve position improves. Depending on definitions, our balance of payments may also.

Others argue, however, that such an apparent improvement does not really aid in adjusting the balance of payments. The country's total liabilities may be unaltered. Added deposits of short-term money that are not simply a transfer of existing outstanding liabilities would perhaps help. Even in this case, however, the basic situation may actually become more unstable if the added liabilities are "hot" and likely to move at the least provocation.

Along with changes in our assets and liabilities there will be changes in receipts and payments of investment income. We may increase our reserve stock temporarily and our debts equally, but we do not improve our net annual flow of earnings. In fact, income may decrease and the future deficit may become worse. Higher payments will be made to foreign holders on both the new and pre-existing liabilities.

If the investments that are attracted are longer term or direct, this is usually considered a more permanent force. Many would consider this a true basic adjustment. A debate does exist, though, as to whether indirect effects on investments through lower income would not completely outweigh the direct effects. If our income growth fell below the optimum, fewer foreigners would invest here. Whether more U.S. firms and individuals would also invest abroad is not at all clear.

Changes in Income and Production

Domestic monetary policy can influence the balance of payments if it successfully alters domestic production, income, and employment. Balance of payments deficits will decrease if a lower GNP leads to smaller imports and a greater desire to export. Some idea of the probable order of magnitudes involved can be obtained from the many available econometric models. Specific estimates in this sphere must be taken with more than the normal grain of salt, but the numbers express the common sense concepts of experience.

The statistics suggest that for each decrease of $10 billion annually in the GNP (assuming for the moment no price effects), U.S. imports of goods and services should drop by $550 to $650 million. Exports would not gain but would be expected to drop because when other countries' income decreases as a result of selling less to the

U.S. they will buy less from us. Depending on how they react, on the time period under consideration, and the amount by which they can offset the fall in income, the net gain in the entire balance of trade estimated by these models is from $150 to $350 million per $10 billion drop in the U.S. GNP. In other words, if the tighter money were effective only in lowering income and did not influence prices or the form of assets, it would require a GNP decline of from $85 to $200 billion per year below its normal rate to offset a deficit of $3 billion in the balance of payments.

Price Effects

Tighter money does not affect income alone. With higher unemployment, prices rise less rapidly. Whether or how much prices would fall is not as clear. U.S. wholesale industrial commodity prices fell minimally in periods after World War II and Korea. The problem of how to deflate prices for balance of payments purposes was a major issue among economists in analyzing the British experience after 1925.

Relative prices do appear to have a considerable balance of payments impact. The models estimate that a 1 per cent drop in wholesale prices relative to those in the rest of the world would be expected to improve the balance of trade by from $400 to $600 million per year. If these estimates are roughly right, to adjust the balance of payments by $3 billion, U.S. wholesale prices would have to improve by 5 to 8 per cent compared to those in the rest of the world.

Adjusting the Balance of Payments

It is against the background of this type of experience and estimated magnitudes that the debate over how to adjust the balance of payments, if this proves necessary, will take place. It is obvious that in a period of over-full employment and rising prices, there is no conflict between desirable action for the domestic economy and that needed for international balance. Conflict arises only if the adjustments required fall outside the limits of desirable domestic policy. In such a case four basically different views have been expressed as to what should take place.

1. Some believe that domestic policies would have to be shifted. Monetary and fiscal policy ought to shift to higher taxes and interest rates in order to increase unemployment, cause GNP to expand below its normal growth rate, and lower prices. Others disagree either because they think the price to be paid in lost income is too high, or because they believe the hoped-for adjustment would not occur. The foreign impacts of a U.S. recession might be such that all trade would decline. Lower incomes here would be matched by lower incomes abroad. The deficit would be less in percentage terms but it would not be wiped out.

2. Some would simply maintain an optimum domestic policy. They assume other countries would either accept the added reserves or would act individually to decrease their own surpluses. Since wholesale prices would be constant here, any increase in prices abroad would

improve the situation. Any countries which were dissatisfied with the rate of improvement could halt their own capital imports by direct action or could move their exchange rates upward. This group assumes that most countries would prefer a gradual improvement while gaining reserves to the threat of a worldwide recession.

3. A third group emphasizes the strong balance of payments improvements which the models show arise from comparatively small changes in relative prices. They argue that the most logical way of getting relative price improvements is through more flexible exchange rates. For example, if the estimates are correct, and if domestic policies maintain internal price stability, movements in relative exchange rates of 1 or 2 per cent a year would allow the balance of payments to adjust by a billion dollars per year.

Some argue that the relatively small changes necessary for adjustment could be achieved without fear of major destabilizing speculative movements by widening the band of permissible exchange fluctuations, but they would not allow them to move beyond fixed limits. Others fear speculative movements far less and see no advantage to imposing any limits on the amount the rates could float.

4. Finally, a further group believes that adjustments should take place through the type of direct and indirect subsidies, taxes, and controls now in use. They feel that if made more flexible and efficient, the continued use of a package of specific programs aimed

at individual expenditure streams is logical. The Foreign Investment Equalization Tax might be extended to all capital and made more flexible. Across-the-board surcharges on imports have been advocated. We could alter the present subsidies on military and economic support and AID. The proposed travel tax is another measure in this package.

Each of these proposals, of course, affects different groups in separate ways. The fact that some of them have been adopted is an indication that many view them as preferable methods of adjustment to the previous three. Others, however, claim that the apparent improvements under these programs are an illusion. They question whether such actions have really adjusted the payments mechanisms. They believe the apparent effects are only temporary and may cause a later opposite swing. They also question whether a permanent system based upon specific adjustments of this type can work because of administrative and control problems.

Conclusion

I recognize that my comments have been far from the specifics in which you usually deal. On the other hand, because I am constantly amazed at the misinformation and misunderstanding which surrounds monetary policy in both the domestic and international spheres, I thought that you might find some of this analysis useful. The results of the projections for the Year P indicate that we should expect a high rate of private investment. The demands for money and credit should also be great. The funds required, however, appear attainable at lower interest rates than now exist assuming that fiscal policy results in limiting Federal demands on the private market.

There is no real way of judging whether or not the balance of trade will produce a sufficient surplus to enable us to support the type of foreign policy we will choose in the postwar period. The needs will depend on what happens in the interim, on where we would be now if the market were free, on our ability to choose a proper fiscal-monetary mix domestically, and on our foreign policy objectives.

We all hope the Year P will soon arrive. We look forward to a period when we can spend our income on more productive purposes. Even in a trillion-dollar economy, however, we will still have more demands than resources. Neither economists nor security analysts need fear unemployment. Rather, I fear we will still be suffering under that ancient Chinese curse: "May your children live in interesting times"!