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Some Thoughts on Our Balance of Payments Problem

by

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One warm afternoon an elderly couple, back in my home town in Nebraska, were sitting out on the front porch rocking, when a parade passed by. John said, "There's a parade going by, Martha."

"Seems to be a right big one," she replied.

"Yep," said John. "I'd say it's the biggest I ever saw."

"Is that a fact?" said Martha. "I'd sure like to see it. It's a pity I'm not facing that way."

This is not typical of people in Broken Bow. Most of the people there, like you gentlemen, need not be told of the importance of taking the trouble to face in the right direction and see what the actual situation is - at least when it comes to controlling the affairs of a business enterprise. The situation can change rapidly from day to day, and it is never safe to assume that the facts that formed the basis of important policy decisions yesterday necessarily govern today. This is a fast moving world, and those who sit back and rock, content to let fast changing events slip by unheeded, are going to have trouble surviving.

This point is made in the story about the golfer whose ball went into the rough and landed near an ant hill. The golfer, who was something of a duffer, swung mightily and missed the ball completely, pretty well demolishing the ant hill in the process. He took another swing, and another, each time with the same result. Finally, there were only two ants left. One of them looked at the other and said, "If we are going to survive, we had better get on the ball."

The need to pay careful attention to day-to-day changes in the actual situation applies just as much to government and public policy as it does to business. This explains why such large sums of money are devoted to research activities in government agencies. Nearly a third of the annual budget of the Federal Reserve Board, for example, is devoted to research activities. We try to make maximum use of the output of our research departments in the formulation of policy. We can be badly misled if we do not know - and face - the facts.

One of the great advantages in the independence that Congress has given the Federal Reserve System is that we are able to act on the facts as we see them without subjecting them to examination under a partisan political microscope. This has the great advantage of permitting us to act with far more speed and flexibility than might otherwise be the case. Some would say that it also permits us to act in a more objective manner, though I personally would say that where in the past we have differed from those in political posts, this has arisen from honest differences of judgment. We can lay no claim to infallibility, but we try hard to keep abreast of the changes in our economic and financial situation and translate honest judgments into timely policy actions.

We are certainly prepared to reverse ourselves, as recent events prove, where the course of developments indicates to a majority of the policy-makers that a previous judgment has been in error. The trend of economic events is seldom so clearly foreseeable that one can confidently adopt measures that cannot quickly be reversed.

Indeed, in spite of the fact that we have one of the world's best economic research organizations, we can never be absolutely certain where we stand at any given moment, because there is an unavoidable lag in the collection and analysis of economic data. Often we know only where we were last week or last month. It is not uncommon to find observers outside government, who are dependent on information that reaches them only after some delay, forced to form judgments about the wisdom of current policy on the basis of what was going on two or three months earlier.

This can be a serious problem, for the absence of factual information may lead to needless misunderstandings, and it often means that even so-called expert opinion, to say nothing of public opinion, is not as well prepared as it might be to suggest, support, or criticize public actions. I think our mass communications media could do a far better job than is now being done to disseminate information in this area, but I also wonder whether we at the Federal Reserve are doing as effective a job as we might in supplying the public with essential information. Let me take this opportunity to invite your suggestions on this score. I am aware that government organizations, being insulated from the discipline of the market, are something less than perfectly responsive to the ever-changing requirements of their clientele. This can be remedied to some degree if the clientele makes its requirements better known.

Two of the major subjects that we must scrutinize constantly are the trend of production and employment here at home and the state of our balance of international payments. Both illustrate the importance of having up-to-the-minute information and maintaining sufficient flexibility in policy to act promptly in response to a changed situation.

For instance, early in 1960 the Federal Reserve detected a decline in key sectors of business activity that might signal the onset of a recession. To counter this threat, we took action in early spring to ease bank reserve positions. In June, and again in August, we reduced the discount rate. Open market operations and adjustments in reserve requirements were employed further in the summer and fall to keep the reserve position of the banking system easy. By the end of 1960 the banks had net <u>free</u> reserves in excess of $700 million, in contrast with net <u>borrowed</u> reserves of a half a billion dollars at the end of 1959. As a consequence, the Treasury bill rate, for example, which had exceeded 4.5 per cent in December 1959, had already fallen to 2.46 per cent in June 1960 and stayed just under this level through the last half of the year.

In spite of these facts, talk of "tight money" policies persisted well through the second half of 1960, perhaps because we had not done an effective job in bringing the public to full awareness of the changes that had taken place. Or perhaps the measures we took, despite their timeliness, were simply not quite adequate. It is easy to see in retrospect that more might well have been done, although I would like to think that the moderateness of this downturn may have been due - at least in part - to the fact that we took cognizance of it at an early date, and acted accordingly.

Some might object to calling this a moderate recession in view of the seriousness of the unemployment problem. Let me emphasize that I apply this adjective with full awareness that the degree of unemployment is not moderate and that we certainly should not view it lightly. However, the broad measures of total output that we use to trace the business cycle do show this to be the mildest of our postwar recessions. Even with respect to unemployment, let us remember that the rate of unemployment in this recession has increased only a third, which compares with an increase of about 75 per cent at the same stage of the 1957-58 downturn. The seriousness of the unemployment problem stems not from this having been an especially severe recession in terms of its effect on employment, but rather from the fact that unemployment was at a high level - about 5 per cent of the labor force - even before the downturn began.

This leads to consideration of the other problem which we must keep under particularly close scrutiny - our balance of payments position. I suppose that the American people have never been made so aware of the balance of payments and its significance as they were in the latter months of 1960, when our loss of $1.6 billion in gold riveted attention on this problem. However, our balance of payments difficulties did not begin in the last half of 1960. They have been with us to a worrisome degree since 1958. Our deficit, as measured by our loss of gold and the increase in our short term liabilities to foreigners, has ranged from $3.5 billion to $3.8 billion for the past three years.

I have advocated, as strongly and persistently as I know how, the point of view that we should not allow the foreign tail to wag the domestic dog, on the ground that the first and foremost responsibility of monetary authorities is the healthy development of the domestic economy. However, I hope no one believes that we can or should formulate and execute monetary policy completely heedless of the impact of our domestic actions on international confidence in the dollar and on our ability to compete in world markets.

This international aspect was one important basis, among many others, for the restrictive tone of monetary policy during 1959. Remember that with the recovery in the latter half of 1958 and its flowering into expansion in the first half of 1959, unemployment was cut from 7 per cent to 5 per cent, and there was reason to hope that the employment picture would continue to improve as activity expanded further. In spite of the fact that we had unemployed resources, we were still experiencing wage increases and upward pressure on prices. We were also experiencing a heavy balance of payments deficit caused in part, at least, by a bulge in imports and a slump in exports. While much of the trouble resulted from differences in the timing of the business cycles here and abroad, there did exist the real danger that inflation here could, among other bad effects, seriously damage our competitive position in foreign markets.

Theorists may argue that it is impossible to have serious inflation as long as you have unemployment, but I submit that the upswing of 1958-59 proves the contrary. Of course, no one wanted to choke off expansion and keep unemployment around the 5 per cent level, but at the same time many of us recognized that the balance of payments situation made it imperative that we expand without inflation.

I did not believe then, nor do I now, that high level employment and a stable dollar are incompatible objectives. However, I confess that we have not succeeded as well as some other countries in achieving both of these objectives in recent years. This does not mean that we must abandon the effort and go all out for one objective at the expense of the other. On the contrary, we should redouble our efforts. We ought to consider very carefully why we have done less well than - for example - Germany and Japan. What do the Germans and Japanese have that we have not?

Even a cursory comparison of the economic data for the three countries reveals some striking differences. One is the substantially higher rate of investment that Japan and Germany have experienced in recent years. During the past decade, the ratio of investment to gross national product has varied from a quarter to a third in Japan, a fifth to a quarter in Germany, and, according to the best available estimates, it has been less than one-fifth in this country. The high rate of investment in Germany and Japan cannot be explained away as simply reconstruction of war damage. Both of these countries had surpassed prewar levels of industrial output by the end of 1952.

Another significant difference is the higher rate of expansion of the labor force in Germany and Japan. These countries have been increasing their output rapidly not only because their high rate of investment has raised productivity, but because the number of workers, especially those engaged in manufacturing, has risen sharply. Both Germany and Japan scored larger gains in productivity than we did and at the same time they have fully employed a labor force that has grown at a faster rate than ours. This means, among other things, that these countries have been doing a better job than we in solving the problems of unemployment that arise from technological changes.

It is one thing to point out that the Germans and the Japanese have had a more rapid expansion of investment and of utilized labor force. It is another to try to explain why this has been the case. Certainly much of the growth in the working population can be explained in terms of utilization of refugees and immigrants in Germany and a mass movement from rural to urban areas in Japan. However, we have not been handicapped by our population not increasing fast enough. Indeed, our problem is that we have not been able to utilize all those who are able and willing to work.

It is relatively easy to point out some of the factors that have not been responsible for the success of the Germans and the Japanese. They have not been more inflationist than we; over the past five years their wholesale and export prices have risen even less than ours. They have not had lower interest rates; on the contrary, their interest rates have been much higher than ours. They have not relied more heavily than we on governmental expenditure to stimulate the economy; in both Germany and Japan, government has absorbed substantially less of the national product than it has in the United States. This, of course, reflects the fact that we have been carrying a heavy military burden, as well as a large program of economic and military aid, which these other countries have not had to bear.

It is less easy to state what factors have been chiefly responsible for the fact that these countries have had higher rates of domestic investment and labor force utilization than we. Each of us might come to different conclusions after studying the same data but, personally, I am strongly impressed by the role that exports have played in their economic expansion. From 1955, when these countries had already recovered from the war, through 1960, Japanese exports more than doubled and German exports increased 86 per cent, while U. S. exports rose less than 40 per cent. Had we increased our exports at the same rate as the Japanese during this period, we would have sold an additional $9.5 billion worth of goods abroad last year.

A leading Japanese bank has concluded that the drive to expand exports ranks with technological innovation as a potent stimulus to investment in plant and equipment. And in Germany there has been an almost pathological emphasis on export promotion over the past decade. It is easy to see why this might spur investment and growth. Cracking export markets often means facing keener competition than is encountered at home. This necessitates adoption of the most efficient techniques and equipment, and at the same time, through providing a larger market, it may bring economies of scale. Where the managers and workers are highly export conscious, they are likely to be more cost conscious and consequently more concerned about inflationary trends that could endanger export markets. The pervasive export consciousness in Germany and Japan undoubtedly has been one reason why these countries have been able to maintain and improve their competitive position in recent years.

This country, on the other hand, went through most of the 1950's with an entirely different attitude. Our exports were almost an embarrassment to us. We had large surpluses in our foreign trade which were financed by government grants and credits to foreign countries, and even in 1958, when we had already begun to run into balance of payments difficulties, some people were still trying to devise ways and means of exporting more American capital rather than more American goods. During the early 1950's the entire emphasis was on finding ways of closing the so-called "dollar gap", and it was thought that the best way to do this was to encourage Americans to increase their purchases of foreign goods, spend more on foreign travel, and invest more money abroad. I do not suppose it occurred to anyone at that time that these policies were not those most conducive to a great increase in our own rate of economic growth, but in retrospect, it appears that we were playing the part of the indolent hare while our foreign competitors were acting like souped-up tortoises.

I do not say that our policies were wrong in the early fifties, but we have long since emerged from the period when they were appropriate. I wish that I could say that we have learned our lesson and are completely reformed. I cannot. We are still a long way from being an export-minded country. There is a touch of pessimism around today with respect to the future of our export performance. It is said that now that we are again up to an annual export rate of nearly $20 billion, we cannot expect much more expansion in the short run. With this attitude I have little patience.

I would like to see us set an ambitious export target and then, instead of just paying lip service to it (as we are wont to do), put all the steam we can generate behind a drive to attain it. This, I submit, would be a more effective way of tackling our balance of payments problem than tinkering with interest rates and invoking quasi-protective measures like "buy-American" policies in foreign aid and smaller duty-free tourist allowances. The German and Japanese experience indicates that it might also be one of the most effective ways to stimulate economic growth.

Some may say that it is shortsighted and unrealistic to think that American exports can be expanded greatly without creating new imbalances in the world and re-introducing the "dollar gap" problem. This is not necessarily true. If we envision a world in which most countries are enjoying a rapid rate of economic growth, we must envision a world of expanding trade. We have seen this in Western Europe and Japan, and we have wisely encouraged these countries to help themselves by reducing trade barriers and making trade expansion possible.

I am afraid that our vision has been somewhat clouded with respect to other parts of the world. There seems to be a feeling that the less developed countries cannot be expected to expand their exports to the degree that would be necessary to support the rate of economic growth they seek to achieve. We have lent large sums of money to these countries for repayment in their own currencies - terms that suggest that we do not believe they are likely to be able to increase export earnings enough to pay us back. We have not encouraged them as much as we have the Europeans to develop their economies through expansion of international trade. Unless the less developed countries of Asia and Africa and Latin America can develop along lines that will bring a substantial increase in exports, they will not for long be able to maintain rising levels of imports. This will make it more difficult to attain the growth in world trade that is needed if we ourselves are to enjoy the kind of economic expansion everyone would like to see.

This suggests that our long-term policy should be not only to emulate Germany and Japan in the development of export trade, but also to persuade the governments of the less developed countries of the desirability of policies that will lead to an expansion of their international trade.

This, of course, means that we will be expected to keep our own doors open to imports from the developing countries, including imports of manufactured goods as well as raw materials. Fortunately, we have a pretty good record on this score, and much of the criticism that is heard of American protectionism reflects not the actual situation, but rather that the critics are not aware how liberal American commercial policy has been in the postwar period.

Frankly, I do not think it will be nearly as hard to persuade the American people to tolerate the importation of goods from the so-called "cheap labor" countries as it will be to persuade many of those countries that they must, in their own best interest, open their doors to the competition of goods manufactured in the "high wage" countries. But if we can accomplish both of these objectives, and not lose sight of the competitive necessity (not merely the desirability) of keeping our own wage and price levels stable, we can look forward to the kind of expansion of world trade that will contribute to higher rates of solid economic growth both here and abroad.