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Banks and the Balance of Payments Problem

My assignment is to give you a report on the progress of the part of the President's balance of payments program administered by the Federal Reserve. In general, I can report, that program has been highly successful and the cooperation of the financial institutions to which it applies has been magnificent. Although it might come more appropriately from one whose background is linked closer to world financial centers than to Broken Bow, Nebraska, I would like to place that particular segment of the balance of payments program in a broader context. In particular, I would like to review the course of our balance of payments over recent years and to bring out the nature of the problem that has called for specific corrective action.

There is no doubt that the balance of payments presents a real challenge to government policies and business decisions in the United States. For us, in contrast to so many other countries, this is a new challenge. For many years, we as a nation were able to ignore the net balance of our international transactions. But those days are over and it is probably safe to predict that they will not return. We must be prepared to have a deliberate balance of payments policy aimed at maintaining equilibrium in our external accounts.

The need for responsible public and private actions aimed at encouraging a vigorously growing domestic economy without inflation has been generally recognized and accepted in the United States. This commitment is expressed in the Employment Act of 1946, and was implemented by the actual policies pursued during the postwar period. We accept the fact that the achievement of our domestic objectives cannot be left fully to market forces but requires the overall influence of governmental policies as well. We must now recognize that the achievement of balance of payments equilibrium also requires governmental policies. Such policies recognize that private economic decisions are basically made in response to market incentives. But the net outcome of a myriad of private decisions to buy and sell and to borrow and lend does not necessarily or automatically result in equilibrium, either in our domestic economy or in our balance of payments.

These observations are confirmed by our balance of payments experience in recent years. Ever since 1958, the United States has each year incurred a deficit in its balance of payments equal to several billion dollars. The first fact to observe about our persistent balance of payments deficit is that it is not of the classical textbook variety. It does not result from excessive spending or inflation at home which inevitably spills over the borders, leading to an excess of imports over exports. On the contrary, the United States has consistently exported more goods than it has imported. Furthermore, the surplus of our exports over imports has been increasing significantly in recent years. The annual surplus on goods and services, including investment income in our receipts and all government expenditures (including capital outlays) abroad in our payments, has grown by $3-1/2 billion between 1960 and 1964.

This, in itself, is a remarkable performance. It is clear that some form of adjustment process has, in fact, been at work. In significant degree, this large improvement in our basic trading position is attributable to our success in maintaining price stability at home while prices abroad rose considerably.

Nevertheless, we still have a balance of payments problem. For while our current account surplus has increased so much, the net outflow of capital from the United States has also increased sharply. There are many reasons for the surge of capital outflow, and I shall discuss some of these in a moment.

It is not my intention to disparage the contribution of capital outflow - either private or governmental - to economic growth abroad and to our own exports as well as to our other earnings abroad. On the other hand, it is an undeniable fact that not all capital outflow is immediately offset by corresponding earnings from exports or investment income.

It seems fair to describe our balance of payments problem in the following way: There is a tendency for capital outflow from the United States to exceed the surplus we are able to earn on our transactions in goods and services, including investment income, if we regard government expenditures and outlays abroad as a necessary deduction from that surplus. Certainly, we have every reason to encourage and foster a growing surplus of exports over imports and thereby enable us to make increased amounts of credit and capital available to other countries. This is in our interest and in the interest of other countries, especially less developed countries that are striving to cope with a shortage of savings in their efforts to accelerate their growth rates. But one must conclude from the experience of recent years that from time to time there will be a tendency for the flow of capital over our borders to exceed the size of even the most favorable account surplus, net of our government payments abroad, that we can reasonably expect to achieve.

Let me turn, therefore, to the question why there is a tendency for American capital to flow abroad in such large and growing amounts. For one thing, the U. S. economy during much of the 1960's had unutilized resources of manpower and plant while Western Europe and Japan tended to experience the opposite problem, excess demand and inflation. In the circumstances, with policies here designed to stimulate aggregate demand and policies abroad attempting to limit total spending, our interest rates and credit conditions were especially conducive to lending and investing abroad. Thus a part of our capital outflow in recent years is explained by a difference in domestic economic conditions and in domestic economic policy as between the United States and other developed countries.

There is every reason to believe, however, that even in the absence of this difference in domestic resource utilization, there would have been a strong tendency for foreign demands for funds to converge heavily on U. S. banks and capital markets and for U. S. investors to be strongly attracted overseas. Here are some of the reasons for these tendencies:

(1) Developed countries abroad, in attempting to cope with domestic inflationary pressures, have leaned more heavily on monetary than on fiscal policy. In

fact, some developed countries have even eased their fiscal policies in the face of domestic inflationary pressures, while tightening monetary policy further. Such actions have inevitably tended to raise interest rates and to make capital inflow more attractive in countries that were already experiencing surpluses in their balances of payments. In the United States the mix of fiscal and monetary policies has, I think, been more appropriate to our combined internal-external position. We have used fiscal policy more forcefully than monetary policy in attempting to restore full use of domestic resources. This has meant that we have not lowered our own interest rates as much as we might have and, in fact, have tended to raise them while pursuing policies designed to stimulate domestic incomes and output. But, because of the overemphasis on monetary policy abroad, interest rates there have advanced at least as much if not more than rates here. What is needed in many foreign countries is greater development and more flexibility of fiscal policy to cope with domestic problems. Of course, this is desirable in any event, quite apart from the problem of balance of payments adjustment.

(2) In addition to these differences in policy, there are important structural differences between capital markets here and abroad. The United States capital market is the largest, most efficient, and most accessible in the world, and, until recently, there were no governmental restrictions on foreign borrowing in this market. In contrast, most foreign capital markets are relatively small and fragmented, hemmed in with restrictions on borrowing by outsiders, and subject to exchange controls that limit the ability of their own residents to invest abroad. The enormous size of our country and the correspondingly large flow of funds from savers to investors through our markets mean that even large amounts of foreign borrowing can be accommodated with only marginal impact on our financial markets. By the same token, it requires a large change in the flow of funds through our markets to affect significantly the flow to foreign borrowers, if we attempt to cope with the problem through general monetary restriction alone.

(3) American financial institutions, both bank and nonbank, are more willing (and often much freer) to extend long-term credits than their counterparts abroad. They have become accustomed to providing liquidity to the funds they gather while satisfying a need for long-term accommodation on the part of those to whom they lend. This helps to explain both the smaller differential between short- and long-term interest rates in the United States and the ready availability of long-term funds to both foreign and domestic borrowers.

(4) American banks are highly competitive, avidly seeking to satisfy the needs of foreign as well as domestic borrowers, in contrast to the more cartelized banking systems in most foreign countries. Both the lower cost and the greater availability of funds have tended to encourage bank lending abroad.

(5) American corporations have faced numerous special incentives to make direct investments in Continental Europe. Rapid growth in the Common Market countries, combined with the prospect of relatively higher tariffs on imports from outside that area, has provided a strong attraction to American corporations to locate there. The rapid development of mass-consumption economies in the Continental European countries, together with their success in overcoming their technological lag as well as their currency problems, is too well known to need elaboration. These dynamic changes, after almost three decades of depression, instability, war, and reconstruction, have provided an environment conducive to a surge of investment, and hence to an unusually heavy demand for investible funds.

Not all of these factors that I have referred to as tending to cause a large flow of capital from the United States to other developed countries will necessarily persist year-in and year-out. Some will change with the business cycle and others will experience a gradual alteration over time. For example, there is evidence that the unusually large profit margins abroad are declining to levels comparable with those earned at home.

But I wish to stress two conclusions that follow from these observations. The first is that the tendency for capital to flow from the United States to other countries in large volume and particularly to other developed countries is not simply the result of inadequate policies within the United States. It should be clear from what I have said that much of the explanation - and I am not speaking in terms of blame but solely of explanation - lies in the institutions and policies found elsewhere. This does not mean that we in the United States must not cope with our own balance of payments problem as best we can; it does mean that the measures we adopt to cope with the problem must recognize its true nature.

In response to these special influences, American capital has moved abroad in a great surge in the first half of the 1960's, offsetting in part at least the distinct improvement in our competitive position. To cope with this tendency, a series of policy measures has been adopted in recent years. You are familiar with them and I shall only mention them in passing. Beginning early in the 1960's, the Federal Reserve began to conduct its monetary policy - which was naturally preoccupied with the high unemployment rate and the large volume of idle capacity in industry - so as to maintain upward pressure on short-term interest rates and thereby to discourage tendencies toward the outflow of short-term funds.

The investment tax credit, enacted in 1962, was a measure designed to enhance the incentive to undertake plant and equipment spending here. It might be regarded as the equivalent of a substantial reduction in long-term interest rates, but one that serves to curtail rather than encourage the outflow of investment funds.

In 1963, the Interest Equalization Tax was proposed as a measure, operating through the market system, to discourage American purchases of securities issued by, and other long-term credits to, borrowers in developed countries abroad (with exceptions for Canada and Japan).

And in early 1965, President Johnson announced a balance of payments program that was highlighted by voluntary efforts aimed at further reducing the flow of credit and direct investment from the United States to developed countries.

Our guidelines, under the Federal Reserve's part of that program, suggested that banks restrain their total credits to foreigners in such a way that outstanding credits at any time during 1965 would not exceed 105 per cent of the amounts outstanding at the end of 1964, thus reducing the outflow of dollars through the expansion of bank credit from $2.4 billion in 1964 to not more than $500 million. They also suggested (as do the new guidelines for 1966) that absolute priority be given to bona fide export credits, and highest priority, among other credits, to loans to less developed countries; that credits not be reduced to Britain, which is suffering from payments difficulties of its own, or Canada and Japan, which are highly dependent for their economic growth on the inflow of U. S. capital and credit; and that any needed reduction in credits in order to meet the target be confined to other developed countries, especially those enjoying a payments surplus, such as the countries of Continental Western Europe.

For financial institutions other than banks (e.g., insurance companies, mutual funds, finance companies, pension funds, foundations, and the like), the guidelines suggested a reduction of liquid funds invested in foreign money markets to the 1963 level. They suggested also a limitation of credits and investments with maturities not exceeding ten years similar to those in the guidelines for banks. But they did not suggest any percentage limitation of long-term credits and investments in regard to less developed countries, Britain, Canada, and Japan. Thus, nonbanking institutions (which had increased their foreign credits last year by over $1 billion) were asked to use greater restraint than banks in regard to the placement of liquid funds; were treated like banks in regard to short- and medium-term credits, in which they compete most nearly with banks; and were treated more leniently in regard to credits with a maturity of more than ten years. This more lenient treatment was designed to make sure that the progress of less developed countries and the economic growth of Canada would not be hampered by our credit restraint efforts.

Both banks and other financial institutions have abided not only by the letter but also by the spirit of those guidelines. They have displayed to the world their willingness to cooperate wholeheartedly in a voluntary effort to solve this national problem - in part, no doubt, because they are particularly qualified to appreciate its full significance. By the end of September 1965, total foreign credits of participating banks actually were below the amounts outstanding at the end of 1964; and total credits and investments of other financial institutions were only 4.8 per cent above the 1964 level.

Even more gratifying than these overall figures was the degree of compliance with the suggested priorities. Banks reduced their short-term credits and increased their long-term credits to foreigners, and especially long-term credits to less developed countries. In fact, their total credits to those countries rose substantially, in spite of the drop in overall credits to foreigners.

Nonbank financial institutions reduced their liquid funds held abroad, kept their other short- and medium-term credits virtually unchanged, and increased their long-term credits and investments by $700 million. While by far the largest single increase was in long-term credits to Canada, there also was a substantial increase in investments in less developed countries. In contrast, long-term credits and investments in developed countries other than Canada and Japan were substantially reduced.

The reduction in the outflow of bank credit, in compliance with the guideline targets, was much larger than the entire improvement in the U. S. payments balance from the first three quarters of 1964 to the same period of 1965. Claims of banks on foreigners rose in the first three quarters of 1964 by $1.4 billion but remained virtually unchanged in the first three quarters of 1965, with a large outflow in the first quarter almost exactly offset by repatriations in the second and third quarters. This change alone would have accounted for an improvement in the U. S. payments balance by $1.4 billion. Since the U. S. deficit for the first three quarters of last year also happened to be about $1.4 billion, this improvement should have been sufficient to eliminate virtually the entire payments deficit for the first three quarters of this year. Actually, however, the overall improvement in our balance of payments amounted to only about $400 million - calculated on the basis of the so-called regular transactions, which exclude special payments by foreign governments to the U. S. Government from U. S. receipts. In other words, other items in our payments balance deteriorated by about $1 billion so that the overall improvement fell short of our hopes.

Part of this shortfall is more apparent than real. Foreign sales of U. S. securities rose by $400 million. It is no secret that this figure presumably reflects sales of securities owned by the British Government and put into liquid assets in order to help finance, if necessary, the payments deficit of the United Kingdom.

But there was some genuine deterioration in other items. First, while our exports rose by about $500 million in comparison with the first three quarters of last year, our imports rose by $1-3/4 billion.

Second, while we do not know yet the exact amount of direct investments abroad of U. S. nonfinancial corporations in the third quarter, there can be no doubt that the total for the first three quarters will turn out to be higher by many hundreds of million dollars than the already unusually large amount of such investments in the first three quarters of last year.

It seems clear that the balance of payments results for 1965 will show a definite improvement over the record for the earlier years of this decade. But we still are far from reasonable equilibrium. In fact, we have barely reached the half-way mark between our huge 1964 deficit and our goal of payments balance, and the second half of the road may be even more difficult than the first half has been.

These considerations have made it necessary to continue the voluntary restraint effort, at least for the time being. The effort has, in fact, been made more stringent for that part of the program that is under the guidance of the Commerce Department and that relates to foreign investments of nonfinancial corporations. Fortunately, because of the excellent results achieved by banks and other financial institutions, we were able to permit our Federal Reserve guidelines to remain essentially unchanged.

Even though the banking and financial system as a whole has stayed well under the suggested ceiling for 1965, some leeway for further expansion in 1966 was deemed appropriate for two reasons. First, I am sure that financial institutions will continue to cooperate with the spirit as well as the letter of the program, and will expand their foreign credits only to the extent necessary to meet priority credit needs. Secondly, I wanted to make doubly certain that export financing will be available in adequate amounts, and that the credit needs of less developed countries will continue to be met.

Consequently, under the 1966 program, commercial banks are requested to restrain any expansion in foreign credits to such an extent that the amount outstanding does not exceed 109 per cent of the amount outstanding on December 31, 1964. Further, in order to spread throughout the year any outflow necessary to meet priority credit requirements, it is requested that the target be only gradually approached, and therefore the ceiling was raised by one per cent per calendar quarter. Special ceilings for banks with small bases, to enable them to meet needs for priority credits (but only those) will add about one per cent to the total, bringing the possible expansion in 1966, for the banking system as a whole, to about the same amount as would have been permissible in 1965.

The 1966 guidelines for nonbank financial institutions are again broadly comparable with the bank guidelines.

All of us realize, however, that the present voluntary programs by their very nature can only be stopgaps. We hope that structural changes may occur that will eliminate at least some of the incentives mentioned before, which have been responsible for the excessive capital outflows of recent years. But we cannot rely merely on good luck.

As we think about where we go from here, perhaps we can start from the following propositions:

(1) The United States must have a balance of payments policy and a policy that is conducive to rapid growth and price stability in our own economy and in the rest of the world, and that is geared as closely as possible to market processes. As is true of general fiscal and monetary policies, our balance of payment policies should leave decisions as to spending and investing and lending and borrowing to private decision-making as much as possible.

(2) The achievement and maintenance of balance of payments equilibrium requires action, not only by countries in deficit, but also by countries in surplus. Just as it takes two to tango, it takes two to eliminate imbalances in international payments. Thus, while the United States continues to exert its strongest efforts to return to equilibrium in its balance of payments, one may hope that countries in surplus, especially those in Continental Europe, will bend their efforts to eliminating restrictions and reducing tariff barriers on imports, encouraging capital outflow, especially to developing countries, modernizing and improving their capital and money markets, and endeavoring to make their fiscal policies more appropriate to their own economic situations, and more flexible as well.

(3) Finally, and in summary of what I have been saying, there are no simple solutions to this problem. It should be clear from what we know of the underlying forces responsible for the deficit that monetary policy alone cannot solve either our balance of payments problem or that of other countries. Monetary policy

in the United States has played a role in the improvement in our foreign position and will continue to do so. But it cannot by itself restore and preserve balance of payments equilibrium while also performing its main task - namely, fostering a vigorously growing and healthy domestic economy, without inflation, in the interest both of our own citizens and of people around the world.