Monetary Policy and the Balance of Payments*

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In a world as dangerous and uncertain as ours, we are fortunate to live in a country whose people and institutions consistently rise to their greatest heights in times of greatest strain.

Just as twenty-two years ago this nation withstood the shock of a savage bombing attack at Pearl Harbor and then moved forward with strength of purpose, so two weeks ago it withstood the shock of an assassin's fire and now—in determination as well as in anguish—is moving forward once again.

The continuity of this movement, as a new President has taken over from the old and pledged himself to carry onward the national course, attests the solidity of our constitutional foundations and the continuing vitality of the institutions we have built upon them.

It is a matter of some pride to me that the Federal Reserve System, which I have the honor to represent here tonight, is one of those institutions. And on this date so near the fiftieth anniversary of the signing of the Federal Reserve Act on December 23, 1913, it is also a matter of some pride to all of us in the Federal Reserve that the System was able to be of some service to its country in this most recent moment of crisis, as in other crises over half a century.

Within minutes after the first news flashes out of Dallas, the Federal Reserve moved into the foreign exchange markets in defense of the dollar, and began offering foreign currencies at prior prevailing exchange rates. With that offer, and the market's knowledge of the magnitude of the resources available, the immediate crisis was safely passed.

That is good, so far as it goes. But it does not, of course, go very far. The problem of our international balance of payments did not spring into being overnight, and it cannot be resolved overnight by any single stroke, however dramatic. It is a serious, a complex problem, and it continues.

Four months and four days before his life was tragically ended, President Kennedy—whose programs President Johnson has vowed to continue—sent a special message to the Congress on the international payments problem and the steps to be taken to meet it. In that message, he declared:

> . . . continued confidence at home and cooperation abroad require further administrative and legislative inroads into the hard core of our continuing payments deficit—augmenting our long-range efforts to improve our economic performance over a period of years in order to achieve both external balance and internal expansion—stepping up our shorter run efforts to reduce our balance-of-payments deficits while the long-range forces are at work—and adding to our stockpile of arrangements designed to finance our deficits during our return to equilibrium in a way that assures the continued smooth functioning of the world's monetary and trade systems.

In that same message, President Kennedy also said:

> . . . this nation will continue to adhere to its historic advocacy of freer trade and capital movements, and . . . will continue to honor its obligation to carry a fair share of the defense and development of the free world. At the same time, we shall continue policies designed to reduce unemployment and stimulate growth here at home —for the well-being of all free peoples is inextricably entwined with the progress achieved by our own people. I want to make it equally clear that this nation will maintain the dollar as good as gold, freely interchangeable with gold at $35 an ounce, the foundation stone of the free world's trade and payments system.

*Remarks before the Annual Dinner Meeting of the United States Council, International Chamber of Commerce, New York City, December 9, 1963.

No one could miss the firmness of that commitment to "maintain the dollar as good as gold". Neither could anyone who heard or read President Johnson's message to the Congress on November 27 miss the equal firmness of his "rededication of this Government" to "the defense of the strength and stability of the dollar".

Likewise, no one could miss the emphasis upon such principles as "freer trade and capital movements", nor the stress upon the need to pursue simultaneously the interrelated policy objectives of internal expansion and external balance without assignment of priority.

The Federal Reserve, for its part, is deeply engaged in the simultaneous pursuit of those interrelated policy objectives, and it is to that engagement I should like to turn now.

As many of you are aware, basic Federal Reserve policies, both domestically and internationally, are reviewed and determined every three weeks in the nation's capital by the Federal Open Market Committee, a statutory body representing the entire Federal Reserve System.

At a meeting twelve months ago—on December 18, 1962, to be exact—the Committee came to the conclusion that it would be dangerously inappropriate to continue further the extensive degree of credit ease that had been long prevalent—since at least the beginning of the 1960's. Accordingly, it redirected its policy toward lessening that degree of ease and toward "accommodating moderate further increases in bank credit and money supply, while aiming at money market conditions that would minimize capital outflows internationally".

Over the past twelve months, the wording of the Committee's over-all policy directive has been changed a number of times but only, and always, to advance policy goals that have, themselves, remained fundamentally the same.

Some thoughtful people would contend that there is an incompatibility between monetary and credit conditions that will help promote sustainable domestic economic expansion and those that will foster balance in our international payments, and that it is not possible for monetary policy at one and the same time to aim at both successfully. But it would be unavailing for a central bank, or for government in general, to do less than attempt to accomplish both. Monetary and credit conditions that are inconsistent with long-run payments balance could hardly serve to promote sustainable economic expansion domestically. And monetary and credit conditions that are inconsistent with sustainable domestic economic growth could hardly serve to promote long-run balance in international payments.

Policies designed to combine orderly economic growth with external equilibrium are appropriate for every country, large or small. They are vital, however, for a country such as the United States, the currency of which is extensively used by the traders, bankers, and investors of many other countries as well as of its own in settlement of international transactions.

Any country suffering from persistent erosion of its monetary reserves faces a threat that confidence may decline in the value of its currency internationally. But whenever any country's currency lacks acceptability and circulation in world markets, its residents can avoid some of the consequences of currency instability by using a more stable currency as their unit of account. The dollar, for instance, is so used in many countries whose currencies are suffering loss of purchasing power at home and depreciation in value abroad. In such cases, the currency depreciation will scarcely affect nonresidents at all because their commercial and financial transactions with that country will generally be denominated and settled in one of the two main international currencies, the dollar or the pound sterling.

In the case of our country, however, neither the United States nor even foreign traders, bankers, and investors can easily switch from their use of the dollar to another currency. Moreover, the predominant position of the dollar in international trade and finance means that uncertainty about the dollar generates uncertainty about all other currencies of the free world. In 1931, the troubles of sterling led, either immediately or within a few years, to troubles for every other currency.

Today, the dollar is more widely used in international economic relations than sterling was thirty-two years ago, and any trouble of the dollar would under present conditions generate trouble for all other currencies—and in turn more trouble for the dollar itself.

Thus, uncertainties about the dollar affect not only the United States economy but the world economy as a whole. Therefore, the Federal Reserve cannot look at the dollar solely from the point of view of its function as a domestic currency. It must also consider the role of the dollar as the main international currency of the free world.

The basic strength of the dollar, of course, lies in the health of the United States economy, in the stability of the dollar's purchasing power, in the variety and competitiveness of United States goods and services available in international markets, in the size of United States markets for foreign short- and long-term capital—and in the fact that, adhering to a commitment involving the faith and credit of the United States, we stand ready to sell gold on demand at the fixed rate of $35 an ounce to foreign monetary authorities for legitimate monetary purposes. This gold convertibility permits foreign central

banks to treat dollars as the equivalent of gold and therefore to keep sizable working balances and reserves in dollars. These foreign dollar holdings have become an essential part of our own and of the world's financial system.

In order to fulfill its commitment to gold convertibility, the United States needs adequate gold reserves. These reserves need not be so large as to cover all dollar holdings of foreign monetary authorities; in this respect, the United States position is like that of a bank, and banks do not —and need not—hold cash balances equal to their liabilities. But the gold reserves must be large enough to give full assurance that even under adverse circumstances the United States would at all times remain able to fulfill all legitimate requests of foreign monetary authorities for gold purchases. That we stand ready to use our gold to meet our international obligations—down to the last bar of gold, if that be necessary—should be crystal clear to all: the Federal Reserve itself, let me remind you, has ample power under the Federal Reserve Act, should the necessity arise, to suspend the statutory reserve requirements against Federal Reserve deposits and notes, and to make any needed part of our gold stock available for sale to foreign monetary authorities.

The dollar not only needs protection from any suspicion that the United States might fail to live up to all its monetary commitments to foreigners, but it must be guarded against exchange market disturbances stemming from any deficit in our international payments as well as from deficits experienced by other leading countries. The most important contribution of the Federal Reserve to the solution of this second problem has been its decision to engage again in foreign exchange operations, including the creation of a network of interchanges of currencies, commonly called "swap arrangements", with foreign central banks.

These arrangements by now have added more than $2 billion to the sums potentially available for the defense of the dollar and of other leading currencies in case of need. Their value has become particularly clear during the two great crises of recent years: the very recent one, to which I referred earlier, and the Cuban missile crisis of October 1962. Apart from actions of the kind already mentioned, it appears on the basis of experience that the mere existence of the facilities has prevented any large-scale attack on the dollar from developing.

This network seems to be complete for the time being, although from time to time the maximum amounts involved in individual arrangements may be altered to conform to changed conditions. For instance, on the day of the President's assassination the maximum amounts of two such arrangements that might have proved insufficient were raised by 50 per cent within a few hours—although in the circumstances it actually proved unnecessary to use those two agreements at all.

And I should refer here to the supplementary step taken by our Treasury to offer to foreign official holders of dollars nonmarketable medium-term Treasury obligations denominated, if desired, in the holder's currency and with maturities flexibly tailored to the holder's needs. These bonds provide foreign monetary authorities an alternative opportunity to invest accumulated dollars instead of converting them into gold. Thus they help to conserve our gold resources.

The Federal Reserve's arrangements for the interchange of currencies are designed to protect our reserves against adverse effects from temporary dollar outflows that are expected to be reversed in the very short run. The Treasury's new-type bonds are designed to prevent repercussions from movements of dollars that may not be reversed until our payments balance is more nearly restored to equilibrium, at least in relation to the foreign country involved. But valuable and important as these arrangements are, they cannot deal with the hard core of the payments problem.

This brings us to consideration of monetary actions to help reduce and eventually eliminate our payments deficit without hampering sustainable economic growth. Let us see how this year's monetary experience agrees with the contending claims about the possibility of successfully achieving the combined goals.

During 1963 the Federal Reserve has gradually lessened the monetary ease that had been prevalent for several years. The only dramatic step was that taken in July, when the discount rate of the Federal Reserve Banks was raised from 3 per cent to 3½ per cent and the maximum rates payable on time deposits with a maturity of three to twelve months were raised to 4 per cent. But over the preceding months, the banking system had been permitted gradually to absorb its margin of uninvested reserve funds.

What happened to the money market, to the domestic economy in general, and to the United States payments balance in the past year?

The gradual curtailment of reserve availability during 1963 was first reflected in a modest uplift in short-term rates but between May and November the rise was more pronounced. All told, rates on money market paper—Treasury bills, bankers' acceptances, finance paper, and prime commercial paper—increased by about ⅝ of 1 percentage point.

In contrast, the movement in long-term rates was smaller and mixed. Average yields on Government bonds and high-grade state and local bonds rose by about ¼

of 1 percentage point; those on lower grade state and local bonds and on high-grade corporate bonds rose much less. But mortgage rates and rates on lower grade corporate bonds declined slightly. And stock prices advanced enough to reduce the dividend-price ratio for common stocks significantly, despite the substantial rise in corporate profits and dividends.

The moderate lessening of credit ease had apparently little restrictive effect this year on the availability to the economy of money and bank credit. The money supply, computed on the basis of currency outside banks and adjusted demand deposits, rose at an annual rate in excess of 3 per cent in the first ten months. In only one out of the past ten years, 1958, a year of revival from recession, was there a higher rate of increase. This year's growth, moreover, has followed two years of non-inflationary economic expansion.

Because time and savings deposits at commercial banks are in practice readily convertible without penalty into demand deposits or currency, many observers believe—and I agree with them—that for purposes of policy determination these deposits should be counted as part of the money supply. Counting the money supply on this basis, the annual rate of increase this year has been 7½ per cent, a pace of expansion approached only once in the past decade—and that was last year.

In the field of bank credit, the expansion this year has been equally striking. While there has been some slowing in the second half of the year, total bank loans and investments so far have risen nearly 7 per cent; bank loans alone, more than 10 per cent. These rates of increase have been exceeded in very few of the ten previous years.

The data cited suggest that there has been no lack of money or bank credit to finance the expansion of business activity and the making of new investments. Over the past four quarters, both industrial production and the gross national product rose 6 per cent. In contrast, consumer prices rose only about 1 per cent and wholesale commodity prices did not rise at all. Thus, virtually the entire growth in the national product has reflected real increases in goods and services available for consumption and investment.

It seems reasonable to conclude that monetary policy, during the past twelve months, was consistent with a policy goal of sustainable economic expansion at stable prices. But what about the international payments situation?

The lessening of monetary ease was hardly enough to have a significant effect either on our surplus of exports of goods and services over imports or on the volume of direct investment abroad by United States corporations. And obviously it could not affect our Government expenditures abroad. The only practical impact on our payments balance in the short run could occur through changes in bank credit to foreigners, in money market investment abroad, and perhaps in some other types of short-term capital movements.

But such an impact could be quite important. A rise in the outflow of short-term capital was largely responsible for the serious increase in the United States payments deficit during the second quarter of 1963. In that quarter, the net outflow of short-term capital from the United States exceeded $500 million. In contrast, the third-quarter outflow, after allowing for a reflux of the so-called window-dressing funds in July, was apparently less than $200 million. The improvement was partly due to a shift in United States money market investments abroad, mainly in flows of United States funds in the so-called Euro-dollar market. A substantial outflow in the second quarter was replaced in the third quarter by a modest reflow.

This change in flows of short-term funds was instrumental in cutting the payments deficit in half between the second and the third quarter. While the remaining deficit is still too large, it is lower than in any other quarter during recent years.

I have not reviewed these data to claim sole credit for Federal Reserve policy as the cause either of the rise in our national production or of the decline in our payments deficit. My purpose has been merely to affirm that monetary policies and credit market conditions consistent with sustainable growth in our domestic economy were also consistent with a significant improvement in the capital account of our payments balance.

All of us recognize, of course, that monetary policy, while indispensable, is only one of many influences affecting attainment of national goals. Many market factors and many other Government policies were at work that had a more decisive impact, both on our domestic economic growth and on our balance of payments, than the modest change in monetary policy could possibly have had. In addition, labor and management have cooperated in keeping costs from rising, thus helping to maintain the stability of average prices and consequently the United States competitiveness in international markets that is so essential to the steady improvement of our export balance.

Nevertheless, this year's experience indicates that monetary measures favorable to the restoration of payments equilibrium can be formulated and carried out in a way that precludes harm to orderly domestic economic growth; and that monetary measures favorable to orderly domestic economic growth can be formulated and carried out in a

way that precludes harm to the attainment of payments equilibrium.

The experience of the past year also points to another lesson, familiar to students of monetary policy but perhaps worth repeating. The great advantage of monetary policy action lies in its flexibility: it is capable of gradual application through a succession of steps, each of which may be as small as deemed prudent at the time.

And, if there had been reason to conclude that the gradual reduction in the availability of bank reserves was having an adverse effect on domestic economic activity, it would have been possible to halt or reverse the process. Such action would be difficult in the case of other tools of national financial policy.

It is this gradualness and flexibility which permits the Federal Reserve to be at the same time cautious and experimental. In recent years, the Federal Reserve has amply demonstrated that it is not bound by preconceived ideas and precedents, and that it is prepared to embark on new and uncharted courses in adapting its activities to meet changing needs. In its domestic open market operations, it extended its operations throughout the maturity range of Government securities, despite the many advantages of the "bills only" or "bills preferably" practice, when the extension seemed to offer somewhat greater advantages in dealing with new economic developments. And internationally, it re-entered the foreign exchange market after an absence of thirty years when it became convinced that open market operations in foreign exchange were needed to deal with new problems.

The battle against our international payments deficit produced relatively satisfactory results during the third quarter. But we cannot be sure that this progress will prove lasting. Some factors that explain the relatively small size of the deficit in recent months have been clearly temporary. And even if we succeed in maintaining the deficit at the third-quarter rate, we will still have a long way to go before achieving equilibrium. We have become prematurely optimistic before, as in early 1961 and again in early 1962, when it looked for a while as if we had been successful in reducing the payments deficit to tolerable levels. We should not make the same mistake again. This is not the time to relax our efforts.

As there are others far more able to speak for the Government itself, I have sought deliberately tonight to confine myself to monetary policy and operations—and principally, in recognition of the interest you have in international matters, to the impact of monetary policy and operations upon the balance of payments.

In so doing, I have been mindful, as I am sure you have, that even the best efforts and wisest decisions of the Federal Reserve System could not alone insure the integrity of the dollar. In this, as in other matters, help is needed.

President Johnson's message has given us the assurance that we shall continue to get that help from the Government. But we must also get help from the economy, from both labor and management. And we must get it not only when our actions are popular, but also, and more urgently, when they are not.

Recent Developments in the Defense of the Dollar*

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Although the tragic death of President Kennedy has darkened our thoughts for the past two weeks, we have had to continue to grapple with those problems and duties that are still our concern. One of the matters that he saw clearly as a primary concern to the nation is our balance of payments and the maintenance of unchallenged confidence in the dollar as a keystone of the international financial structure. In discussing our balance of payments in this distinguished company, I think I can take for granted that we are all generally familiar with the essential facts, which have been worked over ad nauseam in the course of the past five years. This afternoon I would like to philosophize on the role that monetary policy can be

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