For Release at 10 a.m. C.S.T.
(9 a.m. E.S.T.)
Thursday, November 11, 1965

INTEREST RATES, GOLD, AND THE BALANCE OF PAYMENTS

Remarks of

SHERMAN J. MAISEL

Member,
Board of Governors
of the
Federal Reserve System

at the

Joint Meeting of Board of Directors of the
Federal Reserve Bank of Dallas with
Boards of Directors of El Paso, Houston, and San Antonio Branches

Dallas, Texas

November 11, 1965

INTEREST RATES, GOLD, AND THE BALANCE OF PAYMENTS

Some advised me not to bother discussing balance of payments in Texas. Even though the Southwest has a long international border and important ports, they assumed there is less interest in foreign problems here than on the East or West Coast. They probably also guessed that most of you, just as I, wish that our balance of payments and other international problems would disappear. A return to earlier days when we didn't have to hear about the problems of Viet Nam, the Common Market, or other far off places would be comforting.

Unfortunately the disappearance of foreign problems is a dream, not a possibility. We are a major part of the world. As long as we remain on this planet, we will have significant problems of international relations. It is most unlikely that for any long period in the future will we again be able to pay as little attention to our balance of payments as we did from 1940 to 1955.

Balance of Payments and Monetary Policy

Even if you had no concern for foreign problems, you would still have to be interested in the balance of payments. It directly affects our daily activities. Its impact could become still greater. Many people believe that it is necessary to shape domestic monetary policy to fit our balance of payments. They urge that we tighten credit and raise interest rates in an attempt to cut flows of money abroad. I believe this is a bad prescription for two reasons: (1) It is based on a poor theory which is unlikely to work in practice; and (2) Monetary policy should give primary consideration to our economy's needs for growth and price stability.

My belief is not based upon isolationism, but upon considerations of economic efficiency and progress for both the United States and the world. A strong, expanding U.S. economy is not only highly desirable for ourselves but a necessity if the world is to remain free.

Many times a proper use of monetary policy to achieve our domestic goals will help our balance of payments also. However, this does not automatically occur. No unseen economic hand guarantees that either raising or lowering interest rates and credit will lead to a satisfactory balance in our foreign exchanges. On the contrary, the monetary policy needed for domestic price stability and prosperity may frequently give poor balance of payments results.

When a conflict between internal and external stability occurs, we should utilize monetary policy for our domestic objectives. This doesn't mean that we can neglect the external problem. In fact, the opposite is true. We must bring our balance of payments into equilibrium. It does mean, however, that along with policies to insure domestic growth and price stability, we must continue to develop sound selective instruments that work through the price mechanism to enable us to balance our foreign payments.

What is Our Balance of Payments Problem?

We have all looked at enough balance sheets and know enough accounting to recognize that all double-entry bookkeeping accounts balance by definition. This is as true of our foreign as our domestic accounts. Therefore, to find a deficit or lack of equilibrium, we must define our problem.

This country's external accounts reflect our foreign trading of goods and services. But they do much more. The U.S. is an important lender and investor. Moreover, this nation serves as a bank to the rest of the world--other countries use the dollar as a means of payment and as a store of value. A proper appraisal of our balance of payments position requires an awareness of this three-fold role played by the United States in the world economy--as trader, investor, and banker.

In the course of trading, American citizens and businesses pay and receive from foreigners billions of dollars each year. In these current account transactions, our receipts exceed our payments by sizable amounts.

In our lending and investing activity, on the other hand, we have tended to pay out much more than we receive. This is as it should be. The richest country in the world ought to be a capital exporter, sharing our enormous savings, our technology, and know-how. These capital outflows take the form of private direct investment, purchases of foreign securities, bank loans to foreigners and Government grants and loans abroad. Much of this lending is at foreign rather than U.S. initiative.

Adding our trading and lending activities together, we find more dollars paid to the rest of the world than they have paid to us. This excess dollar outflow is a measure of our balance of payments deficit.

The Gold Problem

Most people speak interchangeably of our balance of payments and our gold problem. While the two are related, they are very different. Gold figures are a poor measure of our international exchange problems. They are dramatic but not too useful. A balance of payments problem can exist with no gold loss. Contrariwise, gold may flow out with no balance of payments problem.

These differences arise because of our third international function--as banker to other countries.

Some of the excess payments abroad--that is, a portion of our deficit--serves to meet the dollar balance needs of foreign banks and traders to help finance the growing volume of international trade. Since 1960, for example, such dollar balances privately held by foreigners have increased $4.3 billion, or more than 60 per cent.

Other excess dollar outflows meet the needs of foreign monetary authorities for more reserves in the form of dollar balances. They invest these dollars in the United States and thereby earn interest on them.

Finally, some excess dollars may be used by foreign monetary authorities to purchase gold from the United States. As the major reserve currency country, we stand ready to buy and sell gold for dollars at $35 per ounce.

Since only the last type of transaction causes a gold loss, it is clear that the flow of gold abroad is not a reliable measure of a balance of payments disequilibrium. The flow of gold can be, and usually is, much smaller than the deficit. But it can also be larger, as it was in the first half of 1965, if foreign countries buy gold with previously accumulated dollars.

A normal or equilibrium position for our balance of payments deficit is not zero. As long as foreigners want to increase their holdings of dollars, the United States supplies them. But by the broadest definition of a deficit--although probably a poor one--voluntary accumulations of dollars by foreigners show up as U.S. deficits.

Without in any way entering the argument over the costs or gains due to the U.S. status as a reserve currency country, I merely note that to the extent that foreign countries use the dollar as a reserve currency, we cannot avoid deficits, by the usual definitions. These are not common deficits. We have actually been increasing our international net worth at a rapid rate. They are more closely related to the way a bank's liabilities expand when depositors desire to hold more assets in the form of bank deposits.

A Fractional Reserve System

Let me make two asides:

The first is to draw your attention to the similarities of our problems as a banker to those suffered by New York City banks prior to the establishment of the Federal Reserve System. Every time other parts of the country changed their ratios of gold to money either through private hoarding or for additional bank reserves, New York banks were placed under severe pressure. They had to tighten credit. This frequently led to panics which hit hardest those who had sought to increase their reserves at the expense of New York.

Secondly, I recently noted a study which showed that the results of speculation in gold (fortunately illegal for Americans, who are thus saved large losses), were much poorer than almost any possible investment in dollar assets. On most investment lists, it shows the largest probable losses.

Many people don't recognize how expensive it is to hold gold. They fail to count the interest lost in holding this sterile asset. When lost interest is charged and measures of actual gains and losses from holding gold are compared to other holdings such as of bonds or stocks, the man or bank holding gold turns out to have held an expensive, money-losing asset.

I think people get confused because they don't recognize that in this century the value of gold has depended completely on the dollar. The uninformed think that gold has some unchangeable, intrinsic value. They don't know that its intrinsic or symbolic value is far below the amount paid for it by governments who place it in monetary reserves. Without the governments' and central banks' demand for gold for reserve purposes, industry or individual users would have to pay a much lower price.

Another source of confusion about gold is that we don't publish an index of the value of gold, which would show its sharp changes over time. The reason is that we don't have to. Since its price has been pegged to the dollar, its value is identical to that of the dollar. To find how the value of gold has changed since 1935, simply look at the U.S. price level.

In Theory How Does Tighter Credit Help?

Let us now turn back from this digression on defining the problem of gold and the balance of payments. What I mainly want to discuss is how an existing deficit can be ended. First, let us see how, in the theoretical world, an adjustment might be made.

I guess that most bankers and economists would agree with the theory recently expressed at a symposium sponsored by the American Enterprise Institute:

> "Suppose that a country has an overall deficit due to capital export in excess of its surplus on current account. All that is then required in order to restore equilibrium in the overall balance is a restrictive credit policy, implying higher interest rates which, by putting a brake on aggregate domestic demand, lead to a fall in prices and/or employment, and hence to higher exports and lower imports, and a larger surplus in the balance of payments on current account. The rise in interest rates also has the effect of reducing the capital export, or at least that part of it which is governed by commercial considerations...there obviously exists some level of interest rates at which the current account surplus will be great enough, and the capital export small enough, for the two things to balance."

The Real versus Theoretical World

In much of economics, theories have been reshaped to take into account the frictions and imperfections of the real world. Such revisions have been slower to be accepted among the theories of international trade and finance.

The world of theory departs from the world of reality in three significant ways:

1. There is no way to know if a balance could be brought about at all by this method. But even if it could, what would be the level of domestic output and employment?

2. The theory neglects the important part in the problem played by considerations of national policy. Our military and foreign policies need economics so that we can achieve our national goals as cheaply and efficiently as possible. Economists agree, however, that neither in theory nor in fact should these policies be dominated by economics. For example, we have to find the money to support our troops in Viet Nam. Given a national decision that we fight there, we had better supply all requirements, not curtail them for balance of payments reasons.

3. The theory neglects the actual institutions through which economic policies have their impact. As an example, we have large, free, competitive capital markets. Most of Western Europe's markets are small, restricted and marked by a much higher structure of interest rates. This means that capital flows may not be halted except by extremely large changes in interest and profit rates.

Frictions and Transfers

The great progress that economics has made in the past 25 years occurred because economists took a more careful look at the real world. They saw taxes, unions, giant corporations. They noted tariffs, trade quotas, long transportation hauls, lack of information. These facts of life mean that when you start raising interest rates to halt imports and raise exports, you don't know what results you may end up with.

The theory says that if money is tight enough, sufficient unemployment will be engendered to cut imports. It doesn't say whether the needed increase in unemployment will be 1 or 10 per cent. It supposes that unemployed resources will transfer to export industries. It doesn't say what wages will be offered or whether anyone will accept them.

We do know that the smaller the percentage of foreign trade in an economy, the more difficult and more expensive it will be to adjust the large domestic sector to the small portion made up by foreign trade. Most European countries are in a very different situation from the U.S. While our domestic trade is 15 to 20 times our foreign, their ratios are more likely to be 3 or 4 to 1.

We also have fairly good proof that the theory doesn't work to start with. Unwanted dollar balances in foreign hands are an indication that the real goods transfer mechanism is out of whack. We think that Europe must have a large need for capital because their interest rates are high. We know our capital must be cheaper and more efficient because comparatively, our interest rates are low. The failure of real goods to follow money flows shows that tariffs, quotas, monopolies, or similar interferences with a free market are holding them back.

Foreign Policy and Balance of Payments

We have recognized that government spending and taxes form an important share of our domestic economy. The same is true in the international sphere.

We are doing extremely well in our commercial or business current accounts with the rest of the world. Our commercial foreign exchange balance since 1960 has averaged somewhere between \$5.2 and \$7.5 billion, depending on how it is calculated.

In this period, however, our deficit as a result of military operations overseas plus government grants and loans has on a minimum estimate, run about \$3.5 billion per year or, neglecting offsetting sales, as high as \$6.0 billion. Our military expenditures have averaged from half to two-thirds of the total. These total governmental expenditures have far exceeded our net deficit.

The traditional theory agrees that deficits caused by these expenditures require special adjustments. They will not and should not be influenced by monetary policy.

Economics does tell us that when we have been out of equilibrium for an extended period, something is wrong. Because their impact on the balance of payments differs from their impact on the government budget or GNP, the actual costs of military and economic assistance may be far higher than we recognize. The proper pricing mechanism includes balance of payments effects. There is a question as to whether each dollar sent overseas by the government is returning its true value. Calculating the true costs is difficult and a constant battle. President

Johnson recently instructed each governmental unit to emulate the Defense Department in an attempt to see that the best and latest cost techniques are used. We can hope that the attempts to revalue foreign expenditures will be successful and will lead to better policies plus savings in this sphere.

Capital Flows

The final large segment of foreign expenditures is the $4 billion or more a year of short- and long-term lending and investment. Again, this sum considerably exceeds our total deficit. At first, these flows would seem the most likely to respond to interest and credit changes. We know that some money flows do occur as a result of interest differentials. The question is whether they and enough others could be halted by feasible credit movements.

The recent past looks discouraging. Since 1961, our short-term interest rates have been raised for balance of payments purposes. Capital outflows have not responded as one might hope. In fact, the opposite is true. A high correlation, which should not be assumed to be causal, exists between these interest rate increases and an increased flow of credit overseas.

This result should not surprise us. We know from our domestic experience the many possible reactions to interest rates. We also know that some of our rate increases were simply matched abroad. Everyone reached a higher level with no differential impacts. Perhaps some flows were cut off. But in this period, demand was growing more and more rapidly.

More significantly there is really not much reason that interest rate increases of the type we have experienced, even those since 1961 of 170 basis points, or 75 per cent, in the short-term rate and 50 basis points, or 12 per cent, in the long-term rate, should be expected to stop money from flowing abroad. Secretary of the Treasury Dillon, in one of his final official speeches at Princeton last March, gave an excellent analysis of why this is so. The main reasons are foreign and domestic differences in profit projections and capital markets.

Direct investment has moved abroad because American businesses thought they saw higher possible profits from operating foreign plants. Many reasons are cited for this. European markets have expanded faster. Our rate of growth had been slowed. They have lacked competition while internally our competition has been intense. Their inflation was faster. Our tax laws gave subsidies not available in this country to foreign investment. Their changing tariff situation made production within their markets better. Past unfavorable factors had disappeared while favorable ones had accumulated.

Some of these reasons are conflicting. Some are temporary. Some indicate dangerous illusions by investors. Others show a lag in governmental policy. On the whole, however, most of these forces would not be reduced by a higher interest rate policy here, while several would be strengthened.

The reasons why foreigners want to borrow in our markets are even clearer. Foreign financial markets tend to be poorly developed.

Intermediation is faulty. Mechanisms for tying together short-term savings with long-term lending are lacking. Funds flow through only a few institutions. Many markets are government controlled, and channel most available funds to governments rather than to private investors.

In contrast, American money markets are huge. Savings are large. Competition is intense. Large demands are handled with ease. Funds flow readily from one market to another.

As a result, our lending rates have been far more reasonable than Europe's. It would take sharp, unreasonable curtailments of credit in this country to narrow the gap.

An Analogy

I might sum up my view of the problems by an analogy. We can picture our domestic and foreign trade situation as a lake behind a dam connected to another lake at a lower elevation by a canal. The first lake is our domestic economy. The canal is the connection to other economies. The relationship of its size, which is small compared to that of the lake, reflects the relative magnitudes of our domestic and foreign commerce. The water flow through the canal is controlled by sluicegates at each end. A balance of payment problem exists when the rate at which water is let into the canal is greater than the rate at which it is let out. This leads to an overflow.

Clearly there are three ways of solving the problem of overflow. One could drain some of the lake; a lower level would lower the pressure on the canal. Or one could partially close the upper gate; this, too, would reduce the flow of water through the canal. Or one could widen the opening at the lower gate, thus allowing the water to flow out faster.

Some Methods of Adjusting the Flow

Lowering the level of the lake to halt the overflow is likely to be a very inefficient method of handling the problem. Experience teaches that drastic reductions in the total are likely to be required to achieve small adjustments in a special structural area such as foreign trade. The cost to the United States and to the world of reducing the level of our economic activity below its best growth line would be great. It should be adopted only as a last resort.

The solution to the balance of payments problem should be sought directly in the foreign flow of funds. It must be recognized as an international, as much as a national, problem. The gates regulating foreign interchange are manned at both ends. International agreement must be achieved on available selective instruments. They may either reduce the flow from the U.S. or increase the rate at which foreign economies accept our goods and services.

I can list only some of the many proposals which I feel offer possibilities. Some affect our role as trader; others as lender, and still others as banker.

As a Trader: Let us consider our current accounts as including commercial exports and imports, plus military and government grants and loan expenditures. Substantial improvement in these accounts will be hard to achieve, but may be possible. Domestically, efforts are being made to expand exports. Other services may also be pushed.

The balance of payments costs of our trade policies, our military forces overseas, and our grants have been under constant surveillance. Many believe that partly because of a basic misunderstanding of the real balance of payments problem, our allies have not been carrying their full weight. I would hope that in the light of a complete reexamination of the marginal balance of payments cost of each part of our foreign policy, we could get more for our funds, while convincing other countries of the need to carry their true share. The reexamination should include our trade policy also. Failure of the transfer mechanism indicates critical problems in the trade sphere which are frequently neglected in balance of payments discussions.

<u>As a Lender</u>: We have already taken several steps. We have used the Interest Equalization Tax. We have adopted the Voluntary Foreign Credit Restraint Program. The Administration suggested--and some progress was made toward--a reconsideration of our income tax policy with respect to foreign earnings. The present tax laws appear to subsidize investment sent abroad. Policy in the past was frequently based on the idea that spending abroad should be encouraged. Times have changed. Probably policy should change also.

Another major improvement, particularly aimed at speculative, short-term money flows, which have had a most destabilizing effect, has been promised by the advocates of widening the margin of permissible limits of exchange rate variation. They claim that broader limits would cut our short-term speculative capital outflow since the costs of covering forward would exceed the small interest differentials which now lead to capital exports. Trade would not be influenced since it would still take place either in dollars or at agreed upon exchange rates. They have suggested that we broaden the limits by widening our gold margins. This would have to be done by lowering the purchase price of gold, since we have a firm national commitment to maintain the selling price at $35 an ounce. The Joint Economic Committee of Congress recently urged a much closer examination of this proposal. I agree that a study of the pros and cons of this type of proposal would be worthwhile.

As a Banker: Finally, our role as a banker needs clarification. There are both short and long-run problems. Some reexamination is necessary of the proper banker-depositor relations under a fractional reserve system. Failure to agree on how reserves should be handled caused tremendous difficulties domestically under the National Banking System. Similar uncertainties become a constant source of worry and of consequent wrong action for a reserve currency country. Many logical plans on reserve ratios, value guarantees, funding of overages, etc., have been advanced that would reduce this problem internationally, just as the Federal Reserve and FDIC Acts have reduced it internally.

Another area in which progress may be expected is in methods of improving the future operations of the world monetary system, particularly with respect to the way future world monetary reserves will be provided. The United States is now engaged in negotiations with other countries to improve present procedures. The results of these efforts will be most significant.

Conclusion

As must be clear, I have no panacea for our monetary problems. I do feel it important for all of us to recognize that the panacea offered by others of tighter credit as a basic solution to our balance of payments problem is not likely to work. In order to bring our balance of payments into equilibrium, as we must, we require a much more complete examination on both a national and an international basis, of possible steps to improve the situation. Foreign exchanges are a multi-national problem. Valid solutions are not easy to find. However, many selective policies have been suggested. They promise to be more efficient than an overall reduction in demand.

It is important that the various proposals be carefully reconsidered both individually and as part of a broader package. How can we make our price, lending, and trade mechanisms approach more closely to the goals of free competition? Improvements probably will require international agreements covering a large number of specific policies, some directed toward slowing down the flow from our end, and others toward increasing the rate at which goods and services are accepted at the other.