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Statement by

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I am happy to come here today to discuss with you how we at the Federal Reserve see the problems that are the subject of these hearings.

My major theme this morning will be the persisting imbalance in our international economic accounts. After considering that, I shall turn to the special problem of short-term capital flows, and conclude by discussing some of the policy actions that need to be taken by us and other countries to deal with these two problems.

The Persisting Imbalance

As you well know, our balance of payments is not in a satisfactory condition. Indeed, a deficit in our international accounts has turned up almost every year since 1949. There are several ways of judging the balance of payments--through the balance on official reserve transactions, the balance on the liquidity basis, or the balance on current account and long-term capital. Whichever of these concepts we may adopt, the practical conclusion is the same: a stubborn, persistent deficit has characterized our balance of payments.

We should not, however, be misled by the staggering magnitude of the balance of payments deficit during the past year and a half. In 1970 the deficit on the official settlements basis reached $10.7 billion before allowing for the special drawing rights (SDRs) allocated to us, and the deficit has continued at an extremely high rate in the first five months of this year. These recent deficits exceed anything we have hitherto experienced, but they also greatly exaggerate our true underlying condition. Thus, the official settlements deficit over the thirteen years from 1958 to 1970 averaged only slightly more than $2 billion per year. Moreover, the deficit on current account and long-term capital movements, while larger in 1970 than in immediately preceding years, has been for several years in the 2 to 3 billion dollar range. Of late, this underlying imbalance has been overshadowed by extraordinary short-term capital movements, and it is this that has made our balance of payments position appear much worse than it basically was in 1970--just as it made it appear much better than it basically was in 1968 or 1969.

It is also worth noting, as some European countries have recently discovered, that a surplus in the balance of payments is not always a blessing. Nor, for that matter, is a deficit always bad. We cannot remind ourselves too often that the postwar U.S.

deficits experienced through the late 1950's were welcome deficits. The balance of payments problem in those days was called the world's dollar shortage.

As our deficits persisted through the 1960's, however, it became increasingly clear that further large deficits could prove troublesome to us and to other countries. For the counterpart of the persistent deficit has been a gradual erosion of the U.S. international reserve position.

Our reserve assets--which include, besides gold, our reserve claim on the International Monetary Fund, holdings of convertible foreign currencies, and more recently SDRs--declined fairly steadily from a level of about $25 billion in 1957 to less than $14 billion at the time of the gold crisis in the spring of 1968. Since then our reserve assets at first rose somewhat; but they have fallen back more recently to the previous low point of 1968. In sharp contrast, U.S. liabilities to foreign central banks and governments have increased rather steadily in the postwar period. These claims on U.S. reserve assets grew from an average level of some $4 billion in 1949-51, to about $12 billion in 1960. By the end of this April, they amounted to $31-1/2 billion, and there was a further substantial increase during the foreign exchange crisis in May.

Once welcomed by all concerned, these trends in our reserve position have gone on much too long. Continuation of the decline in U.S. reserve assets and any excessive buildup of our reserve liabilities are neither desirable nor sustainable. If we wanted to finance further sizable deficits by reducing reserve assets, it is obvious that we could not continue doing so very long. On the other hand, if we sought to finance persistent deficits by increasing our liabilities to foreign central banks and governments, we might well find that some countries no longer wish to add to their dollar reserves. Certainly, a continued accumulation of unwanted dollars would make our friends abroad more and more dissatisfied with the workings of the present international monetary system.

Now that SDRs are being created, there is also less reason for large, persistent U.S. deficits. Before the advent of SDRs, our deficits played a major role in supplying monetary reserves to other countries. There is now general agreement, however, that growth in the reserve liabilities of the United States should be much smaller and that the major part of future growth in world monetary reserves should take the form of SDRs.

The most disappointing feature of the U.S. balance of payments in recent years has been the weakness of our foreign trade account. Since a more viable overall balance of payments in the future will require a substantial improvement in our trade balance, I would like to discuss this sector of the balance of payments with you in some detail.

The U.S. surplus on trade of non-military goods averaged $5.6 billion in 1956-57, dropped sharply during the late 1950's, then returned to a robust $5.2 billion average in 1960-61. Despite the strong recovery of the economy between 1962 and 1964, the surplus increased somewhat. Since 1965, however, the trade surplus has been shrinking. In 1968 and 1969, it virtually disappeared. Though rising cyclically to an annual rate of some 2 to 3 billion dollars in the first three quarters of 1970, the trade balance has in recent months been in actual deficit. The data for April and May of this year are particularly unfavorable.

The most important factor contributing to the post-1964 deterioration in our trade position was the emergence of excess demand in our economy and the accompanying inflationary conditions.

To be sure, export receipts--while affected adversely by high demand pressure at home--did increase at a rate of about 10 per cent a year in the period 1965-70. This growth, however, was not as rapid as the growth rate of imports by the rest of the world. Hence the U.S. share in world markets continued its gradual decline.

Data on prices in the United States and foreign countries support the view that our trade balance during 1965-69 was weakened by the inflation. By 1969, export unit values for the United States had risen by 17 per cent from the 1963-64 average. Export unit values for countries such as Germany, Japan, and Italy rose much less. A comparison of wholesale price indices again shows a significantly faster rate of increase for the United States in 1965-69 than for most other industrial countries.

Imports have grown since 1964 at an annual rate of almost 14 per cent, much faster than the growth rate of GNP. As a consequence, the ratio of imports to the gross national product has risen by roughly one-third since 1964 to a current level of about 4 per cent. The impact on imports of the excessive demand pressure in 1965-69 goes far toward explaining this rise in the propensity to import. Shifts in the character of our imports also played a role. Finished manufactures have become an increasingly large proportion of total imports, rising from 37 per cent in 1960 to 56 per cent in 1970. Moreover, imports of finished goods have also been rising rapidly relative to domestic production. These trends were already in evidence in the 1950's, but only in more recent years have they had a major effect on the ratio of imports to the gross national product.

No analysis of our trade position would be complete without reference to the fact that some U.S. products are not freely admitted to foreign markets. They are subject to quantitative or administrative quotas (e.g., consumer goods imports into Japan), to variable border levies and other special import taxes (e.g., EEC restrictions on the import of agricultural goods), to special marketing agreements, and so on. Such restrictions limit our exports of agricultural products, coal, and a wide range of manufactured products including computers, autos, heavy electrical equipment, drugs, and fabrics.

I shall come back later to the outlook for our balance of payments and to policy actions that can be taken to deal with the underlying imbalance. Before doing so, let us focus on the special problem of short-term capital flows, particularly our experience of the last two or three years.

Short-term Capital Flows

Troublesome flows of capital often develop when the business cycle is in a different phase in different countries, and the monetary policies of the countries are accordingly out of phase.

Thus, the massive flow of short-term funds to the United States in 1969 was a byproduct of the tight monetary and fiscal policies here at that time, while in most European countries the policy response to the rising boom was less advanced. Major American banks experienced increasing difficulty in accommodating the credit demands of their customers as their time deposits shrank because of the rise of market interest rates above the Regulation Q ceiling for CD's. The foreign branches of our banks came to the aid of their parent institutions by raising funds in the Euro-dollar market from foreigners whom they induced to shift out of assets in their own currencies into dollars. The Eurodollar market thus served as a channel for large flows of capital to the United States. In a narrow view, this was not unwelcome as an offset to our underlying payments imbalance. But it was trouble-some to some European countries. Moreover, the flow was bound to turn around sooner or later--as in fact it did in 1970.

In the latter part of 1969 and in 1970, many European countries found it necessary to tighten their monetary policies. In the United States, on the other hand, excess demand for goods and services vanished during 1970, and monetary policy shifted away from severe restraint toward moderate ease. It therefore became cheaper for American banks to attract funds at home than to maintain large Eurodollar borrowings. The branches, getting repayments from their head offices, had additional funds to lend abroad. In turn, business firms in Germany and other countries where credit conditions were tight found Eurodollar loans readily available at lower cost; so the Eurodollar market now served as a channel for a flow of short-term capital from the United States to other countries. As a result, the official settlements deficit of the United States increased very sharply, other countries experienced large reserve gains, and the efforts of European countries to fight inflation with restrictive monetary policies were to some degree undermined.

This year, the flow of short-term capital to European countries, particularly to Germany, was at first simply a continuation of the earlier flows arising from national differences in credit conditions. In April and May, however, the international flow of funds--whether through the Eurodollar market or directly from country to country--expanded enormously. Interest differentials could not be the main factor in these new and massive capital movements; for interest rate spreads were then actually in process of narrowing. What happened was that a speculative movement developed in the expectation, which was stimulated by widespread reports concerning intentions of the German government, that the D-mark and some other currencies would soon be revalued. As everyone knows, a monetary upheaval of some dimensions did occur in Europe in early May.

This recent experience with speculation on foreign exchanges underlines the fact that short-term capital flows are not independent of persistent payments imbalances. Had there not been a long experience with U.S. deficits and German surpluses, it is doubtful if the flow of short-term funds to Germany and other countries would have reached such huge proportions.

Incidentally, it is important to recognize that some part of the large reserve gains of European central banks during the past year is directly attributable to the practice of major European central banks in depositing funds, usually through the Bank for International Settlements, in the Eurodollar market. Typically, the banks in which these central bank funds were placed lent them out to European borrowers, who in turn often converted the funds into their own domestic currencies. These conversions into domestic currencies expanded the money supply of the affected countries and eased the liquidity positions of their commercial banks, thereby frustrating to some degree the restrictive policy of central banks. In the end, central banks, serving as residual buyers of dollars in their exchange markets, reacquired--in whole or in part--the funds that they themselves had initially lent to the Eurodollar market. By this process, increases in official dollar holdings were magnified far beyond what they would otherwise have been. Yet the whole blame for the rapid increase in foreign dollar reserves was widely, but incorrectly, attributed to the U.S. deficit.

Outlook for the Balance of Payments

For the near-term future, a repetition of capital flows such as we have recently observed is highly unlikely. The liabilities of U.S. banks to their foreign branches fell from a peak of over $14 billion in 1969 to about $2 billion in recent weeks. Clearly, they are now at or close to rock bottom. Moreover, the Voluntary Foreign Credit Restraint program inhibits the banks in increasing their foreign assets. Thus the large outflow of short-term funds which began in 1970 is now behind us. For this reason alone, we can expect the official settlements deficit to fall back sharply from the unprecedented rates of 1970 and early 1971.

What about the prospects for other categories of transactions? As I try to look ahead, I see some significant areas of strength. First, growth in our receipts of investment income from abroad has been rapid and fairly steady. This trend can be expected to continue.

Second, foreigners have in recent years stepped up their purchase of equities in the U.S. stock market. This trend, too, may well continue in the future--especially if corporate profits pick up and we make reasonable progress in restoring full employment.

Third, the reduction of troop levels in Southeast Asia is mitigating the drain on our balance of payments from overseas military expenditures, and further reductions in the foreign exchange cost of our overseas operations are expected.

To be sure, these favorable trends could be offset by weakness in other categories of international transactions. I have already noted that our trade position is not nearly as strong as it needs to be. The fact that our price performance since 1969 has been better than that of many other industrial countries suggests that we may be on the road to regaining at least part of the competitive strength that we lost in the second half of the 1960's. Any such conclusion, however, would be premature.

On balance, it appears that while we can look forward to a very substantial reduction in the official settlements deficit over the coming months, we need to recognize that economic policies since 1958 or thereabouts have been entirely insufficient to achieve equilibrium in our international accounts. Some decisive steps will need to be taken to correct the situation.

Policy Guidelines for the Future

The obvious place to begin is at home. Let us therefore consider the question: What policy actions can and should the United States take?

The first and foremost requirement for improving our trade position and the overall balance of payments is to restore and maintain general price stability while we continue to strive for a healthy rate of economic expansion. That reliance on monetary and fiscal policy may prove insufficient to realize this objective is attested by our own recent experience as well as that of Canada and Great Britain. In all three countries a substantial increase of unemployment has failed to check the rapidity of wage advances or to moderate appreciably the rise of the general price level.

With increasing conviction, I have therefore come to believe that our nation must supplement monetary and fiscal policy with specific policies to moderate wage and price increases. As I have noted on previous occasions, I am not unaware of the pitfalls that could accompany governmental involvement in the determination of wages and prices. I also recognize that previous experiments with incomes policy have hardly been a huge success. At the same time, I attach great weight to the moral force that strong government leadership could at the present time bring to bear on private decisions in key industries. If we are to restore price stability with high employment in our economy, I see no immediate alternative to a cogent incomes policy. Over the longer run, we may well need legislation to deal with abuses of private power in our labor and product markets.

While the restoration of general price stability is basic to the correction of our trade position, other measures that can improve our exports deserve consideration. The recent decision of the Administration to remove some of the restrictions on trade with mainland China might be followed up by some liberalization of trade with the Soviet Union. A proposal for establishing domestic international sales corporations, whereby taxes on earnings from exports may be deferred, has been put before the Congress. And so too have some proposals for strengthening the Export-Import Bank, such as providing it with increased program authority to extend loans, guarantees, and insurance. All these measures may prove helpful.

But far more important than these specific measures for stimulating exports, as I have already tried to suggest, is the restoration of general price stability and improvement of the economic climate in our country. Restoration of general price stability is vital to the return of a healthy trade balance, while larger profits than American corporations have achieved in the past few years from their domestic enterprises are vital to improvement in the long-term capital account of our international transactions.

Since the United States has experienced a persisting imbalance in its international payments, it follows that the rest of the world has been in persistent surplus. Thus the rest of the world must be prepared to see its surplus decrease if the U.S. deficit is to decrease. This simple thought leads me to ask: What actions should our trading partners take?

There are at least two areas in which they can be very helpful. First, as I have already intimated, other nations need to review their trade policies and relax restrictions on their imports. A timely initiative by Japan and some European countries to open up their markets more freely to the products of others is overdue. Trade liberalization should be accompanied by relaxing the heavy restrictions that nations often impose on investments abroad by their citizens.

Second, foreign countries can and should undertake a significantly larger contribution to the defense of the Free World. The United States is not going to cast off its responsibilities for leadership in this area. But the nations of western Europe and Japan, where overseas military expenditures by the United States are very large, now have strong economies and a capacity to contribute significantly more to the financing of the military shield from which they as well as we benefit. A more equitable sharing of the defense burden would require them to do so.

Clearly, neither the problem of persisting payments imbalances nor the problem of destabilizing short-term capital flows can be dealt with effectively by the United States on a purely unilateral basis. Neither can other major countries effectively deal with these problems by unilateral action. Since we are all parts of a community of nations, perhaps the most important question we have to ask ourselves is: What policy actions can the major countries take cooperatively? There are four areas of joint policy action I would like to stress.

First, we should try to work with other nations to bring about smaller divergences of interest rates. More effective use of fiscal policy by each major country in the interest of its own economy could reduce international differences in credit conditions, thus limiting short-term movements of funds and payments imbalances.

Second, there is a need to work closely with other countries on devising methods to mitigate the undesirable impact of capital flows on international reserves and domestic monetary conditions. Both the United States and other countries have already taken some significant steps in this direction. For example, we recently sold $3 billion of special Export-Import Bank and U.S. Treasury securities to foreign branches of U.S. banks, thereby absorbing funds that probably would otherwise have moved through the Eurodollar market to foreign central banks. We have also indicated our readiness to consult with other governments on the question of providing suitable dollar investments for their reserves held in the United States, and two days ago the Treasury formally announced a $5 billion funding of U.S. liabilities to the Bundesbank in Germany.

I am also pleased to report that the placement of central bank reserves in the Eurodollar market has now been halted by the central banks of the major industrial countries. Furthermore, discussion is proceeding among leading central banks on the question of when and how a gradual withdrawal of central bank reserves from that market might be accomplished. The problem of short-term capital flows is also being studied intensively now by the International Monetary Fund and the Organization for Economic Cooperation and Development.

Cooperative management of world reserves is the third area in which all the major countries need to take joint policy action. Looking to the long future, it is essential to maintain an adequate rate of growth in world monetary reserves and to ensure that there are no destabilizing shifts among countries' holdings of gold, SDRs, and reserve currencies. The nations of the world took a significant step forward with the amendment to the IMF Articles of Agreement providing for the creation of SDRs. The recent rapid buildup of dollars in central bank reserves should not divert us from prudent steps to increase the future role of SDRs in world monetary reserves.

Finally, we should continue to participate actively with other nations in discussions of ways in which the balance of payments adjustment process can be improved. The question of greater flexibility in exchange rates has been extensively discussed in the IMF and elsewhere in the past two years. Thinking has centered on the possible advantages of some widening of the margins for exchange rate fluctuations around their parities, of a "transitional float" from an old to a new parity, and of smaller but more prompt changes in parities. A widening of margins, for example, holds considerable promise as a device for permitting greater divergences in monetary conditions to exist among countries without those divergences giving rise to excessive flows of short-term capital. The turbulent events in exchange markets this May have underlined the need for informed discussion and reconsideration of the international rules governing exchange rate policies.

Concluding Observations

In closing, let me say that I hope I have made it clear that the Federal Reserve Board rejects an attitude of complacency about the U.S. balance of payments. We also reject any radical courses of action that would imperil the institutional arrangements and good will among countries that have been carefully built up in the quarter century since the Second World War. What we need is measured, deliberate steps to resolve the problems that confront us.

We can go about this task in a mood of confidence. For our economy is larger and more productive than that of any country in the world. Not only that, the foreign assets of the United States far exceed our foreign liabilities, and this excess has grown steadily since World War II. It is the liquidity aspect of the U.S. debtor-creditor position, not the overall international balance sheet, that causes us concern. In considering the balance of payments problem, we should not lose sight of our fundamental strength.

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