For release for use
in Afternoon Papers
Wednesday, October 5, 1966

Monetary Policy and the U. S. Balance of Payments

Remarks by

Andrew F. Brimmer
Member
Board of Governors of the
Federal Reserve System

at the

Wharton School of Finance and Commerce
University of Pennsylvania
Philadelphia, Pa.

October 5, 1966

Monetary Policy and the U.S. Balance of Payments

The continuing deficit in the U.S. balance of payments is still a matter of serious national concern. Since the issue this year has not dominated public discussion to the extent it did a year ago, some observers (especially some of those in key financial centers abroad) have concluded that the elimination of the deficit has receded to a lower priority in the array of national objectives.

Such a conclusion is unwarranted. As the Secretary of the Treasury made clear during the recent meeting of the International Monetary Fund, the U.S. is as determined as ever to bring its international payments into balance - although to do so may necessitate the adoption of policies (particularly with respect to capital flows) which this Nation would ordinarily prefer to avoid.

For our part, we in the Federal Reserve System also remain as acutely aware as ever of the seriousness of our balance of payments problem, and we continue to assign a high priority to its early resolution. The basis of this concern is readily evident:

- Since 1957, the monetary reserves of the U.S. have declined steadily, and are declining further this year.
- Simultaneously, U.S. liabilities to foreign central banks and governments (which hold dollars as reserves) have risen steadily.
- Although our reserves are still almost as large as these liabilities ($15 billion compared with $16 billion), seven years ago reserves were twice as large as the liabilities.

Clearly, these trends cannot continue indefinitely. The establishment of a viable equilibrium is not only a matter of our national but also our international interest. The role of the dollar as a major reserve currency and as a vehicle for international transactions lends urgency to our task.

To say this is not to overlook the progress we have already made. The deficit, measured on the basis of the liquidity definition, shrank from over $3 billion a year in 1960-61 to less than $1½ billion in 1965. During the same period, measuring the deficit on the basis of official reserve transactions, the decline was from approximately $2½ billion to $1¼ billion.

Nevertheless, the pace of the improvement has been disappointingly slow. As we all know, the rate of progress has been interrupted by the strong domestic expansion and the acceleration of military activity in Vietnam. In fact, the latter may be contributing as much as $1 billion at an annual rate to the deficit. During the first half of 1966, the deficit on the liquidity basis was essentially unchanged from that recorded in the calendar year 1965, but the official settlements deficit was reduced substantially.

But in one sense we are fortunate: Monetary and fiscal measures required to moderate the excessive level of aggregate demand at home would also move us further toward the elimination of the balance of payments deficit - although the adverse impact of our military effort abroad would still remain.

In fact, although it has not been generally recognized, the Federal Reserve's policy of monetary restraint has been one of the principal factors preventing the further deterioration of the U.S. balance of payments during 1966. The nature of this contribution can be traced in a number of ways:

- Through moderation of certain kinds of domestic demand.
- Through moderation in the outflow of U.S. capital.
- Through acceleration in the inflow of foreign capital.

In fact, the inflow of short-term capital, much of it mobilized by foreign branches of U.S. commercial banks, has been one of the most striking features of the financial scene this year, and especially since mid-year. This development can be linked directly to the policy of monetary restraint followed by the Federal Reserve System and the resulting pressure on bank reserves.

Domestic Demand and the Balance of Payments

We need not review here the mechanism by which a more rapid expansion of aggregate domestic demand than of domestic supply dampens exports and stimulates imports of goods and services - thus possibly shifting a country into external deficit. The fact that the growth of aggregate demand in this country has been excessive over the last year is obvious. The evidence can be seen in the familiar indicators of rising prices, lengthening order backlogs, and increased efforts to accumulate inventories.

What is sometimes forgotten in the United States, because international transactions are small in relation to total domestic activity, is that these transactions may themselves provide evidence of excess demand pressures. For example, in the 12 months through mid-1966, the value of U.S. merchandise imports was 19 per cent larger than in the preceding 12 months. Furthermore, had there not been very substantial releases from Government stockpiles of materials that would otherwise have been imported, the increase would have been even sharper (23 per cent), or two and a half times as rapid as the increase in GNP at current prices.

In this buoyant environment, monetary policy has attempted to hold the expansion of bank credit and money to levels consistent with real growth potential, in the face of demands for credit that have been expanding much more rapidly. To this end, the Federal Reserve has used all the traditional instruments of monetary policy - open market operations, changes in discount rates and reserve requirements - and also some less orthodox tools, including ceilings on the interest rates that member banks may pay on time and savings deposits, and general guidance to banks regarding desirable portfolio adjustments and lending behavior.

These restraints have succeeded in slowing down the rate of bank credit expansion and money supply growth. For instance, bank credit increased about 10 per cent during 1965, but it has expanded at an annual rate of only about 7 per cent during the first 9 months of 1966. The money supply rose 4.8 per cent in 1965; it has increased at a rate of less than 3 per cent in the first 9 months of 1966.

As we know, monetary restraint has had a differential impact on particular sectors of domestic spending and on current international transactions in goods and services. Housing has been hit hard, rather too hard from some points of view, whereas business and consumer spending (which most affect imports and exports) have been less clearly restrained.

Nevertheless, there are recent signs that monetary restraint is producing some moderation in spending even in these latter sectors. In the latest Commerce-SEC plant and equipment survey, business spending plans for this year were not revised upward, the first time this had happened since 1963. This lack of upward revision in money terms may even be interpreted as a slight downward revision in real terms, since the costs of machinery and structures have risen. In the consumer spending field, there is reason to think that some of the moderation in spending for durable goods, notably automobiles, is attributable to more stringent terms on consumer installment credit.

Lenders have been charging higher rates, tightening repayment terms, and requiring higher down payments. Finally, it should not be forgotten that the reduction in residential construction activity has released both materials and labor to satisfy more insistent demands for industrial and commercial construction.

These domestic developments have not yet produced a clear slowing down in the unsustainable rate of import expansion. Merchandise imports rose at least as rapidly from the second quarter to the July-August months as they did earlier in the year. But there is reason to suppose that there will be some slowing down in the months ahead. Perhaps there also will be some additional release of production for export in those sectors of the machinery industry where capacity has been too tight to take full advantage of buoyant foreign demand.

The additional measures of fiscal restraint recently recommended by the President should facilitate the reestablishment of a more sustainable trend in domestic business spending. This in turn should slow down the rise in imports of capital goods, which has hitherto been occurring at a spectacular annual rate of more than 40 per cent.

In summary, while increasing monetary restraint during the last year did not prevent a substantial deterioration in the foreign trade balance, and in the balance on total exports and imports of goods and services, it helped to limit the extent of the deterioration. And there is reason to hope that these unfavorable trends in the current account are now being checked as the effects of monetary restraint filter through the economy. We would hope that the third quarter of 1966 has marked the low point for net exports of goods and services during the current boom.

Monetary Policy and Capital Flows

As I mentioned above, it is in the area of capital outflows that monetary policy and changing credit conditions have had their greatest, and most easily measured, impact on the balance of payments this year. In response to the question much debated only a year or two ago - e.g., whether monetary restraint could improve the U.S. balance of payments significantly on the capital account side - the answer given by recent experience is a clear though qualified "yes."

In appraising recent trends in the capital accounts, we must keep in mind significant developments of earlier years. It is also necessary to recall the variety of measures taken to affect them. Moreover, a full understanding of capital flows must rest on analysis in some detail, since particular types of capital flows (and flows to different areas) have responded differently both to general credit conditions and to specific influences. However, for the present purpose, it is not possible to undertake such a comprehensive task, and a broad summary must suffice.

Recorded net outflows of U.S. private capital were relatively small from the end of World War II through 1955, exceeding $1½ billion in only one year. After 1955, however, they surged upward in three waves, first in 1956-57, again in 1960-61, and most recently in 1963-64, reaching a peak of $6½ billion in the single year 1964.

It was in 1960 that U.S. monetary policy first began to take explicit account of balance of payments considerations. Interest rates were not allowed to fall nearly as low during the recession of 1960-61 as they had in earlier recessions. Efforts were made both by the monetary authorities and by the Treasury in its management of the public debt to maintain short-term interest rates at levels that would not make short-term outflows profitable on an interest-arbitrage basis. Also, the Government began at that time to plan the shift in the policy mix which was later embodied in fiscal measures to stimulate renewed economic expansion, leaving monetary policy somewhat freer to limit capital outflows than it would otherwise have been.

However, the underlying forces stimulating capital outflows continually proved stronger than anticipated. In particular, outflows of long-term capital, into direct investments and into new issues of foreign securities, gathered further momentum. U.S. monetary policy did tighten moderately in 1963. But given the domestic circumstances of high unemployment and unusually stable prices, no very marked tightening of the sort that might affect capital flows substantially seemed appropriate at that time. In addition, developing inflationary pressures in most leading countries abroad were producing a tightening of credit conditions there that offset much of the potential impact of the U.S. monetary actions on capital flows.

Selective Restraint on Capital Flows

In these circumstances, the U.S. Government proposed the Interest Equalization Tax (or I.E.T.) in July of 1963, later enacted retroactively. This measure made it more costly for residents of developed foreign countries to borrow in this country on security issues, but it did not otherwise interfere with the market mechanism for allocating available funds.

The result was a brief respite in 1963-64. With the current account surplus also expanding buoyantly in that period, the over-all payments deficit shrank to its lowest point, up to then, since 1957. But the surge in capital outflows was not yet over. Even before the I.E. T. was proposed, term lending to foreigners by commercial banks began to develop in volume. Short-term bank lending also continued heavy, and the two together rose in a kind of crescendo through 1964, bringing the total bank-reported outflow of U.S. capital in that year to $2½ billion, more than twice the peak reached in 1960-61. Direct investment outflows, particularly to Europe, also began to increase very rapidly in this period, rising in total from $1½ billion in 1962 to $2½ billion in 1964. There was an added large outflow of nearly $1 billion in 1964 of nonbank corporate funds other than direct investments.

By 1964, our other international transactions had improved to the point where we might comfortably have accommodated outflows of private U.S. capital of the 1960-61 order of magnitude - $4 billion. But the further jump in flows I have just described brought the total outflow to $6½ billion, and this demanded new policy actions.

A moderate further tightening of monetary policy seemed appropriate during 1964 and was carried out, in several stages, mainly on international grounds but also on domestic grounds, especially late in the year when price indexes began to creep upward for the first time in six years. But it seemed doubtful that the upward surge in capital outflows could be stemmed, much less reversed, by general monetary actions short of very drastic ones that would be damaging to the domestic economy.

Therefore, in February, 1965, the President sent to Congress a special Balance of Payments Message in which he outlined a number of selective measures. The I.E. T. was broadened to cover most long-term bank loans to developed countries. And a series of voluntary foreign credit restraint programs were undertaken. The Federal Reserve was assigned administrative responsibility for achieving a reduction in capital outflows from financial institutions, and the Commerce Department set out to mobilize the support of nonfinancial corporations in an effort to improve the net payments impact of their international transactions.

The nature and results of the voluntary programs are by now familiar to most of you. The essential point is that, thanks to the cooperation of the business and financial community, we did achieve a very substantial reduction in net U.S. private capital outflows - from $6.5 billion in 1964 to only $3.7 billion in 1965. This over-all result exceeded expectations.

Outflows of bank-reported capital gave way to inflows. For the year 1965 as a whole, there was a reflow of about $100 million, compared with the $2½ billion outflow of the year before. Nonbank claims on foreigners, other than direct investment, diminished by nearly $½ billion during 1965, after having risen by nearly $1 billion the year before. Direct investment outflows were sharply higher in the year 1965 as a whole than in 1964, but diminished significantly in the second half year, and an increasing portion of such outlays was financed by borrowing abroad.

Not all of these results can be attributed to the voluntary programs. To some extent, there was a natural reaction from the large and partly anticipatory outflows of late 1964 and early 1965, and also the application of the I.E.T. to bank loans played some role. About $150 million of Canadian security issues originally scheduled for late 1965 were postponed into 1966 at the request of the U.S. and Canadian Governments. Credit demands from Japan and Italy diminished as economic activity and credit conditions eased in these countries. Finally, the gathering domestic boom, particularly after military activity in Vietnam began to quicken about mid-year, was allowed to produce a considerable tightening of domestic credit conditions which worked also in the direction of limiting capital outflows.

Nevertheless, as a very rough calculation, it might be appropriate to attribute about one-half of the $2.8 billion net reduction in capital outflows from 1964 to 1965 to the voluntary programs. That represents a considerable success, and a handsome contribution to the national interest.

U.S. Capital Outflows in 1966

During the first half of 1966, the net outflow of U.S. private capital rose slightly to an annual rate of $4.0 billion, from last year's $3.7 billion. But these figures include the reinvestment abroad of funds borrowed abroad by U.S. subsidiaries established for that purpose. If these borrowings are subtracted, the net outflow of domestic capital is seen to have declined further, from $3.5 billion in 1965 to an annual rate of $3.0 billion. The decline was still larger if one disregards the Canadian securities flotation postponed from 1965.

This further decline is remarkable, particularly when account is taken of two influences that have been working in the direction of increasing the outflow this year. These are:

- The fact that plant and equipment outlays abroad of affiliates of U.S. corporations are increasing by an estimated 21 per cent this year over last.
- The fact that last year's large repatriation of liquid funds from abroad by nonbank corporations, in compliance with the voluntary program, cannot be repeated.

The influence of monetary policy in holding down outflows of U.S. capital this year is seen most clearly in the statistics reported by banks. I noted earlier that cooperation with the Federal Reserve's voluntary foreign credit restraint program was largely responsible for the cessation of bank credit outflows last year, and for the reflows that occurred after

February,1965. The new ceiling suggested under the voluntary program for 1966 would have permitted the banks' outstanding claims on foreigners to increase from 105 per cent of their end-1964 level to 109 per cent. Since the banks were below the ceiling at the end of 1965, there was room within these guidelines for a net extension of bank credit to foreigners of about $800 million this year.

But in fact, the banks have not extended additional credit to foreigners. Instead, they have further reduced their outstanding claims, by more than $200 million during the first half year, and by a further $200 million(partly seasonal) in July and August. At the end of August, the banks were fully $1 billion below the suggested ceiling. Their outstanding claims on foreigners were $266 million lower than at the end of 1964. Clearly, domestic credit stringency - the product of heavy demands for funds and a monetary policy of increasing restraint - has been a major factor in this development. The voluntary program for banks, which was the principal influence on the behavior of commercial banks a year ago, has been re-inforced in 1966 by the over-all policy of monetary restraint.

Relative credit conditions as between this country and Japan have changed particularly sharply over the last two years. This situation has affected U.S. capital flows in a significant way. Japan accounted for one-fourth ($3.2 billion) of total outstanding claims on foreigners reported by banks in the United States at the end of 1964; it also accounted for more than one-third ($2.8 billion) of the increase in such claims during the preceding 5 years. While interest rates have been rising sharply here, they have declined in Japan. Consequently, for the first time since World War II, it is advantageous for major Japanese borrowers to shift their financing from U.S. banks to Japanese sources. Furthermore, over half of this year's net repayments to U.S. banks have been accounted for by Japan. In fact, the repayments would have been even more rapid if the Japanese authorities had not been urging caution in order to avoid drains on their official reserves of dollars.

The impact of monetary restraint on other flows of U.S. capital is less clearly visible. But it is there. The fact that the rate of sale of new foreign securities in this country, issued mainly by Canadian borrowers, has not increased this year, and indeed has diminished if adjustment is made for the issues postponed from late 1965 to early 1966, owes something to higher U.S. interest rates and sharply reduced credit availability. Also, nonbank corporations have repatriated some additional short-term funds from abroad, even though they had already made large repatriations last year at the President's request, and even though their foreign operations continue to expand.

For direct investment, the conclusion is less clear. The main factor preventing an increase in outflows of direct investment capital this year, in spite of the rapid further expansion of foreign branches and subsidiaries of U.S. firms, is still the voluntary restraint program of the Commerce Department. Under that program, the companies are asked to borrow abroad to the extent feasible to finance their foreign programs. And they are doing so. Their borrowings through foreign subsidiaries - either through the so-called Luxembourg corporations or directly by the operating companies - do not enter the U.S. balance of payments at all, although their effect is to reduce outflows of U.S. capital from what they would otherwise have been.

The foreign borrowings of U.S. subsidiaries - the Delaware corporations set up for that purpose - enter the balance of payments as an inflow of foreign capital and then as an outflow of U.S. capital, and it is proper for analytical purposes to net these flows out, as I did a moment ago in discussing total capital outflows. Delaware corporation borrowings abroad plus exchanges of U.S. company stock for foreign stock came to about $500 million in the first half of this year. Some further, though smaller, amounts are expected to be raised in these ways during the remainder of the year.

While this foreign borrowing is mainly inspired by the voluntary restraint program, it is made a good deal more palatable to the companies by the fact that raising funds in the United States has become much more expensive and more difficult.

Foreign Capital Inflow, 1966: Special Role of Commercial Banks

There has been a very substantial inflow of foreign capital this year, apart from the borrowings of the Delaware corporations. There are two segments, of different sorts. First, long-term capital. This came mainly from foreign official and international institutions, which purchased long-term certificates of deposits and long-term securities issued by Agencies of the U.S. Government. These assets were attractive because of their high yields and their increasingly ready marketability.

Second, short-term capital. The inflow of foreign private liquid funds represented in part a response to the increasingly strained liquidity position of U.S. banks, and in part a reflection of market doubts, especially during July, about the stability of the pound sterling.

Short-term U.S. liabilities to commercial banks abroad increased by $734 million during the first half of 1966. Moreover, these liabilities rose further by $620 million in the single month of July. They are believed to have increased again, though less rapidly, in August and in September. For the year to date the total rise may be more than $1½ billion. In contrast, there was a net increase of only $116 million in such liabilities during 1965. In fact, there have been only two other years in which increases of this order of magnitude have been recorded - 1959, with a figure of $1.2 billion, and 1964, with $1.5 billion.

Most of this increase in liabilities to commercial banks abroad has occurred in the liabilities of a few large U.S. banks to their own foreign branches. The branches have attracted Euro-dollar deposits in large volume and have passed on a substantial proportion to their head offices.

The interest of the head offices in acquiring these funds is clear. Faced with increasing reserve pressures, and increasing difficulties in attracting time deposits, the banks have been willing to pay high rates both for Federal funds and, through their branches, for Euro-dollars, in order to be better able to meet strong domestic demands for credit. It is not surprising that Euro-dollar interest rates have moved closely parallel to Federal funds rates.

The sources of supply abroad to meet these demands are less well known. One important influence in the summer bulge in these flows must have been the nervousness about the pound, which would have provided some incentive for foreigners to move funds out of sterling and into Euro-dollars even if the switch were not particularly profitable from an interest-arbitrage point of view. But also, and especially recently, there have apparently been substantial shifts out of Continental European currencies and into Euro-dollars, because the switch has become very profitable.

The effect of this large inflow to the United States through the Euro-dollar market has been to strengthen the dollar in foreign exchange markets, and to weaken other currencies and reduce the official reserve gains in those countries below what might otherwise have been expected in the light of seasonal factors and underlying payments positions. To put it another way, the inflow of foreign private liquid funds helps to finance the U.S. liquidity deficit, so that less official financing is required. Thus, the inflow reduces the official settlements deficit.

It would doubtless be unwise to count on a liquid inflow of this unusual magnitude continuing for very long. Indeed, the flow is likely to reversed when the pressure on bank reserve positions is relaxed. Thus, the improvement in the balance of payments from this source must be viewed as quite temporary.

Concluding Remarks

In this review of some of the key channels through which the effects of changing credit conditions show up in international capital flows, I have sought to demonstrate that monetary policy has had substantial effects this year in holding down outflows of U.S. capital, and in stimulating in-flows of foreign capital.

No doubt the occasions on which as stringent a policy as we have followed this year will be appropriate are likely to be limited. One hopes so. But it has perhaps been useful to have had a clear demonstration that U.S. monetary policy will be used vigorously when the occasion requires, and that when it is so used, it can have prompt and significant effects, even on the balance of payments.