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How the Federal Reserve Looks at the Balance of Payments

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It is the job of several other speakers during this briefing session to provide detailed discussions of particular aspects of the U.S. balance of payments problem. It therefore seemed most useful for me to try to present an institutional point of view. How do we in the Federal Reserve System tend to analyze and make judgments about the balance of payments in light of our particular responsibilities?

Federal Reserve Policy Goals

It is just as well to start with first principles by reminding you of the multiple policy objectives which condition the Federal Reserve's view of economic events and which underlie all our decisions on the application of monetary policy. These objectives may conveniently be summarized by such expressions as full employment, price stability, sustained and orderly growth of the economy, and a satisfactory state of balance in external transactions. Needless to say, these policy goals are not peculiar to us at the Federal Reserve. They are the major economic goals sought by the Administration and are widely accepted outside the Government as well.

Some of these policy goals are not ultimate, but only intermediate, objectives. For example, price stability or balance in external transactions are not intrinsically desirable goals in the same sense as maximization of output and employment. Our really basic economic and social objectives probably cannot adequately be characterized by any simple unqualified expression. We do believe, nonetheless, that there is a fairly close connection between our more basic objectives on the one hand and the proximate attainment of full employment, price stability, high growth, and external

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balance on the other. Thus these four goals can usefully serve as a shorthand characterization of the main objectives which guide Federal Reserve decision making.

If policy goals are numerous, and if policy tools to promote the achievement of those goals are either weak, limited in number, or uncertain in their effects, all the policy goals may not, at any given time, be simultaneously attainable. This simple, unpleasant fact of life is too often forgotten or de-emphasized. One can imagine plausible economic situations in which any pair of the four goals mentioned earlier could be in short-run conflict. For a classic illustration of the conflict between full employment and external balance, for example, one need only recall the difficult dilemma confronting U.S. economic policy in the first half of the 1960's.

Precisely because policy goals are numerous, and because they may not all be simultaneously attainable in the short run, concern with any single one of them cannot be compartmentalized. The most appropriate package of economic policies--and here I am thinking not just of monetary policy but of all the instruments of economic policy subject to governmental control and influence--is that package which promises to bring about the best attainable combination of our multiple policy goals.

Of all the tools of economic policy, monetary policy is perhaps the most capable of immediate and flexible action. The reconciliation of potentially competing policy objectives is necessarily, then, the daily concern of those responsible for formulating monetary policy. In those times when the goal of external balance seems to require policy action somewhat at odds with the policy action required to achieve domestic economic objectives, it is fair to say that we in the Federal Reserve are peculiarly and painfully distressed.

The unique, central position of the dollar in the world monetary system necessarily requires us to be deeply concerned with any developments that threaten the dollar's international acceptability. Yet it would clearly be tantamount to sacrificing basic ends to intermediate means if policy actions were allowed seriously to jeopardize domestic prosperity just in order to achieve or to maintain external balance in the short run.

The Nature of the U.S. Payments Problem

I propose to return later on in my comments to the difficulties of attaining a number of different policy goals simultaneously. Before doing so, however, let me review briefly with you some salient features of our balance of payments problem as they appear to me.

With the exception of the years 1953 and 1959, the United States has had large surpluses in the current account of its balance of payments throughout the last twenty years. This surplus has, of course, varied with business cycle conditions here and abroad. But taking the long view, it has been an enduring, structural feature of our balance of payments. Barring an unforeseen, radical change in world trading relationships, it will continue large in the future.

It is important to remember that this current account surplus builds up the U.S. international investment position at the same time that it makes real resources available to the rest of the world. This transfer of resources is both natural and desirable for a wealthy, developed country like the United States.

It is true that over the past year we have observed an unprecedented boom in imports and a consequent large deterioration in our current account surplus. These developments, however, have been a manifestation of a boom at home that we are resolved, for domestic reasons, to bring under control--and in fact appear to have done so. It seems probable that the recent deterioration in our current account surplus may already have been reversed.

U.S. Government transactions play an important role in several sectors of the balance of payments. Perhaps the single most important point to make about these transactions is that they mirror rather closely the United States' large foreign-policy commitments and obligations throughout the world. These commitments and obligations are not sacrosanct. They should be re-evaluated constantly. Nevertheless, without major changes in our foreign policy, few of them can be quickly or easily abandoned.

The U.S. private capital outflow has been very large, rising especially rapidly through 1964. This capital outflow, as befits a major capital exporter, has been predominately in longer-term, relatively illiquid assets. There has also been a large foreign private capital inflow to the United States, although not so large as to offset that part of the U.S. capital outflow (Government and private) that was not covered by the current account surplus. This foreign inflow has been primarily in the form of an acquisition of liquid assets.

A number of different reasons for these private capital-flow developments can be given. Without attempting to deal with these explanations in detail or to pass judgment on their relative importance, let me mention some of them briefly:

(a) Some capital movements seem closely related to rates of growth and levels of resource utilization and development here and abroad. Direct investment by U.S. corporations, for example, has been stimulated by the growth and evolution of the Common Market, although a great deal of direct investment has also gone into resource development, manufacturing, and distribution outside the EEC countries.

(b) Foreign industrialized countries have tended to rely rather heavily on monetary policy for stabilization purposes, with the result that interest rate levels have been high abroad relative to what they would have been had there been a more active use of fiscal policies. This has meant in turn that differentials between U.S. and foreign interest rates often have provided strong incentives to move capital abroad.

(c) Changes in relative confidence in other currencies vis-a-vis the dollar have sometimes led to large capital movements, both into and out of the dollar.

(d) The strength, flexibility, and competitiveness of the U.S. capital market and the large, growing volume of U.S. saving combined with the underdevelopment of, and restrictions imposed in, the capital markets of other industrialized countries have all contributed to heavy borrowing by foreigners in the United States.

All these explanations for private capital flows are either directly related to or else heavily influenced by the importance of the United States as the dominant international financial and banking center.

To summarize a very complex institutional situation: the processes of lending, borrowing, and the accompanying financial intermediation that take place across national borders in today's economically integrated world are in substantial measure channeled through (or indirectly involve) the U.S. financial and business communities. Hence the balance of payments of the United States reflects many complicated exchanges of assets and liabilities which defy simple analysis or interpretation.

The final, critical feature of our balance of payments problem on which I must touch has to do with the changes in our monetary reserve assets and the changes in our reserve liabilities to foreign central banks and governments. U.S. reserve assets have been steadily declining since 1957 (they also declined in the early 1950's) and our reserve liabilities have been, at least until recently, just as steadily increasing. In the early postwar years declines in our swollen reserves and increases in our reserve-currency liabilities--representing as they did a needed redistribution and augmentation of the world's stock of reserve assets--were highly desirable and were universally regarded as such. The day is long since past, however, when a sizable decline in U.S. reserve assets can be viewed with equanimity within the U.S. Government.

From the foregoing brief description of our complex balance of payments problem, it should be abundantly clear that the United States is not suffering from the type of payments problem typically described as "living beyond one's means." There is no meaningful sense in which the United States has been getting poorer internationally. The fact that we have been running, year in-year out, large current account surpluses means, of course, just the reverse; our total assets abroad have been rising much faster than our total liabilities.

Another view about the U.S. payments problem frequently heard is that we have been unwisely following a course of lending long and borrowing short. As already noted, however, the United States and U.S. institutions are heavily engaged in the business of providing banking, brokerage, and financial intermediary services to the rest of the world. One of the traditional roles of a financial system is to lend long and borrow short; that is the essence of financial intermediation. Some country or countries will necessarily have to provide the world with these services. It is no cause for alarm in itself that the U.S. balance of payments reflects these complicated exchanges of assets and liabilities.

On the other hand, of course, there is some limit as to how far the process of financial intermediation can and should go. Prudent bankers do lend long and borrow short, but they do not push this process so far that they are unduly exposed to (and hence perhaps even induce) sudden large losses of deposits. Nor would the United States be acting prudently if it allowed its external reserve assets to continue to decline sharply while our liquid liabilities to foreigners go on rising.

What Do We Mean By "Equilibrium"?

Earlier I described one of the Federal Reserve policy objectives as "a satisfactory state of balance in external transactions." But what does it mean for the United States to "restore equilibrium" in its balance of payments? What, in other words, is the definition of success? How do we tell if or when we have actually achieved the goal of satisfactory external balance?

Unfortunately, the notion of "equilibrium" is an elusive one and there is no simple target or formula which the Federal Reserve or anyone else can use. The much-discussed controversy over how to measure the "deficit" in the U.S. balance of payments has brought this fact out quite clearly.

For example, there are several reasons why, in my view, a balance of zero calculated on the liquidity basis would not be a desirable long-run policy objective; such a goal, if achieved, would not be likely to signify payments equilibrium in any economically meaningful sense. To cite one reason: a secular rise of some amount in U.S. liquid liabilities to foreigners--particularly private foreigners--is a natural, welcome concomitant of the rising volume of international trade and financial transactions. If the U.S. long-run policy objective were to attain a balance of zero on the liquidity basis, private foreigners could only increase their dollar holdings to finance expanded world trade to the extent that our official reserves rose or foreign central banks reduced their own dollar reserves.

There are also good reasons for not mechanically taking a zero "official settlements" balance as a policy target. More generally still, regardless of which definition of the balance is used, one should probably be skeptical of the magic appeal of the number zero, or zero $\pm$ x. "Equilibrium" or "payments balance" are essentially analytical concepts that do not have exact statistical counterparts. An accounting deficit--however defined--is only a summary indicator of how things have been going. It is not a complete diagnosis, nor should it be interpreted as a policy prescription.

I trust that nothing I have said so far will be misinterpreted as an attempt to minimize the seriousness of our current balance of payments difficulties. That would be a grave misinterpretation. The full seriousness of our balance of payments problem is unambiguously evident in the persistent decline in our reserves that has continued throughout the current decade. However one wishes to define a "satisfactory" state of balance in our external transactions, it seems to me abundantly clear that a continuation of this persistent decline increasingly exposes us to the necessity of drastic action. It cannot continue much longer without putting an intolerable strain on the international monetary system as presently constituted.

These considerations lead me to the conclusion that a minimum balance of payments target for the medium-term future should be a decisive cessation of the loss of U.S. monetary reserves. For the longer-run future, we will need to think in terms of a dynamic definition of payments equilibrium--one that will take into account specifically both the desired evolution of our own reserves and also the desires of foreigners to add to (and in some cases, to run down) their key-currency and reserve-currency holdings of dollars.

The Role of Monetary Policy in Restoring and Maintaining External Balance

I earlier referred to the Federal Reserve's multiple policy goals and the impossibility of compartmentalizing our concern with the balance of payments. I should like now to consider one of the difficult questions arising out of this multiplicity of policy goals: How much weight should be given to balance of payments considerations in determining the course of monetary policy?

At the outset, it should be clear there is no precise answer to this question in a world where circumstances are constantly changing. And one needs to have a judgment in some depth as to just how and to what extent changes in monetary policy have an impact on the balance of payments. We know that the influence of monetary policy on the balance of payments is often quite indirect and that the precise response is extremely difficult to predict. In fact, this uncertainty about the quantitative impact of monetary policy on the balance of payments as well as on growth and stability is one of the reasons why it is difficult to deal with the question I have put before you.

There are many differing views about the role that monetary policy should play in restoring and maintaining external balance. I propose, in my following remarks, mainly for expository reasons, to caricature for you two of the more extreme views that are currently popular. The first of these, which for convenience I will refer to as Guideline A, holds that general monetary policy should be devoted primarily to the goal of external balance while other policy instruments are being used to regulate the pressure of demand in the domestic economy. The second view, which I shall call Guideline B, is that domestic considerations are so overwhelmingly important in the United States that monetary policy should not be markedly different from what is deemed appropriate on domestic grounds alone.

The rationale for Guideline A--that monetary policy should be largely dictated by balance of payments considerations--is roughly as follows. The degree to which it is possible simultaneously to achieve the two goals of full employment and price stability, it is argued, is not very sensitive to the "mix" of monetary and fiscal policies. Given this relative invariance of the trade-off between inflation and unemployment to the composition of overall demand, the argument continues, then the most appropriate mix of policies to achieve any given targeted level of overall demand can be decided on other grounds. Therefore, proponents of Guideline A would say, monetary policy can be freed to respond mainly to the balance of payments while the desired targeted level of overall domestic demand can be achieved via fiscal policy (where of course the fiscal action takes due account of whatever monetary policy does for balance of payments reasons).

The arguments put forward for Guideline A are interesting and, in some respects, appealing. The proponents of this view are keenly aware of the difficulties of simultaneously achieving both domestic objectives and external balance in a system of fixed exchange rates, and put forward their guideline as a theoretical alternative for reconciling all these potentially conflicting policy goals.

The Federal Reserve did move somewhat in this direction earlier in the 1960's when the goals of internal and external balance were so clearly in conflict. At the same time that tax reductions were carried out in 1964 and 1965 to stimulate demand and reduce high unemployment in the domestic economy, monetary policy gradually moved away from the easy posture it had earlier taken. This change in the mix of monetary and fiscal policies was deliberate and partially motivated by balance of payments considerations.

There are at least four reasons, however, why Guideline A has not in the past gained ascendancy as a rule for the application of monetary policy in the United States and why it is not likely to do so in the future. First, we do not really yet know enough about the rates at which monetary and fiscal policy can be substituted for each other. Some experience has been gained, particularly during the period in the 1960's to which I referred just a moment ago. Nevertheless, much more experience and information would be necessary in order to apply Guideline A with any precision or confidence.

Second, there are many situations in which, if monetary policy were primarily dictated by balance of payments considerations, the policy goal of growth would suffer. In other words, the objective of sustained, reasonably rapid growth might require an opposite mix of fiscal and monetary policies from the mix appropriate to correcting a payments imbalance. Here of course it could be argued that if we could make the structure of taxation sufficiently flexible so that it could be regarded as an additional policy instrument--if special fiscal incentives could be given to various types of investment but not to consumption expenditures--then this particular objection to Guideline A would be muted.

The third reason why monetary policy cannot mechanically follow Guideline A has to do with the way other countries manage their economic policies. Many foreign countries tend to rely quite heavily on monetary policy for regulating their domestic economies. If Guideline A were to be followed by the United States but not by other countries, it is doubtful whether the United States--quite apart from the consequences for our domestic economy--could even be successful in attaining the goal of external balance via monetary policy alone. If Guideline A were ever to be successfully followed by a large country with well-developed, relatively unrestricted capital markets, a prerequisite would be a much greater degree of international harmonization of monetary policies than presently exists in the world.

The final reason why monetary policy cannot be dictated by balance of payments considerations alone is a simple one, but perhaps the most important of all. At any given time fiscal action to regulate the pressure of domestic demand, in accordance with the prescription of Guideline A, may--whether rightly or wrongly--be thought either inappropriate or else impossible. Even if they have the wish to do so, moreover, the fiscal authorities may not be capable of acting quickly enough or with enough flexibility. Monetary policy may then have to step into the breach.

In a situation where monetary policy has to do the brunt of the work both in regulating domestic demand and in restoring external balance, we are relatively fortunate if we have both domestic and external considerations pointing in the same direction so that two policy goals can be served by one policy tool. This in fact has been the case since last winter and spring: in the absence of fiscal action further monetary tightness was called for both to curtail the unsustainably rapid advance of the domestic economy and to prevent the balance of payments from deteriorating. It goes without saying, on the other hand, that matters are quite different in a situation in which the brunt of the work of policy changes is thrown onto monetary policy while domestic and external considerations are pointing in different directions. It is, I'm sure you would agree, difficult enough to kill two birds with one stone when the birds are both flying away in the same direction. Such a task may fairly be termed impossible if they are flying off in opposite directions. In such a situation, nothing less than two stones will do.

What about the other extreme prescription for the application of monetary policy, Guideline B? The United States has a very large economy, proponents of this view argue, yet international trade forms a very small proportion of total GNP. Hence the balance of payments' tail should not be allowed to wag the whole dog (i.e., the domestic economy). Often one even hears it said that the balance of payments problem is a concern of the second order of magnitude, and that any difficulties with the goal of external balance should be handled by specific, selective restraints.

Here again such a simple rule must be rejected. Given the vital international roles played by the dollar, the interdependence of all economies in today's increasingly integrated world, and the extent of U.S. political and economic interest abroad, a continuous shrinkage of our reserves or an unsustainably rapid expansion in our short-term liabilities can become very much a problem of the <u>first</u> order of magnitude.

To recommend that our balance of payments problem should always be dealt with by various selective restrictions, furthermore, may be to take a near-sighted approach to the problem of reconciling competing policy goals. Selective restrictions on international transactions are often not, from the point of view of the whole economy's welfare, costless policy tools to apply--though they may be the least costly alternative in many circumstances. The Voluntary Foreign Credit Restraint program and The Interest Equalization Tax are good examples of appropriately-used selective policies. But selective measures are not always to be preferred. As my fellow Board Member, J. L. Robertson, noted last spring, just as we should not let dogmatic orthodoxy prevent us from using selective tools when they are less inappropriate than any other policy alternative, we should not let dogmatic selectivism prevent us from returning to more orthodox methods if selective tools prove to be too costly or to have outlived their usefulness.

Thus neither extreme guideline for the role of monetary policy is really persuasive. The Federal Reserve seems to be on a middleground between these two views. Monetary policy has ordinarily in the past been heavily focused on domestic considerations. This does not mean that in the past balance of payments developments have always had an insignificant role in monetary policy decisions. Nor does it mean that monetary policy in the future will make little contribution to the restoration and maintenance of external balance. The relative weight given to balance of payments considerations in the formulation of monetary policy must clearly vary from time to time, depending critically on economic (particularly monetary) conditions abroad, on the availability and suitability of other policy instruments for influencing the balance of payments, and on the posture of fiscal policy relative to developments in the domestic economy.

Where Do We Go From Here?

It seems natural in concluding my remarks to advance a judgment and opinion about the constraints that balance of payments considerations will exert in the future on the use of monetary policy for domestic objectives. Are we likely again, from time to time, to be faced with the kind of short-run conflict between internal and external balance which we confronted in the period 1960-1964? Taking fully into account the seriousness of our present balance of payments problem, what sort of mix of monetary and fiscal policies is practicable in the near term? What is the most appropriate role for Federal Reserve policy tools within the overall U.S. balance of payments policy? More generally, how should our overall balance of payments policy in the United States be coordinated in the future with our trading partners, who benefit from the exportation of U.S. industrial equipment, know-how, and capital resources?

In thinking about the answers to these questions and where we go from here, let me leave you with three propositions.

First, as international economic relationships become more pervasive and significant--that is, as we approach "one worldness"--balance of payments considerations will more frequently be of major concern. In the future, just as in recent years, we will have to have an active balance of payments policy, and this policy should be fully integrated with overall domestic economic policy.

Second, the immediate problem of simultaneously achieving multiple policy goals with the aid of only a limited number of policy tools does not admit of any easy, simple solution. In some periods this problem is less difficult than in others. We do face the possibility, however, that from time to time either some policy goal will have to be partially sacrificed, some constraints will have to be broken, or else we will have to use some additional policy tools out of our tool box that, other things being equal, we would have preferred not to use. These choices will be difficult, and I doubt that--despite claims to the contrary--anyone has a valid, cut-and-dried prescription available in advance for making them.

Finally, let me remind you that restoring and maintaining payments balance in a world monetary system based on fixed exchange rates is a two-way proposition. As presently constituted, the burden of balance of payments adjustment in our system falls more heavily on deficit countries than on surplus countries--irrespective of the reasons for the imbalance. While the United States fully intends to restore external balance, it is far from clear that unilateral action by the United States will necessarily and automatically lead to a better overall world payments equilibrium. If some European countries do not actively pursue policies conducive to the reduction of their large surpluses, the counterpart of the improving U.S. payments position may involve seriously deteriorating payments positions elsewhere--for example in the less developed countries, with corresponding damage to these countries' attempts to raise their standards of living. Hence, all countries--those with surpluses and deficits alike, and particularly within the Group of Ten--have a continuing obligation to bring about a better payments balance. The United States expects to play its part. I expect that others will play their parts as well.