August 8, 1963.

AIR MAIL

CONFIDENTIAL (FR)

The Honorable M. W. Holtrop,
President,
The Netherlands Bank,
Amsterdam-C.

Dear Marius:

This letter is the promised follow-up on my acknowledgment of yours of July 23rd. At the outset, let me express gratification at your fresh expression of cooperation in our efforts to bridge the U. S. payments deficit for what we both hope will not be too long a time. At the same time, it is important to assure you that we, on our side, do appreciate that the incidence of our payments deficit falls in part on the surplus countries of Europe, who find themselves, by virtue of their surpluses, exposed to a pace of monetary expansion that has been producing what you refer to as a creeping inflation. The whole development emphasizes that the attainment of the payments equilibrium we are all seeking is a two-sided affair and calls for positive policies on the part of all concerned. We both agree, I'm sure, that the sooner the current disequilibrium is remedied, the healthier will be the financial and economic relationships among the major trading partners of the Western World.

For some time, I have been deeply troubled by the evident feeling among European monetary officials that U. S. policies in recent years have not sufficiently grappled with the U.S. payments deficit. Over much of this period, we have had a delicately-balanced economy and there has been recurrent doubt in some business, financial and governmental places as to whether the U. S. uptrend, which was moderate as compared with other postwar periods of cyclical expansion, would be sustained or superseded by recession,

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perhaps even deflationary recession. In these circumstances, you will understand, I am sure, why we have had to pass through a phase of divided counsels as to whether internal or external developments should receive greater emphasis in our national policies. With existing margins domestically of unemployed manpower and capital resources, it has appeared unavoidable that more positive emphasis on policies oriented to the payments deficit had to be held in abeyance until the course of economic trends clarified. In saying this, I do not mean to convey an impression that we were unprepared or unwilling until the very recent period to take further monetary action for balance-of-payments account, had the evidence of payments flows shown this to be necessary, but the evidence from the currently available data, in my judgment, did not appear to warrant such action. At the June 20th WP-3 meeting, Ralph Young gave a full report on the domestic financial developments that were shaping Federal Reserve views and I think his remarks will warrant your reading because they fairly set forth the dilemma that has confronted us. A copy is enclosed for your personal information.

As it became clear to us that domestic conditions would permit more positive steps by way of monetary action, it appeared appropriate to choose a timing related to a broader program of balance-of-payments policy to be announced by the President and scheduled to be forthcoming regardless of our action. As in all cases of shifting posture for monetary policy and shifting reliance on its available instruments, there are many uncertainties as to effects and counter-effects in domestic and international markets. We can only proceed by watching unfolding developments closely, endeavoring to diagnose them correctly, and responding according to the judgments we make. I felt obliged to comment on this aspect of our monetary policy problem at a hearing before the House Banking and Currency Committee in July 22, held for the purpose of providing further public clarification of the issues, and a copy of my formal statement is also enclosed for your reading. In its concluding paragraph, I stated:

> The Board's recent actions are an essential part of a total effort to bring to an end the U. S. payments deficit, with its harmful effects on the domestic economy as well as on the international standing of the United States. While this process is under way, it is essential that monetary policy remain flexible and uncommitted--free to move either to check an unwanted and inappropriate tightening of credit, should it develop, or to defend more aggressively the international position of the dollar, should that be necessary.

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I am glad to know that you are still wrestling with the question of the "Roosa-paper." I can well understand your disposition toward debt prepayment at this time and I want you to know that, from a U. S. standpoint, your recent decision in this respect was timely and helpful.

I was not personally familiar with the quotation you cited from a Treasury Department ciruular of May 16, but I feel sure that the Treasury, in including the particular quotation, did not intend to convey that it planned to rely importantly on European sources to finance its budget deficit. Our credit markets and large savings supply are surely up to the financing needs of the U. S. Treasury.

And there is no problem of financing these needs through the banks. Indeed, I have personally been surprised that the banks, over the past year and three-quarters, have allocated such a modest proportion of their increase in savings deposits to investment in longer-term U. S. Government securities, which are certainly the best prime quality investment media available to them. Actually, the commercial banks' total holdings of Governments showed no gain during 1962, and over the first half of this year have declined by nearly $3 billion. Since their holdings of long-terms have increased moderately, the decline in their short-terms has exceeded the amount cited, with some consequent erosion in over-all bank liquidity. At the end of 1961, for instance, commercial bank holdings of U. S. Government securities maturing within one year represented 11 per cent of bank deposits, while at mid-1963 the ratio had fallen to 7.5 per cent.

In terms of its total financing operation, the Treasury's statement that you cite is technically correct. But the amount of European placement of intermediate-term paper projected by Under Secretary Roosa is quite marginal in terms of the U. S. Treasury's total financial program. As Roosa has explained himself, this particular international financing operation has as a target, say, a fourth or a little less of an outside projection of our payments deficit. To the extent that progress is made toward payments balance, reliance on this paper would be reduced.

The placement of the intermediate-term paper is, in my judgment, properly arranged on a bilateral basis. The problems and opportunities for its use arise that way and the paper is designed to provide unique advantages, from both a short- and an intermediate-term standpoint, to foreign fiscal and monetary authority holders, while at the same time being advantageous to

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the U. S. as a payments debtor internationally. By acquiring them, a surplus country is under no more internal inflationary pressure than it would be from acquiring, in consequence of any further payments surplus, either dollar exchange or gold. It might be argued that, by resort to them, the U. S. as borrower has relieved itself, to a degree, of deflationary monetary pressures deriving from its payments deficit. But I should think that this is exactly what is desirable in order to avoid risk of starting a deflationary spiral in the U. S., which could have consequences reaching far beyond its own borders.

The purpose of the Treasury's European borrowing exercise is and must be to bridge time. Any concerted action to limit the potential amount of this type of financing, therefore, would be tantamount to setting a formal time limit during which international payments forces have to work through to equilibrium. Aside from the question of whether our economic knowledge is such as to warrant reaching such an embracing judgment by multilateral negotiation, I would personally doubt whether the circumstances warrant European dollar holders taking such stern action, for the action in itself would have far-reaching implications and accordingly widespread effects on world markets. We have tried to make clear a full awareness of our payments deficit problem and a determination to adapt our national policies so that the problem is in reasonable time resolved. A main intention of the President's recently announced program was to make that determination manifest.

By the way, some pertinent discussion of the European borrowing operations of the U. S. Treasury is contained in an article titled, "Conversations on International Finance," being published in the current Monthly Review of the New York Federal Reserve Bank. Its preparation was a collaborative effort of Messrs. Coombs of that Bank, Iklé of the Swiss National Bank, Ranalli of the Bank of Italy, and Tüngeler of the Bundesbank. They are all well known to you and I am sure you will find their observations on this matter interesting and helpful.

I hope that, when you are in Washington for the International Monetary Fund meetings, you can find time not only to visit us but also to discuss with our staff the over-all borrowing program of the U. S. Treasury and its policies with regard to "long-term borrowing in the domestic market." I think you will find from such a review that this is what the U. S. Treasury has been accomplishing--by the method of borrowing new cash short and refunding maturing debt long by the pre-refunding technique. I personally find much to be gratified about in the

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way our Treasury's financing is currently being managed, and I think Secretary Dillon and Under Secretary Roosa deserve a lot of credit for it.

The information you give about reactions to the President's balance-of-payments program is on the whole, heartening. Your comments about the Euro-dollar market and its possible behavior are especially illuminating to me, because we on this side have too little understanding of it.

Your reactions to the interest equalization tax are very much along lines of my own thinking--attractive from the standpoint of theory but with many difficulties in practice. The U. S. Treasury, after wrestling with alternatives--including the deflationary steps necessary to raise long-term interest rates by a full percentage point and the difficulties, under U. S. market conditions, of selective administrative control of foreign issues--came to the conclusion that the tax approach offered most advantages in terms of balance-of-payments necessities and goals. The Treasury felt that the decision once made had to be closely kept until announced. Also, upon announcement, the Treasury had to be prepared to make adaptations in its plan to provide for specialized operating problems and unintentionally severe impacts. These matters have been a preoccupation of the Treasury in the last few weeks.

Let me say a word about the three ghosts you mention, because we are not really so plagued by them as you suggest. In the first place, Congress has demonstrated a capacity to adapt the debt ceiling as conditions warrant, and, to protect the Government's credit, will in my judgment always lift the limit, however reluctantly, in good time. Second, the ceiling on interest payable on Federal Debt has been with us since the Liberty Loan Act of April 24, 1917 and, while, at certain times, it has seriously handicapped Treasury debt management policy, this has only been for relatively short periods. (Nevertheless, I think it should be changed as its inhibitions are a drag on longer-term finance.) Third, the gold cover requirements of the Federal Reserve Act, which are subject to temporary suspension by the Federal Reserve Board, if necessary, are not in fact the barrier they may literally seem and should not prove inhibiting to appropriate U. S. monetary policy. On the whole, I personally doubt that the U. S. has been shackled very much in pursuing a dynamic economic policy by virtue of their existence. And, while they are an administrative nuisance of a sort, they do serve as a focus for political discussion and debate about basic financial issues that ought to receive public attention and this is in their favor.

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Before closing, I should like to comment briefly on the recent U. S. performance with regard to prices and costs, because it has been, I think, perhaps a littëe better than you have thought. Since 1959, our wholesale prices of finished industrial products have been stable, and, considering the improvement in quality of many products, there has probably been some real decline in these prices. Furthermore, prices of industrial materials are 2 per cent lower than four years ago.

As regards costs in the manufacturing sector, labor costs per unit of output, apart from moderate cyclical changes, have changed little since 1959. Over postwar years, however, improvement in the behavior of unit labor costs in manufacturing has been progressive. Comparisons over time, made in such a way as to abstract from cyclical fluctuations, show that unit labor costs in manufacturing rose 15 per cent from 1948 to 1953, 8 per cent from 1953 to 1957, and about 1 per cent from 1957 to 1959-60. Underlying this shift in behavior is a persistent--perhaps, accelerated--advance in output per manhour and a progressively less rapid pace of increase in wage rates and fringe benefits. Output per manhour increased at an annual rate of 3 per cent from 1947 to 1959 and at a rate of 3-1/2 per cent since then. Hourly earnings, after some allowance for fringe benefits, rose at an annual rate of 9 per cent in 1947-48, a rate of 5 per cent in 1955-57, and a rate of about 3 per cent since 1959. A few recently negotiated labor contracts in major manufacturing industries suggest that currently the annual rate of increase in hourly earnings is running a little less than 3 per cent.

I mention this because of your statement that our gains in competitiveness had not yet been sufficient to reestablish equilibrium, implying, I infer, that financial policies strong enough to bring about a progressive decline in our industrial price level might beeter have been applied. Such a course of policy would have involved a broad-scale curtailment of domestic demand. This would have risked a downward force on industrial production greater than on prices. There would also have been a risk that any balance-of-payments gain would have come through a reduction of imports rather than an appreciable expansion of exports. Such a policy course, moreover, would have affected unfavorably output per manhour, tending to reduce manhour output in the short run and slow its growth over the longer run.

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One naturally wonders about the total repercussions, political as well as economic, of such a financial policy and whether the eventual solution to the balance-of-payments problem might not have been one highly disruptive of present international financial and political relations. It has seemed to me a much better approach for us to have followed policies to employ our normal additions to resources and absorb as well some resources that are unemployed, while endeavoring to accelerate the advance in our economy's productivity.

This reply to your letter has run into more pages than I had originally intended, but the matters under discussion are of vital interest and we both seek as much clarification and understanding as it is possible to attain. And, of course, all of us here share your hope that the early future will reveal that the U. S. is now making concrete gains toward a better payments balance internationally.

With warmest personal regards,

Faithfully yours,

Wm. McC. Martin, Jr.

Enclosures 3

cc: Under Secretary Roosa, Treasury

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