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The U.S. Balance-of-Payments Situation: 1963

The Second Quarter of 1963: A Larger Deficit

THE U.S. BALANCE-OF-PAYMENTS DEFICIT in the second quarter of 1963 amounted to $1.3 billion (seasonally adjusted), according to preliminary estimates of the Department of Commerce. In the first quarter the deficit was $0.8 billion. The worsening of the deficit from the first to the second quarter was due to substantial increases in the outflow of private capital.

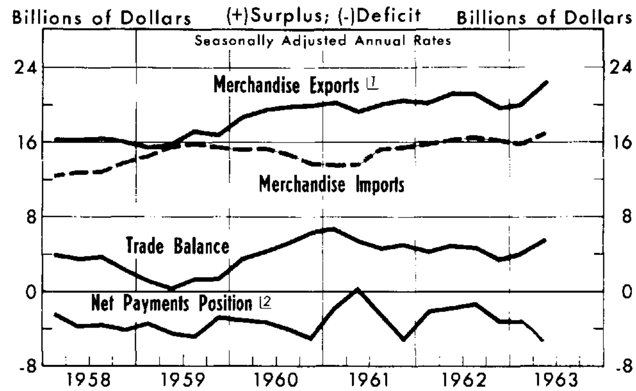
The deficit for 1962, measured as the decline in our monetary reserves plus the increase in freely usable dollar assets held by foreigners, was $2.2 billion. Without allowance for net receipts from special Government transactions, which included $666 million in prepayments of debt by foreign countries, $470 million of advance payments for military exports, and refunding of $251 million of short-term liabilities to foreigners into medium-term borrowings by the Treasury from foreign governments or central banks, the deficit for 1962 was $3.6 billion. While these transactions were helpful in heading off potential claims on U.S. gold, they were by nature special and not likely to recur on a regular basis. Although the 1963 deficit looks considerably larger than that of 1962, much of the difference appears to be accounted for by special transactions.

Balance of Trade

The increase in the second quarter deficit developed in spite of a substantial statistical improvement in the balance of trade. In the first quarter of 1963 the surplus in our balance of trade was at an annual rate of $4.1 billion. The rate in the second quarter moved up to $5.3 billion. This improvement reflected a marked jump in the level of exports, from an annual rate of $20.0 billion in the first quarter to a $22.5 billion annual rate in the second quarter. Imports moved from a $15.9 billion annual rate in the first quarter to a $17.0 billion rate in the second.

It is worth noting that the trade surplus was distorted by the dock strikes that took place in the latter

United States Balance of Trade and Net Payments Position



1 Excluding military transfers under grants.
2 Deficit measured by net decline in U.S. gold and net increases in foreign-held liquid dollar assets. Since 1961 gold sales are net of change in convertible currencies held by U.S. monetary authorities.
Source: U.S. Department of Commerce
Latest data plotted: 2nd Quarter estimated

part of 1962 but which continued their impacts through May 1963. Department of Commerce officials estimate that there may have been some exports in December which, in the absence of the strike threat, would have been made in January. In addition, it is estimated that a substantial portion of the increase in exports in the second quarter of 1963 reflected the unwinding of the earlier dock strikes.

When one views the trade totals for the first six months of 1963 in comparison with the first six months of 1962, the trade position of the United States should continue to be regarded as a plus factor. In the first half of 1963, U.S. imports were at an annual rate of $16.6 billion which is about 3 per cent more than the annual rate reported for the first six months of 1962. However, because imports tend to increase as business activity rises and decline as business slows, much of the rise in imports this year reflects higher levels of activity in the U.S. in 1963. The picture for exports for the first six months of 1963 indicates an annual rate of $21.4 billion, or only 2 per cent higher than the annual rate attained in 1962 for the comparable period. But, exports in the first six months of 1962 reflected some extraordinary trade developments none of which were duplicated in 1963.

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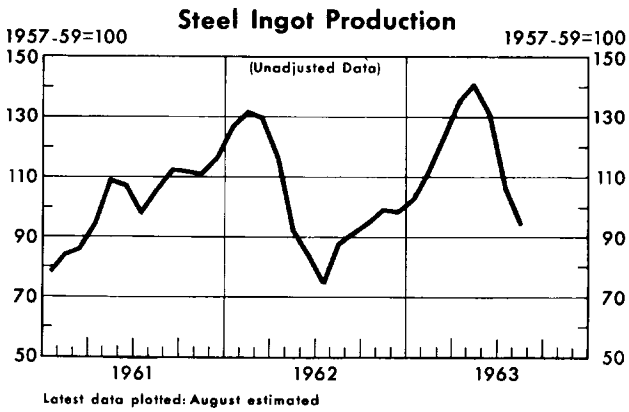
Business Activity, the Money Market, and Monetary Developments

THE RISE IN BUSINESS ACTIVITY from the plateau which prevailed during the last half of 1962 continued in July. Most significant indicators of economic developments showed little change from July to August. The industrial production index, at 126.5 (1957-59=100) in July and 125.6 in August, averaged 6 per cent higher than during the business plateau from May 1962 to January 1963. Industrial output has continued to display strength despite reductions in steel output after completion of the steel labor contract negotiations in June. In 1962 contract negotiations were completed in April, and steel production declined from April to July.



Construction expenditures rose moderately from June to August, reaching a seasonally adjusted annual rate of $65.0 billion. A small increase in private expenditures was about offset by a decrease in public spending. Construction activity had increased in the April-June period, regaining the level of last autumn.

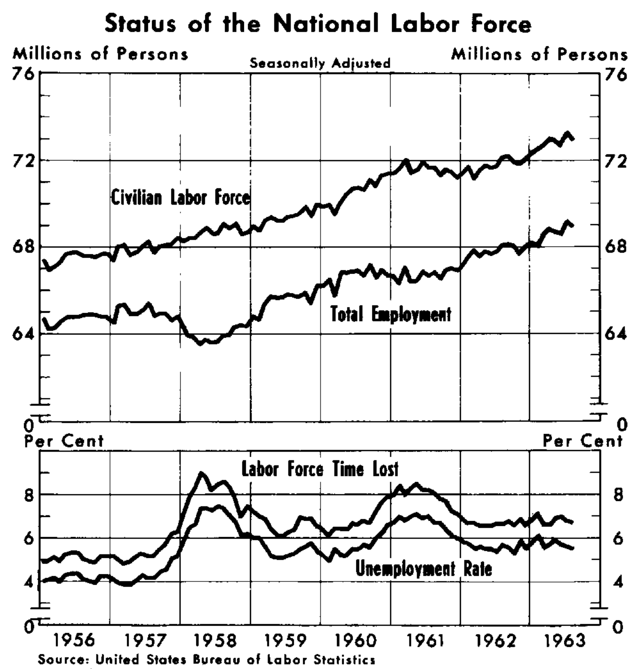
Total employment in the month of August was 68.9 million, up substantially from the level of March to June and nearly a million higher than the level in the August 1962-February 1963 period. Payroll employment was 56.7 million in July, up only fractionally from June but about one million higher than in the June 1962-January 1963 period. Thus, both total employment and nonfarm payroll employment have increased about a million since early this year and since a year ago. The number of persons in the labor force unemployed declined slightly from June to August, and the unemployment rate of 5.5 per cent remained at the prevailing levels of last summer.

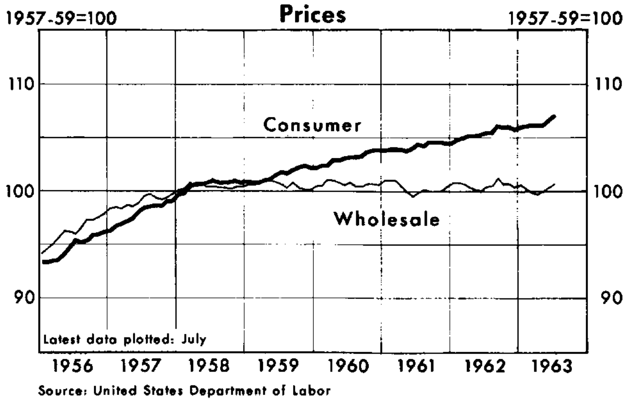
Retail sales increased moderately in July, the second successive monthly increase, but were virtually unchanged from July to August. Since May, retail sales have risen 3 per cent; increases were widespread with gains recorded in both durable and nondurable goods. Prior to this recent increase, from November 1962 to May of this year, sales had remained virtually unchanged.

Prices have increased little in the past twelve months. Although the consumer price index rose 0.5 per cent from June to July, the July index, at 107.1 (1957-59=100), was only 1.5 per cent above a year ago. The wholesale commodity price index also increased from June to mid-July, but it has decreased since then. Over the past five years wholesale prices have remained virtually unchanged (see chart, page 4).

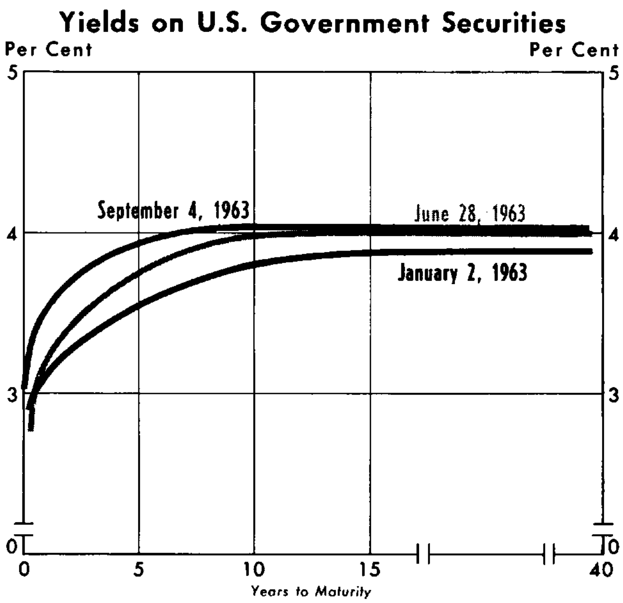
Money Market—Developments in Recent Months

A marked shift in the relationship between short- and long-term interest rates has occurred in recent months. Yields on short-term securities have increased





sharply since June, with the three-month Treasury bill rate rising from about 3.00 per cent in June to 3.35 per cent in early September. Long-term interest rates have changed little since April with Government bond yields fluctuating around the 4.00 per cent level.



The recent increase of short-term interest rates follows a long period of relative stability. Since mid-1960, short-term rates have risen, but the increases have been limited, occurring in step-like fashion. For almost a year and a half, from mid-1960 to late 1961, the three-month Treasury bill rate fluctuated around the 2.30 per cent level. After rising about 30 basis points during November and December of 1961, the rate again stabilized, moving within a relatively narrow range about the 2.75 per cent level until November 1962. During November and December rates moved up slightly, and from January to mid-May of this year the bill rate remained near the 2.90 per cent level. During June the bill rate was at about 3.00 per cent. In July and August the rate moved up but in a rather irregular fashion to about 3.25 per cent.

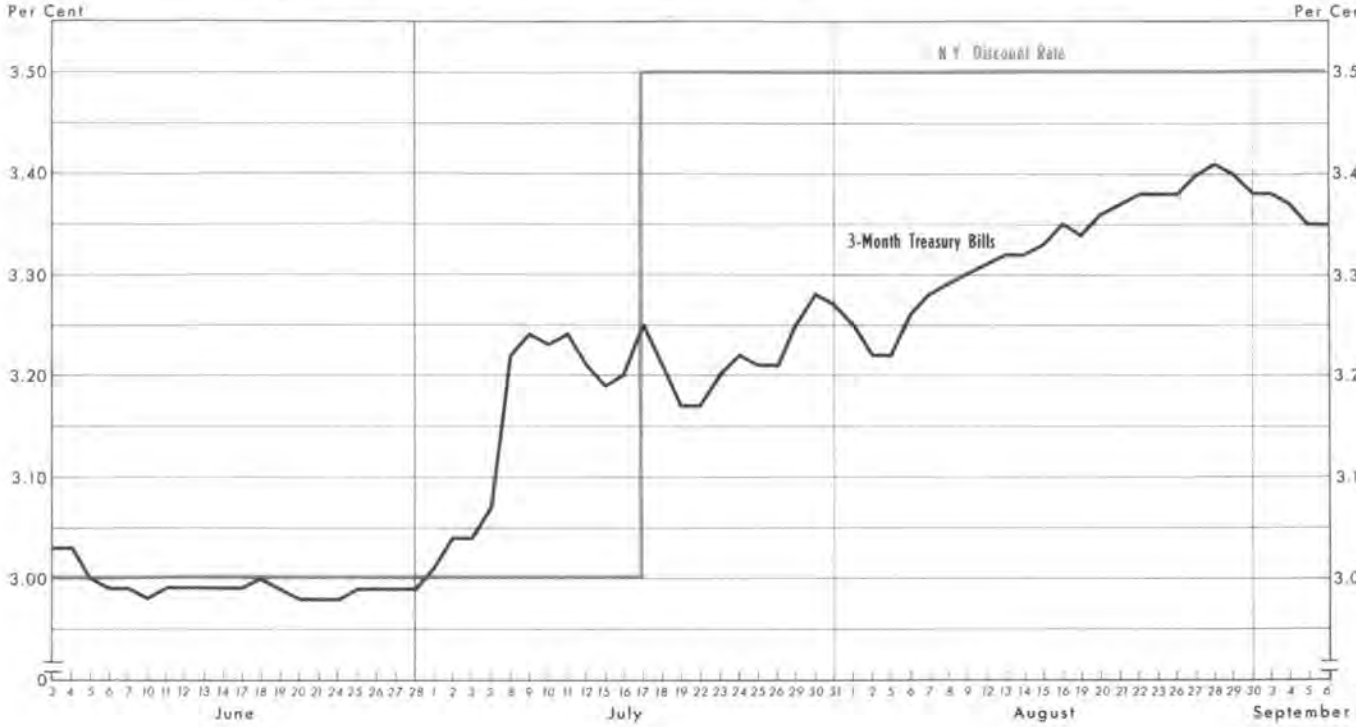
The performance of the bill rate since June indicates a sensitivity of the money market to Governmental statements and actions. In an effort to improve the balance of payments and limit the gold outflow, Government spokesmen in early July advocated a rise in short-term interest rates. In the span of about one week the bill rate increased from 3.00 per cent to almost 3.25 per cent.

Early in July there were numerous predictions in the financial press that the discount rate would soon be raised. The bill rate, which had been steady at about 3.00 per cent during June, increased to 3.07 per cent by Friday, July 5. On Monday, July 8, Secretary of the Treasury Dillon in testimony before the Joint Economic Committee of Congress (JEC) suggested, in essence, that higher short-term interest rates would be desirable in view of the seriousness of the balance-of-payments situation. The Secretary also expressed an opinion that from the point of view of stimulating the domestic economy it would be desirable not to have higher long-term rates. On that day the bill rate jumped from 3.07 per cent to 3.22 per cent. The following day, July 9, Undersecretary of the Treasury Roosa testified before the JEC re-emphasizing Secretary Dillon's position. The bill rate rose further to 3.24 per cent (see chart, top of opposite page).

On July 11 most of the Federal Reserve Banks held their regular monthly Board of Directors meetings, but no announcement of a discount rate change was made. Since changes in the discount rate have frequently been announced soon after such meetings and since a rise was generally anticipated, in the absence of an announcement of a discount rate change the bill rate began to edge down. Rates reached a low of 3.19 per cent on July 15. On July 17, however, the discount rate was raised from 3.0 per cent to 3.5 per cent, and the bill rate rose 6 basis points to 3.25 per cent.

Following the change in the discount rate, the bill rate declined to 3.17 per cent by Friday, July 19. On Thursday, July 18, in an address to Congress, President Kennedy outlined a 10-point program to improve the nation's balance-of-payments position. Included among the President's proposals was the explicit policy of raising short-term interest rates, while at the same time maintaining relatively low long-term rates. On July 22, the following Monday, the Chairman along with several other members of the Board of Governors testified on the discount rate increase before the JEC. The President's recommendation that short-term rates be raised was supported by a majority of the Board members. On July 24 the Treasury announced plans for a $6.6 billion refunding of securities maturing August 15. A fifteen-month note was offered in ex-

Daily Yields on 3-Month Treasury Bills and the Discount Rate



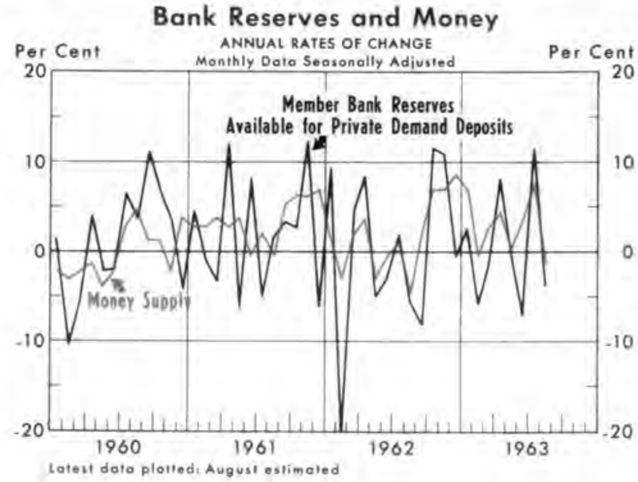
change for the maturing issues. The timing and the short maturity of the refunding operation, as Mr. Roosa said, was intended to give "added weight to maintain, if not lift," short-term rates. During the following few days, the bill rate rose. From the last week in July through the first week in September, the rate rose from about 3.20 per cent to about 3.35 per cent.

Largely reflecting the Treasury advance refunding announcement on the afternoon of September 4, on the following day long-term rates moved up four basis points to 4.04 per cent and short-term rates declined about two basis points.

Bank Reserves and Money Supply— Different Rates of Growth

As short-term rates rose in July, the money supply continued to increase, and total member bank reserves and reserves available for private demand deposits leveled off. While bank reserves and the money supply generally move together, divergences for short periods are not unusual. For example, since the end of 1962, total reserves have increased at an annual rate of 2.3 per cent. Reflecting a decline in Treasury balances at commercial banks, reserves available for private deposits have risen somewhat more rapidly than total reserves (about a 2.8 per cent annual rate). Over the same period, the continued rapid growth of time deposits absorbed a large portion of the reserves available for private deposits. Consequently, reserves available for private demand deposits (the largest

Bank Reserves and Money



RESERVES: DEFINITIONS

Various measures of member bank reserves are frequently referred to in this Review and in other publications. Following are brief definitions of the more commonly used concepts of bank reserves.

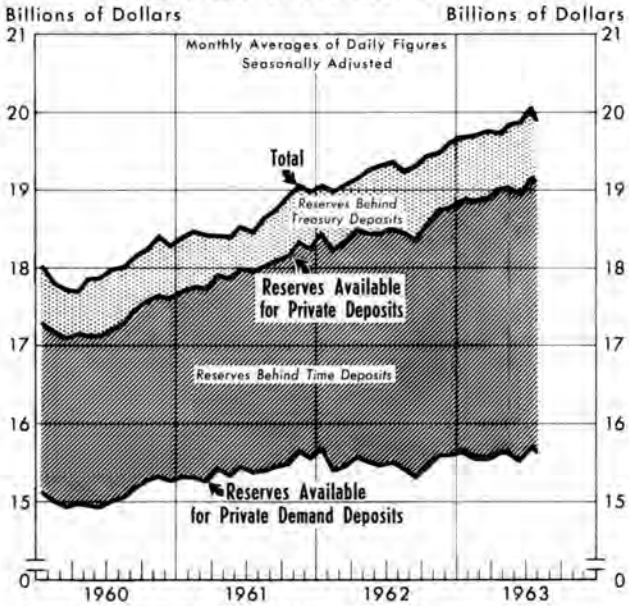
Reserve Measure	Definition
Required Reserves	Member banks are required to maintain as reserves an amount equal to a prescribed portion of their deposits. Currently, reserve requirements are 4 per cent of total time deposits plus 16.5 and 12 per cent, respectively, of reserve city and country bank net demand deposits. (Net demand deposits are gross demand deposits less cash items in the process of collection and demand balances due from domestic banks.)
Excess Reserves	Total reserves less required reserves.
Total Reserves	Member bank deposits with Federal Reserve Banks plus member bank vault cash. The sum of required and excess reserves.
Total Reserves, Adjusted for Reserve Requirement Changes	In order to present a comparable total reserves time series, taking into consideration changes in reserve requirements, certain adjustments are necessary. The required reserve series is recomputed on the basis of current reserve requirements. Required reserves so adjusted are combined with actual excess reserves. The resulting series is sometimes referred to as "effective reserves."
Reserves Available for Private Deposits	Total reserves less required reserves against U.S. Treasury deposits based on current reserve requirements applicable to these deposits for each class of bank.
Reserves Available for Private Demand Deposits	Reserves available for private deposits less required reserves against time and savings deposits based on current reserve requirements.
Borrowed Reserves	Discounts and advances from Federal Reserve Banks, mainly advances secured by U.S. Government securities or eligible paper.
Net Free or Net Borrowed Reserves	Excess reserves less member bank borrowings from Federal Reserve Banks. The resulting difference is called net free when positive and net borrowed when negative.
Nonborrowed Reserves	Total reserves less member bank borrowings from Reserve Banks.

component of the money supply) have increased at an annual rate of only 0.3 per cent during the past eight months. Despite this relatively low rate of increase in reserves available for demand deposits, the money supply has increased at a rate of 3.2 per cent since December.

Divergences between reserve movements and changes in the money supply have also occurred over the past year. The money supply has increased 4.2 per cent while reserves available for private demand deposits have risen only 1.4 per cent. The more rapid increase in money as compared with reserves is explained largely by a decline in excess reserves. In addition, there was an increase in the proportion of the money stock held in the form of currency, an increase in the demand deposits of country member banks relative to demand deposits of reserve city banks, and an increase in nonmember bank demand deposits relative to member bank demand deposits. Each of these developments has meant that any given volume of reserves has been able to support a larger money supply.

The decline in excess reserves from $530 million in July 1962 to $480 million in July 1963 indicates a slightly more intensive utilization of reserves by member banks. Currency, which requires no backing in the form of reserves of member banks, increased from 20.7 per cent of the money supply in July 1962 to 21.0 per cent this past July. The decline in the proportion of demand deposits held by reserve city banks (16½ per cent reserve requirement) and the increase in the proportion of demand deposits held by both country banks

Reserves of Member Banks



*Latest figure plotted is month ending August 15, 1963 preliminary

Excess Reserves & Borrowings of Member Banks

Latest data plotted: August

(12 per cent reserve requirement) and nonmember banks has also been a significant factor behind the more rapid rise of money relative to reserves. This shift in deposits is demonstrated in the accompanying table.

Demand Deposit Component of the Money Supply

Class of Bank	Per Cent of Total July 1962	Per Cent of Total July 1963	Change in Billions of Dollars July 1962 - July 1963
Reserve City	45.9	44.4	$ −0.1
Country	36.0	36.7	$ +2.2
Nonmember	18.2	18.9	$ +1.5
	100.0*	100.0	$ +3.6

*Detail does not add to total due to rounding.

Despite the frequent divergence of direction or rate of increase of reserves available for private demand deposits and of the money supply, changes in these reserves are an important determinant of changes in the money supply. The Federal Reserve System's ability to influence changes in money depends largely on its ability to effect changes in these reserves. The rate of change of the money supply, in turn, has an important influence on total demand for goods and services. Changes in the rate of change of reserves available for private demand deposits reflect, in part, the Federal Reserve's response to the level of economic activity and general price developments. The average annual rate of increase of these reserves has been 1.4 per cent since the most recent business cycle peak in May 1960, 0.8 per cent since the July 1957 peak, and 1.0 per cent since the July 1953 peak.

Economic Growth—Greater Than Monetary Growth

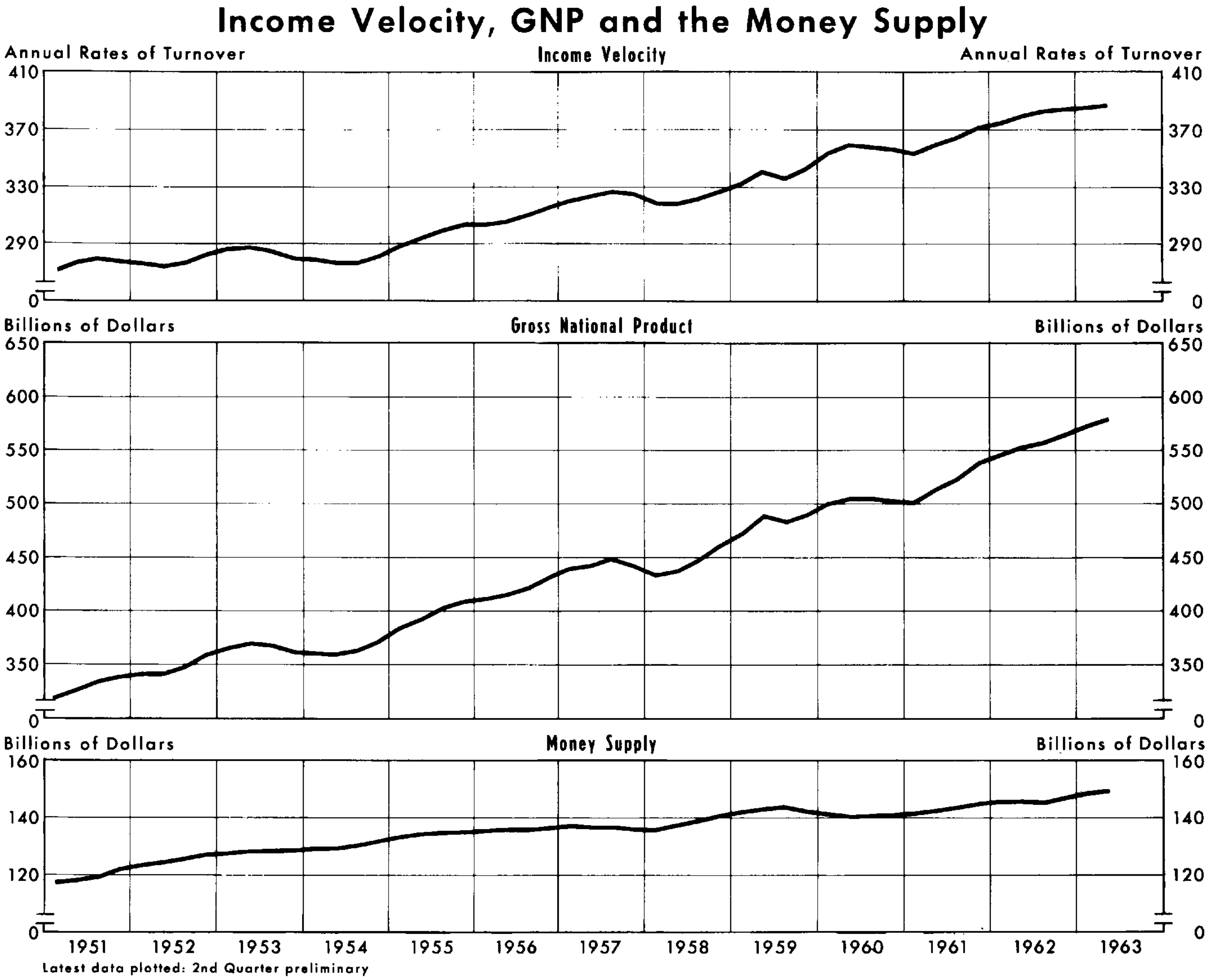
Reflecting in large measure increases in reserves available for private demand deposits, the supply of money (demand deposits and currency) has been rising moderately in recent months and years. Over the past eight months, the money supply has increased at a 3.2 per cent annual rate. Since the May 1960, July 1957, and July 1953 business cycle peaks, the annual rates of increase of the money supply have been 2.3 per cent, 1.7 per cent, and 1.7 per cent, respectively.

These rates of growth in the money supply have been somewhat less than the rates of growth of the economy over the same periods. For example, from the fourth quarter last year to the second quarter this year, real gross national product (i.e., after eliminating the effects of price increases) rose at an annual rate of 3.3 per cent. Increases in real output from past business cycle peaks have been at annual rates of 3.6 per cent since second quarter 1960, 3.3 per cent since third quarter 1957, and 3.1 per cent since second quarter 1953.

As evidenced by these figures, production has grown faster than the money supply and the velocity of circulation of money has increased (both transactions velocity and income velocity). The annual turnover

$$\text{Transactions velocity} = \frac{\text{debits}}{\text{demand deposits}}$$

$$\text{Income velocity} = \frac{\text{gross national product}}{\text{money supply}}$$



in demand deposits increased from 18.9 in 1953 to 28.7 in the first half of 1963, an average annual rate of increase of 5.3 per cent. Over the same period, income velocity increased from 2.85 to 3.86, an average annual rate of increase of 3.6 per cent.

A greater rate of increase of spending than of money has been possible by virtue of an increase in velocity. Nevertheless, the rise in total demands for goods and services has not been sufficient to generate a satisfactory rate of resource utilization. In the early 1950's, the unemployment rate averaged slightly more than 3 per cent, and output of major materials measured about 90 per cent of capacity, while in the first half of 1963 the unemployment rate averaged 5.8 per cent, and capacity utilization averaged about 85 per cent. Total demand large enough to effect a greater use of the nation's resources would probably require a larger money supply, though it is possible that a greater output could be achieved through a further rise in the velocity of money.

New Federal Reserve System Film Available

A new educational motion picture, *MONEY ON THE MOVE—The Federal Reserve Today,* has been released by the Board of Governors in Washington and the twelve regional Federal Reserve Banks.

The 27-minute, 16mm color-sound film is designed to inform the general public of the purposes, organization, and operations of the Federal Reserve System, its 12 Federal Reserve Banks and 24 branches. It may be borrowed from the nearest Federal Reserve Bank or branch at no charge by schools and colleges, clubs and community groups, business, industry, farm and labor organizations and TV stations.

—*Continued from page 2*

An examination of the balance of trade figures for the United States covering the span of years from 1960 to the present time indicates that the balance-of-trade surplus is not increasing at a rate sufficient to offset the net deficits incurred in other accounts in our balance of payments. We had a balance-of-trade surplus of $4.7 billion in 1960; it jumped to $5.4 billion in 1961 and then dropped to $4.3 billion in 1962. The trade surplus was $4.85 billion for the first six months of 1963.

Of significance to our general over-all trading position is the degree of agricultural protectionism which the European Economic Community (EEC) will adopt. The direction of the actions likely to be taken by the EEC is reflected in the current economic battle over poultry involving the Common Market and the United States. The United States announced its decision to retaliate against the European Common Market's poultry import policy, and with the United States' announcement there developed a sharp reaction in Brussels. A Common Market spokesman declared that the proposed U. S. retaliation exceeds the negotiating rights of the United States, the battle being over the value of trade affected by each side's actions. One official of the Common Market termed the U.S. step as most unfortunate and a move that would not help to create a good atmosphere for the proposed round of trade negotiations next year under the General Agreement on Tariffs and Trade.

Foreign Travel Spending

Moving from the merchandise trade account, one finds that tourism is contributing to the widening deficit gap in the U. S. payments position. In 1961 the net deficit on travel amounted to $1.25 billion. Between 1961 and 1962 the U.S. travel gap widened by some $150 million, running up a total travel deficit of $1.4 billion, or 40 per cent of the over-all 1962 U. S. deficit. Indications for 1963 point to a broadening of the imbalance in the travel situation. The deficit in tourism is computed by subtracting what foreign visitors spend in this country and on American international carriers from what Americans spend during trips abroad and for foreign source transportation. In 1962 Americans spent $1,905 million in foreign countries and $563 million on foreign carriers. Balanced against these U.S. expenditures of $2,468 million were our receipts from foreign visitors of $1,038 million, including $117 million paid to U.S. carriers for transportation services.

Capital Outflows and Interest Rates

The recorded outflow of private U.S. capital during the first quarter was at an annual rate of about $3.8 billion, more than the rate of $3.3 billion in 1962 but not quite as high as the rates attained in 1960 and 1961. Outflows of private long-term capital in the first quarter of 1963 were at the annual rate of $4 billion. In contrast to the upsurge of long-term capital outflows, short-term capital returned to the United States on balance in the first quarter as outstanding bank loans were repaid.

An important feature of the long-term capital outflow was the large volume of new foreign security issues in the United States, amounting to about $510 million in the first quarter and $340 million in the second quarter. Compared with an average quarterly total of less than $125 million in the 1959-61 period, sales of new foreign issues to Americans averaged over $250 million per quarter in 1962, and rose to an estimated quarterly average of $425 million in the first half of 1963.

This growing volume of foreign security issues together with the continuing problem of short-term capital outflows (preliminary reports indicate a substantial outflow of short-term capital in the second quarter of 1963) triggered a series of U.S. policy actions in July of this year. The Federal Reserve announced a rise in the discount rate from 3 to 3½ per cent and a revision in Regulation Q to permit commercial banks to pay higher interest rates on time deposits of shorter maturities. These moves were designed to discourage that portion of short-term capital outflows responsive to interest rate differentials between the U. S. and foreign money markets. The Government announced a drive to reduce the foreign exchange costs of Government spending overseas, a standby arrangement with the International Monetary Fund, and a proposal to tax the purchase of certain foreign securities bought by U.S. residents from nonresidents. This proposal, referred to as an "interest equalization" tax, would raise by about 1 percentage point the borrowing costs of foreigners selling bonds (over three-year maturities) to Americans and would increase by 15 per cent the cost to U.S. residents of foreign equity shares purchased from nonresidents. Since a considerable portion of the long-term capital outflow from the U.S. has been induced by the relatively lower interest rates and greater credit availability in U.S. long-term markets, the object of the proposed equalization tax is to reduce temporarily the attractiveness of U.S. capital markets to foreign sellers of securities without changing market conditions for domestic sellers of securities. The tax would not apply to foreign loans made by commercial banks, nor would it apply to security issues of less developed countries.

The effect of the U.S. "action program" on U.S. payments to foreign countries will not be ascertained for some time. Immediate reactions to recent events, however, underscore the difficulties confronting the U.S. whenever it chooses to make a positive move to reduce the payments deficit.

Canadian and Japanese money markets viewed the proposed equalization tax as a road block to their access to capital resources from the United States. The value of the Canadian dollar began to drop, and the Bank of Canada reportedly used $100 million of her reserves in two days to support her currency. Japanese stock prices slumped sharply in response to the announcement of the proposed U.S. tax. The equalization tax measure provides that the President may grant exemptions. In response to Canadian protests, new issues of Canadian securities were exempted from the tax. To date, no other country has been granted this exemption.

The Canadian reaction and the United States response demonstrates the problem confronting the U.S. as it attempts to slow up the outflow of capital. The United States enjoys a surplus in her trade with Canada, and the Canadians are quick to point out that they require access to U.S. credit facilities if U.S. exports are to be financed by Canadian importers. An overt U.S. move to restrict long-term capital outflows could possibly lead both to a natural and a contrived reduction in foreign purchases of American goods.

The recent moves to curb the outflow of short-term capital by raising short-term interest rates also carry with them some risks and limitations. In the absence of a vigorously expanding economy, the monetary policy requirements for a higher short-term rate structure may operate as a deterrent to domestic private spending.

If the higher short-term rates are to act as a deterrent to short-term capital outflows, the rates must rise relative to rates in foreign money markets. Since early July, the U.S. Treasury bill rate has moved up fairly sharply to the highest level in more than 3 years. But at the same time Canadian rates have moved upward, and the Bank of Canada raised its discount rate from 3½ to 4 per cent. The rise in the bank rate has been reported as a technical adjustment forced by the upward pressure of short-term rates. It has also been interpreted as the "orthodox" response of a central bank to a loss of international reserves. In turn, the reserve loss has been traced to the market unsettlement arising out of discussions relating to the proposed U.S. interest equalization tax.

In the face of the U.S. payments deficit statistics for the first half of 1963, it is not surprising that the United States expressed a sense of urgency in the formulation of its program in July. The success of this program will depend essentially on the reactions of other nations and on the ability of the United States to invigorate its economy and to enhance its investment outlook.

Recent Studies Relating to the U. S. Payments Position

In a recent presentation of central bank thinking, four central bankers expressed their views in the August *Monthly Review* of the Federal Reserve Bank of New York. They represented the Federal Reserve Bank of New York, the Swiss National Bank, the Bank of Italy, and the German Federal Bank. These four central bankers rejected the idea that the growing volume of world trade and investment requires the introduction of a new international unit of value or a new system of credit. According to them, the only effective way to assure long-term growth of liquidity is "to rely upon a further development of mutual credit facilities among the major trading nations." The four sources of liquidity as they see it comprise (a) official gold and foreign exchange holdings, (b) formal or informal foreign exchange swap arrangements or similar understandings, (c) special certificates or bond issues denominated in creditor nations' currencies, and (d) access to the International Monetary Fund. These official monetary experts laid great emphasis on the close cooperation practiced by the major central banks and the high degree of flexibility and resilience of the present system as it has worked through a period of recurring pressures.

As the world discussed the various facets of the U.S. program "to do something about the U.S. payments deficit," the Brookings Institution published a report entitled *The United States Balance of Payments in 1968*. The release of this report followed by 10 days President Kennedy's expression of concern over the payments deficit.

The most important concern of the Brookings report is that the international monetary payments system is exposed to a basic inadequacy of "reserves" in relation to the requirements of world trade. The existing international monetary reserves of the free world consist primarily of gold and dollar holdings. If the United States reduces its deficit, it reduces at the same time the flow of dollars into the reserves of foreign nations. A surplus in the U.S. net payments position would contract the volume of foreign-held dollars. The report asserts that, under these circumstances, a United States surplus may be difficult, if not impossible, to attain. European and other leading trading nations, unwilling to see their reserves shrink under the impact of a U.S. surplus, would counter with restrictive actions to reduce their payments to the United States.

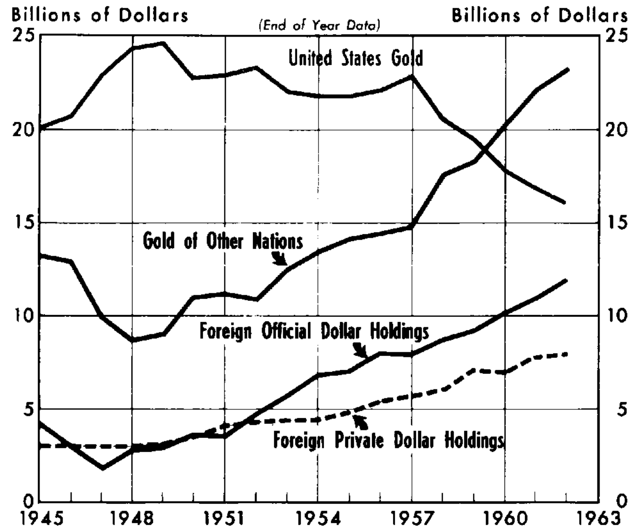
If the world is unable to come up with a new reserve-creating institution (a remodeled International Monetary Fund or a new international central bank) to meet the liquidity requirements of foreign nations, the United States will be unable to eliminate its payments deficit without doing violence to its national domestic objectives and to its objectives of foreign policy and security.

It is an underlying premise of the report that a balance-of-payments equilibrium is not the primary objective of national policy. In the opinion of the authors of the Brookings report, the first order of business for the United States is to address itself to the long-run problem of international liquidity rather than to the short-run objectives of balance-of-payments equilibrium.

A fundamental conclusion of the report is that certain forces now operating will remove the "basic" deficit (excluding any net payments arising out of short-term capital movements and unrecorded transactions) by 1968. The study bases its conclusion partly on the belief that, in the period 1961-68, the competitiveness of American goods in world markets will increase because of a projected 20 per cent increase in European prices and growth rates for the European economy only slightly below those attained in the period 1953-60. Furthermore, the report follows conventional doctrine in suggesting that U.S. capital outflows will slow down as the domestic economy improves. While foreign aid expenditures are expected to increase somewhat, military expenditures are expected to drop by as much as $1 billion if current policies continue.

The report, other than concluding that basic forces are now working to reduce the U. S. payments deficit, made no proposals with respect to "curing" the deficit in the near future. It did issue the caveat that no actions should be taken to improve our balance-of-payments position that would interfere with any major objectives of U. S. domestic or foreign policy. Short-run pressures on the dollar and U. S. gold reserves, according to the report, are best handled by the existing network of international financial arrangements providing additional reserves and support for particular currencies. The report did suggest that the United States might strengthen its position by using $3 to $5 billion in gold to buy foreign currencies. Such a move would leave no doubt about Washington's determination to defend the dollar and would, at the same time, provide the foreign currencies that could be used to finance the U. S. payments deficit. An integral part of the report's proposal with respect to gold is the abolition of the 25 per cent gold certificate requirement which, if removed, would "free" more than $11 billion in gold now used as a reserve against deposit and note liabilities of the Federal Reserve Banks.

Gold and Short-Term Dollar Holdings [1]



[1] Excludes gold and dollar holdings of international institutions. Dollar holdings do not include marketable U.S. Bonds and Notes.
Source: Board of Governors of the Federal Reserve System
Latest data plotted: 1962 preliminary

In a series of three articles[1] Professor Wallich, former member of the Council of Economic Advisers, submits that the Brookings report will not be received favorably by our foreign creditors. As Europeans see it, according to Wallich, the Brookings report is urging that the United States' deficit continue to be financed but not necessarily cured. European creditor nations are not likely to take kindly to the suggestion that the United States, in its debtor position, negotiate for the establishment of some new international central bank with reserve creating ability.

The negotiations and terms surrounding the recent establishment of borrowing facilities for the U. S. at the International Monetary Fund are indicative of what the U. S. may encounter in any proposal for a new international institution. When the short-term creditor nations agreed to supply approximately $2 billion on a stand-by basis to the IMF, they insisted on the right to accept or reject any particular request in a given situation. The IMF would not decide this. Professor Wallich suggests that, under present circumstances, a United States proposal to establish some super bank is subject to outright failure or to conditions which the United States would not find acceptable.

[1] *Journal of Commerce* (New York), August 5, 6 and 7.

In the new super bank, the European short-term creditors probably would want the majority of votes or veto power; they would not accept automatic access to credit on the part of the United States. Access would be made subject to terms and conditions. Perhaps such conditions would include the raising of interest rates, limits on foreign lending and foreign aid, and limits on budget deficits. These are the kind of conditions that might develop if the United States negotiated from weakness. The obvious answer, according to Professor Wallich, is that the United States should regain strength by correcting the balance of payments and then negotiate a plan to increase world liquidity.

This is the policy upon which the United States is now embarked. It is attempting to raise short-term rates and to reduce the net foreign exchange cost of military expenditures and foreign aid. At the same time it is attempting to curb the outflow of long-term capital. These policies are subject to considerable risk in that raising short-term interest rates could entail costs in terms of employment and output. It is possible that our policies might impair the effectiveness of aid and military expenditures and lead to lost opportunities for foreign investment. According to Professor Wallich, however, there are few alternatives to these policies.

Although the public reaction, domestic and international, is likely to lead to a rejection of the Brookings report recommendation for a new super central bank, there is evidence that the major free world nations are concerned about the operation of the international payments system. It seems likely that this concern will lead to renewed efforts at finding ways to improve that system without giving up the main features of the postwar arrangements, based on the international use of gold, reserve currencies, and the resources of supra-national institutions such as the IMF. In particular, further expansion of the role of the IMF and perhaps better utilization of its resources, in line with the 1959 increase in IMF quotas and the subsequent institution of a "borrowing arrangement" among its major members, may well play a prominent role in future investigations and discussions.