

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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Office Correspondence

Date December 15, 1967.

To Board of Governors

Subject: IMF Consultations with

From Robert Solomon

the U.S.

STRICTLY CONFIDENTIAL (FR)

RECORDS SECTION
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Attached for your information are the sum-up remarks of the Fund Team in the U.S. Consultations, as presented by Mr. J. J. Polak yesterday. This statement is being held closely and is not being given to the Executive Board of the Fund.

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Attachment.

Article VIII Consultation with the United States, 1967

Remarks by J. J. Polak for the Fund Team

December 14, 1967

We are indeed grateful for the cooperation you have given us in this Article VIII consultation exercise. Your responses to the many questions we have raised, both written and oral, have provided the essential basis for a very informative report to the Fund's Executive Board. At this point, I should like to sum up the way we see your economic situation and policies. Although you may be sure that our report to the Board will attempt to give a balanced picture of the U.S. economic performance, I will focus here mainly on problems and difficulties rather than on achievements. We consider this another working meeting, and are anticipating some further active discussion.

On this same occasion a year ago, I reviewed the developments of 1965 and 1966 that had led to accelerated price and cost increases, to the emergence of distortions in the domestic economy, to a sharp deterioration of the current account in the balance of payments, and to the creation of various problems for national economic policy in 1967. I then went on to observe that there did not appear to be a set of policies that could get all the variables back on track in the short run, and that economic management for the next year or so might have to settle for a combination of results that would fall short of optimum in at least some directions.

Unfortunately, the same general situation still prevails. Little headway seems to have been made during 1967 in returning to a situation of balanced progress toward multiple economic objectives--especially when such progress is judged in terms of the Administration's hopes and projections at the beginning of the year. Clearly, some important problems remain:

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First, over-all prices have increased in 1967, once again, more than was expected by U.S. officials and more than would be acceptable to the authorities on a longer-run basis.

Second, the expansion of real output this year over 1966--at about 2 1/2 per cent--has been much below the economy's noninflationary potential growth rate. Within the year 1967, the problem facing the authorities has shifted all the way from the avoidance of recession, which happily was successful, to the restraint of aggregate demand and the restoration of balance in the economy--on which issues the jury is still out, primarily because of the difficulties encountered in setting fiscal policy for the period ahead. The year 1967 has certainly posed some unusual problems for demand management, and in this connection the Council is to be commended for having foreseen last January the broad contour of cyclical developments.

Third, the improvement in the external current account this year has been substantially less than that projected in the Council's Report last January. As to the balance of payments as a whole, the deterioration from 1966 to 1967 has not conformed with the anticipation you expressed in last year's consultation that further progress would be made over the near term in reducing the payments deficit.

But let us now look ahead. In an assessment of the economic outlook for 1968 there are numerous questions relating to aggregate demand. What significance should be attached to the recent slowing down in various economic indicators, including retail sales? Will consumers reduce their recent high rates of saving? What is the probable course of outlays for residential construction under differing assumptions about the tightness of monetary

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conditions? How much further will the current efforts to curb federal spending be extended? How strong will be the forces that seem likely to impart a temporary thrust to aggregate spending during the first half of next year? All in all, the economic outlook for 1968 seems somewhat less clear than it did last August when the Administration presented its fiscal proposals, featuring a 10 per cent tax surcharge. But this aspect of the outlook, while noteworthy, is not something on which I would put special emphasis. I do believe, however, that the outlook has undergone significant alteration because of the recent cuts in federal spending.

How much additional fiscal restraint/^{may}be needed depends, of course, on one's judgment about the increase in GNP that is appropriate in view of policy considerations in several areas. During the past year or so, prices have increased more than might have been expected in the light of accepted judgments about the relationship between price movements and the pressure of demand on the economy. While cyclical forces should bring some improvement in productivity, the recent evidence of continuing wage and price pressures is disturbing. And though we were glad to hear that "incomes policy decisions for 1968 are under intensive study by the Administration," we would not expect developments in this field to have a decisive impact during the coming year. It seems to us that the balance of risks lying ahead for the U.S. economy—not only domestically but in the balance of payments as well—calls for a cautious approach to demand management, and we would go somewhat further than you/^{have indicated/} next year's expansion of GNP below what might be justified in terms of capacity considerations alone. After many years of payments deficit and several years of disappointing price performance, some corrective action in this direction seems necessary—bearing in mind also the risk of incurring a much larger real cost if an/^{early} improvement with respect to / these policy aspects is not achieved.

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Our judgment about the need to moderate the expansion of GNP implies the application of some further restraint, and it would be unfortunate if too much of the strain again fell on financial markets--in particular, on the mortgage market. Thus, we share your hope that an increase in income taxes will be enacted in the very near future, although a somewhat smaller increase than originally requested might now be appropriate in the light of the cuts that have been made since August in planned federal expenditures.

Needless to say, we are aware that it may not prove possible to put through a tax bill^{at} a very early date. Neither we nor, we suspect, anyone else is now in a position to judge the suitability of any particular tax measure to be enacted several months hence. This would depend, among other things, on the revenues and expenditures projected in the federal budget for the fiscal year 1969.

The experience of the past few months has pointed up the^{current} difficulty of making timely adjustments in fiscal policy. This inevitably limits the relevance of the near-term economic outlook in the consideration of a particular major tax proposal. On the one hand, the tax change may not be enacted for many months, by which time the outlook may have altered considerably. On the other hand, the new tax rates, once in effect, may be difficult to increase or decrease, whatever changes may have occurred in the economic outlook after their enactment. These thoughts are not comforting. They underline the need to search for fiscal flexibility. Without this, there is a risk of serious departures from good economic performance, not only in an aggregate sense but also with respect to the distortions that follow from the too strenuous use of monetary policy that might be necessary in the circumstances. The fundamental lesson seems clear--that ways must be found to bring more order into the use of fiscal policy through an improvement of the procedures in this area.

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The fact is that monetary policy had to be modified significantly in the course of 1967 (as in 1966) to meet the changing pressures in the economy and in financial markets. The expansionary policy followed by the Federal Reserve System beginning late in 1966 was well suited to the circumstances. Given the situation that had developed by the fall of the year, there can be no question that the economy needed stimulus and that the financial system itself needed respite from an intolerable degree of strain. Since around the middle of 1967, there has been an appropriate change in the direction in which financial conditions have moved. The earlier pattern of easing--with the important cross-current since early 1967 of rising long-term interest rates--has given way to a broad, although gradual, move toward tighter conditions throughout financial markets as the economy has picked up.

It is admittedly difficult to judge whether this tightening has gone far enough. Important considerations have counseled against too rapid a tightening of financial conditions. In the early fall of 1967 scarcely a year had passed since the financial system began to recover from the squeeze of 1966: one would not have lightly run the risk of plunging back into anything like that situation. Moreover, the increasingly difficult position of the pound sterling would have suffered from too sharp an upward adjustment in U.S. interest rates. Hopes for action on the tax bill also militated against vigorous action in the monetary field.

The changes which have occurred in the level and structure of interest rates and in the position of financial institutions have in all likelihood not yet reached the point of markedly affecting spending plans for early 1968. From now on, the monetary authorities may well face the difficult position where further restraint will be needed--even though this restraint could have much of its effect later in the year when the economy may well have entered into a stage of less rapid expansion.

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I turn now to the balance of payments and the question of gold. We are aware of the fact that we are dealing here with extremely sensitive issues that require careful and delicate treatment. However, we have had the benefit of frankness on your side in describing the U.S. position on these matters, and we feel that we would be less than forthcoming if we did not give you our views with equal candor. Needless to say, we invite-- and will doubtless receive--your frank reactions.

As I indicated last week, we have noted two broad stages of approach by the United States to its balance of payments problem during the 1960's. The first stage was characterized by a belief that achievement of payments equilibrium was just around the corner, and that this would come about through the operation of fundamental market forces supplemented by unilateral actions on the part of the United States. This stage, which featured proclamations and promises at the highest level, culminated in late 1965 with the announcement of a target of balance of payments equilibrium for 1966.

The current stage of balance of payments policy can be said to have begun in the early part of 1966 with the first official indication that elimination of the deficit probably would not be feasible so long as the war in Viet-Nam continued. This was followed by evolution of the "structural" thesis that the U.S. payments deficit is a counterpart of the EEC surplus and is dependent for its elimination over the longer run on an approach that sees the adjustment process as a matter of common responsibility.

Since the concept of the U.S. payments deficit as a "structural" problem has been introduced into our discussions, I should like to make a few comments on it--although this is not the time for a full consideration

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of this complex matter. There is, of course, no disagreement on our part with the general proposition that payments imbalances should be tackled by surplus and deficit countries alike. But is it not too narrow a view to regard the current problem as involving simply a U.S.-EEC confrontation? To mention one fact, for example, in the past several years the over-all surplus of the EEC countries has amounted to less than half of the total surpluses of all countries. Even insofar as the EEC countries are concerned, the United States does not need to be mesmerized by their over-all surplus. There is no evidence that these countries are intent on having a surplus at all costs; and insofar as they were, this would not necessarily involve a U.S. deficit as its counterpart: the solution could lie in the area of reserve creation, as U.S. officials have stressed in another context.

What particularly concerns us in this new U.S. "structural" approach to the international payments problem is that it can easily be interpreted to mean that the United States can relax, or has no option other than to relax, unless there are corresponding efforts from the other side. This attitude seems indeed to be reflected in your description of the 1968 payments outlook, which conveyed to us the prospect of another year of "drift" and "wait and see". We did not find an evident real concern about possible continuance of the deficit at the higher 1967 level even though, once again, hopes for some improvement were expressed. And we were not told that there is a U.S. policy intention to reduce the payments deficit over the near term and to bring the balance of payments under firmer control. If the United States has a strategy along these lines, it has not been made public; nor has it been brought out in our consultation discussions. We cannot avoid the impression that the balance of payments has a lower priority

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in U.S. economic policy than it did some years ago. Whether or not you agree with this, I am sure that many others, both in this country and abroad, have the same impression.

In our view, U.S. policy can hardly be based on the confident assumption that year after year two or three billions of dollars can be injected into the world economy by U.S. deficits without an ever increasing gold loss. In the earlier years, conversion of dollars was limited to those held officially. A variety of understandings have now been evolved by which many countries have been refraining from conversions of dollars into gold which they might have wanted to make in other circumstances; and, indeed, some countries have backed off further by turning liquid dollars into somewhat longer assets for various reasons, including a desire to help reduce the U.S. payments deficit on a "liquidity" basis. The short-run strategy that inspires such measures is obvious; at the same time, U.S. officials are no doubt aware that these measures are not in the long run conducive to enhancing the status of the dollar as a fully satisfactory reserve asset.

While the question of official conversion has thus lost some of its immediate importance, private dollar holdings have been given de facto convertibility into gold via the London gold market since November 1960. I am not all that pessimistic about the long-run balance between supply and demand in this market, as seems to have become the fashion. Nonetheless, it seems to me that two propositions with respect to the London gold market are clearly true in present circumstances:

First, that the current supply flowing into it is not adequate to meet total demand whenever speculative forces of some magnitude make themselves felt on the demand side, and

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Second, that speculative forces will continue to appear as long as a solution to the U.S. balance of payments problem is not reasonably in sight.

The view that a continuing U.S. deficit will ultimately lead to a rise in the price of gold is rather widely held. This view has no doubt found encouragement in statements made by private persons of importance that cessation of gold sales by the United States might not necessarily be a bad idea. In this whole setting, it is not difficult to understand the continued flow of some savings into gold on the part of such investors as are allowed to take this action.

We have not the slightest doubt that the resources of gold at the disposal of the gold pool members are large enough to weather any speculative bouts in the London market. The financial measures to limit gold speculation on credit that have been taken in Switzerland, and perhaps elsewhere, can also be significant in this connection. But given the close balance, at best, that exists between the nonspeculative demand for and the supply of gold, and in the absence of stronger evidence that the United States is tackling its payments problem, it seems doubtful to us that either the determination of the gold pool, or the legal measures to control speculative demand in it, would prevent the steady drain of gold that would convince speculators that they are on the winning side in this battle.

At present, moreover, the availability of gold to the gold pool is clouded by uncertainty as to the status of most of U.S. gold. On December 6, the President reaffirmed the U.S. pledge to keep the dollar strong and added that "every ounce of our gold stock stands behind that pledge". We have

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noted, however, that this statement by the President seems to have been ignored by newspapers here and abroad in the same way as they ignored an equally strong statement made some years ago by the Chairman of the Federal Reserve Board. In the public mind only a small amount of gold is available until the minimum "cover" is reached. In the circumstances, legislation to repeal the "cover" provision seems urgent, and if it were felt that such legislation could not be passed promptly much wider knowledge should be given to the escape clauses that do, in fact, permit the use of all U.S. gold even under present legislation.

I have ventured into this rather gloomy discussion of the gold situation not as an exercise in prediction, but to point up a matter that is of real concern to us. For our part, we see a contradiction between, on the one hand, the present approach of the U.S. authorities to the balance of payments and, on the other hand, their strong and unequivocal position publicly taken with respect to the dollar price of gold. In our view, the way to resolve this contradiction in policy is the adoption of a much more positive attitude on the part of the United States toward its balance of payments problem. We would not for a moment suggest that the United States cease to stress the importance of the contribution that European countries and surplus countries elsewhere can make to a smooth adjustment process by suitable payments policies of their own. Certainly, the Fund itself will continue to stress these aspects of the adjustment process. But we would suggest that the United States redirect its policies--comprehensively--so as to make clear that it is determined to bring about a substantial improvement in its payments position.

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As I indicated, I had the balance of payments in mind when I suggested a few minutes ago that the general instruments of fiscal and monetary policy should be directed toward a certain moderation of the expansion of GNP in 1968. This should be helpful with respect to prices and costs and the current account, especially on the import side. In this connection, let me say that we agree very much with the Secretary of the Treasury's statement of November 17 regarding the importance to the balance of payments of a return to relative price stability and cost competitiveness in the domestic economy. This is surely the correct emphasis; even though the effects of rising unit labor costs may not be discernible in short-run changes in export prices and export market shares, the importance of these effects is not to be minimized.

It is not my intention to try to provide a detailed blueprint of the more specific measures that might be adopted by the United States to improve its balance of payments position. Aside from the further restriction of government expenditures abroad, such measures would need to be concentrated on the capital account, and a thorough review of the voluntary restraint programs would certainly be called for. Here, my primary aim is to stress the overriding need for the U.S. authorities to make an early decision to give the balance of payments a higher priority in the scheme of public policy, and to support this decision with a combination of general and specific measures sufficient to bring about a substantial reduction in the payments deficit.

There is a point that needs to be made in conclusion. I have called attention to the contradiction between the clearly stated U.S. objective with respect to the dollar price of gold and the absence of firm action on the balance of payments, and I have suggested that this contradiction be resolved by the adoption of a broad policy addressed to a strengthening of the payments position. Now, I would not want to leave the impression with anyone in this audience that there is

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another choice--that the United States could opt for a soft payments policy if only it were willing to abandon its attachment to the \$35 an ounce price for gold. I do not believe there is such an option.

As far as we can see, the choice for the United States is not whether to take a much more determined position on the balance of payments but when to do so. If such a position is taken promptly, it should be possible to maintain the present gold price not only for official settlements but also for private transactions against convertible currencies. Delay in such a decision may bring the United States to a position where it still has to adopt a payments policy in order to maintain the price of gold in official settlements. And one may envisage a third stage in which gold has been "demonetized" and perhaps all countries are on a day-to-day basis on a dollar standard. Even for that world--which for reasons that I fail to grasp seems to have a strong attraction to certain people--it would, I think, be a complete illusion to believe that other countries would be prepared to absorb a U.S. deficit in the form of a continuous addition to their dollar holdings. In other words, the United States would still be faced with the need to remedy its payments position.

I am aware that I have been dealing with a series of rather grim contingencies. I am afraid that, in the circumstances, I have had no choice but to put these stark truths on the table for your consideration and discussion.