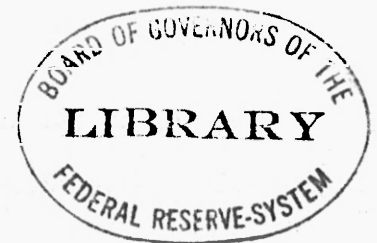


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THE CHALLENGE OF WORLD MARKETS

Remarks of C. Canby Balderston,
Vice Chairman, Board of Governors of the Federal Reserve System,
at the Luncheon Meeting of the Joint Boards of Directors
of the Federal Reserve Bank of San Francisco
and the Salt Lake City Branch,
at the Alta Club,
Salt Lake City, Utah.

The United States is in the position of a farmer whose cash crops are insufficient to meet the obligations that he has taken on to help those outside his immediate family. He has assumed some of these obligations to keep his family and farm safe from attack; others he has assumed, in a spirit of helpfulness, to assist neighbors and friends to get on their feet financially, only to find that those he has helped have become his strongest competitors. Like this farmer, our nation has been spending, lending and investing more abroad than it has been able to pay for.

I shall approach my discussion of our country's current dilemma of balancing this foreign outgo against its domestic needs by recounting briefly how we came to assume these burdens.

The United States emerged from World War II with an enormously expanded plant capacity, with a store of technological improvements that stemmed from war research, and with a population that, despite its tragic losses of dead and disabled, was basically unharmed. Britain, Holland, and Norway, and to some extent France and Belgium, had suffered markedly in loss of plant as well as of trained manpower. Germany, Austria, and Italy had fared even worse. These devastated countries had to rebuild their plants as well as their homes. In the post-war years, the desire for our goods in such areas was apparently insatiable. The buying power to acquire these goods was augmented under the

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Marshall Plan with such generosity as to enable these countries to get on their feet and become good customers. By now they have become strong competitors with plants as good or better than our own.

Meanwhile, a long period of operating without foreign competition in the post-war sunshine of abundant demand for materials and equipment had a softening effect upon our industries. For some years they received orders without aggressive marketing, and increases in unit costs could be passed on to the consumer so long as post-war inflation abroad made price increases possible. Besides, to American suppliers the preservation of markups was appealing. And so our firms got themselves caught in a wage-price spiral that has had unhappy consequences. The heritage from the war of highly mechanized production techniques and of the fruits of research was a technological breakthrough that gave to the United States a great competitive advantage in world markets as long as the industries in other countries were engaged in replenishing their domestic needs. Once they had caught up with basic needs at home, however, the newly equipped foreign plants, employing labor at a fraction of the comparable rates of this country, entered world markets with many products that were as good as our own and cheaper, too.

Although we have exported an unprecedented \$20.8 billion worth of goods during the twelve months ending in August 1962, we must not forget that some of our best customers have been enjoying a boom. Consequently, they have needed our materials and equipment and have been in a position to buy finished consumer goods as well. However, the trade surplus of our exports over imports, which ran about \$4.8 billion in the last twelve months, ought not to be counted upon to resist a world-wide recession.

Our ability to compete in our own domestic markets is also vulnerable to improved and cheaper products from abroad. Foreign-made glass now comes by ship right into Toledo--which had won the name of "The Glass City" of America--

by producing much of the glass used in our American autos. Much of the barbed wire, reinforcing bars and wire nails we use are now of foreign origin, not to speak of a substantial amount of semi-finished steel. We import Japanese transistor radios and electric parts that are cheaper than ours, and Japanese ball bearings and cameras of as fine quality as can be found anywhere. We export more than enough to pay for these imports; like other industrialized countries our exports and imports have both been increasing during recent years. The essence of our balance of payments difficulties is that our trade surplus fails to finance the obligations we have undertaken as leader of the free world together with the current outflow of private capital.

What has happened is that in the post-war years we have built a high cost structure into our economy. Wages and salaries, fringe benefits, taxes, overhead--all have risen regularly from year to year, and in most cases have exceeded the substantial gains in productivity that have been achieved. In the earlier post-war years, when markets were strong and competition moderate, these higher costs could be passed on through higher prices. But as the most urgent market demands have been satisfied, and as competition has become more severe at home and abroad, more and more cost advances have had to be absorbed.

Cost-price controversy often centers upon the upward trend in wage and related costs. But certain other costs have risen even more rapidly than payrolls. Thus, according to a First National City Bank study, the proportion of the sales dollar that the 100 largest manufacturing corporations paid out for materials, payrolls and fringe benefits fell slightly between 1949 and 1961, from 82 to 80 per cent. Surprisingly, the proportion of sales taken by Federal income taxes also dropped a bit, from 4.2 to 3.8 per cent. But other tax payments, including State and local, rose from 2.2 to 4.6 per cent while depreciation charges rose from 3.6 to 4.7 per cent of sales over the twelve year period. It was these cost elements that cut after-tax earnings of the

100 firms from 7.6 to 6.0 per cent of sales between the roughly comparable years of 1949 and 1961.

Increased governmental services entail increased costs, and these costs must be borne by the public either currently in the form of higher taxes, or over the longer-term, in the form of a debt-servicing burden. We are a wealthy economy, and can afford the services that are really needed and useful, but we should be very sure to get our money's worth. Taxation, like direct wage and other production costs, adds to the already high cost-structure of our productive machine. And in our present environment where increasing competition prevents upward price adjustments, even marginal increases in costs, from whatever source, tend to squeeze profit margins and injure investment incentives. In our public affairs, as in private industry, unnecessary frills and expenditures add to an already inflated structure of costs and prices. These must be held in check, and opportunities for the profitable employment of men, money and machines enhanced if we are to be successful in the competitive struggle for world markets.

The competitive edge given us by the post-war breakthrough in mechanization and automation has now been lost in many lines of product. Sophisticated foreigners know that if we inflate more--and they less--they can take foreign markets away from us and make greater inroads into our home market as well. It would not suffice for us merely to keep our costs steady if German, French and Japanese costs were decreasing. However, their costs are now rising, and if ours hold steady, then time should work for us. But the mere passage of time will not work in our favor unless we make those hard decisions necessary to keep prices competitive.

The real test as to whether we are pricing our workers out of jobs is whether our products and services will sell in the markets of the world, including our own. If their design or quality or terms or prices are unattractive,

American firms lose the chance to sell their wares, and in doing so to provide additional jobs for American workers. It is export and import prices that count, not alone those offered in the domestic market by domestic producers; it is world markets that present the test of American competitiveness.

The essential point is that our exports must exceed our imports sufficiently to pay for our new investments abroad, plus the military expenditures and economic aid across the seas that our world leadership seems to entail. This means products of the right design and quality offered at the right terms and prices. Our country is rich in resources and in management know-how. But how much it can invest, spend and lend abroad depends basically upon how much more it exports than it imports. This means that our firms and farms must be competitive in the world's market places, which are coldly realistic.

The problem of selling enough abroad to pay for the lending, spending and investing we are doing abroad has become accentuated since 1958. In that year, currency convertibility was virtually achieved by most industrialized nations. This permitted funds to flow with alacrity among the financial capitals of the world,--that is, from one industrialized country to another.

At the same time the Common Market advanced to a new stage under European leadership and with American encouragement. A unified Europe began to develop the counter-part there of the great market in the United States which had long provided to our companies opportunities for mass selling without the impediment of trade barriers.

The beginning of the Common Market that early proponents had visualized as a step towards a United States of Europe came in 1951 when France, Germany, Italy and the Benelux countries established the European Coal and Steel Community. Then France and the Netherlands put forward suggestions for agricultural unification. These countries sought to tap markets in West Germany

and elsewhere in Europe for their agricultural surpluses. Western Germany with its fragmentation of crop growing areas is a less efficient food producer than is France, and as a result has been both a heavy food importer and a follower of protectionist policies for agricultural items. In contrast, France and the Netherlands had long been exporters of farm products, and wished the barriers to the export of these products to be kept low. This contrast in the policies of these two countries and that of Germany led to the idea of a still broader common market in which concessions on agricultural commodities could be matched with those on industrial goods, and permit the labor displaced from the modernization of agriculture to be absorbed by the expansion of industry. Finally, on January 1, 1958, the Treaty of Rome was signed signifying the birth of the European Economic Community, which is now familiarly known as the Common Market. It contemplates a period of transition of twelve years or less for the member countries to be welded into a single economic unit with freedom for goods, capital and labor to move within it. The agreement also provides ultimately for a common tariff on the external trade of all the member countries.

At first England and six other countries, including neutrals like Austria, Sweden and Switzerland plus the Scandinavian countries, formed a defensive trade alliance. The unexpectedly rapid success of the Common Market has caused these countries to reexamine their positions. Greece has already concluded an agreement for full economic integration, and England, Ireland, Denmark, and Norway have applied for membership in this growing market whose population, if England joins, will be one-fifth larger than that of the United States. The countries comprising the Common Market and the so-called outer seven absorbed last fiscal year about \$1.8 billion of our \$5 billion of agricultural exports. What concerns me, however, is that, if we look solely at the agricultural exports we get paid for, the European share is more than one-half the total. The bulk consists of cotton and tobacco, which will not

be much affected by the Common Market, and three categories that will. These are feed grains, wheat including flour, and soybeans. In the past, France has been taking cotton but little else; the United Kingdom, tobacco and animal fats; the Netherlands, grains and oil seeds; and West Germany, a wide assortment. The agricultural output of Western Europe has increased about one-third during the last decade and is growing faster than consumption.

To achieve a common agricultural policy has been particularly difficult for the Common Market countries and is still the principal barrier to the participation of Great Britain. The pattern being negotiated now consists of price ceilings and floors, together with national targets that will be melded gradually to form a community-wide target price. In case market prices are below the target prices, support purchases will be made at so-called "intervention prices"; if they are above the national targets, levies will be imposed on trade that is within the Common Market. The Common Market agreed recently during the tariff negotiations in Geneva that its common external tariff for new hides and skins should be zero; for inedible tallow, 2 per cent ad valorem; and for variety meats, 20 per cent. If the Common Market countries were to attempt to tighten trade controls over these products, the GATT negotiations would have to be reopened and trade concessions made to compensate the injured countries. Consequently, the prospect for continued export of livestock by-products from the United States would seem to be good.

It is clear that the maturing of the Common Market will bring our country face to face with some reallocation of labor and other resources. What we lose in our agricultural exports, which amount to about one-fourth of total exports, we must strive to make up in the marketing of industrial goods abroad. This is important if we are to provide job opportunities for surplus farm labor. As my colleague, Governor Shepardson, has observed, "we can be sure that it will involve reallocation of resources and markets both

"here and abroad, some of which will doubtless be painful to the areas or segments of our economy most directly affected."

To recapitulate, the current challenge of world markets will test not only our American inventiveness, but our willingness to venture by supporting new ideas with investments made possible by saving. Such venturing, however, will turn upon profit expectations, and these are weakened by inefficiency and waste. One source of waste is the misapplication of resources, human and other, that happens when bad investments are made in the private sector, or useless expenditures in the public one. Moreover, featherbedding, whether in the private or public sector, makes jobs for some people only by destroying job opportunities for others. What destroys trade among ourselves and others kills jobs, but if this country can retain its vaunted efficiency and if its exporting is not inhibited by trade barriers, then the emerging Common Market, with its promise of accelerated economic growth, presents enlarged export opportunities; on the other hand, failure to meet this new challenge will cause our country to lose out to sterner competition not only in foreign markets but at home.