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DOMESTIC STABILIZATION AND THE U. S.
BALANCE OF PAYMENTS

Remarks by

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The fiscal restraint proposals, finally adopted by Congress after nearly a year of debate, should make a major contribution toward the restoration of economic stability at home and the improvement of our balance of payments. However, while higher income taxes and reduced Federal expenditures will begin immediately to dampen the pace of domestic economic activity, the benefits to the balance of payments will come more slowly.

The principal effect of the new fiscal measures on the balance of payments should be an expansion in our trade surplus: while exports should be stimulated somewhat, there should be a noticeable moderation in imports. For the year 1968, the trade surplus may be \$200 million better -- with the added fiscal restraint in place -- than without it, and by the fourth quarter of 1968, the trade surplus may be running at an annual rate of \$400 million better than it otherwise would have been. Furthermore, the trend of trade -- and also of domestic prices and costs -- should be substantially better as we go into 1969. All of these developments will have beneficial implications for confidence in the dollar and for capital flows as well as for the current account.

*Member, Board of Governors of the Federal Reserve System. I am grateful to Mr. John Reynolds of the Board's Staff for assistance in the preparation of these remarks.

In any effort to improve our balance of payments, the expansion of our trade surplus must play a vital role. In his New Year's Day Message on the Balance of Payments, the President stated that:

" . . . we are determined to achieve a substantial improvement in our trade surplus over the coming years. In the year immediately ahead, we expect to realize an improvement of \$500 million."

The President made clear that, among other actions, it would be necessary

" . . . to enact the anti-inflation tax which I have sought for almost a year. Coupled with our expenditure controls and appropriate monetary policy, this will help to stem the inflationary pressures which now threaten our economic prosperity and our trade surplus."

In these remarks, I shall examine the consequences for foreign trade and the balance of payments of the domestic inflation which has emerged during the last few years. I will also appraise the beneficial effects which we might expect if domestic stability is restored.

- First, I will review the long-run importance of trade to the balance of payments.
- Secondly, I will examine the adverse impact of the Vietnam war on our balance of payments.
- Thirdly, I will appraise the implications of domestic stabilization policies for foreign trade and the balance of payments.
- Finally, I will assess the consequences of these balance of payments developments for confidence in the dollar abroad.

Foreign Trade and the Balance of Payments: A Long View

Throughout the last decade of over-all deficits in U. S. international transactions, it has been evident that the international competitiveness of U. S. goods in world markets was the crucial factor. Merchandise exports and imports are by far the largest items in the U. S. balance of international payments, amounting in 1967 to about \$31 billion and \$27 billion, respectively. Hence, small changes in the relative rates of advance of imports and exports can have large effects in dollar terms on the size of the trade balance and the over-all deficit. For example, if exports were to rise from present levels by only 1 per cent a year faster than imports, the trade surplus would increase by about \$300 million a year, whereas a 1 per cent faster rise in imports than in exports would have the opposite effect.

Thus, even a rather gradual worsening in the trade position could, over time, outweigh relatively large improvements in nontrade sectors of the balance of payments -- for example, on capital account and travel. Conversely, a slow but steady increase in the trade surplus could suffice, over time, to reduce greatly, and ultimately eliminate, our payments deficit.

Furthermore, in a growing world economy, trade adjustments that are large in dollar terms but small in percentage terms can be accomplished with a minimum of economic disturbance, and without governmental control or interference. From 1960 to 1967, U. S. merchandise exports increased by \$11 billion, or 56 per cent, while merchandise imports increased by \$12-1/2 billion

or 84 per cent. If exports and imports had each increased over this period by 60 per cent -- growth rates only marginally different from those actually experienced -- the trade surplus would by 1967 have been \$7-1/2 billion instead of the \$3-1/2 billion actually recorded, and the over-all payments deficit would probably not have remained an intractable problem.

Impact of the Vietnam War

The acceleration of military activity in Vietnam in mid-1965 brought in train considerably adverse consequences for our trade surplus and the balance of payments. Experience shows that exports and imports respond fairly promptly to changes in levels of demand at home and abroad. They also respond, although more slowly and to a degree less easily measured, to changes in relative prices and costs, which in turn are influenced partly by demand pressures and supply constraints.

From 1959-60 to 1963-64, exports increased much more rapidly than imports, and the trade surplus nearly doubled, from about \$3 billion a year to about \$6 billion a year. This was a period during which foreign economic activity and demand for goods of all sorts was expanding strongly. But U. S. activity was also expanding strongly.

A key element in the improvement of the trade balance over this period was the stability of U. S. price and cost levels in contrast to generally rising price-cost levels in leading foreign countries. For example, during the years 1960-65, consumer prices in the United States rose by an

average of 1.3 per cent per year. In those leading industrial countries who are our principal competitors, the annual percentage increases during the same years were considerably larger: Japan, 6.0; Italy, 4.9; France, 3.8; United Kingdom, 3.5; Germany, 2.8; Canada, 1.6.

Also during this period, U. S. manufacturers had sufficient capacity beyond that required to meet domestic demands so that they could fill foreign orders reasonably promptly.

Beginning in 1965, however, demand conditions and the competitive situation changed. The addition of Vietnam war demands to an economy already fully employed produced inflation at home, a huge surge in imports, and a reduction in excess capacity which hampered exports. Meanwhile, Britain and Germany slid into a mild recession and excess capacity abroad increased. Price increases accelerated here and slowed abroad.

During the two years ending in 1967, the annual rise in consumer prices in this country averaged 2.9 per cent -- or more than double the rate of increase registered in the first half of the decade. Again, except for Canada, percentage changes in prices in those countries which give us the strongest competition in international markets moderated appreciably during the two years 1966-67: Japan, 4.6; Italy, 2.8; France, 2.7; United Kingdom, 3.2; Germany, 2.5; Canada, 3.7.

Partly as a result of these developments in prices, in imports and in domestic demand and supply conditions, the U. S. trade surplus shrank from nearly \$6 billion a year in 1963-64 to about \$3-1/2 billion a year in 1966-67.

Furthermore, excess demand and inflationary pressures have increased -- not diminished -- during the first half of this year. Under the circumstances, the trade surplus has deteriorated further. During the first quarter, exports rose by 6 per cent, but were only 3-1/2 per cent higher than a year earlier. Simultaneously, imports rose by nearly 10 per cent in the first quarter, to a level 17 per cent higher than a year earlier. Consequently, the annual rate of trade surplus shrank further by roughly \$1 billion dropping from \$1.3 billion in the final quarter of last year to only \$300 million in the first quarter of 1968. Since exports and the trade surplus were depressed by the New York port strike in March, the first four months of this year provide a better indication of the trend. Even so, the annual rate of trade surplus in the January-April months was still only \$1 billion -- far below the \$4 billion rate of early 1967.

Stabilization Policy and the Foreign Trade Outlook

Success in increasing the trade surplus sharply, as we need to do, from these very low recent levels, will require the attainment of two related domestic policy objectives. First, expansion of aggregate domestic demand must be held down to the amount by which output can be expanded, given the available resources of labor and capital. Second, the rapid increases recently experienced in the level of U. S. prices and costs must be greatly slowed down. The first will contribute to the second, but may not suffice, since price-cost increases, once underway, acquire a momentum of their own. Hence the President's stress in his New Year's Day Message on the urgent need for business and labor

". . . to exercise the utmost responsibility in their wage-price decisions, which affect so directly our competitive position at home and in world markets."

On the other hand, business and labor will find it much more difficult to exercise the self-restraint that the national interest requires if aggregate demand is excessive than if vigorous fiscal and monetary restraints are applied in a timely manner.

Given the uncertainties of forecasting economic events, it is not possible to state with any assurance precisely how large imports and exports will be in 1968. However, it is possible to sketch briefly the general effects on our trade surplus of the enactment of greater fiscal restraint, as compared with what might otherwise have happened.

For this purpose, it should be kept in mind that, with the long delay in the adoption of the tax proposal, the Federal Reserve made considerable use of monetary restraint as an imperfect substitute. And if the fiscal package had not finally been enacted, still greater monetary restraint would have been unavoidable. As we know, tighter credit conditions bear unevenly upon different sectors of the economy, affecting construction outlays in particular, and also state and local government spending, while having less effect on consumer spending. Also, monetary restraint undoubtedly works more slowly than a tax surcharge to slow down the advance of prices and costs.

The end result of using monetary policy during the first half of the year as an imperfect substitute for fiscal restraint may be that the total volume of goods and services produced and purchased during 1968 (i.e., real GNP) may be only moderately higher than what would have been produced and purchased with

a tax surcharge in effect during the entire year. But its composition will be different -- with less construction, which has a relatively low import content, and more of other things with a higher import content. Also, prices will be a little higher, and may still be rising faster by year-end than would have been the case if fiscal action had been taken earlier. For this reason also, imports will probably be higher. Meanwhile, exports might be a little lower by year-end than if the tax surcharge had been enacted earlier in the year -- resulting in less erosion in the competitiveness of U. S. prices. All these tendencies would have gone further if fiscal restraint had been further delayed.

On the basis of these assumptions, we can derive some indication of the quantitative importance of the income surtax for the trade surplus. For the full year 1968, imports may now be \$150 million lower with the tax surcharge than they would have been without it, and by year-end they may be running \$300 million a year (one per cent) lower. Exports for the full year may be only \$50 million higher for the full year, but by year-end they may be running \$100 million (or 1/3 of one per cent) higher. The trade surplus may be larger by about \$200 million for the full year, and may be running \$400 million a year larger in the fourth quarter. Moreover, prospects for the trade surplus next year -- during 1969 -- will be better by considerably more than \$400 million, as compared with what they would have been in the absence of tax action, and the prospective trend of the trade surplus will probably be favorable instead of adverse.

Concluding Remarks

In the meantime, our trade surplus remains much too small, and the deficit in our balance of payments remains too large. Last year, the

deficit amounted to \$3.6 billion (on the liquidity basis), having risen sharply from \$1.4 billion in 1966 and \$1.3 billion in 1965. It is still far too early to have a firm estimate of the probable outcome for the U. S. balance of payments this year. There most likely will be some improvement compared with a year ago. In the first three months of this year, despite the adverse effect of the New York port strike on the trade surplus, the liquidity deficit was at an annual rate of \$2.4 billion, compared with last year's \$3.6 billion.

On the other hand, it also seems clear that the improvement of at least \$3 billion visualized in the President's New Year's Day Message will not be achieved. While substantial gains may be recorded with respect to private capital flows, there appears to be no prospect of attaining the projected expansion of \$500 million in our trade surplus from 1967 to 1968. As noted above, the deterioration in the trade position during the January-April months was particularly disturbing. Even with a considerable improvement in the remaining months of the year, the trade surplus in 1968 will be lower than the \$3.5 billion reached in 1967.

This, of course, makes all the more urgent those actions that can be taken to remove excess pressures on resources and to slow the pace of inflation. Unless we can bring about greater domestic stability, we cannot hope to achieve and maintain a trade surplus of the size necessary to help us to erase the deficit in our balance of payments. This failure in turn

might generate disturbingly adverse effects on capital movements. Hopefully, the adoption of higher income taxes and reduced Federal expenditures (although the action came much later than needed) will help us restore domestic stability and bring about some improvement in our international payments position as well.