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THE BALANCE OF PAYMENTS AND INTERNATIONAL LIQUIDITY

Remarks by Governor J. Dewey Daane

Member, Board of Governors of the Federal Reserve System

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As I understand it, anyone from Washington who ever departs from his prepared remarks on a subject is promptly dubbed a "text deviate". At the risk of being placed in this category I would like to diverge from my earlier prepared text on "Our Balance of Payments Situation and International Liquidity" long enough to make a comment or two on the actions which the Federal Reserve Board announced yesterday--actions which are clearly not irrelevant either to the United States balance of payments position or the continuing strength of the dollar as one of the major components of world liquidity. The Federal Reserve actions, in which I participated as one of the majority of the Board members favoring, to approve discount rate increases and raise the rate ceilings on bank time deposits parallel and support the Government's actions, also announced yesterday, to strengthen the balance of payments program particularly with respect to the dollar drain from overseas investment. The rationale of the Federal Reserve actions is, I believe, well set forth in yesterday's press release and I would like to re-emphasize to you the pertinent passages:

> The Federal Reserve announced today two complementary actions to reinforce efforts to maintain price stability, and thus to foster balance in the economy's continued growth and strength in the dollar's international standing.
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> The actions, intended not to cut back on the present pace of credit flows but to dampen mounting demands on banks for still further credit extensions that might add to inflationary pressures, were as follows:-------

The increase in the rates that member banks are permitted to pay their depositors is intended to enable the banks to attract and retain deposits of businesses and individuals and thus to make more effective use of savings funds already available in the economy to finance their loan expansion.

The increase in discount rates is intended to moderate additional bank reliance on short-term borrowings from the Federal Reserve to meet intensifying loan demands.

The action contemplates, however, the continued provision of additional reserves to the banking system, in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy without promoting inflationary excesses, primarily through the Federal Reserve's day-in and day-out purchases of government securities in the open market.

The changes in discount rates and the maximum rates that banks may pay depositors were the first in either respect since November 24, 1964.

Since then, total borrowing by consumers, business, and State and local governments has risen sharply, and interest rates at all maturities from the shortest to the longest have been rising under demand pressures. In these circumstances, the Federal Reserve would be forced to increase bank reserves at an accelerated pace if all demands for borrowing money at present rates were to be satisfied.

With slack in manpower and productive capacity now reduced to narrow proportions, with the economy closer to full potential than at any time in nearly a decade, and with military demands on output and manpower increasing, it was felt that excessive additions to money and credit availabilities in an effort to hold present levels of interest rates would spill over into further price increases in goods and services. Such price rises would endanger the sustainable nature of the present business expansion. Moreover, increases in costs and prices would make it more difficult for American goods to compete in markets at home and abroad.

In addition, a pattern of interest rates that is accepted by borrowers and lenders as fully reflecting market forces should add assurance of a smooth flow of funds to all sectors of the economy. Discount rate increases in 1963 and 1964 did not stop business or credit growth, but helped to keep the economy within an expansion that was sustainable.

In sum, the actions taken today should have the three-pronged impact of:

1. Backing up the Government's efforts to prevent inflationary excesses from damaging an economy now carrying the added burden of military operations in Vietnam;

2. Bolstering the Government's programs to overcome persistent deficits in the U.S. balance of payments; and

3. Demonstrating anew the United States' determination to maintain the international strength of the dollar.

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Five years ago, on the eve of our present relatively long period of sustained expansion, an expansion which I am firmly convinced our action this week will help to keep sustainable, I attended an economists meeting at which one of the leading speakers said profoundly, "We may be entering into an attenuated state of unstable equilibrium." After puzzling on this I decided that he meant the economy might continue to go sideways if it did not go up or down. The second speaker was equally profound, saying, "At present, we seem to have a delicate balance of inflationary and deflationary forces, with possibilities of continuing in this state, of moving temporarily into a moderately deflationary re-adjustment phase, or of having, after new piecemeal adjustments, a renewal of inflationary developments." Again, after thinking about this statement, I decided that he meant if we did not go sideways we would go up or down.

Today, rather than engage in this kind of gobbledygook, which sometimes seems to be the economists' stock-in-trade, I will simply say at the outset that I do not know precisely how the balance of payments situation will appear in the future, or precisely how the problem of shaping our international monetary system for the future will be resolved. What I do know is that we have made substantial progress in 1965 on our balance of payments problem, are taking additional steps to ensure further progress in 1966, and that we are moving ahead also in our efforts to determine basic areas of agreement in the field of international monetary reform.

First, taking a look at our own balance of payments situation, last February the President announced his program to "achieve a substantial reduction in our international deficit during 1965, and secure still further improvement in 1966." The 1965 part of this objective is being fulfilled. On the former concept, referred to as the "regular transactions" basis, our deficit this year may prove to be in the $1-1/2 to $2 billion range, compared with $3.1 billion last year. On the newer "liquidity" or "overall" basis, which simply also takes into account debt prepayments and prepayments for military goods, the deficit may prove to be about in the $1-1/4 to $1-1/2 billion range this year, compared with more than $2-1/2 billion in almost every one of the previous seven years. Finally, the deficit on the newest "official settlements" basis may prove to be in the neighborhood of only $1/2 billion, compared with $1-1/4 billion last year and substantially more in earlier years. I might mention that the 1965 deficit would turn out to be even smaller if the United Kingdom Treasury had not already converted several hundred million dollars of its wartime acquired portfolio of U.S. equity securities into assets we count as liquid and therefore as a drain on our balance.

Most significantly, the improvement in our balance of payments this year has occurred despite a decline in the current account surplus, and specifically in the surplus on trade account. It has resulted primarily from a very sharp reduction in the net outflow of United States private capital from $6-1/2 billion in 1964 to an annual rate thus far this year of about $3-1/2 billion. This reduction is mainly attributable to three developments, (1) the sharp cut in bank credit outflows achieved under the voluntary restraint program, reinforced by the interest equalization tax, (2) the substantial reflow from abroad of corporate liquid funds and, (3) the stronger domestic credit demands generated by our expanding economy.

As a major contributing part of the continuing capital outflow problem, direct investment abroad expanded at a very sharp rate in 1964 and early this year. It has since diminished but the year's total will still be very large. As a result Secretary Connor announced yesterday more ambitious targets for corporations and called for "special efforts" to restrain the outflow of funds for direct investment abroad.

Looking ahead at 1966, some encouragement can be found in the most recent developments in our export and import trade. Averaging the four months July-to-October together to iron out some statistical complexities, the surplus of non-military exports over imports was at an annual rate of $5-1/2 billion, compared with a relatively poor $4-1/2 billion average rate in the first half of this year. Next year we should be able to sustain this improvement in our trade position. We can also expect continuing gains in the receipts of income from foreign investments.

On the capital outflow side, which in 1965 was still a major drain on our balance of payments, there was a strengthening of the President's program announced yesterday, including a strengthening of the Commerce program with respect to direct investment, and a renewing and revising of the Board's program with the issuance of new guidelines for financial institutions to follow during 1966. Accordingly, there should be some further improvement in our payments position next year as outflows of United States capital are held down by these voluntary programs. But beyond 1966 it will no doubt become increasingly difficult to limit capital outflows by voluntary programs. Since the long run objective in any case should be to permit greater freedom of capital movements, it is obvious that continued improvement in the balance of payments will require further gains in our receipts from net exports. In this connection, it remains of crucial importance to avoid inflationary developments in the United States economy, so as to reap the competitive advantage of relative price stability here while price increases are still occurring in most industrial countries abroad. And, in this context, the most recent Federal Reserve actions will clearly serve to reinforce national efforts to maintain price stability.

As to the relationship of the United States balance of payments and the whole matter of international liquidity and monetary reform there are both links and what I would term "non-links" between them. By international liquidity, of course, we mean simply all of the reserves--mainly gold and dollars--and credit facilities available to monetary authorities to settle imbalances in their balance of payments. On the "non-link" side it is a misconception to think that somehow there can be an international liquidity escape route from the hard road of restoring equilibrium in our balance of payments. Nor can or should the creation of international liquidity be looked to as the means for attempting to ensure appropriate efforts to eliminate deficits and surpluses in the balance of payments. Yet both of these misconceptions frequently emerge.

I have been struck by the fact that much of the continental European yearning for international monetary reform and new forms of liquidity basically reflects a desire to constrict the present degree of liquidity, and in a way that would, as they see it, enforce monetary discipline upon the reserve currency countries. To be blunt, it is no secret that some European observers feel that our monetary policies in recent years have not been sufficiently restrictive--and contend that our ability to finance external deficits with the dollar in its role as a reserve currency has exempted us from monetary discipline. Here at home, on the other hand, much of the academic and other clamor for greater international liquidity and for altering the international monetary system reflects the idea that this would enable much more expansionary domestic policies, monetary and other. In fact, both notions are, in my judgment, erroneous.

The answer to the first charge lies in the continuous and increasingly comprehensive efforts made to contain the United States balance of payments deficit, beginning in 1960, broadened greatly in February, 1961, accelerated in mid-1963, widened further in February of 1965, and strengthened again this week--efforts which have all along not neglected actions in the monetary area. Thus I would categorically deny the assertion of some continental European bankers and economists that the reserve currency status of the dollar enables the United States to live consistently beyond its means and to flout the discipline of the balance of payments.

The United States' current willingness to explore new methods of reserve asset creation does not, and cannot, reflect any lessened determination to achieve equilibrium in our balance of payments. President Johnson has made this crystal clear, not only in his remarks last fall at the meetings of the International Monetary Fund and World Bank but in his letter of yesterday approving the strengthened balance of payments program and directing that it be put into effect. Liquidity cannot replace dollar viability and dollar viability rests squarely on the continuance of appropriate domestic policies.

I have dwelt thus far on the "nonlinks" but there are valid links as well between the United States balance of payments deficit and the need for contingency planning with respect to international monetary reform. If one looks at the increase in world monetary reserves over the past seven years, around one-third of the total increase in such reserves was accounted for by increased holdings of United States dollars, reflecting the continuance of United States deficits. Most strikingly, in the earlier part of this period, 1958-1962, the United States deficit contributed substantially to international liquidity as the dollars flowing out were largely retained in foreign reserves. In fact, in this 1958-62 period almost two-thirds of the increase in world monetary reserves represented increased official foreign holding of U. S. dollars. More recently, however, the United States deficit has been neutral or even contractive of world liquidity as foreign central banks have converted dollar reserve accumulations into gold, or even in a few instances so converted previously accumulated dollar balances. Thus, the United States' ability to eliminate its deficit is directly relevant to the amount of world liquidity in the form of monetary reserves.

The real point of contact then between U.S. balance of payments equilibrium and international liquidity is not that more liquidity would enable the United States to avoid taking necessary adjustment measures, but is twofold. Unless the United States succeeds once and for all in dispelling skepticism regarding its ability to put its house in order, the conversion of dollars into gold can and will continue and can only be contractive of world reserves and world liquidity. As the United States succeeds, the outflow of dollars will no longer serve to meet in the same way the needs for world reserves and world liquidity. Hence, both until and after equilibrium is achieved, our dollars will not provide as much international liquidity as they have in the past.

As to the other reserve asset forming the bulk of world monetary reserves, namely gold, it is generally conceded that the production of gold will prove to be insufficient, and Soviet sales unreliable as a supplement, to meet growing needs for reserves. On this score, for example, it is interesting to note that world monetary gold reserves have not increased at all this past year. And total world monetary reserves, including gold, have declined from 58% of imports in 1958 to 39% in 1965.

If we are to ward off the contractive threat of insufficient reserves leading to restrictive measures by various countries--each country seeking to improve its own reserve position at the expense of others, which will inevitably make world economic growth less than it might be and should be--there is a clear need to provide for other means to increase liquidity when and if needed, both through owned reserves and credit facilities. On the latter score much has already been done in the way of additional credit facilities in the network of Federal Reserve swap and standby swap arrangements, now totaling close to $3 billion, in Roosa-type bonds, and in substantial additions to resources of the IMF both by increases in quotas of member countries and by the agreement to provide supplemental resources in the General Arrangements to Borrow. But there has also been a wide variety of proposals for other new arrangements put forth over the past two years, some looking toward new methods of reserve asset creation within the International Monetary Fund itself and others outside of the Fund. I do not intend today to make a detailed examination of these various proposals and of their possible merits and demerits. For that I refer you to the excellent report published last August of the Study Group on the Creation of Reserve Assets, under the chairmanship of one of the Italian Deputies of the Ten, Signor Rinaldo Ossola.

Most of the proposals under discussion are aimed at the deliberate and controlled creation of international reserves. Furthermore, most of them create reserve assets "out of thin air" in the sense that countries participating in the proposed arrangements would benefit from an increase in the reserves without giving up goods and services or accepting a capital inflow. Most schemes would also require some limitation on the freedom of countries to determine the composition of their reserves. For the schemes to be workable, participating countries would have to commit themselves to accepting the newly-created assets in payment for surpluses within agreed limits. In their other characteristics the various schemes for creating reserve assets differ considerably. Although I do not intend to elaborate on the technical aspects of the various proposals, the Ossola Report highlights four issues in reserve asset creation, apart from the fundamental issue of whether a new reserve asset should supplement or supplant reserve currency balances (i.e. dollars or pounds). Those issues, also in part technical, are:

1) the question of a link between gold and a new reserve asset, the closeness of that link, and its effects on the existing system;

2) the width of membership for purposes of management and distribution of the assets;

3) the role of the I.M.F. as regards deliberate reserve creation;

4) the rules for decision-making concerning the creation of reserve assets.

The Deputies of the Ten (the Deputies of the Ministers of Finance and central bank Governors of the ten leading industrial countries) are now engaged in seeking out the basis for agreement on these and related issues with a view to making a progress report by late Spring of 1966.

On these issues, the substantive views of the United States are in process of development and crystalization. But, on the first question of whether or not a new reserve asset can be used for settlements only along with a specified quantity of gold or of other reserves, or may circulate on its own Under Secretary Deming has recently stated: "For our part, we believe that the creation or use of a new unit should not influence nations directly or indirectly to seek to add unnecessarily to their holdings of gold. As the country to whom others turn for gold when new supplies are not available, we have a vital interest in this respect."

On the second question of the width of membership it may be noted that this raises economic, financial, and political questions involving the status of nations outside the Group of Ten and their relationship to the process of creating and distributing new reserve assets.

With respect to the third question of the role of the International Monetary Fund, Pierre-Paul Schweitzer, the Managing Director, says simply and directly that "International liquidity is the business of the Fund." Support for this view which emerged at the last meeting of the International Monetary Fund and World Bank suggests adaptation of the existing IMF procedures to deliberate reserve creation. The general idea is simple in substance: the creation of claims on the Fund and a limited commitment by countries to accept such claims when they are in surplus. On the other hand, others have expressed the view that the International Monetary Fund should properly be provided with sufficient resources to fulfill its function of providing credits to individual countries, but that the Fund should not have a leading or important policy role in the deliberate creation of reserves.

Similarly, as to the fourth question of the rules for decision making, again this involves both economic and political questions as to how to design the decision making process to protect the minority without providing a veto power that could prove stultifying.

Finally, I would like to close with a few comments as to the guidelines or objectives on which the United States has consistently stood firm. The first is that any scheme should not be contractive of world liquidity. A new reserve asset should not be detrimental to existing liquidity. An important part of existing liquidity represents reserve currency holdings, and the attitudes of their holders are of vital concern in constructing an acceptable reserve asset that would add to, and not subtract from, present liquidity. Secondly, the first phase of preparation for new and improved monetary arrangements now underway in the Group of Ten must be followed by a second phase of preparation involving more countries in a wider forum. Secretary Fowler emphasized this point in his address at the Bank-Fund meetings stating that "there lies a second phase of preparation of the utmost importance, on which the United States has been both insistent and persistent in its pursuit of appropriate preparation for an international monetary conference. This second phase should be designed primarily to assure that the basic interests of all members of the Fund in new arrangements for the future of the world monetary system will be adequately and appropriately considered and represented before significant intergovernmental agreements for formal structural improvements of the monetary system are concluded. Within the Fund membership there are variations in the extent to which individual countries are able to, or choose to, accumulate and hold large reserve balances. All, however, have a vital interest in the evolution of the world's monetary arrangements."