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ADJUSTING BALANCE OF PAYMENTS DEFICITS THROUGH THE CAPITAL ACCOUNTS

Remarks of

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In Oregon, there is no need to point out that varying the mix of monetary and fiscal policy causes large differential impacts on the domestic economy. If last year's decisions had resulted in a tax increase in place of credit restriction to fight inflation, current unemployment and prices in the lumber and wood products industries would be far different.

The debate over the proper policy mix for the domestic economy is behind us. Recently, however, some commentators have been predicting another debate over the proper policy mix--but this time a debate heavily focused on the balance of payments problem. I do not think that a debate this year is apt to reach the intensity of last year's discussion.

A good deal of concern reflects a typical worry over previous years' problems. This neglects the fact that many other countries also have learned by experience. We face a quite different situation with respect to capital flows, their causes, and treatment than three or five years ago. However, the problem of the most appropriate policy mix continues to be important. It deserves to be analyzed and debated in public.

Just as different mixtures of monetary and fiscal policies can be used to attain stability and balance in the domestic economy, so can different policy mixes be used to effect equilibrium in our international accounts. Everything else being the same, net capital outflows in the balance of payments will be smaller the higher the level at which U. S.

interest rates are maintained. This latter observation, coupled with legitimate concern for the balance of payments in 1967, has led some to argue that the policy mix should be determined by balance of payments needs and hence that interest rates should be reduced only slowly (if at all) from the high levels prevailing in the latter part of 1966.

How persuasive is this view? I find it quite unpersuasive. Monetary policy decisions ought not to be made primarily on the basis of balance of payments considerations. Domestic credit and interest rate conditions ought not differ markedly from what is desirable on domestic grounds alone merely to attempt to attract or hold international capital.

Those who want to attain balance of payments equilibrium through tighter money tend, I believe, to underestimate the institutional difficulties. They also fail to weigh the heavy costs of dislocations and distortions on our domestic welfare that result from overloading the job of monetary policy.

Necessary adjustments in our international capital accounts should be brought about primarily through fiscal or other nonmonetary means. Both for this and other reasons, we need to re-examine carefully some of our current tax procedures in the international sphere. An improvement in our taxes on foreign investment can increase their value to the country both in terms of domestic welfare and balance of payments stabilization.

The Background

Many observers are pointing out that the Federal Reserve may face a dilemma in attempting to adopt the sound monetary policy required for stability and expansion in the domestic economy if the balance of payments appears to require a different policy.

If such a dilemma arises, what steps could be taken to resolve it? There is agreement that we must reach an equilibrium in our balance of payments. It also seems probable that reaching equilibrium will require specific--as distinct from general--policy actions. To determine what these actions should be, another careful re-evaluation of our international accounts needs to be undertaken. Further adjustments in military expenditures abroad, the net foreign exchange costs of AID, both sides of the trade balance, and more minor items may be necessary.

If the maximum effort in these areas, however, still does not achieve equilibrium, then further adjustment would probably have to come from a reduction in the net outflow through the capital accounts. In future efforts, as in those of the past, the ability and the costs of the United States or foreign countries deliberately adjusting capital flows must be weighed against other possiblities.

Adjusting the Capital Accounts

The classical theory of balance of payments adjustment places great stress on the use of monetary policy to influence capital flows.

1. If comparable interest rates are higher in New York than in Europe, owners of funds will hold more money in the United States rather than in London, Paris, Zürich, or Frankfurt. Short-term liquid capital as well as long-term funds can be attracted by relatively high rates.

2. As we saw this past year, if the American banks are pressed for funds to make domestic loans, they can and will borrow money abroad and bring it back to this country even if the costs are high and the immediate profits appear low or even negative.

3. It is assumed that the flow of direct investment capital may be influenced to some extent in the short run by relative costs of borrowing, though in the long run the dominant factors are relative expected profits.

However, monetary policy is not the only way to adjust the capital accounts. International capital movements can also be influenced by specific fiscal or similar policies.

1. The relative profitability of foreign and domestic investments is influenced as much by relative taxes as it is by relative interest rates. This is the justification for the interest equalization tax.

2. There are numerous possible fiscal incentives in the foreign as in the domestic field that make investments more or less attractive.

3. Change in foreign assets can be influenced directly as through the Voluntary Foreign Credit Program for financial and nonfinancial firms. Similar action can be taken by countries receiving undesired monetary flows.

4. Because in many situations large capital flows in short periods are likely to be particularly destabilizing, both domestically and internationally, it is important to have institutions that can stabilize or offset flows to avoid the extreme problems of "hot money" and similar difficulties.

Advantages in Using Monetary Policy

Since adjustment of international capital flows is possible through many mechanisms, a policy problem arises similar to that in the domestic sphere. It is necessary to determine a proper policy mix. If adjustment is necessary, how much should come through monetary and how much through fiscal policy? What are the relative advantages and disadvantages of each to the economy?

The rationale advanced for relying mainly on monetary policy is both interesting and complex. Advocates of this view argue that simultaneous achievement of the twin goals of full employment and price stability depends mainly on the over-all level of demand in the economy. The mix of monetary and fiscal policies by which that level of over-all demand is achieved is of slight importance.

Therefore, these advocates ask, why not let monetary policy respond mainly to balance of payments considerations? Let the desired level of domestic demand be achieved through fiscal action (where of course fiscal policy takes appropriate account of whatever monetary policy is set for balance of payments reasons). In this way, it is alleged, one can simultaneously achieve both internal and external balance for the economy.

A corollary of this view is that capital movements between countries should be as free as possible from regulation and restrictions. Capital should flow to countries where its marginal product will be higher. This, it is said, leads to the most rational pattern of international investment.

Proponents of this view also argue that attempts to regulate or restrict capital flows are bound either to fail or to be very costly. These pessimists stress the fungibility of money, how it flows easily from use to use and across borders. As a result, a country participating in international trade and finance and eschewing costly restrictions has no real alternative but to adjust its monetary policy to developments in international money markets. If money can't be controlled, a country must coordinate its monetary policy with those of other major countries.

Counter-Arguments

The case I just presented to you is, in some respects, appealing. But there are a number of reasons for being skeptical and uneasy about this view.

First, there is the basic problem of knowledge about the rates at which monetary and fiscal policies can be substituted for each other. The plain truth is that, although some experience has been gained, much more know-how and information would be necessary in order to vary the mix with any precision or confidence.

Second, if monetary policy were primarily determined by the needs of the balance of payments, the policy goal of high and sustained growth could easily suffer. In the past the United States has tended to prefer a mix of relatively low interest rates and (except in wars) relatively minor budget deficits. If we were to shift in the direction of averaging higher interest rates and larger budget deficits, we would probably have a lower growth rate for capital. Many of our most urgent unmet needs for housing, education, rebirth of our cities, growth in technology and plant require large amounts of capital investment. Penalizing these known needs would be a high price to pay for achieving external balance via internationally determined monetary and fiscal policies.

A third reason for rejecting the use of monetary policy to regulate international capital movements is that this approach presupposes a very high degree of international harmonization of monetary policies. While periodic attempts to agree that rates are too high or too low may be feasible, a continuous and detailed coordination of monetary policies in an international forum seems a long way off in the future. Without some agreement on the proper over-all level of world interest rates, moreover, international rates would probably tend to be set by those countries desiring the highest level of interest rates.

However, far more important than the problems of agreement are questions as to the effects on the economy and the national welfare of allowing domestic monetary policy to be dominated by international money markets. We have just experienced some of the distortions and dislocations which occur when interest rates move drastically. These rate movements were justified by the need to halt inflation and bring domestic demand down to its long-run growth rates. But are lower incomes, unemployment, and excess capacity justifiable in order to avoid direct fiscal methods of adjusting the balance of payments?

In aggregate terms our foreign sector is a relatively minor part of our economy. It seems likely to be both easier, cheaper, and more efficient to adjust private yields of foreign versus domestic investment than it is to attempt to shift yields throughout the domestic economy.

At times capital movements can be destabilizing and counter-productive. Furthermore, differences in net yields to private investors at home and abroad cannot always be taken as appropriate indicators of differences in the social returns. Fiscal systems differ markedly from country to country, and so do capital markets. As long as these great differences exist, the argument that a better allocation of world resources results from the freedom of capital to move to where the private return is greatest may be completely wrong.

A final reason why monetary policy cannot be aimed exclusively or even primarily at the balance of payments may be the most important. It may not be possible to obtain fiscal action to regulate the pressure of domestic demand, even though clearly called for. This past year gives no indication that it is a simple matter to adjust domestic fiscal policy to a given monetary policy, either for national or international purposes. In fact recent history seems to prove the opposite.

Altering International Yields Through Taxes

After considering carefully the various methods of influencing international capital flows, I conclude that varying relative yields at home and abroad by taxing them at differing rates is more efficient and more feasible than is shifting them through domestic interest rate changes.

The changes proposed by the President in the interest equalization tax, which would permit varying the tax rate in accordance with both balance of payments needs and national policy,are examples of what I have in mind. It is important that they be adopted. A flexible IET meets the major criteria for a procedure which can help in balance of payments adjustments without the major costs involved in the use of monetary policy for this purpose.

I also believe for the reasons discussed in the next section that we need a careful review of our tax policy with respect to direct investments. We have given direct investments abroad tax advantages which I find hard to justify. Our foreign tax policy ought to aid in achieving national goals. A more flexible view of what credits against domestic taxes should or should not be granted investments abroad would increase the country's welfare. Possibly a reconsideration in this sphere might lead to a different tax design which might end up close to a flexible IET. Such a re-examination of our foreign tax policy should not be based primarily on balance of payments grounds, but any solution ought to take into account the advantages to the economy of having more flexible selective fiscal tools in the international sphere. In the same way, we ought to welcome and not oppose foreign countries adopting more flexible methods of controlling capital flows.

The Unsatisfactory Basis of Taxes on Foreign Income

When a foreign government taxes earnings on direct investment abroad, sums paid become a credit against United States taxes. This means that the United States gives up virtually all taxes on these earnings whether or not such forgiveness seems justified on grounds of economics or equity. For example, net profits on United States direct investments in Western Europe run well over a billion dollars a year, yet the taxes collected by the United States Government on these earnings are practically zero. It is claimed that the doctrine of tax neutrality justifies this policy which results in the U. S. Government collecting no income taxes on these very large earnings. Those making such claims fail to recognize how complex, if not impossible to achieve, is tax neutrality. There is but slight analysis of what lies behind these rather simplistic contentions.

At least four crucial criteria which should help determine proper United States taxes on foreign investments are often passed over.

1. The least important perhaps is the value of direct and indirect aid the investment receives from the U. S. Government through foreign policy, the existence of our Army and Navy, etc. Would such investments be made to the same degree if American tax payments were not supporting an active foreign establishment?

2. More important is the question of equity. Most of the corporate income tax is used to support very basic national goals. Our taxes pay for our defense and our welfare. Should any sizable segment of income received by United States corporations reap the benefits from these policies without paying its fair share of their expenses?

3. Frequently a point is made that investments abroad must be very profitable or they would not be made. This argument completely neglects the fact that this may be true from the individual point of view but far from true as far as the country as a whole is concerned. For every dollar of gross profit earned in the United States, the nation as a whole receives a dollar of earnings--part in taxes and part in net profits. If this same dollar of earnings is received on capital invested abroad, the nation would get only fifty cents. The net contribution to the national welfare of the dollar abroad is only half as great as it appears to be from the individual firm's point of view.

4. Far more complex and difficult to describe is a final criterion, but it is also more crucial because it explains part of the reason why the present tax policy leads to outflows of capital and therefore to balance of payments problems. As noted earlier, each country differs in its monetary/fiscal mix and therefore in its ability to generate and use capital. Savings generated in the U. S. and domestic investment are highly dependent on our tax rates and tax structure. The funds available for investment abroad and the markets available to them might be far less under different policy mixes.

The existing policy of tax credits has developed over time, much of it in periods of very different tax rates. The United States grants these tax credits without a clear indication of whether they aid or hinder the achievement of national goals. The policy question that must be answered is: "If profits after all expenses abroad (including foreign income taxes) were taxed at full or partial rates in the United States would our total welfare be increased or decreased?" Elimination of some taxes in certain cases may well be a good policy. It does not seem likely, however, that a flat 100 per cent elimination of profits taxes on U. S. direct investment in developed countries is likely to be the best policy.

Concluding Remarks

The need to choose between monetary and fiscal adjustments in our international balance of payments is a continuing one. We need to establish the best possible mechanisms to allow these decisions to be made in a manner that will best serve the public welfare. To the present, we have taken certain temporary emergency steps on an ad hoc basis. There has been too little continuing debate on the basic problems and possible solutions. There is too little understanding of the many different ways in which the relative profits and yields of capital flows are influenced by monetary policy or fiscal measures.

Recent experience has shown that the level of both the balance of payments and the domestic economy can be altered either by interest rate changes or by tax or other fiscal methods. Relative yields are altered and flows of demand shift. Some parts of the economy gain while others lose.

As with most stabilization questions, there are no fixed unchanging answers. Shifts in both the domestic and foreign economies alter the costs and benefits of any policy. A tax policy which may have been unimportant in the 1920's and very desirable in the 1940's, could be extremely expensive in the 1960's.

At times policies useful for balance of payments purposes may be equally useful for domestic ones. At other times, a step which may help in one area may be harmful in the others. In both the short and long run, each separate mix has a very different impact on the parts of our economy and on total welfare. For these reasons, the greater the range of possible actions, the more likely is it that a good solution can be reached.

With respect to our domestic economy, we now recognize the need to make explicit decisions about the policy mix. Awareness of the advantages and disadvantages of various alternative policies has been expanding at a rapid rate. An equally searching eye is required to examine all the implications of the alternative policies proposed to stabilize our balance of payments.