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Remarks of J. L. Robertson

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Toward Balance in Our International Payments

Little more than one year ago the President's balance-of-payments program, with its emphasis on foreign credit restraint, drove home to every banker in the United States the importance of restoring balance in our international payments.

How to attain and maintain that balance has been the subject of heated discussion for years. Uncertainty as to the best long-run solution continues to prevail - in places like my home town of Broken Bow, Nebraska, as well as in the nation's capital.

At first glance, the problem seems to be simple enough. For many years, we have been paying out more dollars to foreigners than we receive from them, and since we cannot go on doing so, it might seem, offhand, that the obvious thing to do is to restrict our spending by means of tougher fiscal and monetary policies, and thus reduce payments to the level of receipts.

But if the problem were that easy, it would not be a problem. So, to get into realistic focus, let us examine more closely, first, what we mean by balance in our international accounts; second, what we have been doing so far to achieve balance; and third, what remains to be done.

What do we mean by payments balance?

In international economics, as in daily life, the words we use often condition our thinking. Let us take the term "deficit". When individuals or enterprises complain of a deficit, they mean that they are operating at a loss, that they are depleting their substance. And, indeed, quite a few countries suffer from just such a deficit in their international accounts. They import more than they export, they exhaust their reserves, they run deeper and deeper into debt. Obviously, unless they change their policies they are headed for serious trouble.

But that is not our situation. Our export earnings are much higher than our payments for imports, even when we include in these payments our large expenditures for military and economic assistance. Our problem is that the export

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surplus is not large enough to cover, in addition, our credits to foreigners and our investments abroad. This means that we are not getting poorer internationally; on the contrary, our total claims on foreigners - our assets abroad - have been rising much faster than our total liabilities to the rest of the world. But our international liquid assets - principally our gold reserves - have been declining while our less liquid assets have grown rapidly as the result of loans and investments abroad. Hence, our problem is better described as a decline in our international liquidity position than as a balance of payments deficit.

Now, from the standpoint of national welfare - or for that matter, of the welfare of an individual or an enterprise - a decline in liquidity may be good, bad, or indifferent. It all depends upon the circumstances.

It is sometimes said that nobody should borrow short and lend long or, in other words, reduce his liquidity position. If this were true, banking would be impossible. No bank could survive if it invested its demand deposits only in demand loans. A bank fulfills its economic functions by converting demand deposits into a variety of loans - of limited maturity, to be sure, but certainly not all callable on demand. It always borrows short and lends long in that sense.

This analogy is especially relevant to the United States, since this country serves in effect as a bank to the rest of the world. Our currency is used by foreigners - both private and official - as international money. A substantial part of international trade between non-dollar countries (as, for example, Japanese exports to Latin America) is invoiced and settled in dollars; and foreign central banks hold over $13 billion of their official reserves in dollars.

A nation, like a bank or any other enterprise, can have too much as well as too little liquidity. There is no inherent virtue in maximizing liquidity, or in maintaining forever a given liquidity position. And there is no inherent vice in reducing liquidity.

If the United States had decided at the end of the Second World War to maintain its then existing international

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liquidity position, we would have hoarded the 60 per cent of the world's gold we then held and refused to countenance an increase in our liabilities to foreigners, thus leaving the rest of the world extremely illiquid. The result would have been an agonizingly slow recovery in international trade and in the economic vitality of the free world.

What we did instead was to undertake programs like the Marshall Plan, which had the dual effect of redistributing some of our gold holdings and of supplying dollar balances to the rest of the world. In the pure accounting sense, these reductions in our gold holdings and increases in our dollar liabilities constituted a deficit in our balance of payments. Yet the rest of the world was quite pleased that we were incurring such deficits. In a true sense, therefore, our deficits in the early and mid-fifties were not a sign of payments imbalance; on the contrary, the corresponding decline in our liquidity was beneficial to all parties.

Nevertheless, the growing concern over the persistence of the decline in our international liquidity has not been unwarranted. A decline in the liquidity of a financial institution becomes hazardous if it goes so far as to generate - rightly or wrongly - a lack of confidence in the institution's ability to meet its obligations. The question confronting us today is whether, under the conditions existing here and now, the United States as the world's banker can afford much further decline in its international liquidity without risking a diminution of confidence in a payments system based on the international role of the dollar.

This question, together with the answer to it, has two important implications. On the one hand, it provides some guidance to the appropriate size of a deficit in our payments balance. On the other hand, it explains why the major trading countries and the International Monetary Fund are engaged in discussions concerning new facilities for providing international reserves that would supplement gold and dollars.

Regarding the appropriate size of a U. S. deficit, I am increasingly skeptical about attempts to define the goal of our payments policy in terms of figures, say, in terms of

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a maximum permissible deficit or, more correctly, of a maximum permissible decline in our international net liquidity. Any figure named may turn out to be too high, or too low. Rather, the criterion of our payments policy should be the willingness of foreigners to add to their holdings of dollars as working balances and reserves. Our international accounts are in disequilibrium only when our deficit tends to exceed the total amount by which (1) foreign private merchants, investors, and bankers are willing to increase their dollar holdings, and (2) foreign central banks wish to accumulate additional dollars to hold as reserves.

Under this criterion, it is clear that our payments balance was in equilibrium from the end of the Second World War through 1957, even though our statistics show a substantial payments "deficit" for the period. It is equally clear that our balance of payments has been in disequilibrium since 1957. Hence, in the short run, our main task in the field of international financial policy is to correct, and even overcorrect, the disequilibrium - perhaps by eliminating our payments deficit completely. We may need to redouble our efforts for the time being - in both the private and the public sectors - to curtail the outflow of dollars.

Over the longer run, however, our policy goals will be somewhat more complex. A modest payments deficit may well turn out to be consistent with equilibrium. It is to be expected that <u>private</u> holders of dollars abroad will wish, as they have in the past, to add to their holdings in line with the requirements of expanding international trade and finance. And many official holders - central banks and treasuries - will continue to find it desirable, convenient, and profitable to hold part of their growing reserves in the form of dollar balances.

In both cases, the decisions to hold and add to dollar balances are, needless to say, completely voluntary - at the discretion of the foreign holder. Hence, it is impossible to predict with any degree of assurance the exact amounts of dollars which foreigners will wish to accumulate. It may be that foreign-held dollar balances will not increase as they have in the past. But it seems fairly clear that the needed growth of official reserves will exceed the supply of

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new gold, even if Soviet gold sales continue to supplement production and even if private gold hoarding were to recede from recent peak levels.

For these reasons, among others, the United States has joined with other countries in the Group of Ten and the International Monetary Fund, as I mentioned before, in seeking a new means of creating international reserves - a means that would make the world less dependent on limited gold supplies and an unpredictable outflow of dollars from the United States.

How have we tried to restore payments balance?

Appropriate balance in our international accounts is, and must be, an important goal of our policy. But obviously it is not the only goal. Measures designed to restore balance, like all other measures of our economic policy, must always be judged on the basis of two fundamental considerations.

First, they need to be compatible with the domestic goals set by the Employment Act of 1946, which enjoins us to seek maximum production, maximum employment, and maximum purchasing power, in an environment of stable prices.

Second, they need to be compatible with the international goals inherent in the financial, economic, and political position of the United States within the free world, which impels us to promote continuing progress in international economic welfare.

What would have happened if over the past six years we had followed the advice given in some quarters, abroad as well as at home, to solve our payments problem by restricting domestic economic expansion? We would not only have imposed stagnation and depression on our domestic economy; we would also have spread stagnation and depression to the rest of the world. Even if (as seems questionable) such a policy had enabled us to restore payments balance faster than the methods actually employed, too high a price would have been paid - and paid by the entire world.

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On the other hand, what would have happened if we had followed still another recommendation for solving the payments problem - that we abandon the present fixed value of the dollar in order to gain greater freedom for expansionary domestic policies?

This is not the place to go into all the ramifications of whether, by reducing the established par value of the dollar, we could have accelerated our domestic recovery. Even if this had been possible, such a course would have been irresponsible. The dollar serves as an international standard of value as well as an international means of payment and a monetary reserve asset. Tampering with its value would have undermined international commerce by saddling international transactions with added risks and costs, upset the international monetary system, and thereby frustrated the achievement of maximum international economic welfare.

It is true that in rejecting the advice given on both sides, we seemed to abandon all "orthodox" efforts to solve our payments problem. For "orthodox" economists have long believed - and some still believe - that there are only two ways of correcting a payments deficit: by restrictive financial policies or by currency devaluation. In the situation in which the United States found itself after 1957, neither of the "orthodox" remedies was applicable. Our domestic situation clearly demanded the use of expansionary rather than restrictive policies. And the international role of the dollar clearly forbade any attempt at devaluing the dollar in terms of foreign currencies. This was the famous "dilemma" of U. S. policy, and it led to some interesting experiments in international financial policy.

Let me briefly summarize U. S. actions of recent years:

First, at a time when flows of short-term funds seemed to be playing an important role in our payments deficit, the Federal Reserve and the Treasury employed what has been called "Operation Twist". The purpose was to keep short-term interest rates relatively high, so as to reduce incentives for the outflow of money-market funds, while permitting long-term rates to remain relatively low, so as to encourage domestic investment demand.

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Second, the United States made use of changes in the so-called "mix" of fiscal and monetary policies. While monetary policy became less easy, fiscal policy was eased substantially. The investment tax credit, enacted in 1962, provided a stimulus to investment outlays similar in its effects to a substantial reduction in long-term interest rates, while avoiding the encouragement to capital outflow that might have accompanied a sharp reduction in long-term rates. Furthermore, the income tax reduction of 1964 represented a substantial easing of fiscal policy, which helped move the economy further toward full use of its resources while interest rates, instead of declining, were permitted to rise further, in the hope of reducing incentives to capital outflows.

Third, in a more drastic departure from traditional policy, the United States in 1963 introduced the Interest Equalization Tax in order to insert a degree of insulation between the domestic and international capital markets. The tax initially applied to portfolio investment by Americans in developed countries, with exceptions for Canada and Japan. In 1965 the tax was expanded to cover bank loans of one year or more, but it still excluded direct investments abroad of U. S. enterprises. The tax made purchases of foreign securities relatively less attractive to Americans than purchases of domestic securities, and it did so without raising interest rates in the United States to levels prevailing abroad, which would have been incompatible with expansion of the U. S. economy.

And finally, in 1965 the United States introduced the Voluntary Foreign Credit Restraint programs for business corporations and for banks and other financial institutions. These programs applied to all types of loans and investments, including direct investments, and thus supplemented the Interest Equalization Tax. As in the case of the Interest Equalization Tax, the VFCR programs encouraged a shift from foreign to domestic credits and investments. The voluntary programs recognized important priorities, such as for export credits and for credits to less developed countries. And by enlisting the cooperation of business, the danger of avoidance and evasion was minimized.

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Incidentally, since the Board has assigned me the responsibility for administering the voluntary program on foreign credits of banks and other financial institutions, let me take a moment to report on its most recent accomplishment. In 1965, banks increased their foreign credits by only $155 million, as contrasted with $2.4 billion in 1964, so that at year-end they were $320 million below the guideline target. For 1966, the guideline was set so as to permit the target to rise by 1 percentage point per quarter - to reach 109 per cent of the end-of-1964 level by the end of 1966. But in the first three months of this year banks actually reduced their outstanding foreign loans and investments by a further $290 million, so that today they are more than $800 million below the target. This is a remarkable record of performance.

Turning back to the experimental measures of the 1960's, some of them have been highly successful. It is true that our payments position still has not returned to equilibrium, but on the basis of our conventional calculation, the "deficit" has been cut in half. And this improvement has taken place in the face of the difficulties caused by massive conversions of dollars into gold by one of our European allies, by the recurrent sterling crises, and by the war in Viet Nam. At the same time, the payments system has continued to work well enough to permit an unprecedented expansion of international trade and investment, and - most importantly - well enough not to impede substantial progress toward our domestic goals. After five years of uninterrupted growth, the U. S. economy has returned to nearly full employment of its manpower and capital.

Without the help of the policies I have outlined, we could hardly have escaped even more serious payments difficulties, which would have badly interfered with our domestic progress. In this sense, our international financial policies have, in my judgment, served well the purposes for which they were designed.

What remains to be done?

It has been recognized from the beginning that the kind of selective international financial policies recently

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introduced in the United States could only be applied successfully under certain limited conditions. Those policies were never meant to replace general policy measures, but only to supplement them in times when the general measures could not be expected to work. Furthermore, these measures were designed not to eliminate capital outflows from the United States - which as the richest nation is a natural source of capital for the rest of the world - but to reduce such outflows so as to bring them closer into line with the U. S. surplus of exports over imports.

It must be recognized that selective policies have inevitable shortcomings. Money is fungible, and any attempt to force money into, or out of, specific channels is hazardous. For instance, arbitrage will always restrict the possibilities of a "twist" between short- and long-term interest rates. Fiscal and monetary policies are so closely interrelated that there are limits to feasible changes in the "mix". Restrictions on capital outflows by selective measures can in time be evaded and avoided. Finally, voluntary cooperation in restraint programs is difficult to sustain if the measures impinge too severely upon the profitability of enterprise.

For all these reasons, we must continually review our policies in order to make sure that we do not use any tool longer than needed. Just as we should not let dogmatic orthodoxy prevent us from using selective tools, we should not let dogmatic selectivism prevent us from returning to more "orthodox" methods when changing conditions make that advisable.

And conditions have changed radically over the past twelve months. Not only has our payments deficit declined, but our domestic situation has turned from under-employment to nearly full employment, and perhaps beyond sustainable full employment to a state of emerging inflationary pressures.

These radical changes in underlying conditions have brought with them the need to review policies. No longer do we need to keep interest rates low to stimulate domestic

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investment; on the contrary, we need to restrain investment, which is running ahead at an excessive rate. No longer do we need to accelerate growth in our national income; on the contrary, we are currently obliged to curb demand so as to keep it in line with the expansion of available resources.

Under these conditions there is clearly no longer any reason for fiscal and monetary policies to be employed in opposite directions. On all fronts, firmness is the order of the day, and only the degree, the pace, and the form of firmness can be a matter of differing judgments. If present trends in money and credit markets continue, we may find that capital outflows are discouraged quite independently of the Interest Equalization Tax and of the foreign credit restraint programs. If and when this happens, and in sufficient magnitude, we should be prepared to dismantle unneeded selective restrictions.

We should be careful, however, to do so only in favor of more generalized policies, not in favor of selective restrictions in other spheres, and especially not in favor of restrictions on imports of goods or services. I can conceive of no circumstances under which restrictions on imports would be superior to selective restrictions on capital outflows. If we restricted imports we would invite retaliation and thereby jeopardize our exports; we would disrupt not only the efficient international division of labor but also the optimum allocation of resources in our domestic economy; and most importantly, we would hamper our fight against the danger of inflation. Especially when we need to maintain domestic price and cost stability, freedom of imports is an invaluable tool for restraining cost and price increases over the wide range of import-competing industries here at home.

If, at an appropriate moment, we were to give up some or all selective restrictions on capital outflow, this would not mean that we should turn our back on them for good. Even if selective measures were to become inappropriate in the foreseeable future, they might well become appropriate again at a later time. The combination of domestic under-employment and payments deficit is not unusual, and we should expect similar constellations to appear in the future. It is only necessary to recognize the possibility that from time to

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time, though we hope not continuously, the private capital flow from this country will tend to be excessive - that is, the capital outflow will, given the size of the current account surplus and government outflows, provide more dollars to foreigners than they are willing to hold.

More generally, we have to face the fact that the United States needs continuously to have balance of payments policies, just as it needs to have domestic policies. Just as equilibrium in the domestic economy does not occur automatically, the net outcome of private decisions to buy and sell abroad and to borrow and lend abroad does not automatically result in payments equilibrium.

We can all understand the desirability of having stand-by measures available for use in the case of necessity. Among such stand-by measures, there is one to which I invite your thoughtful attention. I refer to a stand-by authority to impose a tax (similar to the Interest Equalization Tax) on international credits and investments. The tax should be flexible and should cover all forms of capital outflow, especially to fully developed countries. It should be capable of being raised or lowered or taken off altogether by executive action, in accordance with balance of payments needs as reflected in the movement of U. S. reserves and the willingness of foreigners to hold additional dollars. Once the deficit in our international accounts has been reduced to suitable size, we must place our nation in a position to act speedily and comprehensively if and when restrictions on capital outflows again become necessary.

It is probable, and certainly to be desired, that such a tax could, as a rule, be kept on a stand-by basis, to be used only when capital outflows were clearly excessive, under conditions that would make inadvisable the use of general restrictive fiscal and monetary policies. The experience of the past few years indicates, in my judgment, that a stand-by authority such as this is not only desirable, but is necessary if monetary policy is to continue to serve its vital function with respect to the domestic economy.

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