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DOMESTIC AND INTERNATIONAL DETERMINANTS OF FINANCIAL POLICY

Remarks by Governor J. Dewey Daane

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## DOMESTIC AND INTERNATIONAL DETERMINANTS OF FINANCIAL POLICY

When I was first approached by Conference Director Worssam to appear on this forum, he asked me to speak on the subject of "Reconciling U. S. Domestic and International Dollar Policy." Somewhere along the line this got translated by the Conference Board's machinery into the title of your program, "Domestic and International Determinants of Financial Policy." But the program title and its subtitles referring to "credit policy and stable growth at home", "dollar responsibilities abroad", and "alternative means for achieving policy goals" carry the same implication of a possible clash, perhaps even an irreconcilability, between domestic and international policy determinants.

In fact, in the field of dollar policy domestic and international considerations are inextricably intertwined. In my judgment it would be quite wrong to take the simple, mechanical view that improvement in the balance of payments and healthy expansion at home are alternative goals between which we must choose. This view is no more justified than the setting up of a rigid choice or trade-off between price stability and reasonably full use of domestic resources. Those who imagine such unalterable trade-offs fail, it seems to me, to take account of the fact that policies--both public and private--can be adapted in new and imaginative ways to alter the terms of the apparent trade-off--or, to put it differently, to reconcile the apparently unreconcilable, although I would concede that the task is easier at some times than at others. It is not my task to be a spokesman for the wage-price guideposts, but I have no doubt that this

approach--called "incomes policy" in other countries--can, when adequately reinforced by appropriate general monetary and fiscal policies, significantly alter what has at times in the past seemed to be an inevitable relationship between rising employment and the generation of price advances. The mix of monetary and fiscal policies and the specific instruments appertaining to each can be--and I believe have been--flexibly adapted to be mutually supportive of our national economic objectives.

The interdependence rather than inevitable conflict among domestic and international economic goals and policies, and the results from successful pursuit of mutually reinforcing policies, may be seen in the current U. S. economic situation and outlook. Today the position and prospect of the U.S. economy--in both its domestic and international aspects--are more favorable than they have been in a number of years. On the domestic side, as you know, we have in 1965 achieved a rate of resource utilization--of both labor and capital--higher than at any other time in the 1960's, and within striking distance of levels regarded as optimum. This achievement is the more significant by virtue of having been, at least until recently, unblemished by any general rise in prices.

On the international side I would also characterize our situation as favorable for reasons well known to this audience.. The fact that we had a small surplus for three months is less significant than the fact that we have demonstrated our determination, in line with President Johnson's balance of payments program, to put an end to the long string of deficits. As Secretary Fowler pointed out this week the three month surplus does not mean we have solved our problem.

Thus our challenges today--to maintain a healthy, growing, and inflation-free economy and to maintain a viable balance of payments--are both closely related and in many respects interdependent. Whether our price record can be maintained is one of the major challenges facing the economy--important both for its domestic and international aspects. And whether the actions we take to solve the balance of payments problem will continue to be compatible with the continued healthy expansion of our own economy and of others around the world--is a second major challenge.

In responding to these challenges, it seems to me that the financial policy link between domestic and international determinants may be found in what I have termed the "Roosa categorical imperative", deriving from last Friday's Per Jacobsson lecture by Mr. Roosa; namely, that, on the one hand, monetary policy has to be formulated with full regard for all other elements of public policies and objectives--and clearly this includes balance of payments considerations and even international reserve asset creation--while, on the other hand, other appropriate public policies cannot ignore the elements of monetary discipline essential to the system. Credit policy and growth at home cannot be divorced from our dollar responsibilities abroad, and both must be considered together in achieving our overall policy goals.

The rationale of interdependence between a healthy domestic economy and a viable balance of payments is not difficult to find. There are a number of facets which I might mention but I would like to single out two.

(1) A vigorous domestic economy is essential for lasting strength in the balance of payments. The incentives created by a strong home economy with stable prices stimulate the installation of new equipment and the adoption of new techniques. This means higher profit returns, increasing the attractiveness of investment at home as against investment abroad. It also means keeping ahead in the competitive drive to sell our exports. Both on current account and capital account, therefore, the vigor of the domestic economy can affect favorably the balance of payments. Of that there has been ample evidence in recent years in Western Europe.

(2) But the compatibility--and over the longer run, interdependence--of vigorous domestic expansion and a healthy payments balance is based on the assumption that the price level will remain reasonably stable as vigorous expansion proceeds. A reasonably stable price level, in my judgment, is crucial to both sustainable growth and balance of payments equilibrium. It avoids a speculative scramble in the allocation of resources with the distortions and uncertainties that lower the rate of productivity advance, and lead to the kind of deterioration in competitive position such as the United States experienced after the mid-50's inflationary surge. It follows, then, that economic growth and relatively

stable prices are desirable from both the domestic and balance of payments standpoints. The balance of payments cannot remain long in equilibrium if the domestic economy is plagued either by chronic underutilization of its resources or by chronic inflation.

While domestic and international considerations are of necessity interrelated they are not necessarily always related in quite the way that is sometimes assumed. One misconception is that somehow there can be an international liquidity escape route for the domestic liquidity requirements appropriate to the maintenance of sustainable economic growth. In fact, as we look at our domestic policies in the current setting there are two quite distinct and separate international problems relating to them. The first is the problem of the adjustment process, or the way in which we manage our affairs so as to eliminate the deficit in our balance of payments. Parenthetically, I would state categorically that the adjustment process cannot be confined to deficit countries. Surplus countries have to act too and perhaps some should be reminded of U. S. policies back in the days of dollar shortage. The other problem we confront, along with other countries, is that of contingency planning to meet possible future international liquidity needs.

Since Pierre-Paul Schweitzer will be discussing the international monetary reform question with you this noon, I shall at this point simply stress that these are separate problems. I have been struck, however, by the fact that much of the continental 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--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 misconceptions. 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, and widened further in February of 1965--efforts which have not neglected actions in the monetary area. In fact, the latest measures have had, and are having, a very direct and conclusive impact on bank lending abroad.

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 made this crystal clear in his remarks at the Bank-Fund meetings this past week. Liquidity cannot replace dollar viability and dollar viability rests squarely on the continuance of appropriate domestic policies.

But, as always, one must beware of the simple solution to the complex problem. There are some observers who state, with a kind of evangelical certainty, that our balance of payments deficits of recent years could have been cured overnight simply by tightening monetary policy at home. To these observers, the Federal Reserve overfilled the cup and it inevitably overflowed into other countries. All we had to do was to turn off the credit faucet and the problem would solve itself. My own view is that our balance of payments problem is more complex than that simple diagnosis and, accordingly, calls for a more complex prescription--a prescription that attempts to recognize both the needs of the domestic economy and the far-from-simple explanation of our balance of payments problem.

If deficits were experienced only by countries suffering from excess demands and inflation, while surpluses accrued only to countries with inadequate demand and unemployed resources, the policy problem would be relatively simple. Fiscal and monetary policies would be used to stimulate aggregate demand in the latter countries and to restrict demand in the former (deficit-cum-inflation) countries.

As has been evident in recent years, however, the combinations of domestic situation and balance of payments position may pose more difficult policy problems. If a country in balance of payments surplus tightens its monetary policy in order to deal with an inflation problem at home, it tends to attract capital from abroad, thereby increasing its surplus and, in the process, increasing the deficits of other countries. Thus the simple prescription does not always cure the disease. One response to this realization is an increasing recognition that it is sometimes appropriate to try to alter the "mix" of fiscal

and monetary policies in order to cope with the existing combination of domestic and external problems. In fact, the existing mix of policies may itself at times be one of the causes of imbalance in international payments. Two countries which are alike in all other respects but use a different combination of fiscal and monetary policies to influence the domestic economy will tend to have different levels of interest rates, and capital will tend to flow from one to the other for this if for no other reason.

The fact that balance of payments deficits do not always accompany excess demand at home and surpluses are not always found in countries suffering from deficient demand is simply another way of saying that imbalances in international payments are not exclusively a reflection of the degree of demand pressure in domestic economies. Imbalances--surpluses or deficits--often have more deep-seated or structural causes. I have just indicated that differing mixes of fiscal and monetary policies may be one such cause. An example of such a structural problem is the tendency toward a very large capital outflow from the United States to the rest of the world. There are many reasons for the strong tendency for U.S. capital to move abroad, and for foreign borrowers to seek funds here, in large volume. The United States has the largest capital market in the world and the highest level of savings. Equally important, our capital market and our banks are readily accessible to foreign borrowers. They are highly efficient and, until recently, unimpeded by governmental restrictions. Participating in these markets are well-developed financial institutions searching for high-yielding loans and zealously competing for customers. These characteristics

differentiate our financial markets from those in other developed countries.

For these and other reasons, borrowing costs have been relatively low here and the availability of funds to foreign borrowers has been great. The result is understandable. Demands for funds abroad tend to converge on U.S. capital markets and on U.S. banks. And the U.S. institutions have, again quite naturally, had every reason to respond to these demands.

To some degree, the lower cost and greater availability of funds in the United States in the 1960's has reflected the differences in fundamental economic circumstances between the United States and Europe. While Europe experienced excess demand, our domestic problem was to stimulate the use of idle resources. But only a part of the difference in credit conditions is attributable to this factor--and it has diminished as our economy has moved closer to its potential.

There remains a significant part of the difference in credit conditions which must be ascribed to the structural factors that I have called your attention to. It has been both structural factors and differences in the phase of the business cycle between Europe and the United States, that have provided the motivation and the justification for the adoption in recent years of selective measures to supplement general fiscal and monetary policies.

Those selective measures need little elaboration to this audience. They have included, first, the meshing of Federal Reserve-Treasury policies to help maintain short-term money market rates in line

internationally; second, the investment tax credit and depreciation allowances designed to encourage domestic investment in a way that would avoid the adverse effect on international capital flows associated with declining interest rates; third, a turn to the interest equalization tax to narrow the differential in borrowing costs; and fourth, the voluntary program, both bank and nonbank, to deter massive capital outflow.

Meanwhile, as these special selective measures play their role, fiscal and monetary policies continue to be used actively to promote a growing, inflation-free economy, the achievement of which is, as I said earlier, highly interdependent with the maintenance of equilibrium in the balance of payments.

Fiscal policy last year, and again in 1965, demonstrated its power. The heightened rate of expansion of our economy since late 1963 can be ascribed in no small part to the tax reductions of these two years. Meanwhile monetary policy has gradually moved away from the more stimulating posture that was appropriate to an economy operating well below its capacity. This change in the mixture of monetary and fiscal policies is quite in keeping with our balance of payments position.

I am not so sure that the mixes of monetary and fiscal policies in Europe have been quite so appropriate. In those European countries needing to curb demand pressures, the tendency has been to rely heavily on monetary policy--in some cases combined with an easing of fiscal policy--and thus to increase the tendency for capital to move to Europe and for Europeans to borrow abroad.

But I would not want to imply by any means that we have fully unraveled the complex and difficult relationship between differentials in interest rates, reflecting differing domestic requirements, and undesired and disequilibrating capital flows. Instead I would stress that some of the solutions that may seem most obvious in terms of changes in internal policy mixes are not necessarily consistent with the complexities of the problem in terms of factors actually affecting the supplies and demands for funds here and abroad, and the various differing stages of capital markets. Classical remedies have, in fact, not been adequate to cope with this unclassical problem or "stubborn dilemma" as Mr. Roosa has put it of "the tendency for capital to flow out of an economy which has relatively stable prices and high savings toward those economies which block or impede the outflow of their own capital, which have in any event a greater need for capital in relation to their own savings, which are also often undergoing some internal inflation and which thus offer significantly higher rates of interest."<sup>1/</sup>

In conclusion, then, I have been calling your attention to two types of development in the continuing effort to adapt policies toward meeting the interdependent needs of our domestic economy and our external position. One development is a greater flexibility in altering the mix of fiscal and monetary policies. The other is the use, clearly as a supplement to more general policies, of selective instruments to

<sup>1/</sup> R. V. Roosa, The Place of Monetary Policy in the Economic Policy of the United States, Per Jacobsson Foundation Lectures, Washington, D. C., October 1, 1965.

deal with structural-type problems that affect the balance of payments. Some of these selective approaches, clearly of a temporary nature, rely on voluntary action. Others, like the interest equalization tax, affect market prices. All such approaches, as well as general fiscal, monetary, and debt management policies, need continuous examination, innovation and adaptation so as to minimize their interference with free markets while maximizing their contribution to a vigorous economy and a sound currency, domestically and internationally.