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Interest Rates at Home and Abroad

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Interest Rates at Home and Abroad

My subject is monetary policy and the balance of payments.

It is fashionable, today, to express deep concern for the payments deficit, as I will, but the worried tone and troubled brow that are so often displayed may be based on a mistaken diagnosis and a misdirected prescription. One is reminded of the story of the man who sits at home in his Danish chair, sipping Scotch whiskey, wearing Italian shoes, with a German car in his garage, a Japanese camera in his closet and a Canadian bond in his safe deposit box--while complaining about the gold outflow.

Not so many years ago it probably would have been thought incongruous for anyone to address Iowa bankers on the topic "balance of payments." Des Moines is far from a seacoast or seaway and remote, as well, from the financial institutions whose expertise in foreign exchange and international finance accommodates our trade and investment abroad. And in the past only in the environment of foreign trading and finance were people thought to be interested and knowledgeable on the balance of payments. Today I choose this topic without doubts as to your interest and concern. I am confident also that you can enjoy an informed opinion on the economic policy issues involved without being swamped or intimidated by the technicalities of international financial transactions. These are not, in fact, a prerequisite to an understanding of the basic economics of trading and investment beyond the boundaries of one's own economic community.

Let me illustrate what I mean. It is not difficult to think of Iowa as a separate economic community where trading among the citizens and businesses within the State would measure Iowa's self-sufficiency and trading with outsiders would measure Iowa's dependence on external trade. The

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situation differs only in degree when we think of the U. S. as the economic community, which is exactly what we do when we talk about international trade.

You as Iowa businessmen and bankers know that the standard of living in this State would fall sharply if Iowans were forced to be self-sufficient and consume only what could be produced within the State. Many products and services can be more economically produced elsewhere and imported into Iowa. Iowans can buy these products and services because the goods they can produce advantageously can be sold throughout the U. S. and around the world.

The balance of payments problem is one of keeping these payments for goods from the "rest of the world" roughly equal to receipts from sales to the "rest of the world." Obviously, that doesn't have to be done in such a way as to equate sales and purchases exactly for some given period. If sales (exports) are larger than purchases (imports) Iowans can build up claims on the rest of the world which they can invest or spend later on in a variety of ways. Or Iowans can borrow from the "rest of the world" if they want to spend and invest more than they obtain from the sale of Iowa products and services. This is one way in which trading transactions are converted into investment and banking transactions. But it is not the only way.

You, as Iowa bankers, know that within a given community the demand for credit and capital is seldom exactly equal to the local flow of savings from individuals and businesses. You participate daily in the process of channeling funds from areas where savings exceed local uses to areas where local opportunities for profitable investment abound relative to savings.

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Without carrying the parallel further I think you can see there is nothing in the balance of payments that is alien to your own experience as an Iowa citizen, businessman, or banker. The alien part comes in the solution to imbalances in trading and investment flows when we are speaking of the State or the Nation.

Within the U. S. no Government agency, high or low, is charged with policing the balance of payment deficits or surpluses of the country's hundreds or thousands of economic communities. Mainly, these adjustments are accomplished by the use of credit extended through financial intermediaries to businesses, governments, farmers, and individuals. Over the longer run, areas in deficit may decline in population and activity, but just as often the deficit areas are those with the greatest growth rates and bustling activity. California is a prime example of an area whose balance of payments deficit undoubtedly runs back beyond the experience of living men. Within the U. S. adjustments can take place without too much hardship because there are no restraints on labor mobility and people can move where jobs are, if jobs won't move where they are. Similarly, investors are unhampered as to where they put to work new savings and reflows from old saving. The workings of a free economic system without direction from anyone solve the balance of payments "problem."

But when we turn to the balance of payments of the Nation, hoping that normal economic functioning will provide the same automatic solution, we are disappointed. A whole host of problems arises, mainly from the fact that labor and capital resources cannot flow freely from one country to another seeking the optimum use. Moreover, the use of credit as an equilibrative mechanism is impaired by doubts as to political stability in other countries and by lack of confidence in foreign debtors' intentions to repay.

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Thus, in contrast to what happens within nations, imbalances among nations do not necessarily solve themselves in the best possible way. They may require government policies.

This is an important reason for addressing myself to the balance of payments here in Iowa today. Monetary policy--the actions of the Federal Reserve in influencing the money supply, bank credit, and interest rates--affects all parts of the United States. And monetary policy has, for better or worse, come to be determined in part by the U. S. balance of payments position. How much monetary policy should be influenced by the balance of payments deficit is one of the policy issues I should like to discuss.

The State of the Economy

The major problem of the U. S. economy in the Sixties, in contrast to most of the Fifties, has been to achieve full use of our resources. Too many men and women have been unemployed and too much plant capacity has been idle. This condition has been with us, in greater or less degree, since 1957. In the last eight years we have had two recessions--one in 1957-58 and another in 1960-61. Since early 1961, economic activity has risen without a setback, although in 1962 and a good part of 1963 the expansion of output and employment was too slow--barely sufficient to absorb the additions to the labor force and to plant capacity, but not enough to reduce unemployment and idle capacity. Only in recent months has it been apparent that progress is being made in cutting down both on the rate of unemployment and on the margin of unutilized plant capacity.

Substantial credit for the faster expansion of the economy in 1964 goes to the tax cut enacted last spring. This historic fiscal policy measure, through its influence on spending and expectations, has so far been highly

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successful in speeding up the rate of economic activity without generating inflationary pressures.

Monetary Policy in the Upswing

While the recent acceleration of the economy is attributable to fiscal policy, monetary policy can take credit for helping to maintain an uninterrupted 3-1/2 years of expansion, without the excesses of some previous upswings in our economy. Certainly monetary policy differed in 1961-64 from its performance in 1954-57 and 1958-60. Instead of a slowdown in money and credit expansion--accompanied by a rapid advance in interest rates--there has been a relatively steady growth of money and credit and a remarkable stability in long-term interest rates.

I do not offer this evidence in the spirit of a testimonial. It is not that much of a compliment to the Federal Reserve to say that it was capable of recognizing a significant change in economic conditions in the early Sixties and that it adapted its policies to that change. The fact is that a monetary policy posture like that of 1957-59 was unthinkable in the past three years, when, in contrast with the 1950's, prices were stable and unutilized capacity was persistently large. A more useful question for debate regarding monetary policy thus far in the 1960's is whether a still easier policy might not have speeded up economic expansion in 1962 and 1963--before the tax cut was enacted.

The major obstacle to an easier policy has probably been the U. S. balance of payments problem. It was feared that Federal Reserve actions to encourage a more rapid expansion of bank credit and money supply would inevitably depress short-term interest rates. This in turn would encourage funds to move abroad in quest of higher rates, thereby worsening our payments position.

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Now that a more satisfactory rate of economic growth has been achieved, the question is raised whether monetary policy should not be directed even more to improving the balance of payments. Although the payments deficit this year is lower than last year, the problem is far from solved. Let us look, therefore, at the character of the balance of payments problem and ask ourselves whether a more restrictive monetary policy is the proper means to cope with it.

The Balance of Payments Deficit[1/]

The first point to be made is that the U. S. balance of payments deficit is not of the traditional or classical variety and therefore does not call for the "classical medicine." We are not buying abroad more than we are selling, in reflection of an excess of purchasing power in the United States. On the contrary, our exports exceed our imports by about $6 billion per year and this surplus has been rising. Even if aid-financed exports are excluded, our commercial accounts show a substantial excess of exports over imports.[2/]

Equally significant is the fact that our export surplus has risen markedly in recent years. In part our favorable performance in world trade is no doubt a result of the relative stability of prices here while prices have advanced elsewhere, notably in Europe. In these circumstances it is

1/ The United States leans over backward in measuring its deficit. Because the dollar is a reserve currency, we have felt it appropriate to follow a double standard in racking up our assets and liabilities. Thus an acquisition of dollars by foreigners counts as an addition to our deficit. But when Americans acquire short-term assets abroad, this does not reduce our deficit. For example, if Americans place time deposits in agencies of Canadian banks in New York and these agencies purchase U. S. Treasury bills, our deficit increases. But in what sense is the U. S. worse off as the result of such a transaction?
2/ In contrast, most of the countries of Western Europe have an import surplus, financed by earnings on services and by capital inflow.

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reasonable to think that our international competitive position has improved. But this is a very difficult thing to measure.

Sometimes an effort is made to appraise the ability of our exports to compete in world markets by calculating the U. S. share of world exports, or of world exports of manufactured goods. This approach measures competitive positions by results; in the process it attributes all changes in relative trade position to competitive power, whereas there are in fact other important influences on shares of trade. A striking example is provided by the large growth of trade among Common Market countries in the last few years, as these countries have opened their borders to each other and increased their exports to each other at a rapid rate. Between 1959 and 1962, for example, manufactures exports of the Common Market countries to each other increased more than 70 per cent whereas total world exports of manufactures rose less than 30 per cent. Inevitably the U. S. share in the imports of each of these countries declined. This indicates not that our exports are any less competitive but that the six countries are giving preferential advantages to each others' exports.

To compensate statistically for this structural development--the integration of the European Economic Community--it is useful to disregard exports of EEC countries to each other and to compare the combined exports of these six countries to the rest of the world with U. S. exports. When this is done, we find that the U. S. share of manufactures exports--while showing a marked decline from the early postwar years--seems to have reached its low point in 1961 and begun to climb again thereafter. Such a trend is consistent with what we know about price movements in the United States and Europe in recent years.

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It is safe to say, consequently, that this country--earning a $6 billion export surplus and holding its own, if not enlarging its share, in world exports of manufactures--does not have the sort of balance of payments problem that requires that we either change our exchange rate or reduce our imports by slowing down our economy with a restrictive monetary policy.

Rather we find that our problem lies in our capital transactions with the rest of the world. What is happening is that we are transferring to the rest of the world in the form of military outlays, foreign aid, and especially private loans and equity investments a sum of dollars larger than our export surplus. The excess of dollar payments abroad accounted for by those sources is the usual measure of our deficit.

If, for example, an American purchases a foreign 20-year bond and the foreign seller places the proceeds in a U. S. bank, it is true that our liquidity position has worsened--for we have increased our short-term liabilities along with our long-term assets. To a large extent our balance of payment problem can be described in this way. Our international balance sheet has, in fact, been strengthening, since our foreign assets have been increasing more than our liabilities. But our liquidity position has been weakening, since our short-term liabilities have been rising more than our short-term assets. This produces a problem, to the extent that foreign countries are dissatisfied with being on the other end of the process.

A businessman knows that if he incurs short-term debt in order to increase his long-term assets he improves his position and may even be quite comfortable as long as his creditors are willing to hold his IOU's. If, however, his creditors become restive, he finds himself in a liquidity squeeze.

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Thus our problem is not that we are dissipating our resources. We are not "living beyond our means." We are, rather, lending and investing abroad in larger volume than our export surplus can support and are, therefore, increasing our short-term liabilities at a larger rate than some other countries are willing to acquire them.

Government Expenditures Abroad and Private Capital Outflows

It is useful to dissect a little further the Government and private capital transactions that account for our balance of payments problem as I have just characterized it.

The Government share consists mainly of military expenditures abroad and foreign aid. These programs are based on broad political judgment involving the national interest and I shall not attempt to justify or explain them in detail. What is most relevant for us is that both these types of expenditure have been so managed in recent years that they generate a decreasing net flow of dollars to foreigners. Military outlays are being offset in various ways and foreign aid is being tied to U. S. exports.

If we turn to examine private capital movements, we find that there has been, since the mid-fifties, a large increase in both direct investment abroad and in loans and credits to foreigners. For this development there are various explanations.

American firms have found attractive investment opportunities abroad--in raw material supplies and in recent years in manufacturing facilities in Western Europe. Higher interest rates at home would do little to discourage such investment abroad.

Other forms in which U. S. private capital flows abroad include new issues of foreign securities in the United States, purchases of out-

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standing foreign securities and money market assets by Americans, and bank loans and acceptance credits to foreigners. It is these types of outflows that have increased substantially in recent years. And because some of these flows are thought to be sensitive to interest rates--or to differentials between interest rates here and abroad, or to differences in the availability of funds here and abroad--the major controversies regarding the connection between monetary policy and the balance of payments have centered around these types of transactions.

The following questions are raised when we begin to focus on these capital movements: to what extent do they respond to differences in interest rates; what would be the cost to the domestic economy of an increase in interest rates sufficient to restrain these capital outflows; are there alternative methods of discouraging these outflows; would the alternative methods be more or less objectionable than higher interest rates?

Factors Affecting Private Capital Outflows

Some of those who favor an increase in U. S. interest rates as a means of improving the balance of payments seem to assume that domestic borrowing and spending are quite insensitive to interest rates while international capital flows are quite responsive to interest rates. With this judgment, I disagree. The only way general monetary policy can substantially cut down on foreign loans and investment is to raise the entire structure of U. S. interest rates toward levels prevailing abroad. This would require a tightening in U. S. monetary policy--possibly a drastic tightening--with serious braking effects on the rate of domestic spending and income.

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If the U. S. economy were presently subject to excess demand and inflationary pressure, the story would be quite different. In that case, a monetary policy posture appropriate to domestic conditions would also help the balance of payments by discouraging capital outflows--assuming that other countries did not raise their interest rates correspondingly. But as long as there continues to be slack in the economy, a significant increase in interest rates designed to curb capital flows would have the unhappy effect of slowing down domestic expansion.

Now there are some observers who take an overly mechanistic view of our payments problem and claim that capital outflows are the result of excessive money creation, which seeps out across our borders in search of higher earnings abroad. All we need to do, according to this approach, is to cut down the extra monetary and credit expansion and the outflow of capital will be taken care of. It seems to me that this is like saying that the way to deal with a leak in a garden hose is to shut off the water.

This approach really assumes that a substantial part of foreign loans and investments by Americans are marginal--that is, they are at the bottom of the list of preferred borrowers--so that a reduction in the availability of credit and money would result mainly in less lending to foreigners, with little effect on the domestic availability of funds. I have already indicated that direct investment abroad would probably not be cut significantly--it might even increase--if money were tightened severely in the United States. And there is no reason to assume that American banks and other lenders would cut down on foreign loans first if their total lending capacity were reduced.

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Those who call for restrictive monetary policy as a means of dealing with capital outflows sometimes seem to assume, wrongly, that the United States is merely one among numerous equally-situated countries and that the push and pull of the forces acting on capital flows are similar everywhere. From this they deduce that relative changes in interest rates are the major influence on capital movements. The fact is that the U. S. capital and money markets are unique. They are the largest and most accessible in the world. By virtue of our size, our huge flow of savings, and the efficiency of our banking facilities, borrowers abroad have many incentives to seek funds in our markets and from our banks. Often they tap our markets not because they need dollars as foreign exchange but as a means of circumventing credit restrictions in their own countries. And, let us remember, the freedom to borrow in our markets is not matched by similar freedom in other industrial countries. In Europe and Japan, either governmental restrictions or exceedingly high interest rates prevent the free movement of money and capital and lead to a concentration of world-wide borrowing demands on the U. S. markets.

It was in reaction to this asymmetrical situation, which induced a flood of foreign security issues in New York in 1962 and 1963, that President Kennedy proposed the interest equalization tax in July 1963. This tax on American purchases of foreign securities has been quite effective--and was so even before its enactment--in raising the cost of foreign long-term borrowing here without raising long-term interest rates to domestic borrowers.

This tax seems to me a useful example of the selective approach to our capital outflow problem. It is impersonal, avoiding direct rationing, and relying instead on the price system. But, most important, it fits the

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prescription to the disease; it doesn't amputate the leg because an ankle is dislocated. And, it should be noted, the tax applies only to U. S. purchases of securities of industrial countries. It does not discourage the flow of U. S. capital to those areas--the less developed countries--that are in real need of productive capital from abroad.

The success of this tax should now lead us to explore similar techniques for discouraging, as and when necessary, other forms of capital outflow to industrial countries. We do not want to discourage free capital movements as a long run policy. On the contrary. Moreover, it is most appropriate that an advanced industrial country like the United States--and like countries in Europe--should export capital to developing nations. Capital movements among industrial countries also serve fruitful purposes. But capital movements can at times be perverse--aggravating rather than contributing to international balance. When this happens the continuation of completely unhampered capital flows may impose a very high cost--namely, unduly restrictive policies that discourage economic expansion. This is why we need to have at hand acceptable devices, like the interest equalization tax, to reduce such flows when they threaten to force upon the United States a monetary policy inimical to the healthy expansion of its economy.

Meanwhile, it is to be hoped that other industrial countries will take measures, as urged by Secretary Dillon, to develop their own capital markets, so as to reduce the asymmetry I have referred to. Better developed, more accessible, and lower cost capital markets in Europe would make it possible for these countries to supply their own domestic capital needs, as is called for by the stage of advancement they have attained. It would

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also, and this is equally important, provide a means for other industrial countries to increase their export of much needed capital to semi-industrial and less developed countries.

Concluding Remarks

I hope it is clear that what I am preaching is not economic isolationism. I recognize the important and reciprocal relationship between the United States and the rest of the world. And, though I believe we could improve, analytically, our way of looking at the balance of payments deficit, obviously a payments problem remains.

Furthermore, I agree with those who would attack the problem with monetary policy to the extent they imply that the correction must come mainly in the capital accounts. But to discourage capital outflows by raising the entire structure of U. S. interest rates--and they would have to be raised substantially to solve the problem--at a time when we are still a considerable distance from full use of our resources seems to me to be unwise policy. The cost in terms of domestic output, income, and employment would outweigh the benefits in terms of better-balanced international accounts.

For these reasons, therefore, further exploration of the potentiality for selective approaches to regulating capital flows is very much in order. These techniques, like the interest equalization tax, would be available, when needed, to reduce the incentive for such outflows. This is precisely the purpose of those who would accomplish it through monetary policy. The advantage of selective approaches is that they would permit us to follow, as appropriate, a monetary policy conducive to high and growing output and stable prices at home.

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Controversial issues often lead to an appeal to "look at the facts." It isn't always easy to get at the relevant facts and just any facts won't do. Data on the balance of payments are more elusive than most, partly because their policy conditioning function is not more clearly defined.

Let me end, as I began, with a reference to the Iowa economic community. If we turn back to that parallel we need to keep two facts in mind. The first essential fact should tell us whether we are buying more goods and services from outside our community than we are able to sell to outsiders. Here we get a clear answer; our sales exceed our purchases by about 25 per cent--a very sizable surplus. But this bare fact needs some qualification--a substantial part of this surplus arises from the fact that much of our foreign economic and military aid is extended in kind, directly or indirectly, and this swells our export surplus--i.e., the surplus in our trading position is larger by virtue of our tied aid program. But our best estimates--and they are of necessity estimates--indicate that we would still enjoy a substantial trading surplus without tied aid. And that surplus means we are not "living beyond our means."

The second essential is comparable to a question that you as an Iowa banker might ask a businessman with respect to his balance sheet. Knowing that his receipts are larger than his disbursements you want to know what he is doing with the retained earnings and what he may be doing to expand the scope of his operations. If we look at the analogous data on the U. S. international position we would see that in the past four years we have invested on a long-term basis an average of $4-1/2 billion annually abroad. This means that we are plowing our earnings into an expansion of our

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holdings of foreign assets. The Department of Commerce estimates that our total public and private assets abroad at the end of 1963 were $88 billion, which is almost $17 billion greater than it was in 1960.

But once again these facts need some amplification. True, our foreign assets are growing, but what about the composition of those assets and what about the composition of our liabilities? American acquisition of equities through direct investment or purchase of foreign stocks has been the outstanding development of recent years. But, in addition, American financial institutions have been lending large amounts to finance trade, not only between the U. S. and other countries but among other countries. And U. S. institutional and non-institutional investors have been buying foreign bonds.

All in all we have been investing abroad more than our trading surplus could cover. We have, therefore, been borrowing abroad in one way or another to do so. Some of the lenders who have been accommodating us seem reluctant and others do not like the terms. This, then, is the point at which our balance of payments deficit has become a problem.

You as bankers recognize, I am sure, that for these conditions no single cure-all is likely to be at hand and that drastic remedies require cautious use because of possible undesirable side effects. But it seems realistic to me that any lender would want to see only those steps taken that would preserve the health and good will of a valuable customer.

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