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Remarks of J. L. Robertson

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# The Balance of Payments Problem
## Short-term Relief and Long-term Remedy

It is a pleasure to come to Pittsburgh and to meet with the leaders of a community and area that have done such a magnificent job of demonstrating what can be accomplished by that good old-fashioned American virtue of self-help. I feel a certain kinship with you on this score, since my own home town, Broken Bow, Nebraska, has also been an exemplar of this same spirit, albeit on a somewhat smaller scale. However, Broken Bow may even be ahead of you in one respect. Its efforts have inspired a movie, called "The Broken Bow Story", which is not about cowboys and Indians but about the efforts one small community is making to improve its balance of payments.

Of course, they do not describe it quite that way in Broken Bow, but the fact is that balance-of-payments troubles are not confined to the area of international finance. Communities and even individuals may have them; and when we have them, no matter what name we give them, we know that we have a real problem on our hands.

It has taken quite a long time for most Americans to realize that we, as a nation, had this kind of trouble. I made my first talk on this subject just six years ago. I warned at that time that if we ignored the problem, that then had only recently reared its head, the dollar would cease to be the world's soundest and most sought-after currency, our prestige would be impaired, and with it we would see a decline in our ability to play our proper role as leader of the free world. This was pretty strong language for a central banker to use, but the possibility seemed so remote that it caused not a ripple. I cannot honestly say that I find any gratification in the fact that this warning does not, in retrospect, appear to have been in the least bit exaggerated. I only regret that it has taken us so long to arouse the kind of concern that was needed to produce corrective action.

I need not tell you that a strong program, designed to help solve the problem, was launched by President Johnson last February, and that it has been my fate to have been assigned a certain role in it. I have been asked quite frequently how I happened to get the job of riding herd on the

Federal Reserve's part of the program. I want to assure you that I did not volunteer. I was not like the man who many years ago called President Wilson at two o'clock in the morning. The President had had a rugged day and had retired early to nurse a bad cold. He was awakened by an aide who said he had a call from New York. The President asked whether it could not wait until morning, but the aide said the caller insisted that it was urgent. And so Wilson wearily got out of bed and went to the phone. The caller said, "Mr. President, the Collector of Customs for the Port of New York has just had a heart attack and has died." Wilson said, "I am very sorry to hear that, but really, couldn't you have waited until morning to tell me?" The caller said, "Well, I thought you might like me to take his place." To which the President responded, "I would be delighted, but you had better make sure it's all right with the undertaker."

Twenty-five years ago our country's international financial posture, as it impinged upon our domestic economy, was relatively insignificant. It rated only a few lines in standard textbooks on economics - usually to the effect that it could safely be ignored in formulating monetary or fiscal policies. The term "balance of payments" was known to only a few people, and understood by even fewer.

This situation was completely changed by World War II and the events that followed. First we were faced with the "dollar gap", and the need to pump dollars by the billions into foreign countries, chiefly in Western Europe, to stave off economic collapse, and to facilitate recovery from the devastation and economic dislocation caused by the war. These efforts succeeded beyond the most sanguine hopes.

By the mid-1950's the developed countries of Western Europe, as well as Japan, had met their most urgent investment needs and were beginning to use our dollars - which by then were being received from trade and private investment rather than aid - to build up their official reserves. The focus of our aid efforts had shifted from the industrial nations to what have come to be called the "less developed countries". And while we continued to provide official aid to those countries, increasingly large amounts of U. S. private capital were attracted into foreign investment by economic growth and increased political stability abroad, and by the return to convertibility of the major European currencies in 1958. Simultaneously, economic recovery in Europe and Japan, coupled with the delayed effects of the substantial currency devaluations of 1949, greatly enhanced the ability of those areas to compete with us in world markets - including theirs, ours, and those of third countries.

Beginning in 1958, there developed a deficit in our balance of payments which has persisted until the man in the street has become aware that "dollar glut", "gold drain", and "balance of payments deficit" are not merely matters of concern to bankers, but phenomena which pose a threat to world confidence in the dollar and possibly to his own individual financial security.

I do not think it necessary before a group of this kind to spell out the nature of our balance-of-payments problem. Suffice it to say that since 1958 the United States has been sending dollars abroad, as payment for imports and tourism, as military and economic aid, and as private foreign investment, in an amount greater than foreigners are willing to use to buy U. S. goods and services, to invest in the United States, or to hold as monetary reserves. The overflow comes back to us as a claim against our gold supply, which has fallen by more than $8 billion, or more than one-third, since the end of 1957.

The measures adopted in mid-1963, primarily the interest equalization tax, produced only a temporary respite. In the fourth quarter of last year, the deficit reached a record <u>annual</u> <u>rate</u> of $6 billion. It was clear that additional action was called for, and President Johnson's program announced on February 10, 1965, was the answer to the challenge. The objective of this program is to reduce the outflow of dollars to a rate at which they are actually needed by the rest of the world. It is not our purpose to create trouble for any other country, but only to prevent foreigners from being reluctant holders of dollars. We do not want to recreate a "dollar gap". We simply want to slow down the outflow in order to maintain the confidence of the world in the strength of our currency - which is vital to the continued performance of our role of world leadership.

The direction that our effort should take was clear from the statistics. While our favorable balance on goods and services rose in 1964, the outflow of private capital rose even more. The total net outflow of private capital in 1964 was over $6 billion, or twice the amount of the total payments deficit. Of this amount, one-third represented foreign lending by U. S. banks. The annual rate of such lending reached $4 billion in the four months ended with January 1965.

This unprecedented outflow of capital was generated, at least in part, by an apprehension on the part of American corporations and their overseas subsidiaries that interest rates here might rise substantially, or that direct controls on capital outflows might be instituted. I am not criticizing such corporations, or the banks which met the loan demand, but merely noting that the resulting surge was one of the factors we had to consider in our search for a solution to the problem.

The voluntary program was chosen over other alternatives for several reasons. First was the fact that our citizens were aware of the seriousness of the situation and willing to cooperate, even if cooperation impinged upon their profits and upon their personal wishes and plans. Secondly, direct economic controls were rejected as being insufficiently flexible, as likely to have longer lasting adverse effects on our economic system, and as being - to a greater degree - inconsistent with our policy of freedom of movement in international trade and finance. Restrictive monetary policy, an alternative action urged upon us by many of our foreign friends, was rejected for reasons which I will outline in a few moments.

I want to emphasize, without unduly disregarding Shakespeare's warning against protesting too much, that the President's program is a voluntary one. Its effectiveness depends entirely upon the voluntary actions of private individuals and institutions. We in government have simply designed guidelines to aid institutions in coordinating their efforts effectively to achieve the goals which all of us recognize to be essential. Without such guidelines, they might be working at cross-purposes, and inequities might develop which would impair our competitive free-enterprise system. Even with guidelines, it is impossible to provide for absolute equity among all banks and financial institutions - but our efforts have been directed toward that goal.

Those who complain about "government by guideline" must realize that there are situations in which common action must be taken, and in which the consensus necessary for a success of such action must be realized more speedily than could be done by leaving the matter purely to individual decisions. Obviously, no bank could possibly be expected to restrain its foreign lending if it did not know that its competitors would do the same. Since in this country financial institutions have - praise be! - neither compulsory nor voluntary cartel organizations, the government was the only agency that could draft the needed guidelines.

The basic objectives of that part of the President's program assigned to the Federal Reserve System are, I hope, fairly well known. We aim to reduce the expansion of bank credit from a rate of over $2 billion a year, which it attained in 1964, to something in the neighborhood of $500 million in 1965. To achieve comparable results in the area of nonbank financial institutions, we asked them to reduce, in an orderly manner, their holdings of liquid funds abroad to the December 31, 1963 level, to refrain from increasing their holdings of short- and medium-term investments by more than 5 per cent during 1965, and to exercise considerable restraint in increasing their long-term investments.

Barely three months have passed since the guidelines were distributed and we have data on actual transactions only for March and April, and that only for banks. It is already clear, however, that there has been a sharp reduction in the rate of expansion of bank credit; from over $2 billion in 1964, and about $400 million in just the first two months of 1965, the flow was reduced to $40 million in March and converted into a reflux of $140 million in April. We do not yet have specific data (but soon will) on capital flows through the nonbank financial institutions this year (their foreign credits increased 9.4 per cent in 1964, from over $8 billion to over $9 billion), but the information we do have leads us to believe that they, too, are cooperating wholeheartedly with the program.

We are keeping in close touch with all these financial institutions. Regular reports and hundreds of face-to-face meetings with top management give us every reason to believe that the guidelines are being followed, and that the program will be effective in achieving a substantial reduction in the rate of capital outflow while providing adequate financing not only for U. S. exports but also for the needs of the less developed countries of the world.

The reaction of the financial community to the program has been an encouraging example of the way in which American institutions can place the national welfare above their own short-run economic interests. It is true that financial institutions recognize that their welfare is inextricably entwined with the preservation of a sound dollar and an effective international monetary system. Nevertheless, their willingness to cooperate and to refrain from taking competitive advantage of the situation exhibits an admirable sense of public responsibility.

This performance becomes all the more remarkable when one remembers that bankers understandingly hold differing views concerning various facets of the program - they do not all see eye-to-eye with me concerning the appropriateness of each of the guidelines. It is even more remarkable in view of the probability that many junior officers of these institutions will, in the nature of things, be concerned chiefly with volume of business and earnings achievements. It is difficult for these younger executives to place the national economic interest above the drive of personal accomplishment and personal advancement - and I am not sure we would want it to be otherwise. Nevertheless, this situation imposes on the men who head their institutions the heavy burden of making this program work by a skillful combination of inspiration, discipline, and education - and they must do all this without permanently dampening the drive and enthusiasm of the rising men of their organizations.

The reaction abroad has been especially interesting to me. Publicly we were applauded for moving forthrightly to solve the problem. Privately, skepticism was expressed that a voluntary program could have any appreciable effect. This attitude of skepticism has since undergone considerable revision, in view of the demonstrated effectiveness of the program and the concomitant reduction of excess supplies of dollars abroad.

A program of this nature is bound to come in for some criticism and comment. Without undertaking a complete defense against every charge that has been leveled against it, I should like to clear the air a little by commenting on those most frequently made.

1. Some bankers complain that under the Commerce Department program direct investment abroad by nonfinancial corporations is being <u>en</u>couraged, while foreign lending is <u>dis</u>couraged by the Federal Reserve program. This must be a misunderstanding, for surely no one in government expects the banks to shoulder the entire burden of eliminating the payments deficit. Obviously, over the long run, direct investments abroad <u>are</u> desirable, from many points of view - including the balance of payments. But so are bank loans; as a matter of fact, they are even more desirable in some respects because the returns are often surer and quicker than the returns on other investments. The situation simply is one that requires both kinds of dollar outflows to be temporarily curtailed - not eliminated, just curtailed.

2. A closely related criticism results from the fact that the guidelines for nonbank financial institutions exempt foreign credits with original maturities over five years. Some banks feel that this has given the nonbank institutions an unfair competitive advantage. As to that, I can only say that the guidelines for the nonbank institutions were labeled "tentative" because we in the Federal Reserve knew less about

the operations of those institutions than we did about banks. After seeking the advice and counsel of representatives of the institutions affected, we are now in the process of revising those guidelines to make them more specific and more consistent with the bank guidelines. Hence I hope this criticism will soon lose whatever validity it may now have.

3. Perhaps the most serious charge leveled against the voluntary program is that it inhibits U. S. exports. This concerns us, since it would do no good if we reduced the deficit on capital account only by reducing, at the same time and in the same amount, the surplus on current transactions.

We are told, moreover, that loans to finance exports cannot harm the balance of payments since, to use a phrase we often hear, "the money never leaves the country" - the capital outflow is offset by the payment which the foreigner makes to the exporter, with no net effect on the overall balance.

Those who offer this argument are saying implicitly that every export transaction financed by credit from U. S. banks depends for its consummation on the availability of that credit. In some cases this may indeed be so. But, clearly, every foreign purchaser of U. S. goods has essentially three basic alternatives: he can pay cash for the goods from his own funds; he can borrow from his own bank or obtain credit from some other source outside the United States; or he can obtain credit in the United States. Since credit is usually cheaper and more readily available here, he will ordinarily prefer to use United States credit if possible. However, his failure to obtain credit here does not necessarily signify that the exporter will lose the sale. And if the exporter would not lose the sale, it is clear that the credit (if granted by a U. S. bank) would be a net drain on the balance of payments - even if the money never left the country. It would be completely impossible, in my opinion, to establish operational criteria that could distinguish accurately between U. S. bank loans that would be essential to an export sale and those which would finance exports that would be made even in the absence of the loans.

For this reason, we have included all types of bank loans in our target. However, if banks give export credits absolute priority, as the guidelines prescribe - and so far we have every reason to believe that they are doing so - there will be more than ample bank resources available to provide all the export credit that will be needed. Remember, it is not just the 5 per cent expansion that is available to finance additional exports; repayments on outstanding loans, together with the 5 per cent expansion, will put banks in a position to extend a minimum of $7 billion in new credits to foreigners during 1965. Surely within this large amount there can be no lack of bank credit to finance any foreseeable expansion of exports.

If U. S. banks were free to make export credits without limit, foreigners would naturally couch all of their appeals for funds in terms of export credits. The result would be that any overall dollar target that excluded export credits would be meaningless.

Consequently, in the absence of a better case than has been made thus far - one clearly establishing that exports are being lost for lack of financing attributable to this program - I regret to suggest that those who are advocating the exemption of export credits are doomed to disappointment. The risk to the success of the program is too great to permit it.

4. This may be the appropriate place to refer to the one and only exemption that has been given under the guidelines - the exemption for loans guaranteed, insured, or otherwise participated in by the Export-Import Bank. This exemption was not granted because it was considered that such loans had an effect on the U. S. balance of payments different from any other export credits. Rather, it was decided that the Export-Import Bank, as a government agency, should have sufficient flexibility to carry out its program effectively. But this does not mean that we will view with equanimity a rapid rise in such exempted credits which would indicate that credits had been placed under the umbrella of the Export-Import Bank for the purpose of getting them outside the voluntary program and freeing a bank's funds for

non-export credits. We have an understanding with the Export-Import Bank on this point. Both of us are determined to see that the exemption is not used in such a way as to undermine the program.

5. We have also been told that our 105 per cent ceiling has unduly restricted credits to the less developed countries. As you know, banks have been asked to give high priority to such credits, and our information indicates that they are doing so. For instance, commitments by banks since February 10 to make long-term loans to foreigners have amounted to $280 million, of which $220 million, or 80 per cent, was to less developed countries. Total commitments to less developed countries during the first four months of this year amount to $470 million, which may be compared with $970 million in the full year of 1964, when less developed countries accounted for only 40 per cent of the total.

This is not to say that even some high priority credits will not be denied by some institutions because of the program. While the banking system as a whole is under the 105 per cent target, some individual banks are still above it, and they may feel obliged to limit or delay new commitments until they can get back under their ceiling. However, failure to get a loan from an accustomed source does not prove that credit is not available; it may mean merely that some new source of credit must be sought. In this connection I suggest the likelihood that we may have passed the point of tightest pinch on priority loans. Up to now advances under the huge volume of commitments made prior to February 10 have caused some banks to be reluctant to accommodate demands for new credits - even those with high priority. This situation should soon begin to ease.

6. It is frequently asserted that while the government is asking American concerns and financial institutions to curb the flow of private capital abroad, the government itself is not doing its share to correct the balance of payments problem. As to this, let me assert that, from my point of view, it is essential that action be taken in the public sector - as clearly stated in the President's message of February 10 - to contribute in every way possible to the solution of this problem.

7. One further point deserves mention simply because it is frequently advanced by some bankers, both here and abroad. They contend that monetary policy should be used to solve the problem through the traditional measure of tighter credit and higher interest rates. This alternative has been considered. I personally think it is not an appropriate method for dealing with the problem. Let me tell you why.

Our balance of payments is not suffering from the "traditional" ailments for which tighter money has come to be regarded as the "traditional" solution. We are not suffering from domestic inflation, with a resulting excess of imports over exports and accompanied by a flight from the currency. On the contrary, we have a large and growing surplus on current account.

The problem is that our export surplus, large as it has become, has still not been large enough to cover the extraordinary amount of public and private investment funds that we have been providing to the rest of the world in recent years. The public investment portion of these capital outflows has been a part of our country's overall international policy in these postwar years, and ought to be judged accordingly. The private capital outflow has been primarily in response to two sets of market forces: the high level of saving in our relatively affluent society, on the one hand; and the upsurge of attractive investment opportunities, especially in Western Europe's rapidly growing economies, compared with a rather low-growth, high-unemployment United States performance in the late 1950's and early 1960's. In this environment, imposition of a deflationary tight money policy in this country would have, in time, made domestic investment opportunities still less attractive and eventually added to the excess of savings seeking investment elsewhere.

Moreover, if we were to resort to restrictive credit policies in the United States, with the view of raising our interest rate levels to a point comparable with those prevailing abroad - (and, by the way, it could only be done here by reducing the total availability of money and credit) - the probable result would be a ratcheting increase in interest rates elsewhere, with little narrowing of the differential - an outcome that would please no one and would simply impede economic progress throughout the free world.

Hence tight money does not stand the test of careful examination, either as a temporary or permanent remedy for our balance of payments deficit at this juncture. Furthermore, tight money is not now an appropriate prescription for our domestic economic problems, given the current slackening in the rate of business expansion and our sizeable remaining margins of unutilized resources - both human and material. Consequently, I would not favor higher interest rates here unless and until it seemed likely that higher rates would either be needed to contain or curb inflation at home or would significantly improve the balance of payments without jeopardizing our domestic economy - which, of course, is the real source of our strength.

In conclusion, let me say that the preliminary information we have received, both from statistical data and from our continuing conversations with the managers of financial institutions across the country, both bank and nonbank, leads us to believe that our part of the program is operating satisfactorily. However, the success of one part of the program does not mean the success of the whole. If price and wage increases should diminish our ability to compete in world markets and thus cause our export surplus to drop sharply, if corporate investments abroad should unduly expand, if unexpected events on the political front should result in increased governmental spending abroad in spite of all efforts to curtail it, we would still have a problem - a problem calling for more stringent measures. This is not, in any sense, a threat; it is merely a realistic recognition of the fact that we face a problem that must be solved - and solved it will be.

We must not lose sight of the fact that a program such as this one, which does not rely basically on the operation of free market forces and the price mechanism, can only be considered as a holding action. Consequently, we must continue, in both the government and the private sector, to seek for and to follow policies which will achieve the basic adjustments necessary to bring our international payments and receipts into approximate balance. When that has been done then this program can be phased out - as much to my relief as to that of any financial institution.

In the meantime, the success of the voluntary credit restraint program remains a vital issue for everyone. Bankers and businessmen all over the country who are directly affected by it have recognized this fact. The degree of public responsibility which they have displayed in grappling with the problem - a truly complex national problem - has come as no surprise to us, but it has been a revelation to some people abroad who did not believe a voluntary program of this nature could work - even in America.