

Talk by W. Braddock Hickman, President of the Federal Reserve Bank of Cleveland, at the annual meeting of 350 officers and directors of The BancOhio Corporation and officers and directors of its 22 affiliated banks at Columbus, Ohio, on Monday, February 22, 1965.

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THE BALANCE OF PAYMENTS SITUATION

When Lee Stoner invited me to speak to you several months ago, he asked me to talk about monetary policy and the Open Market Committee of the Federal Reserve System. Since, then, one of the principal interests of the Open Market Committee has been the U. S. balance of payments situation, to which we have had to pay increasing attention in recent weeks. I thought it would, therefore, be timely and pertinent if I would talk with you today about this problem and what it involves.

My career as an economist and prognosticator has been a checkered one, but in the balance of payments area I have occasionally been known to hit the nail on the head. Two years ago last month, for example, I talked to a group at the University of Kentucky on this subject, and I began with the statement that the U. S. balance of payments--or rather the deficit in that balance--was one of the most serious problems facing the country. My feeling then was that strong steps were needed to improve the situation--and these steps were not taken. It is an undesirable state of affairs when, some two years later, I can begin a talk on the same subject with the same statement.

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In every year but one since 1950, the United States has experienced a deficit in its balance of payments. In all but one year since 1950 we have paid out to the rest of the world more than the rest of the world has paid us. Total payments by the U. S. to other countries since 1950 have exceeded receipts by nearly \$35 billion; in the past seven years alone, annual deficits have totaled \$25 billion, or an average of \$3.5 billion a year. This can go on for just so long. Moreover, progress in correcting the imbalance has been very slow indeed. In 1962 through 1964, the deficit declined by only \$300 million a year. At this rate, it will take another ten years for us to wipe out the total deficit.

The situation became particularly serious in the fourth quarter of 1964. The year as a whole had been expected to show substantial improvement, and the first quarter of the year was favorable. But the situation deteriorated as the year progressed, and the fourth quarter changed the picture completely. The deficit for the fourth quarter was by far the largest in our recent history, and accounted for about half of the whole year's deficit. This development points up the fact that the balance of payments situation can change very quickly-- unfortunately, often for the worse.

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A deficit has to be financed, and the way in which it is financed has world-wide impact. This became very obvious in the fourth quarter. The United States must finance its deficits either by inducing foreigners to hold more dollars in the form of bank balances and short-term U. S. securities or by permitting them to exchange their dollars for some of our gold reserves. As bankers, we all know that no individual or business can spend more than is earned indefinitely and that we can make up the difference through borrowing or drawing down on savings for only so long. The fourth quarter of 1964 may well have been the turning point for the United States, in that we may have reached the limits of world acceptance of our continuing deficits.

Some recent events will illustrate this. In 1964 as a whole, our creditors built up their dollar balances substantially, but drew on our gold reserve by only \$125 million. That was the smallest reduction in our gold reserve in the past seven years. But this year is an entirely different story, with our gold stock already down \$450 million, over three times the entire loss of 1964. At least one European country apparently intends to exchange all future net increases in dollar claims for gold. Furthermore, there seems to be increasing resistance on the part of several major industrial nations to increasing U. S. investments in their economies. Individuals in France, Germany, the Netherlands, and Belgium have begun to grumble about American subsidiaries moving into those countries.

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These foreign attitudes may be a little easier to understand against the background of time. The United States has been running balance of payments deficits quite consistently in the postwar period. Before 1957, this was an intentional policy, in that we were trying to fill the world need for dollars to finance reconstruction from World War II. By 1958, however, most European nations had recovered from the war to such an extent that they began to use our deficit dollars to build their financial reserves. The result was the first large drain on the U. S. gold supply.

Since 1958, dollar claims held by foreigners have increased sharply, serving as a reminder that our gold stock could be threatened. Our Government has had to resort to a number of special financing arrangements to induce our creditors not to exchange dollars for gold. These technical arrangements include currency swap agreements, special Treasury bonds (known as Roosa bonds), and advance payments on foreign debts to the U. S. Most recently, a law has passed both Houses of Congress to increase the supply of gold that is free to meet the demands of our creditors. I am referring, of course, to the measure that eliminates the necessity of holding gold reserves against member bank deposits at the Federal Reserve Banks.

Now what has been causing our balance of payments difficulties in the past few years? We had some warning in 1958 that the so-called world dollar shortage of the early postwar period had turned into a dollar surplus. It was not until 1960, however, that measures were taken to counter-balance our deficits. But progress has been poor, with great expectations disappointed frequently.

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What developments in our international transactions share the blame? In a nutshell, our current earnings overseas have been less than our foreign loans and investments and Government grants and loans. In effect, we are like a bank that is over-loaned and over-invested.

An examination of the major categories of the U. S. balance of payments accounts reveals some contrasting patterns. For one thing, we have achieved a large net surplus on current account in recent years. This means that we have earned much more from the export of goods and services than we have had to pay for similar imports. Also contributing to the excellent showing of this category is the increasing stream of income from U. S. investments in other countries--income in the form of interest and dividends on foreign stocks and bonds and profits returned from overseas branches of U. S. companies.

Our past showing on current account does not convey a picture of a nation losing out in its current transactions in world markets. This is particularly true in merchandise trade where the United States has a very strong and favorable position in exports. About the only "losers" in the current account are the large annual exodus of U. S. tourists and their money to other countries and net outpayments for pensions and charity. Even these outflows reflect the prosperity of our nation.

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Unfortunately, our net earnings from sales of goods and services abroad have not been large enough to wipe out serious deficits in other categories of the balance of payments. We know that U. S. Government grants and loans abroad have been large throughout the postwar period, reflecting the role of this country as a leader of the free world. Many of the decisions that shape these flows of funds are political rather than economic, but efforts have been made to reduce the drain. The Government is struggling to improve the efficiency of U. S. foreign aid programs and to obtain more assistance from other countries in aiding under-developed areas of the world. One effective counter-measure has been to increase the proportion of U. S. aid that is spent directly on U. S. merchandise--so-called "tied aid". Government capital flows continue to represent a serious drain on our balance of payments, but recent efforts to hold down these flows have paid off.

The remaining major category in our international accounts reflects transfers of private capital. Private capital outflows have been a constant drain on our balance of payments in recent years, climbing to a peak level in the fourth quarter last year. Such outflows may be long- or short-term in nature and take many forms. Long-term capital outflows generally are divided into two parts: direct investment (spending by U. S. companies on branches and affiliates overseas) and indirect investment (extensions of longer-term U. S. bank loans abroad and U. S. purchases of foreign stocks and bonds.)

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Basically, long-term funds flow out to other countries because profit opportunities are greater there than here. U. S. funds have been readily available because of relatively easy conditions in credit and capital markets, the high level of liquidity in the economy, and the increasing volume of earnings. The outflow of direct investment has been particularly heavy to Europe, as American companies have rushed to get established in the Common Market to take advantage of tariff benefits and attractive markets. Many of the countries that have received large U. S. direct investments are the same ones that have been taking U. S. gold. Last year, the net outflow of direct investment from this country rose to more than \$2 billion.

Indirect investments also have been increasing rapidly, so much so that controls were proposed in 1963 to restrict use of our capital markets. U. S. indirect investment rose sharply during the last half of 1962 and early 1963, chiefly in the form of new foreign bonds and stocks floated in our capital markets. This development prompted the Treasury to impose the interest equalization tax, designed to make foreign borrowing more costly. The threat of the tax and its effect when enacted did have some success in restraining this type of capital outflow, but the success was limited because under-developed countries were excluded from the tax and Canada, the largest foreign borrower in the U. S. , was exempted.

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Moreover, a new and offsetting trend developed, when foreigners turned from our capital markets to our banking system as an alternative source of funds. Beginning in 1963, there was a very large expansion in the volume of term lending to foreigners by U. S. banks, lending that was exempt under the interest equalization tax. Term lending in 1964 amounted to about \$1 billion, and was four times as large as in 1962.

Some outflows of U. S. capital, including bank loans, are short-term in nature. In addition to bank loans, such transactions represent the shifting of liquid corporate funds from a bank balance here in Columbus, Ohio, or Cleveland, to a time deposit in a Canadian bank or into British or Canadian Treasury bills. Short-term capital outflows in the aggregate rose markedly in 1964, following some improvement in this area in the previous two years. Because liquid funds usually move to gain an interest rate advantage, the Federal Reserve and the Treasury have tried to keep interest rates here and abroad in rough alignment and to avoid or cushion disturbances in world financial markets that might lead to speculative runs against the key reserve currencies (the pound and the dollar). Despite all our efforts, the outflow of total short-term funds from the U. S. was not discouraged last year; in fact, the volume may even have doubled from the 1963 level to reach \$2 billion.

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The overall deficit in the fourth quarter of last year has caused grave concern in this country and abroad, particularly because it came on the heels of the currency crisis in Great Britain and despite efforts of the Federal Reserve and the Administration to correct our balance of payments difficulties. Speaking very frankly, the lack of success in controlling the deficits has weakened the international position of the dollar, put the United States in a bad bargaining position in world politics, and hampered policy actions concerning domestic economic activity. As a result, the President with the full support of the Federal Reserve System has initiated a broad-scale program to combat our balance of payments situation. Granted that some of the fourth quarter developments may have been temporary in nature, the basic problem has been going on far too long and permanent progress has been much too slow to be tolerated. As the President pointed out in his special message to Congress on the balance of payments on February 10, accelerated progress must be achieved in order to assure the "continued and growing strength" of the dollar in world markets. We have told the world that the dollar is "as good as gold", and we must strive to keep it that way so that the world will be willing to hold dollars "as a safe and convenient medium of international exchange."

The new balance of payments program has special significance for us as members of the financial community, and so I would like to spend the remaining minutes in outlining the major proposals. There are two basic parts to the program: first, recommended legislation, and second, measures needing voluntary cooperation. Let me summarize the requested legislation.

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The interest equalization tax would be extended beyond its original life to remain in effect through 1967, and broadened to cover nonbank loans with a maturity of more than one year to borrowers in developed countries. The President also imposed the tax on bank loans of similar maturity to the same borrowers. Congress has been asked to provide banks with immunity from the anti-trust laws to allow bankers to serve on committees seeking to reduce foreign loans.

Legislation also will be requested to improve tax incentives affecting the purchase of U. S. securities by foreigners, in order to encourage investment in the United States.

Recognizing the impact of foreign travel on the balance of payments, the President has asked that the duty-free exemption on overseas purchases by U. S. travelers be reduced from the present \$100 to only \$50, and applied at the retail rather than the wholesale level.

The heart of the new program--the real punch--is contained in a series of voluntary proposals applying to banks and businesses. On the one hand, the Commerce Department is going to deal with business corporations in an attempt to restrain their loans and investments overseas. For example, U. S. corporations will be asked not to increase their holdings of Canadian time deposits or British bills. Furthermore, businesses will be requested to return more foreign earnings to this country, to borrow funds abroad, and to limit the establishment or enlargement of new plants in the developed countries.

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In addition to negotiating the voluntary investment restraint program, the Commerce Department will continue its vigorous efforts to promote growth in U. S. merchandise exports. American business will be reminded again that continued wage and price moderation is essential in order to strengthen our world trade position.

The Federal Reserve System is assigned the responsibility of dealing with banks and other financial institutions (insurance companies, pension funds, charitable institutions, etc.). Banks are being asked to limit their foreign lending to finance U. S. exports and to restrict the increase in their total foreign claims this year to 5 percent of foreign loans and investments held as of December 31, 1964. Specific details about the voluntary lending restraints are still being formulated, but we already know that there will be many problems to be solved in the administration of the program. For example, we know that some banks are already forward-committed to provide credits to foreign countries in excess of the 5 percent guideline--and if these commitments are firm, they will have to be honored. At the same time, special efforts must be made to promote export credits so as not to hinder sales of U. S. goods abroad. Finally, the new restraints will not be equitable for all banks. Those just starting in the business of foreign lending will have fewer maturing foreign loans that can be renewed or extended to other foreign borrowers than banks that have been operating for a long time in the foreign field; in effect, each bank will be tied into its existing foreign loan base on the books on December 31, 1964.

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Nevertheless, despite many problems, we must remember the national importance of the entire program. We must defend the dollar and the position of the United States in world finance. The heart of the balance of payments program is voluntary, as opposed to one based on direct controls, and it is in our national interest to join in to the fullest extent. Thus far, all the Fourth District banks that I have contacted will cooperate 100 percent. There is some foreign skepticism--but I think I know the American people--and particularly bankers--better than they do. If we all pull together, we can make this thing work.

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