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TRADE, AID, AND MONETARY ISSUES IN THE U.S. BALANCE
OF PAYMENTS PROBLEM

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My assignment, as I understand it, is to talk to you about our country's balance of payments problem: about how we came to have a problem, what progress we have made in solving it, and what the prospects are for finally ridding ourselves of it in the years immediately ahead. Naturally, I shall endeavor to be faithful to the announced title of my remarks. As I go along, I shall give particular attention to how the behavior of U.S. exports and imports and aid and military expenditures have contributed to our payments problem and its solution; and I shall finish up with a few observations about the domestic and international monetary aspects of our international position.

I embark on my task of this noontime with trepidation. There probably are very few of you here today who haven't heard a great deal in recent years about the U.S. balance of payments problem; and, what is worse, many of you may already have heard more than you have cared to about it. Nor is it that I have startlingly new facts or interpretations to offer. What I shall say is very much a piece of Professor Galbraith's "conventional wisdom."

I am consoled, however, by the fact that you do have a pleasant, healthful alternative to listening; you can always take an after-lunch nap. From this it would seem that I am in a fortunate position. Either I shall enlighten you in some small degree or, if not this, then by lulling you to sleep contribute more directly to your happiness and well-being.

Before getting into substance, I must congratulate the University of Minnesota, the Department of Agriculture and all the organizations which have cooperated in the staging of this conference. I may doubt the judgment of those responsible for my being here as a speaker, but, quite seriously, there can be no doubt about the immense value of the conference itself. As one having a measure of responsibility for improving the economy of the Upper Midwest, I can congratulate those responsible for organizing the conference and you who have come to participate. Nothing could be more consistent with improvement of our region's economy than an expansion of agricultural exports. And as one having a measure of responsibility for helping solve the U.S. international payments problem, I can offer my congratulations. It is to a considerable extent in an expansion of U.S. exports--agricultural exports and, of course, nonagricultural exports as well--that we shall find what we are seeking, a permanent solution to the U.S. payments problem.

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But, now, to get on with my task. To begin, I should like to take you back to the years immediately after World War II, to a time light years ago when the U.S. found it easy to produce what by present standards were huge merchandise and current account surpluses.

In 1947 the volume of world trade was much smaller than it is today and yet our largest postwar merchandise account surplus was recorded in that year. In 1947 merchandise exports exceeded merchandise imports by \$10 billion. In 1964, our best year in a long time, the merchandise account surplus was only \$6.7 billion. And 1947, even if a record year, wasn't an altogether freakish one. Over the four years 1946-49 our merchandise surplus averaged \$6.9 billion. But over the most recent four years, 1962-65, our merchandise account surplus averaged only \$5.2 billion. And over the late

1940s our current account surplus, or balance on goods and services account, averaged \$8.0 billion. In contrast, through 1962-65 it averaged only \$6.7 billion.

As most everyone is aware, though, the late 1940s were not "good old days." The very large and impressive U.S. merchandise and current account surpluses of this period were the product of unnatural, politically unhealthy circumstances and, more particularly, the blow which World War II dealt European economies. That these circumstances had to be altered the U.S. government acknowledged when, early on in the postwar period, it adopted large-scale grant and loan programs--including that monument to enlightened self-interest, the Marshall Plan. In recent years, of course, the total of government grants and loans to foreigners has been considerably less than it was in the late 1940s, when this flow averaged \$5.5 billion per year.

Perhaps the most important effects of the Marshall Plan were political in nature. But by making possible a greater volume of European purchases of U.S. production than otherwise there could have been--by making possible, in other words, the large merchandise and current account surpluses of which I have spoken--the Plan probably speeded up European recovery and hastened the decline of the U.S. as the overwhelmingly dominant power in world markets. In explaining this decline, though, one must go beyond mention of the Marshall Plan. Mention must be made of the European exchange rate devaluations of 1949 and the Korean War. The 1949 devaluations improved considerably the European competitive position. And so presumably did the Korean War, which produced more than a little inflation in the U.S. The Korean War may also have reduced, at least for a time, the supply of U.S. output to foreign markets and reawakened U.S. interest in European goods and services. I might note here in passing that many students of international economics believe

the full effects of the 1949 devaluations and the Korean War were not immediately reflected in our balance of payments account; they believe the U.S. competitive advantage was quite sharply reduced, but that this was only gradually revealed with the continuing recovery of European economies from the devastations of World War II.

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The first year of the Korean War, 1950, witnessed very sharp declines in our merchandise and current account surplus and, by the "liquidity" definition at least, our first postwar balance of payments deficit. For a good many years thereafter our merchandise and current account surpluses continued to run at levels much below those of the late 1940s; over the years 1950-56 these surpluses averaged, respectively, 42 per cent and 29 per cent of what they had averaged over the years 1946-49. And the deficits persisted through 1956, although they were for the most part smaller than those of 1958 and the years following.

Our shrunken surpluses and persisting payments deficits did not, *however, alarm the government.* In fact, the deficits were welcomed. How else were other countries to gain reserves, or reach the position where they could dismantle foreign exchange controls and make their own currencies generally convertible? And these deficits of the early and mid-1950s, for the most part relatively small, did not result in large gold losses. Between the end of 1949 and the end of 1956, the U.S. gold stock declined but \$2.5 billion; and, more importantly, at the end of 1956 the gold stock was still larger, by almost \$2 billion, than it had been at the close of World War II. It is well to remind ourselves that through most of the 1950s the dollar, as an international reserve asset, was a much better substitute for gold than, for some countries anyway, it is today.

Even at the end of 1956, then, after seven years of deficits ranging

between \$300 million and \$3.6 billion, any sort of crisis of confidence in the dollar was still several years in the future. And the year 1957 was, from the standpoint of the U.S. balance of payments, a good one. Thanks largely to the Suez crisis, we had a large current account surplus in 1957, a surplus which for the first time in many years came close to those of the late 1940s. Further, in 1957 we experienced an over-all balance of payments surplus and an increase of more than \$1 billion in our gold stock. But the three years 1958-60 were not good ones. Current account surpluses were small during these years; indeed, in 1959 there was for all practical purposes no current account surplus. During these years, then, there were no large current account surpluses of foreign exchange which could be used to finance overseas military expenditures, increased somewhat from prior years, and government aid payments. Or to finance long-term investments in Europe and elsewhere around the world. The combined private long-term capital outflow, direct investment and portfolio investment, would grow larger in the 1960s, but it first became considerable in 1956.

In sum, there were through 1958-60 large balance of payments deficits. And these years witnessed a gold outflow of dramatic proportions; between the end of 1957 and the end of 1960 the U.S. gold stock declined \$5 billion or 22 per cent.

Thus, 1960--or, more exactly, October 1960--was the top of the watershed. If the U.S. had a balance of payments problem before 1960, few of our officials or economists were aware of it; there undoubtedly were some prescient individuals, but not many. Responsible officials could not, however, fail to grasp the significance of the speculation in gold which occupied the late summer of 1960 and which in October pushed the London gold market price to \$40 per ounce. By the admission of highly placed U.S. monetary officials,

it was this October 1960 episode which convinced them that the U.S. badly needed to restore confidence in the dollar and would henceforth have to examine all domestic economic policies for their balance of payments implications.

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For most of us, the tendency is to associate balance of payments deficits with prosperous or even excessively prosperous times. We tend to think of domestic economic expansion as increasing the demand for imports, decreasing the supply of exports and, if it proceeds to a high level of resource utilization, as throwing the balance of payments into deficit. Nor can there be any doubt about this; for evidence one has to look no further than the postwar record of the U.S. Yet prosperity at home can't be the whole of our story, for 1958 and 1960 were not years of low unemployment or rapid economic advance. There was rapid advance in 1959 and this was reflected in the behavior of our exports and imports. But even in 1959 unemployment averaged as high as it did in 1954, which was a recession year.

What we must conclude, I believe, is that the dollar crisis of late 1960 caught the U.S. not in the grip of inflation but of excessive unemployment. It found the U.S. not on its way to an inflationary cyclical peak but in a mild recession; and, on trend, the U.S. economy was moving not rapidly upwards but pretty nearly sideways.

Now the nice feature of traditional thinking about balance of payments surpluses and deficits--in which, as I've said, most of us indulge most of the time--is that it keeps domestic and international or internal and external economic objectives consistent. If balance of payments deficits occurred only in prosperous or excessively prosperous times and surpluses only in times of excessive unemployment, then the appropriate domestic

economic policies would always serve perfectly the external objective of balance in the international account. But in 1960, there was, as we have seen, no sweet harmony. Domestic economic conditions demanded an expansionary economic policy. And our international position demanded a restrictive economic policy. Or if not a restrictive over-all economic policy, at least a restrictive monetary policy. It mattered not whether in fact the European devaluations of 1949 and thereafter and the inflationary outbursts which marked the early and mid-1950s had seriously impaired the U.S. international position, for this is what much of the western world believed. And a reserve currency country, like a bank, must respond to what its creditors think.

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What I've just been saying can be put differently. Back in late 1960 it became clear that the U.S. had to adopt as a policy objective a virtual elimination of balance of payments deficits. But it was also clear from the start that this objective was only one of several. There was the objective of a return to full-employment. And military and foreign policy objectives couldn't be disregarded. Overseas military and aid expenditures couldn't be abruptly ended. (Or so the government believed. And rightly, it seems to me.)

Actually, if in 1958-60 the U.S.'s international position, as measured by its over-all payments surplus or deficit, suddenly worsened, this worsening wasn't caused by a sharp increase in overseas aid and military expenditures. The net outflow of government grants and loans did average slightly more over the years 1958-60 than it did over the mid-1950s, but considerably less, I might add, than over the late 1940s or than it would in the 1960s. And overseas military expenditures were higher in the late 1950s than in the mid-1950s, but not much higher. One cannot therefore find a

simple total explanation for the payments deficits of 1958-60, which brought in our first dollar crisis, in the behavior of U.S. overseas and military expenditures.

I said just a moment ago that our government has apparently never felt it was wise to sacrifice military and foreign policy objectives to a quest for balance of payments equilibrium. I didn't mean to suggest, however, that nothing has been done to make overseas military and aid expenditures more consistent with our international position. Quite the contrary. The net outflow of government grants and loans did increase between 1959 and 1964; and over the years 1961-65 averaged about \$500 million more than over the years 1958-60. But the higher outflows of recent years probably had a less unfavorable effect on our over-all payments position than did the smaller outflows of the years 1958-60. I of course have in mind the efforts of the government to "tie" aid expenditures, to make aid recipients purchase U.S. goods and services. Even granting that aid expenditures are, as the experts say, "fungible," there must have been some net gain obtained from these efforts. And if overseas aid expenditures have increased, overseas military expenditures have been decreasing. Or were until quite recently. Even in 1965 overseas military expenditures were only infinitesimally greater than in 1964. This is remarkable, given the expansion of the Viet Nam war effort, and indicative of the drive the Defense Department has made to make our military commitments increasingly consistent with our international position

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Among the several promises implicit in the announced title of these remarks of mine, there is one--to talk about monetary issues in the U.S. balance of payments problem--which I've hardly begun to fulfill. I did indicate a few moments ago that late 1960 and early 1961 found administration

and Federal Reserve officials alike facing conflicting demands, to move the economy closer to full-employment and, at the source, reduce our payments deficit. The issue, then, for administration and Federal Reserve officials alike, was how to resolve these conflicting demands. Actually, I would have done better to say seemingly conflicting demands. It is true that if a government restricts itself to using either monetary policy or fiscal policy, it cannot achieve both a reduction in the unemployment rate and a reduction in its payments deficit. An expansionary monetary policy will reduce unemployment; it will also, however, increase the payments deficit. But by using monetary and fiscal policies in concert, a government can simultaneously pursue the seemingly conflicting objectives of lower unemployment and a smaller payments deficit. And using monetary and fiscal policies in proper combination is precisely what the administration and Federal Reserve did through the period 1961-65. Fiscal policy was expansionary; if government spending increased only slowly at times, there were tax reductions in 1962, 1964 and 1965. And the effects of the expansionary fiscal policy were offset--but, most importantly, not entirely--by the effects of what was as the years went by an increasingly restrictive monetary policy.

Such sophistication in the design and execution of monetary and fiscal policies as we got through 1961-65 is deserving, I believe, of our praise. I can say this in good taste for I joined the Federal Reserve System late in this period--to be exact, in the spring of 1965--about the time our troubles gained a new impetus, for which I can be given no credit either, may I hasten to add. Not that the coordinated effort of the administration and the Federal Reserve, the coordinated use of monetary and fiscal policies, was crowned with complete success. We had a payments deficit last year and the outlook, about which more presently, is for another in 1966. Still, we have

survived. Indeed, we have come a long way toward our objective of full-employment, possibly even a bit too far, and yet the dollar is stronger today than it was in 1960-61.

In some considerable measure, of course, it was the willingness of the administration to deal selectively with capital outflows--to institute the Interest Equalization Tax and the Voluntary Credit Restraint Program--that enabled us to make progress both domestically and internationally. But in parceling out credit, we shouldn't overlook the properly coordinated monetary and fiscal policies of the last few years.

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So far I have been speaking of the past, of the emergence of the U.S. balance of payments problem and, if very incompletely, of how our government responded to the problem. I should like to turn now, then, to the future. I shall have to be brief; and for several reasons, the most important of which is that the role of a soothsayer is fraught with far more dangers than that of a historian. But I would like to say a little something about the balance of payments outlook and a little something about a second monetary issue in the U.S. balance of payments problem, that of international monetary reform.

In late 1965, the Treasury--lately our most optimistic of federal agencies--announced that 1966 would see the U.S. return to balance of payments equilibrium. Since then even Secretary Fowler's optimism has faded. There was the escalation in Viet Nam which will make overseas military and aid expenditures greater than it was thought they would be. And last fall it wasn't foreseen that the economy would be as buoyant as it has been. And, as I said before, there is no denying the effect of economic expansion, or high levels of resource utilization, on a country's balance of payments. Now, therefore, the outlook is for little if any improvement in our balance of

payments this year; it could even be that unless there is a tax increase or further monetary restraint there will be a modest deterioration.

What we must be careful of, however, is misreading what happens this year. Suppose it turns out that this year's deficit is about the same as last year's. Or even somewhat greater. We shouldn't be too quick to interpret such a result as "back-sliding." We shouldn't be surprised or dismayed to find that a country living through a boom of great proportions and fighting a costly overseas war should experience a slight deterioration in its balance of payments.

There is something to worry about in the present economic situation--namely, the possibility of ^asharp rise_^ in the prices of our manufactured goods. If we get such a rise, then truly we shall have lost ground. In recent years our current account surplus, which in a manner of speaking pays for our overseas aid expenditures and foreign investments, has on trend been increasing. Over the years 1963-65 this surplus averaged \$7.2 billion or about \$5 billion more than over the years 1958-60. And over these same years our merchandise surplus averaged \$5.5 billion or \$2.5 billion more than over the years 1958-60. There is in this fact the suggestion that our competitive position has improved, that if we lost international competitive position during the 1950s, we have managed some improvement since. But because an even larger merchandise account surplus than we have lately averaged is imperative if we are to persevere to a final solution of our balance of payments problem, it is quite essential that we keep free of inflation. And quite essential, I might add, that more conferences of this very sort be held around the country.

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I am optimistic that one day soon, within the next few years, we shall find ourselves having reattained balance of payments equilibrium--and

without the help of selective control of capital outflows. Many officials and economists believe this and, paradoxically enough, are worried by the prospect. It is the prospect of the U.S.'s return to payments equilibrium which makes us wonder from where new supplies of international reserves, entirely necessary for the continuing growth of world trade, are going to come. For years now, the U.S., in running payments deficits, has been supplying the world with reserves. Of course, as foreign dollar holdings have mounted, the dollar has become a less good reserve asset. But the prospect of no flow of dollars into world reserves is still disconcerting. As you know, current gold production isn't anywhere near great enough to meet the ever-growing world demand for international reserves.

It was a recognition of what the U.S.'s return to international equilibrium would mean that prompted Secretary of Treasury Fowler to call together the leading industrial countries of the western world to find a solution for the problem of international reserves and for almost a year these countries' representatives have been hard at it. How far they have got we presumably should know presently, for a report from the so-called Group of Ten is scheduled for mid-year. We mustn't be too optimistic. Differences of interest, political and economic, and opinion between the various countries involved are great and will not, I believe, be easily compromised. Fortunately, there is still time. There is at present no great shortage of international reserves; an immediate retreat into economic isolationism isn't in the offing. We can take some comfort in not having waited on the threat of near-catastrophy before starting international monetary discussions. But whether we shall make much progress before other countries--those which aren't reserve currency countries--see clearly that the handwriting on the wall was meant for them to read, *is another matter,*

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Excerpt from remarks made by Governor J. Dewey Daane
before the Investment Bankers Association meeting
At White Sulphur Springs, West Virginia, May 12, 1966

.....If one asks oneself what have been the sources of new international reserves over the last decade or so, the answer is that the rest of the world has depended to a very large extent on increases in holdings of dollars and on gold mainly acquired from the United States. In other words, the rest of the world has been dependent on balance of payments deficits in the United States for increases in international reserves.

The attempt to turn a
complex problem of this kind
into a simple moral question
for the heart to answer, is of
course a necessary part of all
political discussions

Frank Colby

Meanwhile, we have enough to occupy us at home. As I hope I've made clear, we still have a balance of payments problem to solve. We've made considerable progress in reducing our payments deficit, but in some measure by resorting to direct control of foreign investment and we must look forward to the day when such control will no longer be necessary. It would be wrong to think that our interest in investing abroad will soon diminish. Or that our foreign policy and military objectives will soon change in such a way as to put sharply lessened pressure on our international payments position. We must look for merchandise and current account surpluses even greater than those of the past few years. And in achieving these surpluses, there are roles to be played by both the government and the business community. The government has got to make sure that domestic inflation does not erupt and impair our business community's competitive position. It has got to keep pressing for greater access to foreign markets for U.S. businessmen and continue its efforts to acquaint them with overseas opportunities for profit. And what have U.S. businessmen to do? Nothing beyond searching out profitable opportunities abroad with the same zeal they have displayed in searching domestic markets.