Notes in Preparation for a Meeting of the
Balance of Payments Committee
of the Business Council

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September 19, 1963.

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1. The basic problem remains much as it has been, although the published figures for the second quarter of 1963, showing a deficit at an annual rate of $5.2 billion gave the problem an alarming and presumably exaggerated tinge.

2. Nevertheless it was the knowledge of this kind of a second quarter record, and of the step-up in U. S. portfolio investment in foreign securities which was the immediate cause of the worsening figures, that triggered the hasty proposal of an "interest equalization tax" to try to check such investment.

3. While this tax is in the no-man's land between executive proposal and Congressional action, this type of capital flow is in a state of suspended animation. I doubt if it is possible to produce figures which would accurately indicate what its effect on the movement of portfolio capital, over time, may be if and when it is in actual operation. Nor has there been time and opportunity to see what its ultimate effects might be on foreign confidence in our maintenance of freedom from control of other dollar movements. In principle, however, I see no reason to revise earlier views that the proposal of an interest equalization tax was a mistaken departure from a general policy of non-interference with the international movements of private capital. The proposal attempts to zero in on one sector of a market which is notably fluid in character, and which will find ways to function, abetted by the variety of exemptions from the tax which have been found necessary to make it even partially workable. In effect, it is a proposal for a capital issues experiment, the mechanics of which involve the arbitrary distinction between developed and less developed countries, the difficult distinctions in equity between direct and portfolio investment abroad, and the placing of the power in the hands of the President, by executive order, to grant exemptions in the "interest of international monetary stability". (The Canada escape hatch - and maybe others.) If our situation had reached the point at which freedom of international access to our capital market had to be curtailed, it would be less confusing and more directly effective to have a capital issues committee.

4. I do not think we have reached that extremity. The relative strength of our economy and its ability to compete in the markets of the world is still unquestioned. We are a most solvent nation. It is our liquidity position which has been jeopardized by a succession of years of large deficits in our balance of payments and by the apparent check to improvement in our position during the past year. But we still have the resources to protect our liquidity position, if we adopt a program of improvement in our balance of payments which carries within itself the seed of success. Our domestic reserves are still large, and can be further enlarged if we find it necessary to reduce our

gold reserve requirements. Our access to drawing rights and credits at the International Monetary Fund and our bi-lateral currency arrangements with the principal countries of western Europe are a substantial defense against sudden adverse developments. We still have time to finish putting together a program which will attack a basic weakness instead of fluttering around the edges of the problem.

5. Such a program, of course, is the one we have been recommending, which transfers to fiscal policy (tax reduction) more of the task of promoting economic growth at home and releaes monetary policy to deal more actively with international capital movements by way of impersonal and pervasive changes in the availability of credit and in interest rates.

6. It is noteworthy, I think, what muffled emphasis has been placed on tax reduction as an important factor in improving our balance of payments. It has been mentioned, but fearfully as if it would stir up too much opposition, from those who want easier, not tighter, money and lower, not higher, interest rates, if the connection were stressed. It would stir up opposition, of course, but we can't lick this problem with gifts for everyone. If the fiscal-monetary policy mix is to work, there has to be room for a further increase in short term rates, if necessary, and for some increase in long term rates also, if necessary. The dangers of this prescription for the domestic economy have been over-stated, particularly as it relates to long term rates. An economy stimulated by the increased demand and the increased retention of profits by the private sector, inherent in a reduction of individual and corporate income taxes, could stand an increase in long term rates without faltering, particularly as important long term markets - mortgage, consumer credit and municipals - have their own forms of insulation from ordinary market effects fo higher rates, OR ARE SLOW IN THEIR RESPONSE.

7. We should again press for the combination of tax reduction and a less easy credit policy to be justified, in an important way as a major means of improving our balance of payments position. And we shouldn't, at this stage, encumber our advocacy with reservations demanding some specific reduction of estimated federal expenditures in fiscal 1964. There is too much spending already built in to fiscal '64 to make this a practical approach. The time to curb federal expenditures will be in subsequent fiscal years, to prevent their rising with the increase in government revenues which is the hope of tax reduction, ultimately.

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The study of the balance of payments made by six economists for the Brookings Institution, at the request of the President through the Council of Economic Advisers, does little to help us in our present situation. The estimates of the balance of payments in 1968, based on a variety of assumptions (the quality of which is admittedly speculative) showing a "basic balance" somewhere between a surplus of $1.9 billion and a deficit of $600 million, does little to meet the doubts of 1963, 1964 and

1965. And the counsel to avoid pre-occupation with the immediate discipline of the balance of payments, because it may interfer with more important goals of national and international policy, is positively mischievous. The integrity of the dollar and other goals of national and international policy are one and indivisible. Finally, the diversion of attention, in the policy recommendations of the report, to the asserted need for measures to improve international liquidity is an excursion into a realm beloved of scholars and the British, who have been beating this drum for years. To adopt the major policy recommendation of the report that the U. S. should immediately begin to press for an agreement to strengthen international liquidity, and that its major effort should be directed toward achieving an adequate international liquidity mechanism, would be the equivalent of saying the present mechanism has broken down, or is about to break down, which could not help but harm the position of the dollar in terms of fears of ultimate devaluation.

"Further study" by the International Monetary Fund is indicated here; not pressure by the U. S. to retrieve British chestnuts.

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The Freeman proposal of a tax incentive to promote exports, which was distributed on July 29, 1963, seems to me to be wrong in principle and wrong in practice. In principle, it would be an attempt to subsidize exports which is the kind of export competition between the leading industrial countries which has already gone pretty far, and which we should be seeking to abate, not promote. In practice, as Mr. Freeman describes it, a tax reduction related to an increase in exports over some base period would lead to a variety of inequities between competing firms which have developed their export lines and those which have not, between companies which have made large direct investments abroad and those which have not, and between large and small firms. And a tax credit which would enable some firms to export at a "modest profit or even at cost" because an increase in exports would reduce the tax on its income from domestic business, sounds like a pocketfull of fish hooks.

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