Monthly Review

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TWELFTH FEDERAL RESERVE DISTRICT

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In This Issue

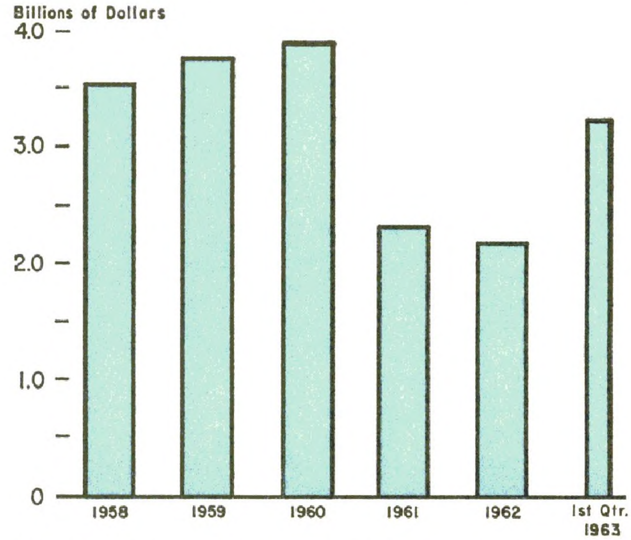
Reducing Our Payments Deficit: A Progress Report

FIGURES recently released, indicating that the United States balance of payments deficit in the first quarter of 1963 totaled \$3.2 billion at a seasonally adjusted annual rate, stimulated re-examination of the progress achieved so far in reducing our payments gap. The failure of the deficit to decline below the figure for the final quarter of 1962 generated pessimism in some quarters, which was counteracted only in part by official assurances that progress had been, and is being, made toward balancing our international accounts. Preliminary estimates that the outflow of funds continued into the second quarter of 1963 at an undiminished rate and that there was little improvement in our payments position resulted in a special Presidential message to Congress detailing further constructive steps to reduce the payments gap.

A look at the detailed balance of payments accounts for the first three months of 1963 presents the casual observer with a rather bleak picture. The merchandise trade surplus, at a seasonally adjusted annual rate, was only \$4.1 billion, compared with \$4.3 billion for 1962 as a whole.[1] The surplus on nonmilitary service items in the first quarter of 1963 was little changed from the 1962 figure, and there was only a small reduction in the net outflow of funds on military transactions. As a consequence, the balance on goods and services of \$4.8 billion at an annual rate (including Government-financed shipments) was about the same as in 1962.

The first quarter outflow of United States Government grants and other capital at a \$3.7 billion rate was larger than both the preceding quarter and 1962 as a whole because advance loan repayments were negligible in

First quarter 1963 payments deficit almost half again as large as in 1962



Note: First quarter 1963 at a seasonally adjusted annual rate.
Source: United States Department of Commerce.

the most recent quarter. Total recorded net United States private capital outflows were significantly higher at \$3.8 billion. Private capital exports were bolstered by acquisition of stock in a French automobile firm by a major United States automobile producer and by a record volume of foreign security flotations in the United States capital market, while additional private capital moved overseas into purchases of existing foreign securities. These outflows were partly counterbalanced by repayment of long- and short-term bank loans (particularly by Venezuela and Japan) and some return flow of funds to the United States by foreign banks that had repatriated dollar funds at the end of 1962 for window-dressing purposes. There was a small net inflow of funds on short-term private capital account in the first quarter, on a seasonally adjusted basis, mainly because of loan repayments. In the same quarter, foreigners also were net investors in the United States in private portfolio and other long-term investments and in special nonconvertible long-term Treasury securities, although the Treasury transactions

[1] If Government-financed exports are excluded, the excess of exports over imports on private account was only \$2.0 billion in 1962 and \$1.6 billion at a seasonally adjusted annual rate in the first quarter of 1963, compared with \$3.2 billion in 1961. The deterioration from 1961 to 1962 in the privately financed trade surplus was due to a strong upsurge in imports in 1962 in response to the quickened pace of domestic economic activity.

UNITED STATES BALANCE OF PAYMENTS, 1958-63

(billions of dollars)

	1958	1959	1960	1961	1962	1st Qtr. 1963[1]
Current account						
Merchandise exports	16.3	16.3	19.5	19.9	20.5	20.0
Merchandise imports	−13.0	−15.3	−14.7	−14.5	−16.1	−16.0
Trade balance	3.3	1.0	4.7	5.4	4.3	4.1
Military sales	0.3	0.3	0.3	0.4	0.6	0.7
Military expenditures	− 3.4	− 3.1	− 3.0	− 2.9	− 3.0	− 3.0
Balance	− 3.1	− 2.8	− 2.7	− 2.5	− 2.4	− 2.2
Nonmilitary service exports	6.5	6.9	7.2	8.0	8.7	8.7
Nonmilitary service imports	− 4.5	− 4.9	− 5.4	− 5.4	− 5.8	− 5.8
Balance on services	2.0	2.0	1.7	2.6	2.9	3.0
Balance on goods and services	2.2	0.1	3.8	5.4	4.8	4.8
Capital account and grants						
Remittances and pensions	− 0.7	− 0.8	− 0.7	− 0.7	− 0.7	− 0.9
U. S. Government capital						
Grants and loans (gross)	− 3.1	− 3.0	− 3.4	− 4.1	− 4.3	− 4.3
Repayments	0.5	1.1	0.6	1.3	1.3	0.7
Total	− 2.6	− 2.0	− 2.8	− 2.8	− 3.0	− 3.7
U. S. private capital						
Direct investments	− 1.2	− 1.4	− 1.7	− 1.6	− 1.5	− 2.2
Long-term capital	− 1.4	− 0.9	− 0.9	− 1.0	− 1.2	− 1.8
Short-term capital	− 0.3	− 0.1	− 1.3	− 1.5	− 0.5	0.2
Total	− 2.9	− 2.4	− 3.9	− 4.2	− 3.3	− 3.8
Foreign nonliquid capital						
Private liabilities	*	0.9	0.3	0.6	0.2	0.1
Government liabilities	[2]	[2]	*	0.1	0.9	0.5
Balance on grants and capital	− 6.2	− 4.3	− 7.0	− 6.9	− 6.0	− 7.8
Errors and omissions	0.4	0.4	− 0.7	− 0.9	− 1.0	− 0.2
Over-all balance (deficit —)	− 3.5	− 3.7	− 3.9	− 2.4	− 2.2	− 3.2

*Less than $50 million.
[1] Seasonally adjusted annual rate. [2] Not shown separately.
Note: Minus sign indicates outflow. Data may not add to totals due to rounding.
Source: United States Department of Commerce.

were on a much smaller scale than in the preceding quarter. The movement of foreign funds into the United States was the largest since the stock market break in May and June of 1962 which had acted to dampen the interest of foreign investors in United States securities. Unrecorded transactions (errors and omissions), on the other hand, added to the outflow of funds from the United States, but at a substantially lower rate than in the third and fourth quarters of 1962.

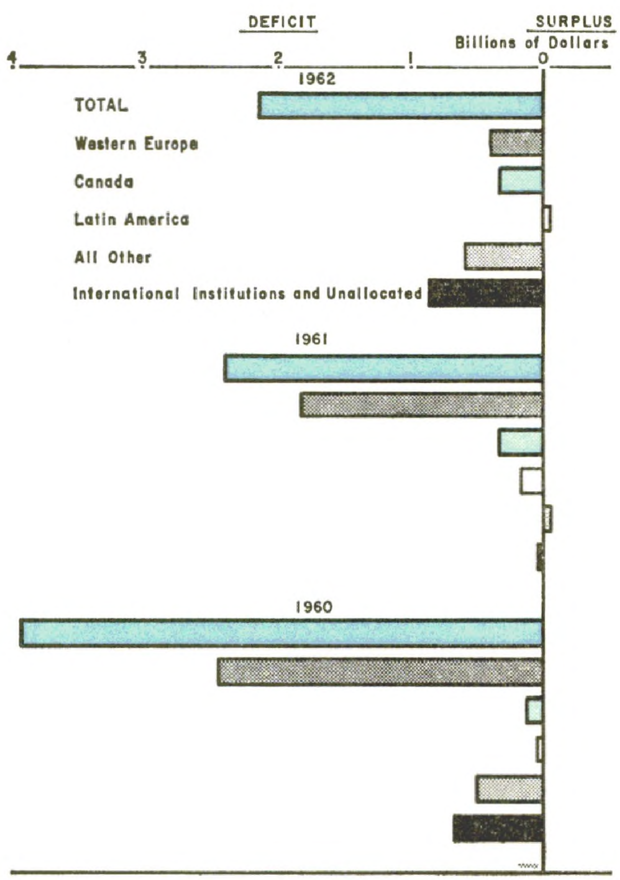
The net result of these transactions — a deficit larger than in the last quarter of 1962 and at an annual rate almost 50 percent greater than the payments gap for all of 1962 — was not very encouraging. But a number of extenuating circumstances tend to brighten the picture. In the first place, special transactions that helped to keep the deficit down were substantially lower than in any of the preceding four quarters. Merchandise trade for the first quarter, moreover, was distorted by the dockworkers' strike that began in late December and lasted through most of January, tying up foreign trade operations on the East and Gulf Coasts. Exports were affected more adversely by the work stoppage than were imports. At the end of March, a backlog of cargo was reported to be still awaiting shipment. Other balance of payments developments during the quarter, although seemingly minor, promise longer term beneficial effects for our payments position. These include the maintenance of military sales at the higher levels recorded in 1962 as a partial offset to our military expenditures abroad, some signs of a revival of foreign investor interest in United States securities, the small net inflow of short-term capital, continuation of the Treasury program to strengthen United States defenses against short-term capital flows, and Treasury sales to foreign monetary authorities of special nonmarketable securities denominated in foreign currencies to minimize gold losses. The rise in direct investments abroad and the absence of advance debt repayments in the latest three-month period are not necessarily adverse for our over-all balance of payments position since these two types of flows by their very nature occur at discrete intervals. The distribution of gold and dollar gains among foreign countries through transactions with the United States also continued to be more favorable than it had been in 1960 and 1961. With the exception of France, which accumulated sizable amounts of gold and dollars in the first quarter, most of our deficit was incurred with countries that tend to hold a major share of their reserve gains in the form of dollars.

The reception accorded the announcement of the first quarter deficit to some extent resembled public reaction to many recent balance of payments developments—a reaction that tends to underrate the action that has been taken to eliminate our payments imbalance and to strengthen the United States payments position over the longer run. In this connection, it should be stressed that the appearance of sizable United States deficits was not an overnight phenomenon but a development that emerged gradually over a number of years as the economies of the war-torn countries recovered and as international payments were freed from many of the restrictions of the immediate postwar period. It is therefore unrealistic to expect all the necessary structural adjustments to be completed in a period of two or three years since many of these adjustments necessitate basic changes in both Government and private policies, procedures, and attitudes and in international trade and payments relationships. Consequently, it might be useful at this time to examine the principal measures that have been taken at home and abroad to improve our payments position and to increase the effectiveness of the international payments mechanism, in order to place our current performance in somewhat better perspective. Too much emphasis has been placed on gold losses, which — although a manifestation of the underlying imbalance in our payments position—are strongly influenced by the geographical distribution of dollar gains, while too little attention has been paid to the more fundamental, far-reaching but slower acting developments that have been taking place.

Short-term capital outflows down to more manageable proportions

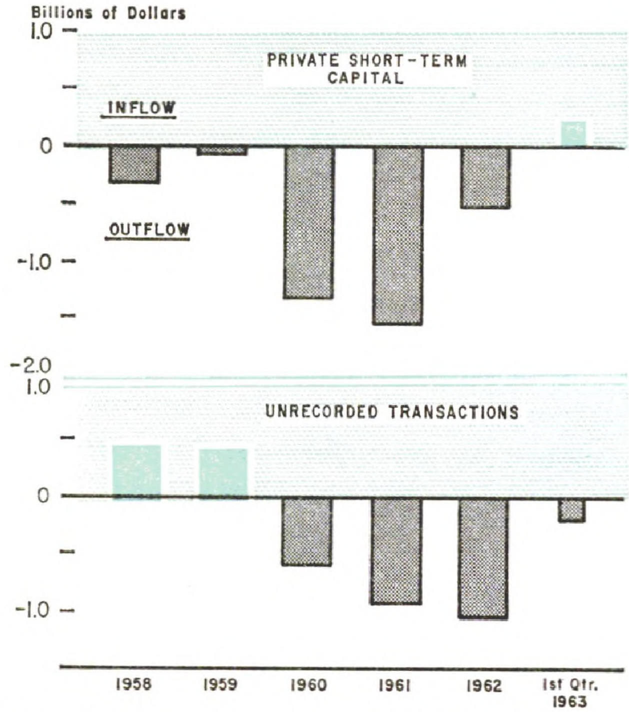
The sizable short-term capital outflows (including the outflow through unrecorded transactions) in the latter part of 1960, which

Distribution of foreign gold and dollar gains recently has been somewhat more favorable



Source: United States Department of Commerce.

U. S. short-term capital flows down to more manageable proportions



Note: First quarter 1963 at a seasonally adjusted annual rate.
Source: United States Department of Commerce.

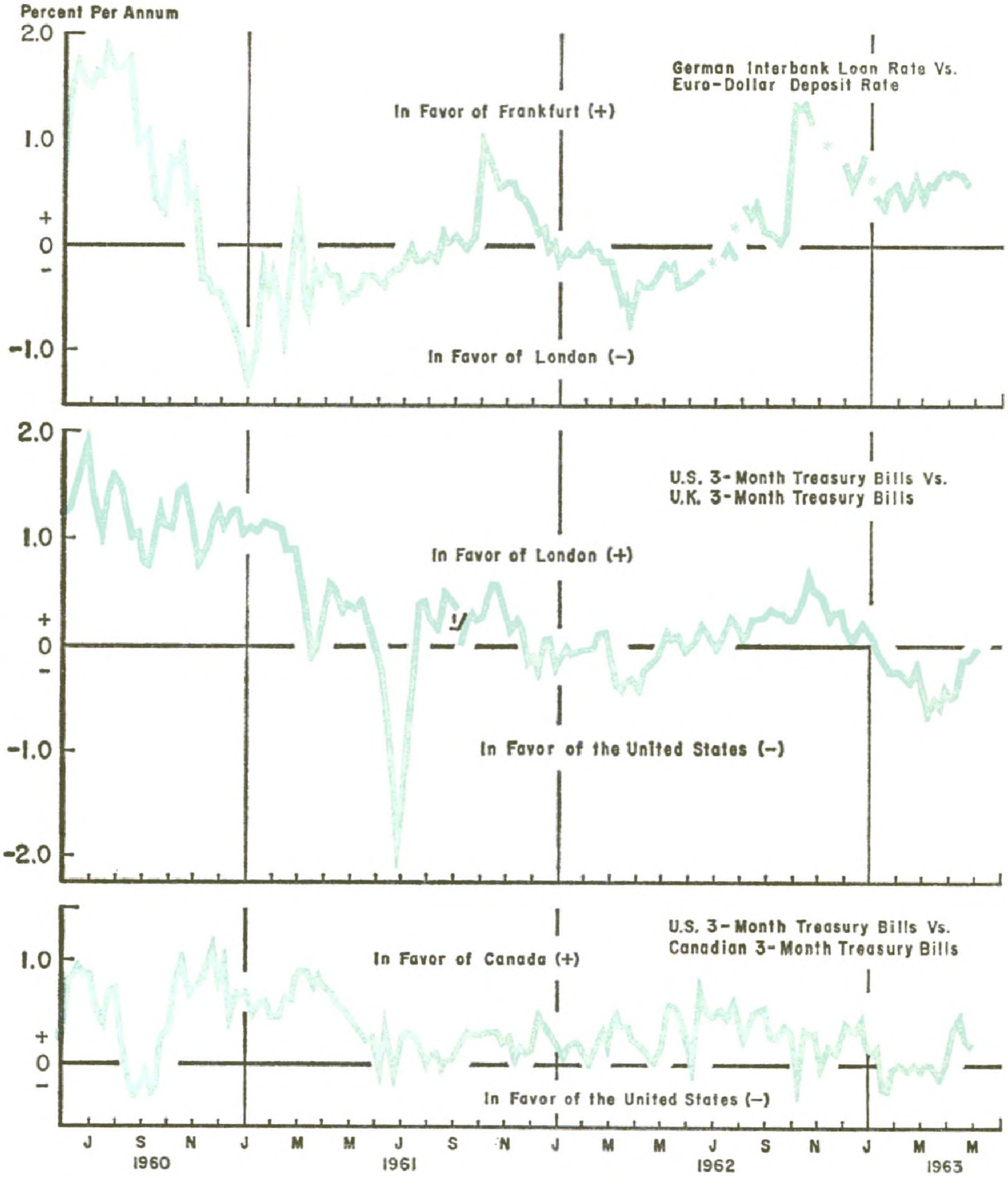
reached a record rate of $3.5 billion in the fourth quarter of that year and occasioned a heavy run on the dollar, have now fallen to more manageable proportions. The 1960 crisis was brought about by the cumulated weight of various developments which converged in the fall of that year. Persistent payments deficits despite large surpluses on merchandise trade, increases in short-term capital exports because of boom conditions abroad, more attractive yields on foreign short-term investments, and more favorable prospects for capital appreciation combined with sizable gold losses, rumors of dollar devaluation, and fears of renewed inflation in the United States to trigger the run on the dollar. The flight from the dollar was arrested by a series of measures, principal among which were official denials of any intention to devalue our currency, adaptation of United States monetary and debt management policies to take balance of payments considerations into account more explicitly, British intervention in the London gold market to discourage speculation against the dollar, and measures adopted by the major European countries to stem the inflow of short-term funds. Short-term capital outflows from the United States have since been reduced significantly, and short-term capital movements now finance mainly international trade and service transactions. The so-called errors and omissions figure, however, remained large in 1962, possibly reflecting leads and lags in payments with Canada and Japan when these two countries experienced payments difficulties. Gold and dollar accruals to western European countries from unrecorded transactions were almost halved between 1961 and 1962.

Defenses against disruptive short-term capital movements have been strengthened

An impressive and effective arsenal of weapons has been developed since 1960 to deal with future massive flows of hot money between countries. At home, the Treasury and the Federal Reserve System have cooperated to maintain short-term rates at levels that help to minimize the outflow of short-term funds from this country through debt management and open market operations. As a further step, in March 1961, the Treasury began operations in the foreign exchange markets to reduce fluctuations in exchange rates and thus weaken possible speculation against the dollar. Early in 1962, the Federal Reserve System also initiated operations in foreign exchange by concluding a series of foreign currency swaps with foreign central banks. These swaps provide credit facilities in foreign currencies to the parties concerned. Under the terms of these swaps, either party may draw foreign currencies for use in the exchange markets when needed to dampen sharp exchange rate fluctuations and to combat speculative pressures on exchange rates. In the latter half of 1962, the Treasury started to sell special foreign currency bonds of 15 month's maturity or longer to foreign monetary authorities. The proceeds have been added to the Treasury's holdings of convertible currencies or serve to absorb dollars held by countries that might otherwise use the dollars to purchase gold from the Treasury.

Additional measures were taken by the Federal Reserve System to reduce the incentive to invest short-term funds abroad. The increase in January 1962 in the maximum interest rate payable on savings deposits and on time deposits of more than six months' maturity was designed partly to increase the attractiveness of such holdings to foreigners.

The incentive to shift short-term funds abroad has declined



*Not available.
[1] Change in reporting basis from average tender rate to market rate.
Source: Board of Governors of the Federal Reserve System.

The three-year suspension in October 1962 of interest rate ceilings on time deposits held by foreign monetary authorities and certain international financial institutions under Regulation Q also was intended to achieve similar results. The latest steps—taken in mid-July 1963 for balance of payments reasons—included an increase in the discount rate of Federal Reserve Banks from 3 percent—which had been in effect since September 1960—to 3½ percent, and a boost from 3½ percent to 4 percent in the maximum rate payable on time deposits with a maturity of more than 90 days and less than 1 year.

After the run on the dollar in late 1960, major financial centers abroad took action to lower their interest rates and discourage capital imports, so that the incentive to shift funds abroad has been narrowed or even eliminated in some cases. Germany and Switzerland instituted various measures to discourage the influx of foreign capital, and they deliberately placed greater reliance on weapons other than interest rate policy to restrain domestic expansion because higher interest rates would have tended to draw more funds toward them with consequent adverse balance of payments repercussions. Interest rate differentials between the United States and Canada and between the United States and the United Kingdom, at the present time, provide relatively little incentive for short-term investment abroad on a covered basis. The Bank of England's discount rate was steadily reduced from the crisis level of 7 percent established in July 1961 to its present level of 4 percent as the domestic economy and balance of payments position of the United Kingdom strengthened. The Canadian bank rate similarly was cut from the 6 percent level fixed in June 1962 to 3½ percent by May 1963. Various other central banks also have aligned their domestic interest rates more closely with rates in other countries so as to reduce the flow of interest-sensitive balances between countries. Some funds, however, are reported still to be moving into the Euro-dollar market and into Canadian commercial and finance company paper.

Multilateral financial assistance also has evolved since March 1961, when massive financial support was given for the first time to a major currency in difficulties—the pound sterling—through an informal arrangement among several European central banks that is popularly known as the Basle Agreement. The success of this emergency aid in halting the flight from sterling led to the establishment of more formal arrangements that could be relied upon in case of unexpected speculative attacks on the leading currencies. Under the aegis of the International Monetary Fund, a $6 billion standby arrangement has been set up with ten major countries (including the United States) to supplement the resources of the International Monetary Fund. Less formalized arrangements are also being used, as evidenced by the more than $1 billion in financial assistance given Canada during the exchange crisis of last June and the help extended to the United Kingdom more recently. The operations of a so-called "gold pool," whereby various central banks cooperate in avoiding disorderly conditions in the London gold market, reportedly have also served to minimize fluctuations in the price of gold and thus restrain speculative pressures.

These defenses against disruptive shifts of short-term capital, combined with improved confidence in the leading international currencies and a narrower spread between interest rates in the United States and foreign countries, have made interest rate considerations somewhat less pressing. This does not imply, however, that interest rate differentials will no longer be a problem for this country or for other major countries, but it does mean that current arrangements should provide adequate safeguards against repetition of situations similar to the one that occurred in 1960. Testing of these defenses has taken place on several occasions: in the spring of 1961 when concerted official international action was taken following the German and Dutch revaluations; during the Canadian crisis of June 1962; in January 1963 when the United Kingdom-Common Market negotiations broke down; and, most recently, in March 1963 when rumors of sterling devaluation circulated in the exchange markets.

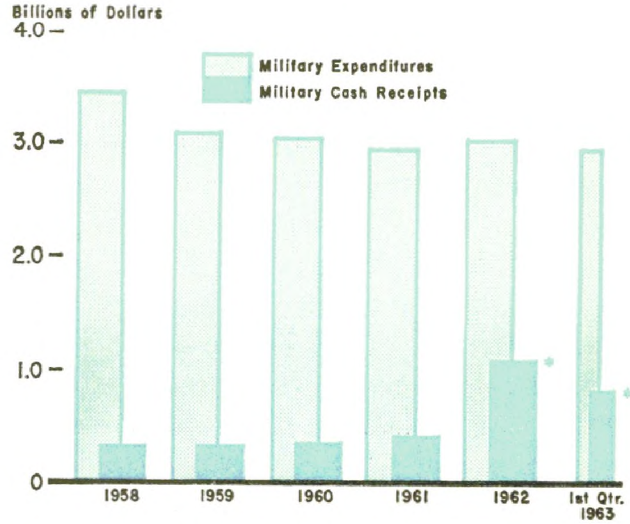
Various forms of international cooperation thus can be called upon to deal with temporary, reversible, and speculative short-term capital movements — and to allow time for longer term adjustments to take effect. The Federal Reserve System had negotiated by the end of June 1963 a total of $1.55 billion in swap facilities with ten foreign central banks and the Bank for International Settlements. Total drawings at the initiative of either the System or foreign central banks have exceeded $600 million since the beginning of System operations, but, at the end of February 1963, System drawings outstanding were considerably less than $100 million. By May 31, 1963 the Treasury had sold $630 million in foreign currency bonds, of which $605 million were in the 15- to 24-month maturity range, in addition to operations in both the spot and the forward exchange markets.

United States action to correct basic payments imbalance

Some further immediate relief for our balance of payments has been obtained through measures such as the reduction in the duty-free exemption for American tourists traveling abroad from $500 to $100, some widening of the preference for United States bidders over foreign bidders in vying for Government contracts, and tying of foreign aid to purchases in the United States. More importantly, various steps have been taken to improve the basic payments position of this country on a more permanent basis. The adaptation of monetary and debt management policies—and greater flexibility in their use—to take into account directly and specifically both domestic and international considerations is now an integral part of Government policy in dealing with either deficits or surpluses in our international payments accounts. Foreign exchange operations similarly help to produce longer range benefits for our balance of payments through their impact on the international payments mechanism.

Reduction of dollar drains through United States military expenditures abroad and through foreign aid has also been effected. Since United States military spending overseas is determined largely by our political responsibilities and not by economic considerations, it cannot readily be cut simply in order to improve our payments position, although measures to minimize the balance of payments costs of the program are being taken. The sharing of the financial burden of mutual defense increasingly has been assumed

Offsets to our military expenditures abroad have been increasing



*Receipts include $470 million in advance payments in 1962 and $92 million at an annual rate in the first quarter of 1963.
Note: First quarter 1963 at a seasonally adjusted rate.
Source: United States Department of Commerce.

by countries that are financially able to help — partly by increasing their military purchases in this country. Germany and Italy, for example, have agreed to increase their military procurement in the United States to offset our military costs in their respective countries. To the extent, also, that United States foreign aid does not take the form of direct exports of goods and services from the United States, there is a net drain on our balance of payments from this source. Greater participation by other countries in assistance to less developed areas, however, has shown little progress because the extension of aid oftentimes is impeded by the structure of internal money and capital markets and by continued strong domestic demand for investment capital in the potential creditor country. The expedient, therefore, of tying American aid to purchases in the United States has been adopted pending the elimination or easing of these major obstacles. The proportion of grant aid spent in the United States has been rising steadily for the last three years. Other forms of spending by Government agencies abroad also have been subject to more careful scrutiny in order to effect economies wherever possible. At the present time, for example, reactivation of the barter program involving exchange of United States surplus agricultural commodities for certain Government imports is reported to be under study. Although savings from the various programs mentioned may not be very large individually, collectively they can contribute meaningfully to a reduction of our payments deficit.

It is in the area of merchandise trade, however, that most of the improvement in our payments position will have to come in the long run. Merchandise trade constitutes the major share of both our payments and receipts. The authority given the President in the Trade Expansion Act of 1962 to negotiate reciprocal reductions in tariffs and other barriers to trade provides an excellent opportunity for the United States to expand markets abroad for its products. The so-called "Kennedy round" of tariff negotiations will take place early next year. Success would lead to an expanding volume of world trade in which United States traders can share if they maintain or improve their competitive standing. The prospects for boosting our exports also have been enhanced by the vigorous export promotion program conducted by the Government to inform domestic manufacturers of the opportunities for trading abroad and to assist them in marketing their output overseas. Additional incentive to sell in foreign markets has been provided by an export credit insurance program, which covers both political and commercial risks for short- and medium-term transactions, established through the joint efforts of the privately organized Foreign Credit Insurance Association and the Export-Import Bank. Since its inauguration early last year, the FCIA has been able to reduce its premiums several times because of favorable operating results.

Measures to speed up our rate of economic growth—intended primarily for the domestic economy—tend to have desirable balance of payments effects. The liberalized depreciation allowances and provisions for investment tax credits, for example, should increase the efficiency and productivity of domestic producers and strengthen their ability to compete both at home and abroad. Development of export markets, however, is slow, so that the benefits to our balance of payments will not be apparent for some time.

The special message sent by President Kennedy to Congress on July 18 reaffirmed the intention of the United States to maintain the value of the United States dollar and its convertibility into gold at $35 per ounce, called for one new piece of legislation, and outlined other steps being taken to correct our payments imbalance. Because United States capital had moved into foreign long-term portfolio investments at a record annual rate of $1.5 billion in the first six months of 1963 and at a $1.2 billion rate in 1962, a temporary new tax on United States investor purchases of long-term securities (both equity and debt) of designated foreign countries is being proposed.[1] The tax would be set at 15 percent on purchases of foreign stocks and graduated according to maturity on bonds and other debt securities with maturities over three years, with a maximum of 15 percent on securities over 28½ years in maturity. It is estimated that the net effect of the tax would be to reduce the return to United States investors by an average of 1 percent, bringing yields on foreign securities more into line with yields on comparable domestic securities, and to cut the outflow through portfolio investment to $600 million a year and increase tax revenues by approximately $100 million a year. Another new development was the announcement that the United States had concluded an agreement with the International Monetary Fund for a 1-year standby credit of $500 million. The net effect of the standby arrangement would be to permit the United States to

[1] Securities of less developed countries and of selected international institutions are to be exempted from the new tax.

absorb dollars that would otherwise be sold in the exchange markets against convertible currencies by countries wishing to make repayments to the Fund, and thereby lessen pressures on the exchange rate for the United States dollar. In addition, efforts to cut Federal spending abroad by the Department of Defense, for strategic materials, and through foreign aid, and programs to increase exports and foreign travel in the United States are to be pursued even more vigorously than before. The net savings resulting from stepped-up activity in these areas are estimated to total $900 million over the next 18 months. The over-all gain, including the new tax on foreign security transactions and the impact of higher short-term rates on capital outflow, is expected to reduce our payments deficit by about $2 billion, according to Administration sources.

Measures taken abroad to restore international payments equilibrium

The task of reducing the basic payments deficit and of curbing movements of liquid funds has been significantly eased for the United States by the measures taken simultaneously by various foreign countries, some of which have already been mentioned above. These include the German and Dutch currency revaluations in March 1961 when their efforts to check inflows of short-term capital by other means were failing to stem the tide. Germany also modified its policy on foreign exchange swaps with German commercial banks in accordance with its aim to minimize unstable flows of funds. The German central bank at the end of 1962 further requested German banks to hold to a minimum their repatriation of funds for year-end window-dressing purposes for the same reason. France and Italy, in addition, have initiated a series of measures in the last few months to rationalize their money and capital markets as a means of enhancing their effectiveness in channeling domestic savings into productive investment. These latter moves may tend, at the same time, to reduce the dependence of these countries on foreign capital and may even lead eventually to the opening of these capital markets to foreign borrowers. International capital transactions in general also have been increasingly freed from restrictions, thus facilitating more multilateral financing of international payments.

In other instances, action taken by various countries in the domestic or international sphere increasingly have been influenced by considerations of their possible impact on other countries. Thus, countries that have had substantial payments surpluses, such as Germany, France, the Netherlands, and Italy, have arranged advance debt repayments to the United States, while Italy and France have tried to contain inflationary pressures partly by relaxation of import restrictions or lowering of import tariffs. A stronger payments position was also responsible for the abolition by France and the Benelux countries of restrictions on trade with Japan — restrictions which had been permitted under Article 35 of the General Agreement on Tariffs and Trade, while steady increases in Canada's foreign exchange reserves resulted in the complete removal by the end of March 1963 of the temporary surcharges imposed on imports in June 1962.

International cooperation—whether in the form of inter-central bank assistance and consultation or multilateral financial arrangements (such as the International Monetary Fund's standby arrangement) or in the increased recognition by individual countries that national policies can have widespread international repercussions — thus has been an outstanding development of the past few years. International cooperation has proved a fruitful avenue of approach to the problem of easing balance of payments adjustments in a world where trade and payments have been increasingly liberalized.

Surplus and deficit nations both responsible for international payments equilibrium

If international cooperation had not been generally accepted, the international payments mechanism would have been seriously weakened. As it turned out, nations with balance of payments surpluses and countries in deficit have pooled their resources and their efforts to bring their payments into better balance. In the early postwar period, the United States — as a surplus nation — undertook a massive program of foreign aid, which resulted in a major redistribution of its large holdings of gold. The revaluation of the German mark and Dutch guilder was dictated primarily by international considerations, while the financial assistance granted to Canada in 1962 was extended by deficit and surplus countries alike. Meanwhile, several of the countries that have experienced payments deficits—such as Canada, the United Kingdom, and Japan—generally have tried to follow orthodox monetary and fiscal policies to restrain expansionary pressures and thus balance their international accounts.

The postwar period has brought home clearly the necessity and desirability of participation by both surplus and deficit countries in the attainment of international payments equilibrium. Pursuit of an independent course without regard to other countries would lead to the transmittal of inflationary or deflationary pressures from one country to another at the expense of international specialization and the optimum allocation of resources. Nevertheless, the question arises as to the extent to which international cooperation should be carried. How much inflation or exchange appreciation should a surplus country, for example, undertake in order to help a deficit country? And, conversely, how much deflation or devaluation should a deficit country be expected to bear?

There are no hard and fast rules governing these situations because the variables are many and the environments in which they operate diverse. Some of the problems involved, however, might be pinpointed by a brief examination of the German revaluation. At the time of the appreciation of the Deutschemark, the German economy was strong, production was expanding, and the balance of payments was persistently registering sizable surpluses. Credit restraint, however, was ineffective because high interest rates attracted a substantial inflow of both foreign and overseas German capital. The 5 percent appreciation was decided upon by the German authorities as an adjustment sufficient to bring German costs and prices into better alignment with cost-price relationships in other major industrial countries, after taking into account expected trends in the economy. The German authorities correctly anticipated that demand pressures and supply limitations—particularly of labor—would become more important in the ensuing months and years and would thus bring about a further adjustment. By the end of 1962, Germany's surplus had been eliminated. A surplus has reappeared this year, however, mainly due to an influx of capital attracted by favorable yields on securities offered on the German capital market, where credit demands still are strong and the supply of savings limited. The shift back to a surplus within a relatively short span of time—and at a time when domestic inflationary pressures still are considered a problem — points up the need for constant adaptation of the policies of a surplus country to changes both in its own internal position and in its relationships with other countries.

In the case of a deficit country, what are the limits on its policies? Should it be expected to adopt deflationary policies affecting the domestic economy and maintain them until its international payments have been brought into balance, without regard to substantial underutilization of productive capac-

CHANGES IN OFFICIAL GOLD AND FOREIGN EXCHANGE HOLDINGS OF SELECTED COUNTRIES, 1959-62

(millions of United States dollars)

	1959[1]	1960	1961	1962
Europe				
Austria	+ 20	+ 19	+ 128	+ 229
Belgium	— 247	+ 200	+ 235	— 35
France	+ 736	+ 350	+ 869	+ 671
Germany	—1,085	+2,204	— 195	— 95
Italy	+ 894	+ 127	+ 339	+ 22
Netherlands	— 97	+ 403	— 27	+ 28
Spain	+ 152	+ 372	+ 279	+ 160
Switzerland	0	+ 261	+ 435	+ 113
United Kingdom	— 192	+ 489	+ 85	— 515
Canada	— 9	— 40	+ 228	+ 483
Japan	+ 524	+ 502	— 338	+ 356
All other	+ 992	— 519	+ 183	— 310
All foreigners	+1,688	+4,368	+2,221	+1,107
International Monetary Fund	+ 48	+ 109	— 513	+ 584

[1] Country data adjusted to include gold payments to the International Monetary Fund in 1959 when quotas were enlarged. Figures for the International Monetary Fund are adjusted to exclude increases in gold and convertible currency holdings due to the enlargement of quotas.
Source: International Monetary Fund, *International Financial Statistics.*

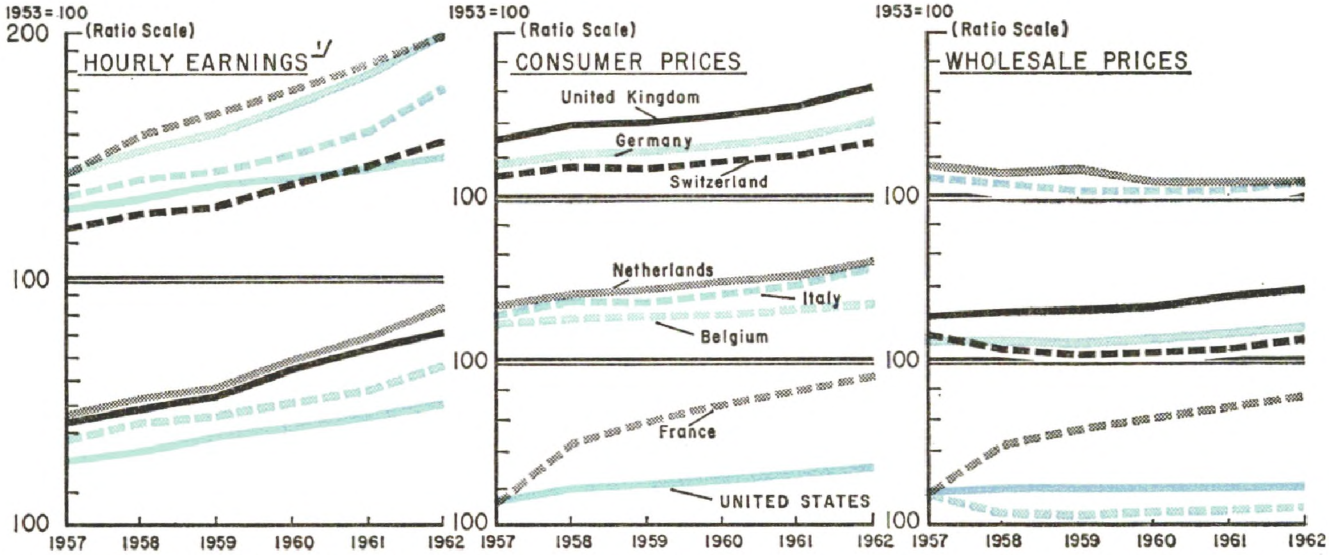
ity and unemployment? For countries that are important trading nations, the danger exists that deflationary policies will carry the deflation to other countries and cause a cumulative downward spiral in international economic activity. For key currency countries, the limits may be even more restricted because the deflation would reduce the availability of international means of payment. Under these circumstances, a higher rate of economic growth, stimulated by expansionary measures, clearly constitutes a more worthwhile line of approach.

International payments position of most major countries stronger

At the present time, the international payments positions of most major countries are stronger than at any time during the postwar period. The economies of Japan, Canada, and the leading countries of Europe have been expanding steadily, and their international reserves have been built up to generally adequate levels, although in some cases through special financial assistance. The less developed countries, however, are still faced with payments problems, mainly due to a fundamental imbalance between domestic savings and consumer and investment demand rather than because of a shortage of international liquidity.

Nevertheless, a number of major problems continue to confront various countries. The surplus in Germany's international accounts has reappeared against a background of labor shortage and price and wage pressures. The large surpluses accumulated by France have shown few signs of declining, despite a deterioration in its merchandise trade balance. France has gained reserves consistently since the franc was devalued in December 1958, because the currency adjustment placed France in a very strong competitive position. Continued accumulation of reserves by France has tended to exert pressure on the payments positions of other countries, despite efforts by France to keep its reserves down by advance debt repayments. Japan and Canada, after surmounting balance of payments difficulties last year, have turned their attention to the

Recent changes in costs, prices, and hourly earnings have favored the United States



[1] For France and the Netherlands, hourly wage rates in manufacturing.
Source: Organization for Economic Co-operation and Development.

stimulation of domestic economic expansion without worsening their payments positions. The United Kingdom has also oriented its economic policies toward a broad expansionary program as the best means of stepping up its rate of economic growth and of strengthening its balance of payments.

Recent shift in price-cost relationships favor the United States

The failure of United States balance of payments statistics to show some visible improvement in our payments position indicates the need for continued efforts to reduce our payments deficit. This task should be facilitated by the relative movement of costs and prices in the United States and in some of the leading industrial countries. Since 1957, and particularly in the last two years, price increases in the United States have been relatively small. Both wholesale prices and consumer prices have risen more rapidly in the major European countries than they have in the United States. Costs, especially of labor, have climbed sharply as labor shortages have become widespread in most European countries. Hourly earnings in Germany, for example, have risen much more sharply and steadily than have earnings in the United States. Wage increases within the past year in many European countries have been outstripping increases in productivity, in contrast with the situation in earlier years when productivity gains exceeded wage increases.

As a consequence, the competitive position of United States manufacturers in foreign markets and in their own domestic markets has improved. Wage increases here generally have remained within the limits of productivity gains. In view of the existence of substantial unused capacity and unemployed labor resources, the United States is in a position to maintain—or possibly even widen—this advantage. In contrast, the approach of a number of European countries and of Japan to capacity production and shortages of skilled labor will tend to limit further increases in productivity. The narrowing of the disparity in prices and costs between the United States and other major industrial countries may prove to be of major significance. Continuation of this trend may contribute importantly to bolstering our balance of payments position over the longer run because it strengthens our competitive position and improves our ability to export.

Recent price-cost developments favoring the United States to some extent are a natural outgrowth of postwar trends. The rapid rise in productivity in the European countries in the early postwar period was made possible by the extensive replacement of obsolete or war-damaged plant and equipment with modern productive facilities and by the availability of plentiful supplies of labor. Government spending and investment demand—followed by rising exports—were the principal forces behind economic expansion. Rising levels of production in turn have led to rising levels of consumer demand, which now is competing actively with the investment sector for materials and labor. The resultant price pressures partly reflect the strength of these competing demands, with the consumer sector striving to increase its share in the larger national product even if this means bidding up prices.

Problems still face the United States

Despite the favorable turn in price-cost relationships, the United States cannot afford to become complacent about its balance of payments. The payments gap still is large, and further progress is liable to be slow because reduction of the hard core of imbalance will take time. Unpredictable shifts in the payments positions of other countries, moreover, may delay, rather than accelerate, our progress from time to time. In the meantime, the United States may continue to lose gold as long as countries view their dollar holdings as excessive in relation to their requirements and as long as they believe that a high ratio of gold to total international reserves is an indispensable adjunct of economic strength and security. Because of the limited supplies of new gold, such an attitude tends to overlook the possibility that achievement of a more balanced set of international payments and reserve relationships would reduce the magnitude of swings in the payments position of individual major countries and thus would reduce their need for gold. International facilities to meet short-term fluctuations in any country's payments, moreover, have been strengthened, and these, too, should help both to reduce the needs of individual countries for large reserves of gold and to increase the safety of holding reserves in the form of major currencies.

Economic as well as noneconomic considerations dictate the maintenance of United States foreign aid. The underdeveloped state of capital markets abroad also dims the prospects for an early substantial reduction in foreign long-term borrowing in the United States. Japan, for example, has announced its intention of increasing its reliance on foreign capital for long-term investment. Until other countries are able to supply capital market facilities that are as broad and as resilient as the United States capital market, our international responsibilities as a key currency country will include supplying long-term capital to the rest of the world. The temporary tax on foreign security transactions proposed by President Kennedy does not bar foreigners from our capital market but will tend in effect to equalize the costs of borrowing in the United States with borrowing costs abroad. Where capital is not obtainable elsewhere, the United States capital market still will constitute an important source of funds. Moreover, it can play a useful role in bringing together foreign dollar holders who are interested in investing in dollar-denominated securities.

Of more immediate concern is the near-term outlook for United States merchandise trade. The evolution of the European Common Market countries into a large, competitive trading bloc has resulted in a significant expansion of trade because of the area's generally liberal policies. But in certain fields of particular interest to the United States, recent developments have given some cause for disquiet. Agricultural policy, for example, has tended to be restrictive of trade—a disadvantage to the United States since the Common Market is the largest single dollar market for our agricultural commodities. Limitations on admission to Common Market membership also may tend to have adverse repercussions on the freer flow of goods, services, and capital. Continued expansion in the major industrial countries, although at a slower rate than in 1961-62, indicates, however, that United States exports will continue to increase.

The disappointing rate of economic growth that has characterized the United States economy in recent years has been an indirect, but nonetheless crucial, factor affecting our balance of payments. The incentive for manufacturers to expand and modernize their plant and to increase output has been weakened, while more sophisticated investors have sought greener pastures overseas in the absence of adequate and equally attractive investment outlets at home. The competitive position of American manufacturers at home and abroad, as a consequence, has therefore suffered. A program to reduce the tax burden on the economy through tax reduction and reform, in addition to other measures to stimulate our growth rate, therefore might have a favorable impact on our payments position. Our exports would become more competitive in world markets as production was carried on more efficiently and at lower cost, while import-competitive industries would find their market position improved, even though imports would tend to rise in response to higher levels of economic activity and this would offset some of the expansion in exports. The strength of the economy would encourage direct and portfolio investment in this country by United States and foreign investors as opportunities for more profitable employment of funds opened up here. Foreigners would show increased willingness to hold dollars. Increased reliance on fiscal policy at this time should benefit both the domestic economy and our balance of payments. Fiscal policy shares with monetary policy the responsibility for maintaining economic growth at levels of relatively full employment and stable prices.

Constant shifts in payments relationships and in particular accounts within the balance of payments underscore the necessity of every country remaining alert to the significance and implications of payments developments for their domestic economy and for their relations with the rest of the world. The so-called "balance of payments discipline" has consciously and increasingly been integrated into national policies because of the realization that domestic objectives can be blocked effectively by offsetting developments in the international arena. In some countries, the discipline of the balance of payments is immediate and cannot easily be ignored, even temporarily, particularly in countries where foreign transactions are a major determinant of income and output. In the United States, on the other hand, exports and imports of goods and services each account for 5 percent or less of gross national product, and the domestic impact of balance of payments developments is relatively obscured. In such a situation, remedies to correct a payments imbalance that are appropriate for a country heavily dependent on foreign trade may not be equally effective or practicable. Nevertheless, no real conflict exists between a country's long-range internal and external requirements because the basic objectives of each are identical, namely, a strong and healthy economy whose currency is highly regarded both at home and abroad.

District Business Highlights

As measured by a number of key indicators, the pace of business activity in the Twelfth District about matched that in the nation during May and June. Following a sharp drop in employment in April, which carried the unemployment rate in the District[1] to 6.0 percent of the labor force (compared with 5.4 percent in March), employment rose slightly in May and the unemployment rate in the District dipped to 5.9 percent. Nationally, the unemployment rate, which rose to 5.7 percent in April from 5.6 percent in March, increased further to 5.9 percent in May—the same rate as in the District. At this level, the unemployment rate was higher than the 5.5 percent rate which prevailed in both the District and the nation a year ago. However, during this 12-month period, employment and the labor force increased at a faster rate in the District than in the nation; consequently, the number of unemployed rose somewhat less rapidly in the District.

Although total employment in the District rose during May, manufacturing employment again fell for the fourth consecutive month. The decline centered in the Pacific Coast States, where employment in defense-related manufacturing industries (ordnance, electrical equipment, and aircraft) dipped to a level 2 percent below the 1963 high which prevailed in January. Nevertheless, in May, total nonfarm payroll employment in all but two (Washington and Idaho) of the nine District states exceeded year-ago levels; California, with a gain of almost 200,000, accounted for 90 percent of the total increase in the District over the 12-month period.

In June, the rate of unemployment in the Pacific Coast States was unchanged from the May figure of 5.9 percent, whereas the national rate declined to 5.7 percent. Civilian employment remained virtually unchanged, with an increase in agricultural employment offsetting a slight loss in the nonagricultural sector. The decline in nonfarm employment was again concentrated in manufacturing and was accentuated by the labor dispute in the lumber industry in Oregon and Washington. Weakness continued in the defense-related industries, as producers of aircraft and electrical equipment laid off additional workers. The reduction in aircraft employment occurred in Washington, with the number of such workers in California remaining at the April-May level. However, employment in the ordnance industry in California increased by 0.7 percent in June, the first monthly increase since February of this year.

District department store sales rose 10 percent in May, on a seasonally adjusted basis, about recouping the April decline. In June, sales fell slightly below the May level, according to preliminary data. In both the District and nation, department store sales during the first half of 1963 have exceeded year-ago levels by about 4 percent. New car registrations in California also continued at high levels in May and June. Registrations during the first six months were about 14 percent above those in the corresponding period of 1962, surpassing a 10 percent gain in sales nationally.

Private housing starts in the West[1] rose by about 6 percent in May, following a similar gain in April. Preliminary figures for June indicate a decline of 5 percent. The increase in May was somewhat larger than the national gain, and the June decline was less in the District than in the nation. Various "advance indicators" of District construction activity also continued to post strong gains in May. The

[1] Previously reported for the Pacific Coast States only, seasonally adjusted labor force data are now available for all states in the Twelfth District except Alaska and Hawaii.

[1] The 13 western states, including Alaska and Hawaii.

value of total construction contracts awarded in District states[1] rose sharply to $1.1 billion in May, representing a gain of 32 percent over April. The value of construction awards during the first five months of 1963 was 23 percent above that of a year ago, compared with only a 5 percent gain in the nation. As compared with a year ago, all District states for which data are available, except Oregon, recorded a larger volume of construction awards through May of this year, although the gains ranged from a low of about 1 percent in Washington, which had a high level of activity last year associated with the World's Fair, to a high of 58 percent in Nevada. According to April data, the number of building permits authorized in the District during the first four months of the year also was maintained at a high level, surpassing that of a year ago by about 20 percent. District states showing particularly strong gains over last year were Nevada and California, while Hawaii and the Pacific Northwest States recorded a lower volume of permits than last year. The generally high and rising volume of contract awards and building permits, together with a continuing ample supply of mortgage funds, indicates a continuing high level of construction activity in the Twelfth District in the months ahead.

[1] All District states, except Alaska and Hawaii.

Reprint Available

Reprints of the report "Federal Reserve Open Market Operations in 1962" by Robert W. Stone, Manager of the System Open Market Account and Vice President of the Federal Reserve Bank of New York, which appeared in the April 1963 issue of the *Federal Reserve Bulletin* are available on request from the Federal Reserve Bank of San Francisco or the Board of Governors of the Federal Reserve System, Washington, D. C.

BANKING AND CREDIT STATISTICS AND BUSINESS INDEXES—TWELFTH DISTRICT[1]

(Indexes: 1957-1959=100. Dollar amounts in millions of dollars)

Year and Month	Condition items of all member banks[2, 7]				Bank debits index 31 cities[4, 5]	Bank rates on short-term business loans[6, 7]	Total nonagricultural employment	Total mf'g employment	Carloadings (number)[5]	Dep't store sales (value)[5]	Retail food prices[7, 8]
	Loans and discounts	U.S. Gov't securities	Demand deposits adjusted[3]	Total time deposits							
1929	2,239	495	1,234	1,790	19	....	...	...	110	18	53
1933	1,486	720	951	1,609	8	....	...	...	56	11	34
1939	1,967	1,450	1,983	2,267	14	....	...	...	83	19	38
1953	9,220	6,639	10,515	7,997	69	4.14	86	86	108	74	93
1954	9,418	7,942	11,196	8,699	71	4.09	85	84	103	74	93
1955	11,124	7,239	11,864	9,120	80	4.10	90	90	112	82	92
1956	12,613	6,452	12,169	9,424	88	4.50	95	96	112	91	94
1957	13,178	6,619	11,870	10,679	94	4.97	98	101	103	93	97
1958	13,812	8,003	12,729	12,077	96	4.88	98	96	96	98	101
1959	16,537	6,673	13,375	12,452	109	5.36	104	103	101	109	101
1960	17,139	6,964	13,060	13,034	117	5.62	106	103	95	110	103
1961	18,499	8,278	14,163	15,116	125	5.46	108	103	94	115	104
1962	....	....	....	....	141	....	113	109	104	123	...
1962											
June	19,625	7,689	13,101	16,511	143r	5.52	112	108	102	123	106
July	19,669	7,532	13,535	16,587	144r	....	113	109	106	123	105
August	20,017	7,309	13,255	16,655	144r	....	113	109	105	124	105
September	20,165	7,471	13,446	16,772	143	5.49	114	110	107	122	106
October	20,460	7,471	13,969	16,934	142r	....	114	111	104	121	106
November	20,589	7,501	14,012	16,827	144r	....	114	110	102	128	105
December	21,102	7,608	14,431	17,093	146	5.50	115	111	101	127	106
1963											
January	21,035	7,454	13,917	17,390	146	....	116	111	90	127	107
February	21,403	7,130	13,527	17,532	149	....	116	111	105	128	107
March	21,480	7,130	13,646	17,760	152	5.46	116	111	105	130	107
April	21,714	7,103	14,175	17,868	147	....	116	110	...	118	107
May	21,894	7,069	13,427	18,111	152	....	116p	110p	...	129	106
June	22,140	7,153	13,610	18,264	152	5.53	...	...	...	...	...

Year and month	Industrial production (physical volume)[5]							Waterborne Foreign Trade Index[7, 9, 10]					
	Lumber	Petroleum[7] Crude	Petroleum[7] Refined	Cement	Steel[7]	Copper[7]	Electric power	Exports Total	Exports Dry Cargo	Exports Tanker	Imports Total	Imports Dry Cargo	Imports Tanker
1929	84	91	61	34	...	89	13	96	61	193	20	55	*
1933	35	54	39	17	...	15	11	55	...	...	12	...	..
1939	62	70	49	35	16	70	17	82	43	190	16	41r	1
1952	101	112	90	77	92	100	61	86	81	101r	33	61r	18
1953	102	114	95	82	105	98	69	71	56	113	51	70	41
1954	101	111	92	83	85	90	73	67	57	96	44	71	28
1955	107	111	96	90	102	104	82	84	72	117r	52r	80	35
1956	104	109	100	97	108	114	89	101	105	91	75	86	69
1957	93	106	103	93	114	113	95	117r	124	96	95	93	97
1958	98	98	96	99	94	101	97	89	86	96	92	95	91
1959	109	96	101	108	92	86	107	95	90	108	112	113	112
1960	98	95	104	101	102	112	115	122	123	120r	133r	117r	142r
1961	95	96	108	105	111	119	124	126	134	104	134	116	145
1962	97	96	111	111	100	128	...	...	...	...	...	...	...
1962													
May	96	96	108	111	107	136	131	134	145	104r	137	138	137
June	94	96	112	94	103	130	128	104	121	59	156	132	170r
July	98	96	115	115	84	112	128	82	85	74	154	122	172
August	95	97	114	117	89	115	134	116	130	76	168	136	186
September	98	96	113	115	90	119	134	105	121	61	137	122	145
October	98	97	112	120	88	127	132	96	105	72	158	154	161
November	104	97	113	115	91	127	135	93	91	99	163	127	183
December	103	97	113	121	100	127	...	154	157	143	134	124	140
1963													
January	101	96	113	122	100p	125	...	...	...	...	...	...	...
February	94	96	111	118	114p	130	...	...	...	...	...	...	...
March	104	97	110	122	127p	134	...	...	...	...	...	...	...
April	89	98	108	105	138p	...	...	...	...	...	...	...	...
May	...	98	112	111	145p	...	...	...	...	...	...	...	...

[1] Adjusted for seasonal variation, except where indicated. Except for banking and credit and department store statistics, all indexes are based upon data from outside sources, as follows: lumber, National Lumber Manufacturers' Association, West Coast Lumberman's Association, and Western Pine Association; petroleum, cement, and copper, U.S. Bureau of Mines; steel, U.S. Department of Commerce and American Iron and Steel Institute; electric power, Federal Power Commission; nonagricultural and manufacturing employment, U.S. Bureau of Labor Statistics and cooperating state agencies; retail food prices, U.S. Bureau of Labor Statistics; carloadings, various railroads and railroad associations; and foreign trade, U.S. Department of Commerce. [2] Annual figures are as of end of year, monthly figures as of last Wednesday in month. [3] Demand deposits, excluding interbank and U.S. Government deposits, less cash items in process of collection. Monthly data partly estimated. [4] Debits to total deposits except interbank prior to 1942. Debits to demand deposits except U.S. Government and interbank deposits from 1942. [5] Daily average. [6] Average rates on loans made in five major cities, weighted by loan size category. [7] Not adjusted for seasonal variation. [8] A new index now combining not only Los Angeles, San Francisco, and Seattle food indexes but also Portland. Reweighted by 1960 Census figures on population of standard metropolitan areas. [9] Commercial cargo only, in physical volume, for the Pacific Coast customs districts plus Alaska and Hawaii; starting with July 1950, "special category" exports are excluded because of security reasons. [10] Alaska and Hawaii are included in indexes beginning in 1950. *p*—Preliminary. *r*—Revised. * Less than 0.5 percent.