

FEDERAL RESERVE BANK OF ST. LOUIS

NOVEMBER 1971



REVIEW



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Vol. 53, No. 11

Monetary Policy and Relative Prices in an Incomes Policy

by R. ALTON GILBERT

MONETARY policy will have an important influence on the effectiveness of the President's program for achieving price stability through direct controls of wages and prices. Lasting price stability requires a prudent course of monetary action.

The prospects for achieving price stability and full employment sooner with wage and price controls than with traditional monetary and fiscal actions alone depend on the ability of the wage and price controls to dampen expectations of inflation. Until expectations of inflation are substantially reduced, inflationary pressures will remain strong even though measured prices are constrained by government controls. The role of monetary policy is to keep the expansion of aggregate demand in line with the expansion in productive capacity.¹ Given an excessive rate of monetary expansion, inflation will break into the open as soon as government controls are removed.

Besides the rate of monetary expansion, the viability of a system of price and wage controls may depend upon how closely the individual prices and wages fixed by administrative decisions correspond to the relative prices and wages that would exist without controls. A program for slowing the rate of inflation through direct controls is implemented through controls on wages and prices in individual industries, whereas under traditional stabilization policies the structure of wages and prices among industries is

determined by the price system. The rate of economic recovery will probably be influenced by the impact the decisions of the pay board and price commission will have on the profit and labor shares of income. The allocation of output among industries will be influenced by the structure of wages and prices established by the control boards.

The role of monetary policy in an incomes policy of wage and price controls is analyzed in the first part of this article. Inflation is analyzed as a response to rapid monetary expansion. The prospects for achieving price stability through wage and price controls are discussed in terms of the monetary explanation for inflation. The prospects for economic expansion and an efficient allocation of resources under wage and price controls are discussed in the second section of the article. The issues analyzed are:

- (a) the relation between economic recovery and the profit share of income, and
- (b) the effects of individual wage and price decisions on the allocation of investment, employment, and output among industries.

Monetary Policy and Inflation

Two Views on Inflation and Controls

The success that wage and price controls can be expected to have in dampening inflationary pressures depends upon the type of forces that initiate inflation and the reasons for persistent inflation when resources are no longer fully utilized. In one view, inflation is the result of increases in the market power of firms and labor over the prices they charge. Inflation due to rising market power is considered relatively insensitive to traditional monetary and fiscal policies. According to this view of the inflationary process, one means of dealing directly with inflationary forces is wage and price controls.

¹This statement about the role of monetary policy does not imply that price stability is the only objective of monetary policy. Full employment is also a policy objective. There is assumed to be no long-run trade off between the rate of inflation and the unemployment rate, and therefore, price stability and full employment can be achieved simultaneously if the rate of monetary expansion remains moderate. For a discussion of the inflation-unemployment trade off, see Roger W. Spencer, "The Relation Between Prices and Employment: Two Views," this *Review* (March 1969), pp. 15-21.

An alternative explanation for inflation, the explanation followed in this article, is that the rate of inflation is determined by the trend of aggregate demand.² The rate of increase in aggregate demand has been observed to be directly related to the rate of growth of the money stock.³ With the economy at full employment, the rate of inflation is related to the rates of increase in aggregate demand and productive capacity. If aggregate demand increases faster than productive capacity, prices will rise to clear the markets for output.

After prices have been rising for some time due to excessive growth in aggregate demand, expectations of continued inflation begin to affect negotiations for wages and prices. Even as the rate of output expansion declines because of a reduction in the rate of monetary expansion, prices may continue to rise due to the general expectation of inflation and the wage and price demands of the workers and firms who have not yet adjusted their wages and prices to the inflation that has already occurred. Inflationary pressures can be gradually eliminated through moderate monetary expansion. With a moderate expansion of the money stock, aggregate demand does not rise fast enough to purchase full-employment output at the price level that is generally expected to exist. Wages and prices then gradually respond to the emergence of excess capacity.

Slowing Inflation as an Adjustment Process

The emergence of inflation since 1965 can be analyzed in terms of the monetary explanation for inflation. From the second quarter of 1965 to the first quarter of 1969, the money stock rose at a 5.6 per cent annual rate, compared to a 2.9 per cent rate in the previous 5 years. In the three and a half years from the second quarter of 1965 to the fourth quarter of 1969, total spending rose at about an 8 per cent annual rate, compared to a 6 per cent rate in the previous 5 years. The rate of growth in the money stock slowed in 1969, rising at a 2.8 per cent annual rate from the first quarter to the fourth quarter of 1969, compared to a 7.9 per cent growth in the previous year. Due to the lag in the effects of a change in the rate of money growth on spending, the growth rate of aggregate demand did not slow significantly until the fourth quarter of 1969.

²For a more thorough discussion of the market power and monetary expansion explanations for inflation, see Keith M. Carlson, "Slowing in Money Growth: The Key to Success in Curbing Inflation," this *Review* (October 1971), pp. 2-5.

³See Leonall C. Andersen and Keith M. Carlson, "A Monetarist Model for Economic Stabilization," this *Review* (April 1970), pp. 7-21.

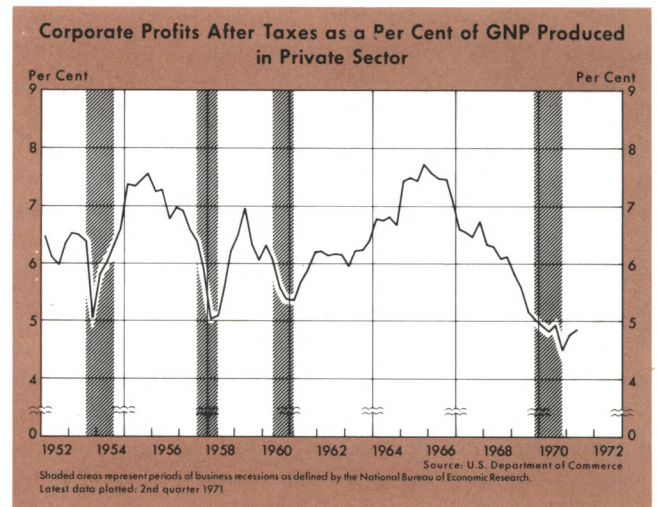
The economy had reached full employment by 1965, so that increases in output were constrained by the growth of productive capacity, estimated at about 4 per cent per year. The general price level rose at about a 4 per cent annual rate from the second quarter of 1965 to the fourth quarter of 1969, compared with a 1.4 per cent rate of increase in the previous 5 years.

The money stock rose 5.1 per cent from the fourth quarter of 1969 to the fourth quarter of 1970. Due to restrictive monetary policy in 1969 and moderate monetary expansion in 1970, spending rose 4.3 per cent during the 1969-70 recession, compared with 6.5 per cent in the previous year. The general price level rose 5.7 per cent from the fourth quarter of 1969 to the fourth quarter of 1970, compared with a 5.1 per cent increase during the previous year. The decline in the rate of economic activity in late 1969 failed to retard price increases because of cost pressures and the expectations of continued inflation. The continued cost pressures resulted from demands for higher nominal wages by workers who had their real wages reduced by unanticipated inflation and the inflationary anticipations of workers gradually formulated during the 1965-69 period.

Total spending in the economy has increased 7.7 per cent since the third quarter of 1970, a significant acceleration from the 4.6 per cent rise in the previous year. The expansion in aggregate demand is partially a response to the rapid growth in the money stock in the first half of 1971. Due to the continuing adjustments outlined above, however, most of the increase in total spending has been translated into price increases. The 4.7 per cent annual rate of increase in the general price level from the fourth quarter of 1970 to the second quarter of 1971, compared with a 5.7 per cent increase in the previous year, shows the rate of inflation started to slow before the price freeze was initiated.

The Current Role of Monetary Policy

The success of the government's program for reducing inflationary pressures through direct controls on wages and prices is now discussed in terms of the monetary explanation for inflation. One condition for success of the program is a faster reduction in inflationary expectations than with traditional stabilization policies alone. If expectations of inflation can be reduced more quickly through wage and price controls, the economy can attain full employment and price stability sooner. The success of the New Economic Program also depends upon the rate of expansion in aggregate demand during the period of controls. If aggregate demand expands rapidly, consum-



ers will demand more goods and services than firms wish to supply at the officially established prices. In such a situation, there would be pressures to evade the wage and price controls. Inflation could take such forms as quality deterioration and the development of black markets.

The role of monetary policy in controlling inflation under an incomes policy is the same as the role without an incomes policy—to keep the expansion of aggregate demand in line with the growth of potential output. If the relations observed in the past between changes in the money stock and aggregate demand continue to hold during the New Economic Program, the rate of increase in aggregate demand in the near future will be partially determined by past monetary actions. The rate of monetary expansion was rapid earlier this year. The money stock increased at a 10.5 per cent annual rate between December and June and has increased at a 1.6 per cent rate since June. With the lagged effect of changes in the money stock on total spending, the near term outlook is for expansion of total spending in the economy. Current monetary expansion will influence how rapid the expansion in aggregate demand will be in the near term.

Incomes Policy and the Adjustment Process

In attempting to deal with overall wage and price inflation through direct controls, the pay board and the price commission will influence the allocation of income between wages and profits and the relative wages and prices among industries. The allocation of income between wages and profits and relative wages and prices were in a process of change through the price system before the wage and price controls were

established. This allocation of income in the near future is likely to affect the rate of economic recovery through the effect the profit share has on investment. The degree to which changes in relative wages and prices among industries in the near future replicate the changes that would have occurred without wage and price controls will determine the degree to which resources will be allocated efficiently. Resources are allocated efficiently if they are used to produce the combination of goods and services that yields the greatest consumer satisfaction. An incomes policy that allows for changes in wages, prices, and income distribution consistent with the goals of overall price stability, economic recovery, and efficient allocation of resources will be difficult to design.

The Allocation of Income

One of the most prominent effects of the rapid economic expansion initiated in 1965 was a relatively large shift in income distribution of the private sector between labor income and returns to capital. The accompanying charts show after-tax corporate profits and compensation of employees as portions of total private product. Both the profit and labor shares of income have varied cyclically. The labor share tends to rise, and the profit share tends to fall during a period of economic expansion; the pattern is reversed during periods of recovery.⁴ Since 1965 labor compensation

⁴For additional information on the cyclical pattern of the profit share of income, see Thor Hultgren, *Cost, Prices, and Profits: Their Cyclical Relations*, (New York: National Bureau of Economic Research, 1965), pp. 78-97. There is an inconsistency in the tax treatment of the income shares used in this article in that profits are measured after taxes and labor compensation is measured before the taxes workers pay. Both corporate profits before taxes and corporate profits after taxes could be used to measure the profit concept in this article. Profits after taxes are used as a better estimate of the returns on investment. These two measures of profits as a fraction of income have similar cyclical patterns.

Table I

Wages, Prices and Employment by Industry
(Annual Rates of Change)

1960-1965

	Prices	Real Wages ¹	Wages ²	Productivity ³	Unit Labor Cost	Employment
Construction	5.2%	3.0%	4.2%	-0.7%	4.9%	2.3%
Services	3.1	3.1	4.4	1.1	3.1	3.2
Trade	0.9	2.4	3.6	2.9	0.7	2.0
Finance	1.3	2.8	4.0	3.0	1.0	2.3
Manufacturing	0.3	1.9	4.0	4.6	-0.6	1.5
Communication	-0.1	3.5	4.4	6.7	-1.9	0.9
Transportation	0.3	2.9	4.0	5.5	-1.4	-0.5
Utilities	-0.1	3.2	4.4	5.0	-0.6	0.3
Mining	-1.2	2.5	3.7	4.5	-3.5	-1.9
Agriculture	1.5	3.5	4.6	4.7	0.0	-2.9
All Private Industries	1.1% ⁴	2.8%	4.0%	3.3%	0.6%	1.7%

1965-1970

Construction	8.2%	3.5%	7.2%	-2.0%	9.5%	1.6%
Services	6.0	3.1	7.0	-0.4	7.4	3.9
Trade	4.2	1.4	5.1	+0.5	4.6	3.4
Finance	4.2	2.3	6.1	-0.8	6.9	4.0
Manufacturing	2.3	1.6	5.3	1.2	4.1	1.4
Communication	0.1	1.7	5.5	3.3	2.1	5.0
Transportation	2.0	2.3	6.1	2.5	3.5	1.1
Utilities	0.6	2.4	6.1	3.6	2.5	2.0
Mining	1.5	2.9	6.7	3.3	3.3	-0.3
Agriculture	3.8	4.9	8.8	3.8	4.8	-3.5
All Private Industries	3.7% ⁴	2.0%	5.8%	0.7%	5.0%	2.4%

¹The real wage rate is calculated as compensation per employee divided by implicit price deflator for private GNP.

²The wage rate is calculated as labor compensation per full-time equivalent employee.

³Productivity is calculated as output per full-time equivalent employee.

⁴This rate of price change is for the private sector, which includes all of the above private industries plus government enterprise and rest of world.

Source: U. S. Department of Commerce, Office of Business Economics, *Survey of Current Business*.

has accounted for a rapidly increasing portion of private income, rising from 52.8 per cent in 1965 to 56.7 per cent in 1970. During the same period corporate profits after taxes changed little on average and accounted for a sharply decreasing portion of private income, from 7.5 per cent to less than 5 per cent.

The patterns of change in wages, prices, and productivity demonstrate the forces behind the recent decline in the profit share. Productivity increased slowly in the 1965-70 period relative to the rate of increase in previous years (see Table I). With a rapid increase in wages, unit labor cost rose at a 5.0 per cent annual rate in private industries during the 1965-70 period while output prices rose at a 3.7 per cent rate in the private sector.⁵ Since labor cost per

⁵Unit labor cost equals labor compensation divided by physical output, or the labor cost per unit of output.

unit of output rose faster than prices during the 1965-70 period, the share of the firms' revenues allocated to wages increased; a smaller share of revenue was left for other income categories.

If adjustments in the profit and wage shares are allowed to continue in accord with free market forces, and if historical patterns prevail, the profit share will tend to rise over the near term, and labor's share of income will tend to fall. With the economy monitored by wage and price boards, a rise in the profit share and a decline in the labor share in the near future may be interpreted by some observers as an undue concession to business. However, such a reallocation is to be expected during the recovery phase of a business cycle in an economy without controls on wages and prices. Any attempt to thwart such a change in income shares might hamper economic recovery.

Income Shares by Industry

The degree to which the labor share of output rose between 1965 and 1970 varied significantly among industries. As shown in Table I, the relations between the rate of change in prices and the rate of change in unit labor cost varied among industries during the 1965-70 period. The labor shares for individual industries in 1965 and 1970 are given in Table II.⁶ The rates of increase in labor shares were highest in the finance and communication industries, the industries in which the rates of increase in employment were highest between 1965 and 1970 (see Table I). The rates of increase were lowest in the trade and agriculture industries. The annual rates of increase in the labor shares varied from 2.6 per cent for the finance industry to 0.4 per cent for the trade industry.

Some of the variation in the rates of change in labor shares may be due to differences among industries in the degrees to which the labor shares fluctuate over the business cycle. Trends in the labor shares vary among industries due to such factors as changes in the labor intensity of production. The rates of decrease in labor share can be expected to vary

⁶Only labor shares are given by industry and not profit shares since the profit shares that would correspond to the overall profit share in the accompanying chart are not available by industry.

Table II

Labor Share of Income Among Industries

	1965	1970	Annual Rate of Change
Construction	73.2%	77.8%	1.2%
Services	60.9	64.9	1.3
Trade	56.5	57.6	0.4
Finance	20.1	22.9	2.6
Manufacturing	65.7	71.8	1.8
Communication	43.8	48.4	2.0
Transportation	65.7	70.7	1.5
Utilities	31.8	34.9	1.9
Mining	35.6	38.9	1.8
Agriculture	14.1	14.8	1.0
Private Sector ¹	52.8%	56.7%	1.4%

¹The private sector includes all of the above private industries plus government enterprise and rest of world.

Source: U. S. Department of Commerce, Office of Business Economics, *Survey of Current Business*.

among industries during the current recovery because of the cyclical and trend effects if wages and prices change as they would without wage and price controls.

The allocation of investment expenditure is directly related to the relative rates of return on capital among industries. The control boards will influence this allocation to the extent that they influence the rates of increase in the profit shares among industries. An incomes policy that is neutral with respect to the allocation of investment seems difficult to design.

Relative Prices and Wages

Reallocations of output and employment among industries will be necessary for efficient production in the near future due to continuing changes in consumer tastes and technology. The wage and price boards should allow wages and prices to rise faster in some industries than in others to avoid excess demand for output in some industries and excess supply in others. As an indication of trends in the reallocation of output and employment among industries, Table III shows the distribution of output and employment among a ten industry breakdown of the private sector in selected years. Between 1952 and 1970 the shares of output produced in the agriculture, mining and construction industries declined most rapidly, while the shares in the communication, utilities, finance, and trade industries increased most rapidly. During the past 18 years, the shares of employment in the

Table III

Allocation of Output and Employment Among Private Industries

	Output			
	1952	1960	1965	1970
Construction	5.3%	5.0%	4.2%	3.5%
Services	10.0	10.7	10.3	10.5
Trade	18.2	18.8	18.8	19.5
Finance	12.9	14.7	14.9	14.9
Manufacturing	34.3	32.3	34.1	33.3
Communication	1.8	2.3	2.6	3.3
Transportation	6.1	5.2	5.1	5.2
Utilities	2.1	2.8	2.9	3.2
Mining	3.4	3.0	2.7	2.6
Agriculture	5.8	5.3	4.5	3.9
	Employment			
	1952	1960	1965	1970
Construction	6.1%	6.1%	6.3%	6.1%
Services	14.9	17.7	19.1	20.5
Trade	20.5	21.2	21.5	22.6
Finance	4.4	5.3	5.5	5.9
Manufacturing	37.8	35.9	35.6	34.0
Communication	1.8	1.8	1.7	1.9
Transportation	6.3	5.1	4.5	4.3
Utilities	1.3	1.3	1.2	1.2
Mining	2.1	1.5	1.3	1.1
Agriculture	5.0	4.1	3.3	2.4

Source: U. S. Department of Commerce, Office of Business Economics, *Survey of Current Business*.

private sector increased most rapidly in the services and finance industries and decreased most rapidly in the mining and agriculture industries.

In a market economy this reallocation of output and employment is achieved through the price system. Uncontrolled wages and prices respond to such forces as changes in consumer taste and technology of production.⁷ Table I shows the rates of change in prices and real wages by industry for the periods 1960-65 and 1965-70 to give an indication of the degree of change in relative wages and prices among industries during the last ten years.

Firms and workers in different industries have been adjusting their prices and wages to inflation at dif-

⁷Relative wages and prices also respond to such forces as changes in the distribution of market power and the application of laws, such as the minimum wage law. An examination of Tables I and III indicates that wages did not necessarily rise fastest in the industries in which employment rose the fastest, and prices did not necessarily rise the fastest in industries in which output rose the fastest.

ferent rates. Variation in the length and expiration date of labor and output contracts affects the degree to which expectations of inflation influence current transactions. Wages and prices tend to rise faster at those firms in which both the workers and management have higher than average expectations of inflation. For these reasons, the relative prices and wages that exist at any one point in the adjustment process of reducing the rate of inflation may not be consistent in the long run with the existing composition of demand for output among industries. Maintaining the relative wages and prices that existed immediately before the price and wage controls were initiated could slow an adjustment process necessary for an efficient allocation of resources, even if there were no change in the allocation of demand among industries.⁸

⁸The economy tends to be in a state of disequilibrium in the formation of relative wages and prices among industries and the allocation of resources in response to continuing changes in the allocation of demand among industries. As indicated above, there were additional reasons for disequilibrium at the time when price and wage controls were initiated. For a more thorough discussion of price formation in a changing economy, see Armen A. Alchian and William R. Allen, *University Economics* (Belmont: Wadsworth Publishing Co., 1967), pp. 274-355.

Conclusion

The success of the President's New Economic Program in achieving full employment and price stability is dependent upon several important, and somewhat neglected, aspects:

1. An effective system of wage and price controls can reduce inflationary pressures faster than with traditional stabilization policies alone if it succeeds in eliminating expectations of inflation sooner than otherwise.
2. A moderate rate of monetary expansion is essential to the maintenance of a rate of increase in aggregate demand consistent with the dampening of fundamental inflationary pressures.
3. The rate of economic recovery will be influenced by the increase in the profit share of income allowed by the pay board and price commission.

Relative wages and prices among industries should be relatively free to change in response to changes in consumer tastes and technology if resources are to be allocated efficiently and the progress of economic recovery is not to be hampered.



German Banks as Financial Department Stores

by DIETHER H. HOFFMANN

This paper was presented by Dr. Diether H. Hoffmann, Member of the Board of Management of Bank für Gemeinwirtschaft, Frankfurt, at Ohio State University, Columbus, Ohio, on November 30, 1970. He also discussed the paper in the Research Department at the Federal Reserve Bank of St. Louis.

NEW DEVELOPMENTS in the banking industry, greater demands for more adequate services, and the necessity to finance much larger operations have in recent years led many persons in the United States to ask whether the U.S. banking structure is adequate or whether changes should be made. For a discussion of such problems, it is useful to look across borders. Of course, it is impossible to simply copy the system of another country, because both the historical development and the interrelationships with other systems in that country have a bearing on the functioning of a banking system. But a comparison, for example, of the German with the U.S. banking structure at least clarifies alternatives, and even raises certain questions which may not arise if all the elements of a system are taken for granted.

I do not think it is appropriate for me to take a position on the current discussions in the United States. This is your discussion, and you as citizens will have to work out the appropriate answers. I shall, therefore, restrict myself to describing how the banking system is organized in Germany. I shall try not to delve too deeply into our history; rather, I shall describe the present situation and some of the discussions prevailing in Germany.¹

German Financial Institutions

In the Federal Republic of Germany we have about 8,500 credit institutions: 305 commercial banks; 844

savings institutions and their central banks; 7,072 cooperative banks and their central institutions; 46 long-term banks; 180 finance companies; and 102 institutions which have special functions discussed later. In addition, we have building societies with total deposits of 40 billion marks (DM) as deposits in the giro system and almost 10 billion DM as savings deposits.²

The credit institutions reporting to our central bank, the Bundesbank, have total deposits from the non-bank public of 447 billion DM. Distribution of these deposits among the credit institutions indicates their relative importance. Commercial banks hold 113 billion DM (59 billion DM are held by three banks). Savings institutions and their central banks hold 188 billion DM, of which 126 billion DM are savings deposits. These savings deposits are very steady money which a banker can almost consider as long-term money, even though most of them can be withdrawn on three months' notice. The cooperative banks and their central institutions hold 55.5 billion DM, the largest portion of the remaining 146 billion DM. The credit institutions also have issued bonds amounting to 119 billion DM.

A unique and significant feature of the German banking system is the importance of our savings institutions, most of which are owned by the municipalities. These institutions were established during

¹All data, unless otherwise stated, are as of December 31, 1970.

²The mark-dollar exchange rate has been about 3.65.

Table I

Assets and Liabilities of Banking Institutions in Germany
(Millions of Marks)

Group	Year	Assets		Liabilities	
		Total Volume of Business	Total Nonbank Loans	Savings Deposits	Total Nonbank Deposits
All Banking Groups	1960	252,518	154,898	52,864	104,051
	1964	408,038	261,219	93,500	233,499
	1967	562,846	356,228	144,672	319,856
	1970	822,158	510,598	208,687	447,058
Commercial Banks	1960	61,626	36,097	8,161	20,224
	1964	91,581	55,739	14,055	54,906
	1967	124,085	74,005	24,950	75,851
	1970	203,609	115,942	34,211	113,013
Savings Bank Sector (Giro Institutions & Savings Banks)	1960	90,339	52,685	33,811	48,497
	1964	149,429	93,019	59,849	96,055
	1967	214,878	130,853	89,752	133,877
	1970	314,953	191,965	126,316	187,461
Cooperative Bank Sector (Central Institutions & Credit Cooperatives)	1960	21,683	11,100	7,609	12,681
	1964	39,205	19,773	14,388	22,691
	1967	59,855	28,686	23,075	20,298
	1970	94,417	45,892	38,154	55,519
Other Banking Institutions*	1960	78,870	55,016	3,283	22,649
	1964	127,823	92,688	5,208	59,847
	1967	164,028	122,684	6,895	89,830
	1970	209,179	156,799	10,006	91,065

*Mortgage banks, finance institutions, banks with special functions, and postal giro and savings bank offices.

NOTE: The mark-dollar exchange rate in December 1970 was 3.6480.

the last century to safeguard the small saver — the laborer, the artisan and the small shopowner — against criminal or immoral practices in general and to encourage the spirit of saving. Considering the size of their deposits, they did very well in fulfilling this task. They also serve their communities by being very active lenders, holding about 23 per cent of all loans extended by credit institutions to the nonbank public. During the last ten years, they have become partners as well as competitors in almost all the other fields in which commercial banks operate. Their central banks, the Girozentralen, are established in each state and are particularly active in loans to big corporations and in long-term lending. Table I further illustrates the division of business among the various credit institutions.

Competition in the German Banking Industry

Competition in the German banking industry is very keen. Until a few years ago, however, we had several regulations limiting competition. Government fixed the rates for deposits and loans and even told banks how to advertise and approach their customers. All these limitations were rescinded in 1967. Now the only constraints are those imposed by the market and the cost/earnings structure of each bank, which limit

the interest rates paid or demanded. Banks are no longer required to refrain from certain methods of advertising or soliciting new customers, as long as these methods do not violate the national laws on competition, which are stricter than those prevailing in the United States. This new freedom has led to sophisticated promotional incentives for the saver. Debtors are more aware now that interest rates are not dictated by the banks, but can be negotiated.

After four years during which German banks have worked in this more liberal atmosphere, I feel justified in stating that this greater freedom has assisted in enhancing growth in the economy in general, and in particular, has aided the smaller customer. Competition for small deposits and personal loans only became effective after the former limitations were rescinded. Now, banks too have to prove their efficiency to their customers in the free market. In general, they have succeeded in this effort. The fear that increased competition could easily lead to more bankruptcies of smaller banks was unjustified; very few banks have failed during these years.

One of the first promotional incentives was a special savings certificate for the small saver, with interest rates which are not fixed according to the contracted time of deposit, but which rise according to the actual time of deposit. This complements the theory that small deposits have a tendency to stay for a much longer period than agreed upon when the deposit is made. Another incentive was a casualty insurance for the saver. The German insurance authority, however, permitted this practice only under the condition that the saver pay a special premium for the insurance, making such an incentive unattractive as a tool of competition since the premium would have to be deducted openly from the interest rate.

The interest rate for three-month savings deposits, the rate generally considered the guideline for all

savings and time deposit rates, is currently about 4.5 per cent; for four-year deposits it is up to 7 per cent. Larger sums deposited over the year-end as regular term deposits could earn up to 8.5 per cent. Demand deposits generally bear $\frac{1}{8}$ per cent interest. Table II shows the development of the rates for three-month term deposits of sums under one million DM.

The discount rate of the Bundesbank is the guideline for bank loan rates. Short-term business loans are issued at a margin above the discount rate. The prime rate is about 3.5 per cent above the Bundesbank discount rate. Rates for customers which do not get the prime rate are about 1 per cent higher. Who gets prime interest rates generally is decided by the standing of the borrower; other circumstances, such as the amount of business the customer conducts at the bank and his total deposits, are only of secondary importance in this respect. The rates are either flat rates or subject to additional charges, particularly those linked to the turnover on the accounts; the instrument of compensating balances is not in use.

Although there is competition among the banks as far as the margin above the Bundesbank rate is concerned, in general, the Bundesbank's discount rate affects directly the cost of borrowing from a bank. German bankers are discussing the American system of setting the prime rate themselves, which would allow them to consider not only the Bundesbank rate, but also other factors influencing the cost of money, including the domestic money market. We have made slight changes in this direction during the last two years, but it is too early to forecast our further course in rate policy.

The picture of our short-term lending activities would not be complete unless I describe a special type of short-term financing practiced by German banks. We discount bills from our customers. These bills must be due within three months, bear two "good" signatures, and must be drawn in connection with a sale of goods. Then, they are rediscounted by the Bundesbank. We add a small margin above the Bundesbank rate. This margin is lower than for loans for which this special method of refinancing is not provided. For many years it was .5 to 1 per cent; with recent increases in the cost of money, it has risen to 2 per cent. This method reduces considerably the average cost of short-term financing for clients who can use this kind of credit. Other methods of financing have only minor importance in the short-term market. The U.S. system—especially with its commercial paper market—seems to be far more sophisticated.

Table II

Average Interest Rate for Three-Month
Term Deposits
(Under One Million Marks)

Reporting Period	Average Interest Rate
1968 March	2.82%
June	2.84
September	2.85
November	3.08
1969 February	3.01
May	3.24
August	4.16
November	4.88
1970 February	6.95
May	7.93
August	7.67
November	7.49
1971 January	6.64
February	6.56

While the rates for short-term loans are flexible, long-term rates and consumer credit rates are fixed. This applies to long-term loans when issued by mortgage banks and paid out of the proceeds of mortgage-secured bonds, which only these special banks can sell. These rates recently have been above 9 per cent. They cannot be changed by the bank or the customer during the time of the loan, which may be up to 33 years. Long-term loans not given by these special banks, but by commercial banks or savings institutions are, of course, linked either to the Bundesbank rate or to the cost of money. For consumer loans the rates are fixed at the time they are made, thus allowing the banks to quote a fixed amount for both amortization and interest which the client has to pay each month.

Loan Activity Abroad

With the Deutsche Mark freely convertible, and since for a long time we have had little exchange control, German bankers are allowed to make loans to any foreign company anywhere in the industrialized world as well as in developing countries. In 1969 especially, German banks were large exporters of capital. They made loans of almost 25 billion DM, a large portion of which was long-term money. This capital export continued through April of 1970 with an increase of 2.5 billion DM. But then it stopped, and there was a light counterflow, since the burden had been too heavy for the German banking system as a whole. Most of these loans have been portfolio investments rather than regular export financing. For export financing, our banks, not the government, set

up a special institution to make loans at comparatively low rates.

Scope of Business

Most of the functions mentioned so far can be performed by both the commercial banks and the savings institutions. They all are allowed to make short-term commercial, long-term, and consumer loans, and to accept demand, time and savings deposits. They participate in the clearing system for money transfers established by the Bundesbank, and their customers can use their services by drawing checks or signing transfer orders, which is the more common method of paying a bill in Germany. Only mortgage banks and the Girozentralen, the central banks of the savings institutions, can issue and sell mortgage-secured bonds. The Girozentralen have the largest range of activities; they are permitted to do all things savings institutions and commercial banks can do, in addition to selling mortgage-secured bonds. It is therefore no wonder that the largest bank in the Federal Republic is the Westdeutsche Landesbank, the Girozentrale serving the heavy industrial Ruhr area.

Regular mortgage banks, in extending long-term loans against first mortgages on buildings or to public authorities, are limited to the use of funds received from the sale of their bonds. They may not accept regular deposits, which prevents them from extending short-term loans. This rule has two important exceptions: because their charter was issued in the middle of the last century, two Bavarian banks have the same right as the Girozentralen; that is, they can perform all the activities in short- and in long-term business.

Further limitations apply to special institutions; finance companies may extend only installment loans, both as consumer credit and as loans financing the sale of machinery to smaller companies. Other credit institutions are factoring and leasing companies. The latter have only recently been established and have not been too active — partly because tax problems remain to be solved.

Bank Structure

Our banking laws thus are very liberal. There are two major prerequisites for opening a bank in Germany: sufficient capital of 5 million DM (although several smaller banks established earlier only have 1 or 2 million DM as capital plus reserves) and competent management. Until 1962 the banking authority had the right to decide whether there was an eco-

nomic need for the establishment of a new bank; however, this provision was found unconstitutional by our Supreme Administrative Court and was rescinded.

Once a bank is established, the number of branches it wishes to operate is unlimited. There is little or no restriction as to the area where these branches may be opened. Legally, all banks could have branches all over the country. Only the savings institutions are restricted; their charters limit them to the municipality to which they belong. Similar restrictions limit the Girozentralen to the states of the savings institutions they represent. Nevertheless, we only have four banks which have nationwide branches — Deutsche Bank, Dresdner Bank, Commerzbank and Bank für Gemeinwirtschaft. To give you a picture of their size, Deutsche Bank has total assets of 31 billion DM, and Bank für Gemeinwirtschaft has 12 billion DM. The four banks together attracted about 12 per cent of the total deposits held by German credit institutions.

There are more than 32,000 branches of credit institutions in Germany. This, added to the 8,500 established head offices, means that altogether there are over 40,000 locations in which the services of a bank or some other financial institution are offered. Compared with a population of over 60 million, there is one bank location per 1,500 inhabitants. I understand that in the United States, one bank or savings bank serves an average of 5,700 inhabitants.

The picture becomes clearer when one breaks down these figures by groups of credit institutions; of those 40,000 offices, over 16,000 belong to the savings institutions and their central banks, more than 18,000 to the cooperative banks, and 5,300 to the commercial banks, of which the four banks operating on a nationwide basis have almost 3,000. If you think of the amount of savings deposits drawn in by German savings institutions and their network of branches, it is understandable why even the smallest child thinks first of the Sparkasse (the savings institution) when he is asked to put some money aside.

Of the 40,000 offices mentioned, 47 are operated by 24 foreign banks, mostly U.S. banks. Although the banking authority could refuse a concession to them on the grounds that the German constitution guarantees the freedom to do business only to indigenous corporations, it has been very liberal and granted the concession if the applying bank was of good standing and provided qualified management for the branch. Difficulties arose in only one case — the Intra Bank of Beirut which discontinued operations — but no credi-

tor in Germany was hurt since the branch had enough capital at its disposal, and business inside Germany had not contributed to the failure of this bank.

German laws, on the other hand, do not impose any limitation on German banks if they want to go abroad. However, operations within our economy have, so far, proven to be more appealing than foreign opportunities. Thus, you find only a few branches or subsidiaries of German banks in other countries. New forms of international cooperation with German banks as partners have been developed only recently.

Regulations and Limitations on German Banks

So far you have heard only of very liberal provisions of the law and a very liberal attitude of the banking authority in Germany. You might, therefore, wonder if the banks in our country are free from controls. The answer to this question is clearly no. Rather strict regulations limit the activities of a bank in its lending by stipulating that the total amount of its loans must be in certain proportions to its capital plus reserves, to its long-term and savings deposits, and to its total liabilities. This is a rather complicated, but very effective, regulation. So far it has prevented serious cases of bankruptcies of German banks. In the few cases where bankruptcy has occurred, other banks have provided the money necessary to insure the smaller savers against loss.

There is no state insurance for depositors as in the United States. However, in 1969, the banking community established several funds which would pay up to 10,000 DM to each depositor in case of a bankruptcy. Further limitations include minimum reserve requirements, which were particularly effective during recent months when the Bundesbank tried to restrict the inflow of money from abroad.

Other Activities of German Banks

This may all sound familiar to the American banker so far. There are, however, two other specific functions of German banks. They can own stock in other companies — banks or nonbanks — and they can operate as stock brokers.

The banking crisis which occurred in our country in 1931 was due mainly to bad management in loan operations. If the government had not intervened, heavy losses on loans would have led to the bankruptcy of several leading banks. It was the loan and not the stock market business which was at the root of the difficulties. Therefore, the question which was discussed at great length in your country after 1929

— whether banks should continue to do business on the stock exchange — was not considered very important in Germany. Banks continued to be the only agents of the stock exchange — both for their customers and their own portfolios. This means that in practice almost all transactions in shares are done through the banks, and the orders must be executed at the stock exchange, although there is no legal provision to this effect.

Again and again the question arises as to whether the example of the United States, in which broker and bank business is separated, should be followed. Only serious examples of mismanagement, however, could lead German legislators to change a structure which so far seems to have worked rather satisfactorily. Two arguments are raised whenever this question is discussed. First of all, it is said that banks are interested in making loans; therefore, they may use their influence to keep corporations from attracting funds in the stock market. However, this argument neglects the main obstacle against the issue of new shares: corporations prefer to pay interest on a loan rather than leaving half of their earnings to the tax authorities. As long as there is this differential tax treatment of interest and dividends, corporations will prefer to borrow from banks to acquire funds.

Compared with the United States, we have an underdeveloped stock market. German savers invest in a more speculative manner, such as buying stock, only after having put a certain amount of money into a savings deposit. To be objective, one must admit that until recently German banks were not very eager to sell stocks or mutual funds. Although some of these funds were already established in the 1950's, it was the promotional activity and success of Investors Overseas Services Ltd. (IOS) and other American organizations that caused bankers to realize that their customers were interested in this service also. Now, German commercial banks are trying to innovate in this field. Mutual fund sales totaled 390 million DM in 1960; in 1969 the German public purchased 5.5 billion DM of mutual funds, while foreign mutual funds sold 2.1 billion DM.

The Investors Overseas Services Ltd. crisis brought a sharp reduction in total mutual fund sales during 1970; all funds sold totaled only 1.5 billion DM. New changes may result from the discussion of whether savings institutions should form holding companies and sell shares of these companies to their clients, especially to the small savers.

The second argument brought forth against the banks in their capacity as brokers is that they exercise

an enormous influence on the German economy by means of directorships in most of the important German companies. Bear in mind that the German stockholder generally leaves his shares with his bank and gives the bank power-of-attorney to represent him at shareholders' meetings, exercising all his rights for him including his voice. This, of course, makes it easy for the banks to have their officers elected as directors of the companies. Until a new law in 1966 limited to ten the number of directorships one person could hold, one banker was a director of more than 30 companies. Now, of course, he and his colleagues in the banking community are limited by law, but it cannot be denied that their influence through directorships is rather strong.

The only question I am asking in this connection is whether there really is a better method of safeguarding the interests of the small shareholder. I personally am not sure that the method prevailing in your country, which in general results in management electing the directors of a company, really provides a better system of control than ours.

Of course, this influence of banks on the economy becomes even stronger when backed by an important participation by the bank itself. This leads us to the other feature which I mentioned before. German banks are only limited in one way as far as participations are concerned. Their investments in participations and real estate must not be higher than their capital plus reserves.

This legal situation has enabled German banks to be promoters of new companies, to buy shares from a major shareholder who wanted to dispose of his holding, or to take over a company which ran into difficulties. Transactions of this kind have attracted the attention of the public again and again, not only at the beginning of the era of industrialization, but also recently.

It is the philosophy of my bank that permanent participations should be made only if they are connected either with the services usually rendered by banks or with the activities of our shareholders, which are trade unions and consumer cooperatives. Follow-

ing this guideline, we have participations in our own banks and finance companies in Switzerland, Israel, Luxemburg, and the Netherlands, a merchant bank, two finance companies, two mortgage banks in Germany, three insurance companies, and a travel agency. In addition, we own one-third of the stock of the wholesale company of the German consumers' cooperatives.

Other banks do not follow similar guidelines restricting their policy for participations. They are also important shareholders in large industrial corporations. Deutsche Bank alone owns more than 25 per cent of the following large corporations: Germany's biggest shipping company, Hapag Loyd; the large sugar company, Süddeutsche Zucker; and one of the two largest department store chains, Karstadt. Another 25 per cent of the latter is held by Commerzbank, which at the same time is a major stockholder in the other big department store chain, Kaufhof. Furthermore, Commerzbank is involved as shareholder in breweries, another construction firm, and a hotel chain.

I would like to mention briefly the role of service organizations. Consultant firms for legal and tax matters are permitted only under private partnerships. However, banks may enter into the fields of auditing, accounting, management consulting, and particularly, computer services. These may be the fields of the future. So far, banks have not really discovered them.

Conclusions

All this may have given you the impression that German banks are acting more as conglomerates than as finance institutions. However, you may be assured that they have played an important role in attracting and lending the money necessary for our reconstruction and growth, and Germany has thus fared very well. We do not close our eyes against the dangers of such a very liberal structure, and international comparison is of great importance in this respect. There is hesitancy, however, to forcefully impose changes on a system that has a long tradition and so far has proven its efficiency.

This article is available as Reprint No. 73

The Flexible Exchange Rate: Gain or Loss to the United States?

Speech by DARRYL R. FRANCIS, President, Federal Reserve Bank of St. Louis
to the Twenty-Second World Trade Conference
International Center of the University of Louisville, November 10, 1971

I AM PLEASED to have this opportunity to discuss with you some of the current issues in international trade. I am particularly interested in this topic since the recent decision by President Nixon to suspend dollar convertibility into gold is eliciting high-pitched discussion in the world press and, even more important, this decision has a serious impact on the welfare of all consumers in the world.

Although international trade represents only four or five per cent of the U.S. gross national product, its impact on domestic welfare is much greater, and the settlement of current problems and uncertainties will be felt by all of us for a long time to come. As far as I am concerned, the agreement on an international payments mechanism is of far greater importance than the ten per cent surcharge, and consequently I will address my remarks to that portion of the new international economic policy.

First, I will discuss the functioning of the international payments system; second, the historical events leading to the current situation; third, the alternative solutions available. Finally, I will indicate my choice of an international payments mechanism.

The Benefits from Trading Internationally

The United States can produce virtually any commodity and service that it currently consumes. Why, then, do we engage in international trade and incur the risks and crises that have plagued us for the past

fifty years? The answer, of course, is that international trade, like domestic trade, is profitable. It is profitable in the sense that it increases the welfare of trading countries.

The reason we buy an imported commodity is simply that we can purchase it cheaper abroad than we can produce it domestically. We pay for our imports by selling goods and services to foreigners who will accept them only if our goods are cheaper than the same goods produced by them. Therefore, the citizens of both trading countries, given their resources, can consume more goods and services than they could in the absence of such trade.

The reasons for the relative price differentials are varied — it may be productive efficiency or it may be domestic demand conditions. What is important is that the price of the delivered foreign commodity or service is lower than the price of the same commodity produced at home. Therein lies the benefit from international trade. If such benefit does not exist, trade will not take place. Any artificial restrictions which lower this price differential reduce the amount of international trade and therefore the welfare gains that may accrue.

The same reasoning applies to international capital movements. We buy foreign capital goods or foreign securities only if they promise a higher rate of return than domestic ones. In that sense, a given amount of resources increases our income and welfare. The

country selling the securities benefits by attracting a scarce resource to facilitate the efficiency of the productive process.

What is important to remember throughout any discussion of international trade is that benefits accrue from our ability to consume more; that is, from *imports* of goods, services and securities.

The Mechanism of International Payments

Since gains from trade derive from imports, why don't we keep importing as much as possible and forget about exports, reserve balances, and various exchange problems? Like everything else, imports must be paid for, and exports are the ultimate means of payment. But since the barter system is extremely inefficient in individual transactions, we avoid the item by item matching of imports and exports by using the international payments mechanism, just as we avoid the matching of goods and services in domestic transactions with the use of money.

To demonstrate international payments, let's assume that I buy a Japanese radio for \$30. I write a check on my bank and send it to the Japanese exporter who deposits the check in his bank and gets Japanese money for it. If the Bank of Tokyo can find an importer who wants \$30 to buy something in the United States, it will sell the draft to him and my \$30 finds its way into the account of a U. S. exporter in a U. S. bank. Under these circumstances, an import was offset by an export, the quantity of dollars supplied was equal to the quantity demanded, and the price of the dollar — the exchange rate — remained the same.

But what if the Bank of Tokyo cannot immediately find an importer who wants to buy U. S. goods and services? What can it do with my \$30 check? At this point we must specify the international payments mechanism that is used by the United States and Japan. There are three main payments systems that have been used: the gold standard, the dollar or sterling exchange standard, and a flexible exchange standard.

On a true gold standard, the Bank of Tokyo will sell my check to the Japanese central bank who, in turn, will buy \$30 worth of gold from the U. S. Treasury. Thus, my import of a radio was matched by an export of gold. The exchange rate, which is fixed in terms of gold, does not change.

If we are on a dollar exchange standard, as existed until recently, the price of a dollar is fixed in terms

of gold and the prices of all other currencies are fixed in terms of the dollar. In order for the exchange rate to remain constant, the supply of dollars created by my purchase must be matched by an equivalent quantity demanded. Since central banks are committed to maintenance of a fixed exchange rate, in the absence of private demanders of dollars the central banks must buy and hold the \$30, thus increasing their foreign reserves.

A flexible exchange standard implies that the price of the dollar will be determined by market forces without official intervention. In this instance, the Bank of Tokyo would offer my \$30 on the exchange market. If there are buyers of U. S. goods and services at existing prices, the \$30 will be purchased by them and the exchange rate will not change. But if these importers view U. S. prices as being too high, they will offer less foreign currency for my \$30 check and the transaction will be consummated only at the lower price of the dollar. Thus, my import is still paid by an export, but only when accompanied by a change in the exchange rate.

To summarize this illustration, my import of the radio was paid for with either a gold export, a U. S. liability that a foreign central bank is willing to hold, or an export of U. S. goods and services.

It should be clear, however, that an excess of imports over exports can be continued under a gold standard only as long as our gold supply lasts. Similarly, under the dollar exchange standard the excess can continue only as long as foreigners are willing to supply us with goods and services in exchange for dollar accounts in U. S. banks. Since we desire imports, what is there to prevent the United States from exhausting its gold stock or prevent an ever increasing accumulation of dollar balances by foreign central banks? In other words, is there an adjustment mechanism which prevents permanent imbalance in trade and possible breakdown of international economic relations? Let us examine the adjustment process in each of the three payments systems I have outlined.

Adjustment Processes

The gold standard, if permitted to function, would cause an export of gold in our Japanese radio example. A decline in the U. S. gold stock will cause a contraction of money supply in the United States and a decline in nominal income. Exactly the opposite will occur in Japan. With U. S. income declining, and Japanese income rising, our purchases of Japanese goods will decline and our sales to Japan will increase.

This would cause an elimination of any U. S. import surplus.

Similarly, under the dollar exchange standard, the accumulation of dollar balances by foreigners would increase their reserves, which in turn, would lead to an increase in their money supply and income level. The opposite could happen here, and again our balance-of-payments deficit would be corrected.

The flexible exchange rate, as we have seen, would tend to establish a balance between imports and exports by causing a decline in the price of the dollar in terms of foreign currencies, which would make foreign goods more expensive to us and our commodities cheaper to foreigners. This change in relative prices would discourage our imports and encourage our exports.

All three systems of international payments mechanisms facilitate trade, provide adjustments, and have within them necessary means for prevention of trade breakdown. Two of them do it with fixed exchange rates, and one with a flexible rate. Thus, the question arises as to what are the ultimate differences among them, and why should a person advocate one exchange rate system over another.

The major difference is that within the fixed exchange schemes — both the gold and the dollar exchange standards — the adjustments which are necessary to maintain an equilibrium in the balance of payments take place in the domestic economies in the form of changes in price, income, and employment levels. In a flexible exchange rate mechanism, the adjustment is in the form of changes of prices and quantities of internationally-traded commodities, and in the welfare aspects generated by the changes of the terms of trade.

The adjustments required by a fixed exchange rate system frequently conflict with domestic goals. Virtually all national governments have adequately demonstrated that they are committed to the achievement of stable conditions in domestic economic activity. In our example, for instance, it is difficult to imagine that, given an import balance, the United States would be willing to permit the indicated contraction of domestic production with its inherent probability of higher unemployment. It is just as difficult to visualize Japan deliberately submitting to inflation because their exports have exceeded their imports.

As a result of the strong desire for economic stability at home, central banks have generally undertaken policies which mitigate the adjustments necessary to

correct a disequilibrium in international trade under a system of fixed exchange rates. Such actions have resulted in the development of persistent and fundamental trade deficits and surpluses. In turn, these surpluses and deficits have produced crises requiring periodic adjustments in the exchange rate, direct controls, and other arbitrary impediments to international trade.

A flexible exchange rate, on the other hand, does not necessarily imply domestic fluctuations in income and employment. It is, therefore, more likely to be permitted to achieve the adjustments necessary for the smooth functioning of international trade. In the choice of different exchange rate systems, it seems to me, the crux of the matter is not the *ability* of these systems to make necessary adjustments; rather, given the demonstrated political necessity of maintaining full domestic production and employment, it is a matter of which one will be *permitted* to do so.

Historical Background of the Present Crisis

I have sketched the various international payments mechanisms and have indicated how equilibrium can be achieved under several exchange rate standards. I would like to turn now to the specific case of the U. S. balance-of-payments difficulties and discuss historical events leading to the "international monetary crisis" of 1971. In capsule form the history of the U. S. balance-of-payments position is as follows.

From 1790 to 1875, the United States was a net importer of goods, services, and capital. A developing economy provides good investment opportunities and foreign capital flows in. This inflow financed the excess of merchandise imports. As the economy matured and the ratio of capital to other resources began to grow, repayment of foreign loans, and eventually U. S. foreign investment, began to take place. In the United States this change occurred approximately in 1875, and since that time we have been a net exporter of capital and merchandise.

At the end of World War II, we emerged as virtually the only industrial country with its productive capacity intact. In spite of the strong postwar domestic demand, our relative prices were still lower than those in foreign countries and our export balance became very large. This excess of exports over imports was financed by private and government lending and unilateral transfers. After 1950, U. S. private and government capital outflows began to exceed the exports of merchandise and services, thus supplying more dollars to the foreign exchange markets than foreign importers were willing to absorb. That is, since

1950 the U. S. balance of payments on a liquidity basis has been in deficit.

The international payments mechanism, as established by the Bretton Woods agreements of 1944, provided that countries can fix their exchange rates either in terms of gold or in terms of the dollar. As it turned out, the United States established the price of the dollar in terms of gold at \$35 per ounce and most other countries defined the prices of their currencies in terms of the dollar. The exchange rates were fixed by foreign central bank intervention in the form of buying dollars when the price of the dollar was falling in terms of foreign currencies and selling when the price of the dollar was rising. It isn't difficult to see that a persistent deficit in the U. S. balance of payments and a fixed dollar exchange rate could co-exist only with the accumulation of dollar balances by private foreigners and foreign central banks.

Until the latter half of the 1960's the United States experienced a significantly lower rate of inflation and a lower amplitude of cyclical fluctuations than did other major foreign economies. Therefore, the dollar, as the most stable of all major currencies, was extensively used as an international means of payment. A large portion of the deficit-induced dollar balances were thus held willingly and provided a service as international money.

During the late sixties, however, the U. S. balance in goods and services began to decline while capital outflows remained virtually constant. At the same time, domestic monetary and fiscal policies resulted in large decreases in the purchasing power of the U. S. dollar, both domestically and internationally. Thus, in world trade we had an increasing rate of dollars being supplied and a reduced demand for them, and under these circumstances something had to give.

With these developments in mind, let's analyze our position in the spring of 1971.

U. S. International Position in Spring 1971

1. Expansionary monetary and fiscal policies since 1965 resulted in a rapidly rising price level and growing expectations of inflation. Attempts to moderate inflationary pressures by restrictive fiscal actions in 1968 and restrictive monetary actions in 1969 were reversed in 1970, eliminating any hope of quickly achieving price level stability.

2. As a result, our imports continued to increase, while our exports began to decline. A deteriorating balance in goods and services, coupled with substantial net investment in other countries and government

expenditures abroad, meant an increase in the quantity of dollars supplied without a corresponding increase in demand.

3. The international price of the dollar could remain fixed only through sales of gold to foreigners or through massive accumulation of dollar balances by foreign private individuals and central banks. Our gold supply has dwindled to \$10 billion, and we were reluctant to permit its continued depletion. Dollar accumulation by foreigners reached \$45 billion by March 31, 1971.

4. Foreign exchange dealers and owners of liquid dollar balances, in anticipation of some kind of a downward readjustment in the value of the dollar, began converting dollar holdings into foreign currencies. This forced foreign central banks to purchase even larger amounts of dollar claims.

5. With these pressures increasing, and with no hope for redress, Germany, Netherlands, and Belgium announced that they would no longer purchase additional dollars, thus floating their currencies and permitting them to appreciate. Meanwhile, Switzerland and Austria undertook outright revaluation by announcing that their central banks would continue to purchase dollars, but only at a lower price.

6. Our deteriorating competitive position and resulting reduction in the export surplus were contributing to unemployment in the United States.

Alternative Options Available

Given this situation, neither the United States nor the major trading countries which were running sizeable surpluses could continue under the existing fixed exchange rate alignment. It was clear that the U. S. dollar was overvalued with respect to many major currencies and that the existing exchange rate mechanism was prone to the development of persistent balance-of-payments deficits and surpluses. Any new system which could remain viable for any length of time would not only have to alleviate the U.S. deficit, but also provide for a payments mechanism which would inhibit the persistence of international disequilibrium.

Three unilateral actions were available to the United States: the establishment of import controls in order to equalize exports and imports, the revaluation of gold with the hope that other countries would permit the exchange depreciation of the dollar, and the suspension of dollar convertibility into gold, thus subjecting the international value of the dollar to market forces.

Import controls, whether in the form of high tariffs or of direct or exchange quotas, represent a type of interference with consumer choice. As we have seen earlier, the benefits from international trade are a result of satisfying consumer preference for imported commodities and the consequent reallocation of resources so as to increase the efficiency of the trading economies. Arbitrary intervention with the consumer preference pattern will reduce the total volume of trade and the benefits to be derived from it. The size of this welfare loss is difficult to measure, but it is of such magnitude that, even under the most trying circumstances, governments which are concerned with the satisfaction of individual citizens' wants have undertaken such measures only as a policy of last resort.

The revaluation of gold, in spite of its current mention as a solution, does not produce the desired effects, particularly when it is unilateral. As we have seen, exchange rates are fixed at their established parities by central bank intervention. Devaluing the dollar in terms of gold does not, by itself, realign exchange rates and therefore neither improves the U.S. balance-of-payments position nor provides a payments mechanism which will preclude persistent deficits or surpluses.

The suspension of dollar convertibility into gold, again, as a unilateral action, does not insure that the dollar will float in response to market forces. *We* may say that the dollar is floating and *we* may not intervene in the foreign exchange market, but that does not prevent foreign central banks from interfering and fixing the dollar rate of their currencies at some level desired by them.

It may be asked at this point, why then *did* the President suspend the conversion of dollars into gold? The answer is to be found in the huge dollar balances accumulated by the central banks of surplus countries. Without convertibility into gold, these balances can only be used to buy U. S. goods and services. Since the accumulation itself is a sign that at current prices foreigners find it unprofitable to import from the United States, the probability that they will continue to support the prevailing price of the dollar is very small. This was already indicated by the revaluation and floatation of the currencies of several countries which took place in May 1971. In addition, inconvertibility of the dollar into gold, in effect, removed the cornerstone of the Bretton Woods agreements and made some multilateral action imperative.

To sum up, unilateral actions on the part of the United States, as economically powerful as it may be, either do not solve the current international economic problems or are too costly to undertake and

enforce. What is required is a multilateral action of all countries involved to realign the exchange rates and to agree to a payments system which will provide enough exchange rate flexibility to forestall another crisis such as we face today.

Possible Choices of Payments Mechanisms

In view of the discussion up to now and in view of the sentiments expressed by international authorities and the world press, we are left with two effective possible payments systems: a multilaterally agreed upon freely fluctuating exchange rate mechanism or a multilaterally established fixed exchange rate system with readjusted par values and with somewhat greater flexibility around par. I should like to discuss these in reverse order.

Fixed exchange rate. A fixed exchange rate system will require a negotiated realignment of exchange rates. The events of the past few weeks demonstrate the magnitude of the problem. Surplus countries all appear to acknowledge the necessity of devaluing the dollar. However, when it comes to a true commitment, few countries wish to revalue their currencies to a true market level at which their surpluses and our deficits would be eliminated. In short, a surplus to them at the expense of a deficit to the United States is "fair."

Given this attitude, it is difficult to conceive that the governments involved would pursue the domestic policies necessary for a fixed rate system to survive, because fixed rates without balance-of-payments difficulties require that each country maintain a rate of domestic economic growth approximately equal to that of other countries. Significantly different growth rates would again produce persistent balance-of-payments surpluses and deficits and would again lead to exchange crises with all the losses of trade that accompany them.

Increased flexibility around par will permit larger deviations from a concerted rate of growth but will not eliminate the possibility of some country being temporarily successful in using foreign trade as a tool of domestic policy. So long as such a possibility exists, some governments will have the incentive to use this politically expedient economic measure at the expense of welfare gains to their consumers.

Thus, even if a "correct" exchange realignment is agreed upon, and the U.S. balance-of-payments problems are solved, the permanency of such a system is very much in question. Of course, if the established bands around par were very wide, and the par were to change easily and automatically, my objections

would be removed. But then, of course, it would not be a fixed rate system.

Freely fluctuating exchange rate. This leads us to the consideration of the freely fluctuating exchange rate. I believe that such a system would best solve current difficulties and would assure a permanent exchange rate mechanism which should be free of the type of trade slowdowns we are experiencing now. Rates would respond to the forces of demand and supply and accurately reflect the trading positions of all nations. Unwanted accumulations of currencies could not take place; there would be no development of crises with their resultant losses. And, what is more important, all governments could pursue totally independent domestic policies without imposing their excesses upon others.

An inflationary policy, for example, would cause an increase in a country's demand for imports and a decline in its exports. Instead of running an extended deficit and exporting its inflation, it will find that the international value of its currency has fallen and its import surplus is eliminated. Thus, domestic excesses would have to be paid for at home. I believe that the knowledge of this fact will prevent the use of the international market for domestic goals.

Two major criticisms of the freely fluctuating exchange rate are most frequently voiced. First, because of daily or conceivably even hourly fluctuations in the rate, it is contended that the increase in uncertainty will cause a reduction in the volume of trade. Second, it is further contended that the freely fluctuating rate will elicit trade restrictions and unbridled speculation.

There is little doubt that continuous small changes in the exchange rates would induce marginally greater daily risks and therefore somewhat greater costs of international currency convertibility. This is supported by the sparse historical evidence and by the recent behavior of the forward rate. The forward rate, which among other things reflects the insurance premium for delivery of some currency at a specified price at some future date, has increased. Interestingly enough, however, the increases are minimal where the float is "clean" and large where central bank intervention is either present or anticipated. This seems to indicate that the actual flexibility is a small contributor to increased costs, while intervention, or anticipated official revaluations as exist under a fixed rate, is the real culprit.

Most of our domestic commodity, stock and money markets have hourly fluctuations and the premium

associated with frequent changes does not appear to be prohibitive nor does it impair the efficiency of these markets. Here too, large fluctuations in forward prices occur when there are anticipations of some natural disaster or a strike or some institutional interference, events not unlike anticipated changes in the exchange rate.

The question that should be asked is not whether *convertibility* costs are higher under a flexible exchange rate as compared with the fixed rate, but whether they are higher than the total trade costs of periodic real or anticipated revaluations of the fixed rate. Since 1944, out of 92 countries which have established parities under the International Monetary Fund, forty-five countries have changed par values seventy-four times. Several of these changes were accompanied by serious international economic disturbances, and most of them by domestic problems of reallocation of resources. Every sudden official change in the exchange rate causes a movement of resources between export and import competing industries, and each movement implies an increase in structural unemployment. Consequently, the economic costs of a fixed exchange rate system are sizeable. With a flexible rate system, on the other hand, resources move gradually and with a minimum of friction, resulting in lower costs.

Similar remarks can be made about speculation, an activity which stabilizes rather than destabilizes prices. Destabilizing speculation, which everyone fears, occurs as a result of anticipations of forces outside the normal economic realm. With freely fluctuating exchange rates, such forces are much less likely to materialize than with a fixed rate system which experiences periodic crises.

An interesting observation is that with fixed exchange rates and the associated central bank intervention in exchange markets, a form of speculation is performed by central banks rather than by those individuals who voluntarily bear the risks. Thus, the risk of loss is borne by all taxpayers, whether they want it or not.

As for the criticism that freely fluctuating exchange rates will elicit trade restrictions greater than under fixed rates, one simply has to look at the situation which existed for the past 27 years. It really all depends on what one means by trade restrictions. It seems to me that arguing that a fluctuating rate will lead to more restrictions is simply saying that where disequilibrium fixed rates can no longer be used to pursue domestic goals, alternative means may take the form of new trade restrictions. In other words, a

country, which for purposes of domestic stabilization, maintained an undervalued currency and an export balance under a fixed rate system, will now have to resort to other trade restrictions to achieve the same goal. It is certainly not an inevitable consequence of flexible rates, and in any case, it is only a different manifestation of the same restrictive policy.

The usual example put forward is the economic warfare of the early thirties. At that time there was truly a proliferation of various international trade barriers and for a while the British pound was removed from its convertibility into gold. What these critics fail to point out is that there was a worldwide depression under way and that the restraints began to multiply in 1929 while the pound was not floated until 1931. A causal relationship is certainly not indicated.

Conclusion

I believe that the freely fluctuating exchange rate is far preferable to a fixed one. Whatever the costs involved, they are less than those imposed by the present system. There is the chance now to establish a mechanism which prohibits the exchange exploita-

tion of one country by another and which therefore has a better chance of long-run survival.

From reading the reports of the present international economic "crisis," one gets an impression that the current decline in global trade is caused by the so called "floating" of exchange rates. It is our view that nothing can be further from the truth. In the first place, the crisis existed prior to the floating of the rates and secondly, the rates are not being allowed to float freely. The high risks which are instrumental in the decline of trade are not created by the flexibility of the exchange rate, but by the anticipations of a new and unpredictable exchange rate fix.

I do not believe that freely fluctuating exchange rates will be agreed upon immediately. I would rather expect that the first agreement will produce a new exchange rate realignment with wider bands around the par. Then, the next inevitable crisis will add to it a crawling peg. From there it is only a small step to the freely fluctuating exchange rate. So, in spite of all the terrible disasters that are predicted for flexibility, I believe that we may yet see an international payments mechanism which will utilize freely fluctuating exchange rates and which will assure a maximum of welfare without artificial obstructions.



Regional and Multilateral Dimensions of the United States Balance of Payments*

Remarks by ANDREW F. BRIMMER, Member,
Board of Governors of the Federal Reserve System,
Before a Luncheon Sponsored Jointly By The Boards of Directors of the
Federal Reserve Bank of St. Louis and its Louisville Branch
Louisville, Kentucky, October 14, 1971

A CONSIDERABLE number of words have been spoken and written about the United States balance-of-payments problem, and in the last two months vigorous steps have been taken to correct the deep and persistent deficit. However, both before and after the mid-August actions, explanations of the causes of our balance-of-payments difficulties have varied widely. And, as one would expect, these different explanations have led to a variety of conclusions as to the appropriate cure. Unfortunately, many of these suggested courses have involved the pursuit of partial and specific targets, rather than focusing more broadly on the multilateral dimensions of the problem. I believe we must look to these broader aspects if we are to achieve lasting improvement.

Among the more specific targets for action to reduce the deficit have been the following:

Military expenditures abroad: How can the level be reduced? How big a premium should be paid for procurement in the U.S.?

Private capital outflows: How much restraint should be imposed on purchases of foreign securities, on direct investment, and on U.S. bank lending abroad?

Unfair trading practices of foreign countries: What are the best ways to reduce barriers which discriminate against U.S. exports.

*I am indebted to several members of the Board's staff for assistance in the preparation of these remarks, especially to Mr. Samuel Pizer, Miss Kathryn A. Morisse, and Mrs. Betty L. Barker.

Among the more generalized targets have been the following:

Inflation in the United States: How can excess demand be curbed to help check deterioration in our trade account?

Structural changes and foreign competition: How can we cope with modernization and productivity improvements abroad which enhance the ability of foreign countries to compete in merchandise trade with the United States?

Exchange rate adjustment: Can exchange rate adjustments be envisaged that would contribute significantly to improving the U.S. competitive position?

Cutting across these categories, the point is often made (usually in connection with an analysis of merchandise trade flows) that our increasing deficits can be traced to transactions with a few countries or regions. Usually Japan and Canada are singled out. It is then suggested that we should concentrate our efforts on improving our situation with those countries in particular.

Clearly we are dealing with a most complex — if not the most complex — problem in economic analysis and policy making. Much could be said about each of the factors or types of international transactions listed. Yet, a clear lesson to be learned from the collapse of the payments system this year is that there are many factors at work — each of which on the surface can be blamed for a large part of our deficits of the last few

years. In fact, if we added up the separate effects of these different factors, we would quickly come to a sum that greatly exceeds our deficits. Furthermore, concentration on one aspect at a time tends to lead to policy prescriptions that are clearly inadequate. More importantly, we may be misled into the adoption of direct controls or other protectionist devices that can only hamper trade in the long run.

Given the complexity of our balance-of-payments difficulties, and in light of the current efforts to bring about a fundamental correction of the deficit, we should strive to increase our understanding of as many dimensions of the problem as we possibly can. One way of contributing to this understanding is to look in some depth at our transactions with various regions or countries and at the overall international transactions of those regions. There are at least two reasons supporting such an approach. These relationships are intrinsically important, and there is a need to look at them more broadly than in terms of the trade accounts alone. There is also a need to recognize that adjustment of the U.S. balance of payments involves for each of these countries or regions, not just a change in the bilateral relationship with the United States, but a many-sided adjustment involving their positions vis-à-vis the rest of the world as a whole.

With this objective in mind, and without attempting a detailed analysis of trends in U.S. trade and financial relations with major foreign countries and areas, a brief review has been made of the regional pattern of our trade and service transactions and of long-term private capital flows. The results of the analysis are presented in the following sections, but a summary can be sketched here:

The persistent deficit in our overall balance of payments (which reached an annual rate of some \$20 billion in the first six months of this year) was the result of a fundamental deterioration in our competitive position which showed no signs of being checked. At mid-year, the outlook was for a further worsening in 1972. Thus, a striking change in the international competitive environment was called for. The measures announced by the United States on August 15 were directed at that objective.

Among the major countries and regions of the world, there is naturally a primary interest in our trade and payments relations with those countries enjoying sizable surpluses — particularly Canada, Japan, and Germany. In what follows, I will focus on trends in the current and long-term capital accounts so as to avoid the wide fluctuations in the flows of short-term capital.

With respect to Canada, a striking and lasting change has occurred in the United States-Canadian bilateral relationship since the early 1960's. In 1970, the overall U.S. deficit with Canada amounted to \$1.7 billion, compared with a surplus of \$0.8 billion in 1964. Indeed, Canada's overall position in the world economy has improved dramatically, and a substantial share of the gain has centered in its trade with the United States. A significant part of this strengthening is a result of the United States-Canadian automobile agreement. In the quest to correct the deficit in the U.S. balance of payments, it may be appropriate to remove the restrictions on exports of U.S. automobiles to Canada contained in the 1965 agreement.

In the case of Japan, the U.S. bilateral deficit amounted to \$1.6 billion last year; in 1964 the deficit was much smaller, under \$100 million. These growing deficits with Japan reflected spurts in U.S. imports. While voluntary quotas have moderated the rate of expansion in our deficit with Japan, the latter's restrictions on imports have hampered potential U.S. exports to an even greater degree. Consequently, a reduction of Japanese barriers to U.S. trade must be a principal objective of the current negotiations to rebuild the payments system.

The United States overall balance of payments with Western Europe registered a surplus of nearly \$1 billion in 1970. In 1964, our accounts were in deficit by \$160 million. However, in the first six months of this year, we recorded a deficit of \$1.6 billion with Western Europe. Almost half of that total was with the European Economic Community (EEC). The noticeable deterioration in the U.S. balance of payments with Western Europe in the last year or so reflected the waning of favorable capital flows and the passing of the fortuitous benefits to our trade from cyclical developments here and abroad. More fundamentally, however, the greatly strengthened position of Western Europe can be traced to a basic change in its competitive stance vis-à-vis the United States.

Changes in the U.S. bilateral balance of payments with other countries have been far less dramatic. There was no significant change in our position with respect to other developed countries (Australia, New Zealand, and South Africa) between 1964 and 1970. In the case of developing nations, the major change in flows vis-à-vis the United States has been an increase in the amount of long-term private capital they have received — which rose from \$1 billion in 1964 to \$1.6 billion last year. U.S. trade with these areas has remained virtually static since the early 1960's, showing an annual U.S. surplus of about \$1.5 billion.

The bilateral balance of payments of the United States with other regions can show only a part of the overall payments situation which they face. We must look at their surplus or deficit position with the rest of the world if we are to evaluate the extent to which they could or should adjust their external transactions as part of their contribution to rebuild-

ing the international payments system. Such a review shows that the major countries which have large surpluses with the United States (particularly Canada, Germany and Japan) also have overall surpluses with the rest of the world. However, taking all the leading industrial countries as a group, it is clear that they will have to withstand a sizable diminution in their aggregate surpluses if the United States is to make meaningful progress in correcting its own deficit.

Regional Dimensions of the U.S. Balance of Payments

The published data on the U.S. balance of payments enable one to trace our transactions with major foreign countries and areas. These data are summarized in Tables I and II.¹ Our overall balance on trade, services, and long-term private capital transactions (sometimes called the "basic" balance) has been nearly always in deficit since 1960 – and generally on a rising scale. By 1970, this underlying deficit was \$3 billion and in the first half of 1971, it reached \$4.8 billion (not an annual rate). This latest increase may have been exaggerated somewhat by the strikes then in effect or threatened and by changes in the timing of payments as traders and investors moved to protect themselves against the unstable international monetary situation. But the basic worsening was unmistakable, and projections for 1972 indicated that a further worsening was in store unless a striking change in the international competitive environment was brought about.

The worsening trend appeared in most major categories of transactions. Our trade balance moved into an almost unprecedented deficit position in April, and in the April-August period the United States ran a

deficit at an annual rate of over \$4 billion. Private long-term capital registered a moderate net outflow of \$1.5 billion in 1970; but in the first six months of this year, the net outflow totaled \$3.3 billion. The net outflow associated with U.S. Government economic grants and capital flows also rose somewhat. The exception to this trend was a considerable rise in U.S. net receipts from service transactions, mainly because of an improvement in net income receipts. This rise was also to a considerable extent a temporary bulge related to some special transactions.

Having sketched in the overall trends in these major accounts, let us now turn to the trends in our dealings with some of the major regions of the world.

Canada: Between 1964 and 1970, our overall trade balance deteriorated by \$4.7 billion. Of this amount, \$2.5 billion was in trade with Canada. About \$1.2 billion of the change in the U.S. trade balance with Canada was in automobiles, trucks, and parts. However, even apart from this special factor, U.S. trade with Canada worsened by over \$1 billion during the 1964-70 period. The further worsening in 1970 (apart from automobiles) resulted from a sizable increase in U.S. imports, while exports to Canada rose only slightly because of the weakness of the Canadian economy. In the first half of this year, the U.S. trade balance with Canada again declined substantially, as the deficit ran at an annual rate of nearly \$2 billion. One might have expected that reduced trade balances with Canada would have been offset by increases in other current account transactions, especially net investment income. Yet, net receipts from these transactions have grown very slowly and have been only a minor offset to the losses on trade account.

The flow of private long-term capital to Canada has been relatively free from restraints, but the volume has shown no tendency to rise since the middle-1960's. In fact, the outflow was relatively small in the first half of this year (roughly \$230 million). In considerable part, the slowdown in these flows reflects efforts by the Canadian Government to reduce the dependence of Canadian borrowers on the U.S. capital market.

Looking ahead, as the pace of economic activity picks up both in Canada and in the United States, our trade balance with Canada should improve. However, the net outflow of private capital will probably expand also. The rise in the exchange rate for the Canadian dollar should help the trade balance to become less unfavorable for the United States. Over the longer run, the bilateral trade balance may also

¹Note on Trade Data, Tables I, II, III, and IV.

Data in Table IV are reported on the same basis as in Table I and Table II (e.g., balance-of-payments basis – exports and imports f.o.b.).

The trade data reported in Table III differ from data in Tables I, II, and IV because:

1. Imports in Table III are derived from export data as reported by the partner exporting countries. For example, exports of the United States to Canada are also, by definition, Canadian imports from the United States. These derived Canadian imports will differ from Canadian imports as reported in Canadian trade statistics.
2. Export data in Table III are adjusted by the United Nations to conform to U.N. standards.
3. Western Europe's trade balances with the United States, Canada, and Japan, as shown in Table III, appear to be consistent with those shown in other sources. However, Western Europe's trade balances with the rest of the world, as derived from the United Nations data, differ markedly from those shown in other sources, and these differences have not yet been reconciled.

Table 1

Regional Distribution of the U.S. Balance on Current Account and Long-Term Capital

(millions of dollars)

	1960	1965	1968	1969	1970	1970		1971
						1st Half	2nd Half	1st Half
						(not seasonally adjusted)		
All Areas:								
Current account and long-term capital	-1,155	-1,814	-1,349	-2,879	-3,038	-2,210	-829	-4,802
Goods, services, and remittances	3,498	6,102	1,321	745	2,182	1,838	345	968
of which: Trade	4,906	4,942	624	660	2,110	1,662	448	-418
Private long-term capital	-2,100	-4,577	1,198	-50	-1,454	-1,956	502	-3,284
U.S. Govt. grants and capital ¹	-2,553	-3,340	-3,869	-3,574	-3,766	-2,092	-1,675	-2,488
Canada:								
Current account and long-term capital	686	320	-512	-1,367	-1,651	-402	-1,247	-333
Goods, services, and remittances	1,311	1,712	433	47	-596	116	-712	-79
of which: Trade	1,024	864	-435	-799	-1,676	-581	-1,095	-838
Private long-term capital	-623	-1,398	-963	-1,417	-1,035	-522	-513	-231
U.S. Govt. grants and capital ¹	-2	7	19	3	-20	4	-22	-25
Japan:								
Current account and long-term capital	-131	-466	-1,227	-2,129	-1,577	-683	-895	-1,921
Goods, services, and remittances	-98	-479	-1,374	-1,774	-1,545	-583	-961	-1,433
of which: Trade	225	-387	-1,110	-1,390	-1,246	-442	-804	-1,382
Private long-term capital	-24	-49	50	-383	-92	-133	41	-454
U.S. Govt. grants and capital ¹	-9	62	97	28	60	33	25	-31
EEC:								
Current account and long-term capital	$\frac{4}{}$	$\frac{4}{}$	919	1,725	532	39	494	-794
Goods, services, and remittances			-721	-46	497	548	-50	-98
of which: Trade			150	1,045	1,718	1,029	689	340
Private long-term capital			1,527	1,709	-111	-549	438	-591
U.S. Govt. grants and capital ¹			113	62	146	40	106	-101
Other Western Europe:²								
Current account and long-term capital	-211	-450	987	-614	454	-258	714	-848
Goods, services, and remittances	477	1,166	-698	-1,012	-588	-314	-273	-337
of which: Trade	2,549	2,683	185	391	1,181	685	496	384
Private long-term capital	-752	-1,723	1,991	634	1,146	171	976	-436
U.S. Govt. grants and capital ¹	64	108	-306	-237	-105	-115	10	-74
All Other:³								
Current account and long-term capital	-1,499	-1,218	-1,516	-494	-796	-906	105	-906
Goods, services, and remittances	1,808	3,703	3,681	3,530	4,414	2,071	2,341	2,915
of which: Trade	1,108	1,782	1,834	1,413	2,133	971	1,162	1,078
Private long-term capital	-701	-1,407	-1,407	-593	-1,362	-923	-440	-1,572
U.S. Govt. grants and capital ¹	-2,606	-3,517	-3,792	-3,430	-3,847	-2,054	-1,794	-2,257

¹Includes U.S. Government nonliquid liabilities to other than official reserve holders.²Includes the United Kingdom.³Includes international organizations, unallocated transactions, and certain long-term liabilities to private foreigners reported by banks not allocated by area.⁴EEC countries are included in "Other Western Europe" prior to 1966.

Note: Details may not add to totals because of rounding.

Source: U.S. Department of Commerce.

improve, despite the large U.S. demand for Canadian-produced materials of all kinds and the likelihood that Canada will strive for more self-sufficiency in manufacturing. Moreover, the United States faces con-

tinued keen competition for the Canadian market from Europe and Japan. Receipts from investments in Canada should rise more strongly than in the past as the Canadian economy recovers. The flow of U.S.

Table II

Current and Long-Term Capital Transactions Between the United States
and Major Foreign Areas
(millions of dollars)

	1964	1965	1966	1967	1968	1969	1970	1970		1971
								1st Half	2nd Half	1st Half
								(not seasonally adjusted)		
Trade balance	6,831	4,942	3,927	3,859	624	660	2,110	1,662	448	-418
Canada	776	864	783	449	-435	-799	-1,676	-581	-1,095	-838
Japan	200	-387	-629	-345	-1,110	-1,390	-1,246	-442	-804	-1,382
EEC	} 3,377	2,683	1,309	1,015	150	1,045	1,718	1,029	689	340
Other Western Europe ¹			625	566	185	391	1,181	685	496	384
All other ²	2,478	1,782	1,839	2,174	1,834	1,413	2,133	971	1,162	1,078
Balance on services and remittances	903	1,160	393	83	697	85	72	176	-103	1,386
Canada	686	848	936	589	868	846	1,080	697	383	759
Japan	-92	-92	-277	-239	-264	-384	-299	-141	-157	-51
EEC	} -1,425	-1,517	-805	-802	-871	-1,091	-1,221	-481	-739	-438
Other Western Europe ¹			-851	-651	-883	-1,403	-1,769	-999	-769	-721
All other ²	1,734	1,921	1,390	1,186	1,847	2,117	2,281	1,100	1,179	1,837
Balance on goods, services, and remittances	7,734	6,102	4,320	3,942	1,321	745	2,182	1,838	345	968
Canada	1,462	1,712	1,719	1,038	433	47	-596	116	-712	-79
Japan	108	-479	-906	-584	-1,374	-1,774	-1,545	-583	-961	-1,433
EEC	} 1,952	1,166	504	213	-721	-46	497	548	-50	-98
Other Western Europe ¹			-226	-85	-698	-1,012	-588	-314	-273	-337
All other ²	4,212	3,703	3,229	3,360	3,681	3,530	4,414	2,071	2,341	2,915
U. S. Government grants and capital³	-3,237	-3,340	-3,379	-4,226	-3,869	-3,574	-3,766	-2,092	-1,675	-2,488
Canada	22	7	16	-54	19	3	-20	4	-22	-25
Japan	50	62	-44	-3	97	28	60	33	25	-31
EEC	} -57	108	511	60	113	62	146	40	106	-101
Other Western Europe ¹			-227	-367	-306	-237	-105	-115	10	-74
All other ²	-3,252	-3,517	-3,635	-3,862	-3,792	-3,430	-3,847	-2,054	-1,794	-2,257
Private long-term capital, net	-4,470	-4,577	-2,555	-2,912	1,198	-50	-1,454	-1,956	502	-3,284
Canada	-1,138	-1,398	-1,482	-987	-963	-1,417	-1,035	-522	-513	-231
Japan	-235	-49	82	64	50	-383	-92	-133	41	-454
EEC	} -2,055	-1,723	-310	-54	1,527	1,709	-111	-549	438	-591
Other Western Europe ¹			-439	-426	1,991	634	1,146	171	976	-436
All other ²	-1,042	-1,407	-406	-1,509	-1,407	-593	-1,362	-923	-440	-1,572
Balance on current account and long-term capital	+28	-1,814	-1,614	-3,196	-1,349	-2,879	-3,038	-2,210	-829	-4,802
Canada	346	320	253	-3	-512	-1,367	-1,651	-402	-1,247	-333
Japan	-77	-466	-869	-523	-1,227	-2,129	-1,577	-683	-895	-1,921
EEC	} -160	-450	705	219	919	1,725	532	39	494	-794
Other Western Europe ¹			-892	-878	987	-614	454	-258	714	-848
All other ²	-81	-1,218	-811	-2,011	-1,516	-494	-796	-906	105	-906

¹Includes the United Kingdom.²Includes international organizations, unallocated transactions, and certain long-term liabilities to private foreigners reported by banks not allocated by area.³Includes U.S. Government nonliquid liabilities to other than foreign official reserve holders.

Note: Details may not add to totals because of rounding.

Source: U.S. Department of Commerce.

private capital to Canada may also trend upwards, but perhaps relatively slowly if Canadian capital markets become better adapted to Canada's needs.

Clearly a striking and perhaps lasting change has taken place in the United States-Canadian bilateral relationship since the early 1960's. Indeed, Canada's overall position in the world economy has changed

dramatically, as noted in the following section, and much of the improvement has centered in its transactions with the United States.

Japan: In the case of Japan, the U.S. bilateral trade balance shifted into sizable deficit (\$387 million) in 1965; it moved to a still deeper deficit (\$1.1 billion) in 1968, and then dropped sharply to a deficit at an

annual rate of perhaps \$2.8 billion in the first half of 1971. These growing deficits reflected spurts in U.S. imports. Voluntary quotas imposed by Japan have kept the trade deficit from growing even faster. On the other hand, Japan's restrictions on imports have reduced potential U.S. exports, perhaps by an even larger amount.

The United States also has a deficit with Japan in the non-trade sectors of the current account, mainly direct military expenditures. This deficit also has risen over the period from about \$100 million in 1964 to about \$300 million in 1970. Moreover, there has been a rising private long-term capital outflow to Japan, which would probably be substantially larger if restrictions were not imposed by both countries. These outflows rose sharply to nearly \$0.5 billion in the first half of this year, probably reflecting expectations of a Japanese revaluation. In 1970, Japan's overall surplus on current and long-term capital transactions with the United States was about \$1.6 billion, compared to a surplus less than one-third as large in 1965. In the first half of 1971, these transactions resulted in a U.S. deficit of nearly \$2 billion with Japan. Although this total was inflated by anticipatory transactions of various kinds, the underlying trend was clearly and sharply adverse to the United States.

Western Europe: After averaging deficits of about \$350 million annually in 1964-67, the U.S. balance with Europe on current account and long-term capital was transformed into a surplus of \$2 billion in 1968. The shift was due mainly to the impact of the tightening of U.S. controls on private capital outflows. After that, however, the surpluses diminished, and in the first six months of this year, we registered a deficit of \$1.6 billion in these transactions with Western Europe.

On trade account alone, the surplus with Western Europe dipped very sharply from 1964 through 1968. Subsequently it recovered markedly as the rise in U.S. imports slowed down while strong demand in Europe supported a steep rise in U.S. exports to those countries. The cyclical situation as between the United States and major European countries was especially favorable for the U.S. trade balance in 1970, raising the surplus to \$2.9 billion — not far from the peak of 1964. However, over the coming year, as the United States moves toward more vigorous growth, at a time when output in the European countries will probably be lagging, some reduction in the trade balance is to be expected. Already in the first half of this year, the U.S. surplus in trade with Europe was only about \$1.25 billion at an annual rate.

The picture of U.S. transactions with Europe is significantly different when the whole current account is taken into consideration. On this basis, the U.S. position is noticeably weaker. The balance deteriorated by nearly \$2 billion between 1964 and 1970. Of this amount, \$0.5 billion was in merchandise trade, and almost \$1.5 billion related to current transactions other than trade with Europe. Principal among these were larger deficits in tourism, rising military expenditures, and reduced net receipts on investment income (especially in 1969 and 1970) due to larger interest payments from the United States on accumulating debt.

More than offsetting the worsening of current transactions with Europe from 1964 to 1970 was the sharp improvement in the private long-term capital accounts. These long-term capital flows shifted from a net outflow to Europe of about \$2.1 billion in 1964 to a net outflow of only \$0.7 billion in 1966 (after voluntary restraints on capital outflows were installed) and to a net *inflow* of about \$3.5 billion in 1968 (when mandatory controls on certain capital flows were initiated). After that the net inflow of capital from Europe diminished, although it still remained at about \$1 billion in 1970. This year private long-term capital has again been flowing to Europe from the United States on an enormous scale, despite the restrictions.

The principal feature of the change in capital flows between the United States and Europe during the 1964-70 period was the dramatic increase in European investments in U.S. corporate securities and other obligations. This trend began in 1965, when the United States started a voluntary program to reduce the outflow of U.S. funds for direct investments abroad. The appeal induced U.S. corporations to seek financing in Europe, although the amounts involved were relatively small until 1968. In that year, the inflow of private capital from Europe (apart from short-term funds) rose to \$4.5 billion, from less than \$1.5 billion in 1967. The improvement reflected the combined impact of a tightening of the direct investment controls and stepped-up European purchases of U.S. stocks in a rising market. However, the inflow has slackened since then to about \$3.5 billion in 1970 and to less than \$1 billion in the first half of 1971.

At the moment, the outlook for capital inflows from Europe is clouded by many uncertainties, not least of which is the anticipation of exchange rate changes. European purchases of U.S. corporate stocks have dwindled. In any case, after the major portfolio adjustment that occurred in 1968-69 (with the help of vigorous marketing efforts by investment funds) the

“normal” level of inflows could be expected to be considerably smaller. U.S. corporations have found it more difficult to sell long-term debt abroad and instead have turned to shorter-term financing for their foreign affiliates. European direct investments in the United States had been rising until recently, and they probably will do so again once the international financial environment has settled.

Flows of U.S. private long-term capital to Europe have been held down by the controls. The steep increase in plant and equipment expenditures of European affiliates of U.S. companies (from \$2 billion in 1968 to a projected \$4.4 billion next year) has been largely financed from foreign sources. Banks have reduced their credits to Europe under the Voluntary Foreign Credit Restraint Program, and the growth of the European bond market has relieved demands on U.S. capital markets — not only from European borrowers but also from Canadians and others.

To sum up this brief review, the improvement in the U.S. bilateral balance with Europe in 1970 depended mainly on a favorable shift in capital flows that at mid-year was already showing signs of diminishing and on an enlarged trade surplus that reflected in large part a favorable cyclical situation. Even though temporary factors may have contributed a good deal to the abrupt worsening in these trade and capital transactions with Europe so far this year, the underlying trend was clearly adverse.

Other countries: United States bilateral balances with other developed countries (Australia, New Zealand, and South Africa) did not shift significantly between 1964 and 1970. As for the developing countries, the principal change in flows vis-à-vis the U.S. has been an increase in the outflow of private capital to them in the last few years. The U.S. trade balance with developing nations has been nearly static since the early 1960's, showing an annual U.S. surplus of about \$1.5 billion.

Overall Position of Major Regions

The preceding review of the bilateral position of the United States with various regions, in terms of the balance on current account and long-term flows of private capital, can show only a part of the overall payments situation facing each of these regions. It is only by looking at their *overall* surpluses or deficits that we can evaluate the extent to which they could or should adjust their external transactions. In effect, the U.S. disequilibrium is the sum of the global disequilibria of other countries. So, when we speak of the

adjustment that is needed from the U.S. point of view, we are really speaking about some sizable fraction of, say, the overall German surplus, rather than being concerned only with the German position vis-à-vis the United States.

The most accessible body of data on country-by-country transactions relates to international trade. But it has not been possible to develop an accurate set of regional flows because of discrepancies in country statistics. A matrix of regional trade flows has been constructed as a starting point for discussion (Table III). However, it can only be used to indicate tendencies over the period and is less accurate for any given country than the data given in Table IV. Based on the United Nations data used in the matrix, the Canadian trade balance improved from a bare surplus of \$0.3 billion in 1965 to \$3.7 billion in 1970. Of this \$3.4 billion improvement, \$2.7 billion came through trade with the United States. Canada's trade balance with Europe also improved substantially (by about \$600 million), and Canada even recorded an improvement in trade with Japan. Evidently, the Canadian gain was broadly based, although the brunt of the improvement fell on the United States.

Japan's trade balance rose about \$2 billion between 1965 and 1970. About half of the 1965-70 gain in trade was with the United States, a little over 35 per cent with Western Europe, and another 15 per cent with other countries. Of particular interest in the case of Japan is the sharp upsurge in the export surplus since mid-1970. In the last half of 1970, Japanese net exports jumped to an annual rate of over \$5 billion, and the rate reached \$5.7 billion in the first half of 1971 (Table IV). Although trade with the United States accounted for about 40 per cent of Japan's overall trade surplus in 1970, a larger share of the gain in 1971 seems to be in trade with this country. However, there have been several factors operating recently to bring about a temporary surge in Japan's balance with us. American and Japanese traders were probably attempting to anticipate strikes in the United States and to avoid being caught in a yen revaluation, while at the same time the Japanese economy has been going through a period of slowdown at home.

Although the U.N. data show a large overall trade deficit for Western Europe as a whole, country data suggest that (apart from a deficit with the United States) Europe probably has a surplus with the rest of the world. The trade positions of the individual European countries vary widely. These country balances have been assembled in Table IV. Among European countries, Germany has by far the strongest

Table IV

Trade Balances of Selected Industrial Countries
(billions of dollars, f.o.b. basis)

	1964	1967	1970	Half-years (annual rate, not seasonally adjusted)		
				1970		1971
				1st Half	2nd Half	1st Half
United States	6.8	3.9	2.1	3.4 ³	1.0 ³	-1.9 ³
Foreign Industrial Countries:						
EEC						
Belgium	.0	.1	.8	.7	.8	.5
France	n.a.	.4	.4	.7	.0	1.0
Germany	2.4	5.2	5.8	4.9	6.6	5.4
Italy	-.6	.0	-.3	-.5	-.2	.1
Netherlands	-.7	-.6	-.9	-.9	-.9	-.9
EFTA						
United Kingdom	-1.5	-1.4	.0	.0	.0	.2
Austria	-.4	-.5	-.7	-.5	-.9	-.9
Denmark	-.4	-.5	-.8	-.9	-.7	-.7
Norway	-.6	-1.0	-1.2	-1.0	-1.4	-1.4
Sweden ¹	-.1	-.1	-.2	-.6	.2	.4
Switzerland ¹	-1.0	-0.6	-1.4	-1.4	-1.4	-1.6
Canada	.7	.6	3.0	2.6	3.4	2.5
Japan	.4	1.2	4.0	2.9	5.1	5.7
Australia	.2	.0	.5	.6	.4	.3
New Zealand	.2	.1	.2	.4	.1	.4
South Africa	-.7	-.9	-1.6	-1.4	-1.9	-2.4 ⁴

¹Imports on c.i.f. basis.²First half 1971 is estimated.³Seasonally adjusted annual rates; 1971 = Jan. - July.⁴Based on first quarter only.Source: International Monetary Fund, *International Financial Statistics*, September 1971.

trade position, with the other countries normally in deficit. Recently, however, several other countries (Belgium, France, the Netherlands, and the United Kingdom) have been improving their trade situation.

While these data on trade balances are informative, they can also be misleading as indicators of a country's overall surplus or deficit. For some countries, there are significant current account transactions apart from the trade accounts. For instance, statistics on current account balances in Table V show that much of Germany's large trade surplus is offset by other current payments to foreigners - especially wages to foreign workers in Germany, tourist expenditures, and private remittances. Thus, although Germany had a trade surplus of \$5.8 billion in 1970, that country's current account surplus was only \$1.7 billion. For Japan also, a large part of the trade surplus is offset by net payments on other current transactions. On the other hand, nearly all European countries except Germany derive substantial net receipts from current transactions apart from trade - with tourist receipts often a major source of income. These other receipts are especially important for the United Kingdom, Austria,

Italy, and Switzerland. In fact, for all the European countries (other than Germany) shown in Tables IV and V, net current receipts for non-trade transactions were approximately \$8 billion in 1970. Receipts from the United States (\$3 billion) constituted a substantial part of the total (Table II).

Trends in Reserves of Industrial Countries

Up to this point, we have not been considering the effects of the massive flows of short-term capital which have so greatly aggravated the basic imbalances in world payments. These flows often escape the accounting mechanisms that have been developed to record capital flows. Consequently, we learn that they have occurred mainly because official reserves are changing in excess of the amounts that can be ac-

Table V

Current Account Balances¹
(millions of dollars)

	1965	1970
United States	+6,102	+2,182
Germany	-751	+1,658
Italy	+2,353	+1,325
Netherlands	+56	-518
France	n.a.	+12
Belgium-Luxembourg	+212	+918
EEC	n.a.	+3,395
United Kingdom	+280	+1,897
Canada	-1	+1,449
Japan	+1,026	+2,146
Switzerland	-54	+561 ²
Austria	-55	-6
Denmark	-174	-228 ³
Norway	-146	-148
Sweden	-146	-225

¹Balance on goods, services, and private transfers.²1969 data.³1968 data.Source: International Monetary Fund, *Balance of Payments Yearbook*, and U.S. Department of Commerce.

Table VI

Net Official Reserves¹
(millions of dollars, not seasonally adjusted)

	Amounts ²				Changes ³	
	Year-end		1971		Years	1971
	1965	1970	March	August	1966-70	Jan-Aug
Germany	7,431	13,610	15,802	16,713	+5,977	+2,932
Italy	4,800	5,299	6,024	6,520	+394	+1,114
Netherlands	2,416	3,234	3,542	3,505	+731	+196
France	6,343	4,351	4,881	7,622	-2,158	+3,116
Belgium-Lux.	2,337	2,854	3,081	3,451	+443	+525
EEC	(23,327)	(29,348)	(33,330)	(37,817)	(+5,387)	(+7,884)
United Kingdom	1,097	998	2,176	4,310	-509	+3,012
Canada	3,037	4,679	4,845	4,992	+1,518	+195
Japan	2,152	4,839	5,898	12,514	+2,565	+7,547
Switzerland	3,444	5,132	4,623	6,581	+1,688	+1,449
TOTAL of above countries	33,057	44,996	50,872	66,214	+10,649	+20,087
United States						
Official reserve assets	15,450	14,487	14,342	12,128	-1,830	-3,076
Official settlements balance					-9,544	-11,884 ⁴

¹Net reserves include gold, SDRs, foreign exchange and reserve position in the IMF, less any use of IMF credit but excluding other official borrowings.

²Amounts include SDR allocations in 1970 and 1971.

³Changes exclude SDR allocations.

⁴January-June 1971, not seasonally adjusted.

counted for by normal transactions. These flows may sometimes be outright flows of liquid funds from one currency to another, or they may take the form of shifting the timing of delivery or payment for ordinary commercial or financial transactions. Perhaps the best way to illustrate the size and direction, not only of these volatile capital flows but also the impact of the other trends we have been discussing, is to examine changes in countries' reserve positions.

As shown in Table VI, between 1965 and 1970, the net official reserves of the world's principal industrial countries (other than the United States) rose almost 40 per cent — from \$33 billion to \$45 billion. Some of this gain (about \$1.3 billion) represented allocations of Special Drawing Rights (SDRs). However, most of it was associated with the U.S. deficit on the official reserve transactions basis, which totaled \$9.5 billion for the period. Reserves of the countries constituting the European Economic Community (EEC) increased by over \$5 billion — apart from SDR allocations. Most of the expansion was concentrated in Germany, which gained about \$6 billion. On the other hand, France was a major net loser of reserves (\$2.2 billion) for that period as a whole.

Other major reserve gainers in the 1966-70 period were Canada (\$1.5 billion), Japan (\$2.6 billion), and Switzerland (\$1.7 billion). In addition, some of the non-industrialized countries not discussed here in-

creased their reserves considerably. Although the U.S. deficit on official transactions was quite large, U.S. reserve losses were held down to under \$2 billion. The U.S. deficits were financed largely by borrowing.

In 1971, of course, there has been an enormous increase in reserves of foreign countries — a rise of about \$20 billion through August, and an additional but relatively minor gain has been registered since then. The published U.S. balance-of-payments data cover only the first half of the year, when the official settlements deficit reached \$12 billion. However, from the figures showing changes in official re-

serves of leading foreign countries, it is evident that the U.S. deficits in the last few months were enormous.

Gains in reserves this year have been spread among many nations — most noticeably Germany, France, the United Kingdom and Japan. But other countries also had sizable increases relative to their total reserve holdings. By the end of August, net official reserves of these major countries had reached \$66 billion, compared to \$12 billion of reserves held by the United States. At the end of August, both Germany and Japan had larger reserves than the United States.

In my opinion, the size of these reserve gains is not really representative of the size of the U.S. imbalance. It will be recalled that a dominant feature of the three-month period prior to August 15 was a massive flow of liquid funds into those currencies that were thought to be the best candidates for appreciation. This flow included foreign funds previously held in dollar-denominated assets in the United States (mainly represented by borrowings by U.S. banks through their foreign branches) as well as outflows of U.S. funds either into foreign currencies or into high-yielding Eurodollar deposits. However, our discussion of the basic balance-of-payments position of the United States has shown that the situation was not merely a transitory crisis of confidence. Instead, the fundamental weakness in our trade and other transactions also had much to do with the deteriorating environment. The cumulative impact of these difficulties was

too great to permit us to continue the pursuit of the same balance-of-payments policies.

Exchange Rates and Multilateral Adjustment

Once the need for a change in policy was recognized, there could be no doubt that a large adjustment in the U.S. accounts was necessary. It was also clear that the adjustment would have to be distributed over a considerable number of countries. Part of the adjustment question involves specific actions to lessen discriminations against U.S. goods in world trade and a more equitable sharing of the burden of defense outlays.

More lastingly, however, there would have to be major changes in relative shares of world trade that could be brought about over time only by some adjustment in exchange rates. We could no longer see any reasonable possibility of effecting such changes through monetary and fiscal policies to control domestic inflation. There was simply too much lost ground to be regained.

From the United States' point of view, we are interested in a constellation of exchange rates that — along with other measures in the trade and burden-sharing areas — assures elimination of our deficit and provides a safety margin over time. A key to this outcome is a surplus on current account — which will have to center mainly in a surplus on trade account.

I am sure there will be agreement on at least one fact: no one can possibly estimate with any accuracy the effects on a particular country of the multiplicity of modifications in relative exchange rates and other features of the international monetary system that are currently at issue.

This very difficulty of seeing clearly what the effects of such changes will be in the months and years ahead is a strong argument, in my opinion, for allowing more flexibility of exchange rates than we have had during the last 25 years. Most of the key industrial countries seem to agree that some increased flexibility is a necessary feature of the new international monetary system that will emerge from the present negotiations. However, the crux of the issue turns on the extent to which those countries with sizable trade surpluses are prepared to see these balances shaved somewhat as part of the multilateral effort to make the payments mechanism function with a reasonable degree of predictability and efficiency.

In my personal opinion, as I have stated previously, the most urgent requirement at the present time is for a wider understanding among the major industrial nations with respect to the fundamental goals of the payments system, and for a better coordination of national goals in the areas of international trade, investment, and assistance to the developing countries. The efforts to negotiate new exchange rates and to promote institutional changes are obviously necessary. But I remain less than optimistic about the long-run viability of such arrangements unless there is a broad consensus on goals. The recent Annual Meeting of the International Monetary Fund did result in some movement in that direction, in that ten of its principal industrial members agreed on a list of priorities for negotiation and a plan of work over the months ahead. However, the tough issues of exchange rate adjustment and the reduction of trade barriers remain to be resolved. If we are successful in resolving these issues and also in producing fundamental improvements in the payments system, the benefits of increased international trade and investment would be considerable.



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