Our International Payments Deficit: A Continuing Challenge*

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It is always pleasant and stimulating to meet with this fine group and discuss some of the important issues facing us as commercial and central bankers. As commercial bankers, you are of course the principal channel through which monetary policy has its impact on the economy—and I am delighted to say that your help over the years in working toward our common goals has been invaluable and much appreciated. In the period ahead, I believe that close cooperation and mutual understanding will be more essential than ever.

On several past occasions I have stressed in this gathering the international payments problems that have assumed growing importance in our policy considerations in recent years. Unfortunately, those problems are still very much with us despite all the efforts of the past four or five years; and the sterling crisis of last November, together with other developments in the exchange and gold markets growing out of that crisis, has focused world attention on these matters. The dollar, as the leading world currency, widely used both for reserve purposes and as a medium of international trade and payments, could hardly expect to escape some of this attention; so it seems especially appropriate today to dwell on this side of our continuing problem, although I shall also have something to say on domestic developments.

Exchange crises are of course not new. We have had several in the last two or three years, of various origins, and they have all been met successfully through timely measures of international cooperation. But naturally a crisis is more serious when it involves a reserve currency or a currency used widely for trade and investment—and sterling fills both of these roles. Also, the severity of this sterling crisis may have been enhanced by the fact that it was one of a series of crises affecting sterling over the postwar period.

Let me take this occasion to register a dissent from the contention that such crises demonstrate an inherent weakness in our whole reserve currency—or gold exchange—system. It is not the system itself or any lack of early enough knowledge of trouble that is to blame, but rather the all-too-human tendency, observable by no means in the United Kingdom alone, to underestimate the difficulty of the payments problem to be dealt with and the rigor of the discipline needed to correct it. It is always easier to detect the flaws in another country's methods than in one's own, and the United Kingdom did not lack warnings from abroad that decisive measures needed to be taken—any more than we have lacked foreign advice on the importance of meeting our own payments problem. While domestic and international objectives complement one another in the long run, there is all too often a genuine conflict in the short run between international and domestic priorities, and there are frequently political problems involved in taking the needed remedial measures.

The fundamental soundness of a currency is based ultimately on the strength and stability of the domestic economy, but the balance of payments is the most important factor determining its market strength at any given time. And a chronic payments problem for a major trading currency can of course be greatly accentuated by large temporary swings reflecting so-called "leads and lags" or a natural desire of traders and investors, including bankers, to hedge their present or prospective holdings of the currency in question. This type of action is far more important, for a country like the United Kingdom, than the deliberate raids of outright speculators, so dear to the hearts of some journalists. Of course, a change in the atti-

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tudes of the principal holders of a currency as an international reserve could, in itself, further accentuate the temporary pressures; but this appears to have been a minor element in the recent sterling troubles.

Crises are never welcome, but looking back on the recent sterling experience even with the brief perspective now available I can find much that is heartening. First, the $3 billion credit arrangement was a dramatic demonstration of the solidarity of the major financial nations, when they saw a threat to the whole international financial system, and of their ability and willingness to act with great dispatch. Second, there is a firm understanding among the financial authorities of these same nations—in contrast to the views of some academicians and financial writers—that devaluation of a major currency is not a workable solution to monetary ills; and that a successful attack on one major currency could have serious consequences for most others and for the international financial system in general. Third, the United Kingdom authorities recognized the threat to their currency and were willing to take actions which in the aggregate constitute a much more effective package than has been generally appreciated as yet in the market.

Once the exchange markets become unsettled there is a natural susceptibility to all kinds of unfounded rumors which tend to perpetuate or even compound the market uncertainty. Thus, in the case of the dollar, the initial reports about the possible elimination or modification of the 25 per cent gold reserve requirement gave rise to a misinterpretation abroad which was the exact opposite of the correct understanding. Obviously the purpose of changing the requirement would be not to weaken the fixed tie between gold and the dollar at $35 per ounce, but to make crystal clear that all our gold stock is available to fulfill its primary purpose, i.e., to enable the United States to meet its international obligations and preserve the dollar's strength. There should be no illusion that the soundness of the dollar depends on maintenance of this or any other arbitrary reserve ratio. Rather it depends on the staunch pursuit of noninflationary domestic growth policies and the reestablishment of equilibrium in our balance of payments.

Taking the latter point first, and looking back over the past year, we may find that there has been some modest improvement in our payments position, but not nearly enough in view of the persistent large deficits from 1958 on. All the data for last year are not yet available, but it is sobering to bear in mind that the cumulative deficit in the six years from 1958 to 1963 reached some $21.6 billion. Essentially what happened in this past year was that our trade surplus grew faster than anyone expected, but most of the gains from this and other sources were offset by a sharp rise in private capital outflows. Bank lending abroad has played a large role, especially in the past few months, and much of this lending has gone to the industrial countries of Europe. Direct investment has also increased in the past year—both to Europe and in the aggregate. No doubt the rising trade surplus and increased capital outflow are in some degree interdependent, but this does not mean we can be complacent about the capital outflow or about any other element of our total payments position. It is the net result that counts and that net result has been one that we cannot tolerate much longer.

As I have said so often, time is working against us, as long as deficits are accumulating, even if at a diminishing pace, for the cumulative effect of past deficits is to increase the threat of conversions of dollars into gold. In 1964 there were very significant mitigating factors, notably the desire of private foreign interests to increase their dollar holdings sharply and the unusually heavy flow of gold into the London market. It may be that the statistical treatment of certain items in our deficit presents a picture of somewhat unwarranted gloom; for example, the statistical deficit is enlarged by the operations of agencies of Canadian and some other foreign banks as intermediaries in our own markets, when they receive United States dollar deposits from Americans and lend or invest them in the United States. Yet we must bear in mind that developments in other countries, such as a tightening in their own local credit conditions, can draw dollars out of private holdings and into the central banks. We must also recognize that no statistical rearrangement alters the fact that liquid claims against us are very large indeed.

As the leading world currency the dollar has a special obligation to observe high standards of behavior, especially as to the maintenance of its internal value. By meeting this goal, and reducing or hopefully eliminating our payments deficit, noninflationary adjustments in other countries will be greatly facilitated and solid support will be provided for our system of fixed exchange rates. Needless to say, we are also very much interested in furthering expanded world trade and investment by maintaining a high level of domestic economic activity.

Parenthetically, I might add that, while we should—and in fact must—do more to eliminate our payments deficit, I would certainly not subscribe to the thesis that we should let the deficit automatically bring about a sharp decline in domestic liquidity and credit availability. No nation today can afford to permit any such automatic response; but each country must give due weight to international factors in deciding what constitutes appropriate liquidity. The "fruitful tension" between domestic and international objectives, to use the phrase of Dr. Emminger of the German Bundesbank, has itself been an important influence toward better international cooperation and coordination of policies.

The attack on our payments deficit must be many-pronged. There should of course be a continuing effort to stimulate exports—especially through keeping our costs and prices stable so that American products are fully competitive both abroad and at home—and the Government should redouble its efforts to reduce the net drain of foreign military operations and foreign aid. But the spotlight at the moment would seem to be on capital movements. And this brings us squarely to the question of how far capital outflows can and should be influenced by general credit availability and to what extent by selective measures. To my mind there are strong advantages in the former approach—that is, one based on general credit availability—to the degree it can be used without unduly impeding domestic objectives. Certainly this approach is more in keeping with our long-range objective of maximizing freedom of international trade and investment, and also with our tradition of favoring impersonal, nondiscriminatory controls whenever possible. And we cannot overlook the fact that, despite increases in the discount rate and in short-term market rates in 1963 and late 1964, there is still ample credit availability to accommodate a large aggregate of foreign lending by domestic banks.

At the same time, we must recognize that the subject of short- and long-term capital movements among major industrial countries is highly complex, and that our own position must be developed in a world that is already crisscrossed by infringements on the free movement of capital imposed by many, if not most, other countries. For example, several European countries with strong balance-of-payments positions are still placing severe restrictions on foreign bond flotations and other capital exports. On the other hand, we must face the fact that United States capital inflows are by no means always welcome in Europe. In several instances the authorities in some European countries have acted to restrict inflows, whether in the form of bank loans or of longer term investments, because they sought to avoid the corresponding increase in domestic liquidity—or in some cases because of serious concern over the prospect of increasing American ownership of key national industries.

In the light of these complex factors, and the importance of achieving a rapid improvement in our balance of payments, I am reluctantly coming to the conclusion that we must face the possibility of a more direct approach on certain components of this problem, even if it involves some compromise with our basic philosophy of complete freedom to lend and invest abroad. Of course the interest equalization tax already represents one such compromise, and the extension of this tax to certain types of bank loans, as permitted in existing legislation, is one possible line of approach that has received attention. Another and to my mind a preferable possibility would be to enlist the support of our commercial banks in voluntarily reducing the heavy outflows of bank credit. But whatever may be done in the area of selective measures, whether through the tax route or otherwise, should be regarded as a temporary expedient, to be eliminated at the earliest opportunity. Moreover, I believe that any selective measure must be backed by a posture on general credit availability that is not so easy as to encourage excessive leakages that would thwart the purpose of the selective approach.

Turning now to the domestic side, let me say forthwith that I consider domestic aspects of our economy's development no less important than the international side to which I have given attention in my remarks thus far. It hardly needs reiteration that these two aspects are inextricably connected—that we cannot gain the full fruits of our domestic economic potential without achieving a viable international position, but also that the dollar's international strength ultimately rests on a healthy domestic economy.

Looking at the economy's recent record I believe there is much cause for satisfaction. Despite the disruption caused by the autumn automobile strikes, business was moving ahead at the year end and the outlook is for further gains this year, provided we can avoid costly work stoppages. So far the threat to price and cost stability embodied in the automobile labor settlements remains only a threat, and the cost-price structure remains reasonably stable, although there have been some scattered signs of upward price pressures. Unfortunately, the generally well-balanced growth of the past four years is now endangered by a sharp steel inventory buildup in anticipation of a strike this spring, which could lead to increased price pressures, as well as subsequent slackening of business; but this unhappy outcome is not a foregone conclusion.

The outlook for the second half of the year is even less clear than for the first half; much depends on the size of the first-half steel buildup, and on success in avoiding either an extended work stoppage or a wage settlement that might engender fresh price pressures. The outlook also depends importantly on the extent to which Federal fiscal policy may provide an added stimulus. From our current vantage point, it seems likely that the net budgetary stimulus could be a good deal stronger in the second half of the year than in the first; this might arise both because of possible excise tax cuts and increases in planned expenditures and also because of eliminating the first-half drag arising from the catch-up with 1964 personal income tax payments.

As for developments in the credit area, the most striking feature of 1964 is that bank credit has grown at about the same substantial rate as in 1963 and indeed at about the same rate as in 1961 and 1962—roughly 8 per cent each year. A year ago I was inclined to question whether this continuing rate was not a bit excessive, particularly in the light of our balance-of-payments problem. This is still a relevant question, especially as we enter a new year with a smaller margin of unused resources than was available a year ago. If we look at the money supply (currency plus demand deposits), we find that it grew as rapidly in 1964 as in 1963, and somewhat more rapidly than in the two preceding years. To be sure, total nonbank liquidity rose a little more slowly last year than in 1963, mainly because of a slowdown in growth of time deposits, which had surged ahead in 1962 and 1963 under the stimulus of changes in Regulation Q and the development of certificates of deposit. Even so, nonbank liquidity fully kept pace with total activity last year so that the ratio of liquid holdings to gross national product remained at the high level reached at the end of 1963. Commercial banks, it is true, are now more heavily loaned up than they were a year ago, but not to the point where we can detect any lessened desire to seek additional loans, either at home or abroad. We can find satisfaction in the relatively steady level of stock market credit and in some reduction in delinquency rates on consumer and mortgage loans, although there has been some concern about the quality of credit in a number of areas.

As we look ahead, we undoubtedly face another year of perplexing crosscurrents and challenging problems for monetary policy. The challenge at home is to assure continued growth of the economy in a noninflationary atmosphere; and with manpower and productive resources now somewhat more fully utilized than in the last four years it may be more difficult to maintain earlier growth rates without courting price and cost pressures. The need for a "noninflationary atmosphere" can hardly be overemphasized, with respect to both our domestic and international objectives—and I wish I felt more confident that its critical importance is recognized throughout the country.

I feel encouraged by the growing recognition that fiscal policy can be used more actively and more flexibly than in the past as a stimulative force. Indeed, if the economy should show signs of lagging growth later in the year, the burden of providing further stimulation could hardly be assumed by monetary policy, in the present international setting, although monetary policy will obviously have to see that credit remains sufficiently available for all essential needs. Rather the burden would have to rest largely on fiscal policy and other types of Government and private actions. In other words, the proper composition of the so-called "policy mix", which has emerged as a basic element in national economic policy in the last few years, will remain highly important in 1965.

As for the international challenge, I have said already that we can no longer afford to temporize with our balance-of-payments problem. The first order of business of the United States authorities in the financial area should be a combined attack—not merely to gain time, but to solve the problem. I am confident that the wholehearted cooperation of bankers and other private interests will be forthcoming, for all of us have an equally large stake in a successful solution.