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The U.S. Balance of Payments--Present and Future

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The U.S. Balance of Payments--Present and Future 1/

The dramatic improvement in the U.S. payments balance since mid-1963 has become a matter of general knowledge. The seasonally adjusted annual rate of the deficit, as conventionally calculated, has declined from $5 billion in the first half of 1963 and $1-3/4 billion in the second half to as little as $500 million in the first quarter of 1964.

The improvement from the first to the second half of 1963 was due mainly to a decline in net capital outflows. This decline in turn may be attributed in part to the mid-July proposal of the interest equalization tax, which greatly curtailed net purchases of foreign securities by U.S. investors; and in part to the mid-July actions of the Federal Reserve on the discount rate and on interest rates on time deposits, which greatly reduced and at times actually reversed outflows of money market funds into Euro-dollars and into paper denominated in foreign currencies.

While complete details for the first quarter of 1964 are not yet available, it seems that the further improvement in that quarter was due primarily to a further increase in our trade surplus, which in turn reflected a strong expansion in exports together with relative stability in imports.

Permanent and temporary causes of improvement

The factors making for the improvement in our payments balance are partly permanent and partly temporary.

Our trade surplus has no doubt been enhanced by the success of the United States in keeping costs and prices relatively stable, and indeed far more stable than they have recently been in most other industrial countries. Thanks to the moderation of business and labor leaders as well as to public policies, including the monetary policies of the Federal Reserve, U.S. industry appears to have regained some of the competitiveness it had lost as a consequence of the devaluation of the most important foreign currencies between 1949 and 1958, and of the creeping inflation of the 'forties and the early and middle 'fifties.

1/ Paper presented before the Philadelphia Economists' Discussion Group, Philadelphia, Pa., on May 19, 1964. The paper reflects exclusively the author's personal views and must not be regarded as representing the opinion of the Board of Governors of the Federal Reserve System.

But the trade surplus has recently been further increased by temporary factors, including food sales to the Soviet area and, more importantly, the fortuitous concurrence of an economic expansion in virtually all foreign industrial countries and a hitherto rather modest increase in U.S. production. The boom in Europe, Canada, and Japan has not only stimulated our exports to those areas but also improved export earnings of raw material producing nations, and thus helped to raise or maintain our exports to less-developed countries as well. At the same time, the failure of our industrial production to rise more rapidly has kept our raw material imports from increasing as fast as would otherwise have been expected in a period of continued economic upswing.

Similarly, some of the reasons for the decline in our net capital outflow are likely to prove permanent. The measures taken in mid-1963 have, I hope for good, dispelled any notion that the United States did not care about its payments deficit, and was either unable or unwilling to do anything decisive about it. Today, little is heard about the alleged weakness of the dollar, about the danger of a dollar devaluation, about the need for an increase in the dollar price of gold or for flexible dollar exchange rates.

Beyond this, a complete reassessment of the economic prospects of Europe and the United States seems slowly to be taking place. Recent inflationary developments in Italy, France, the Netherlands, and even Switzerland have raised doubts as to the basic economic stability of these countries. Political prospects in Britain and some Continental European countries may appear uncertain. Even in Germany, action to curtail the country's persistent and excessive trade surplus may make investment, and especially the placement of foreign funds, less profitable.

Both short-term financial and long-range economic considerations make it therefore less attractive to shift U.S. funds to Europe. At the same time it is to be hoped that the effects of domestic expansionary policies, and especially of the recent tax cut, will make investments at home more attractive. In this way, the seepage abroad of funds not only for short-term and portfolio placement but also for direct investments may be permanently reduced from the unusually high levels of recent years.

At the same time, however, some of the recent improvements in capital movements must be considered temporary. As soon as the interest equalization tax is enacted, U.S. investors will no doubt take advantage of whatever loopholes may be found in the bill. The recent expansion of bank loans to foreigners may, to some extent, have already been connected with an effort of foreign borrowers to substitute bank loans for security issues. These efforts may well become bolder, unless the banks themselves show some restraint in accepting such business. Moreover, the maintenance of ready credit availability in this country, designed to sustain the impetus of expansion under conditions of persistent high unemployment of manpower and capital resources, may well continue to encourage some spill-over of funds into those foreign markets where profit and interest rates are likely to remain higher than in the United States.

Payments prospects for 1964

In view of the temporary nature of many of the factors responsible for the recent improvement in our payments balance, few observers expect much further improvement for the rest of the year, and most of them expect some backsliding.

On trade account, any strong expansionary effect of the tax cut on domestic economic activity would almost certainly lead to a sharper increase in imports, even if we managed to prevent prices and wages from rising faster than in recent years. At the same time, the anti-inflationary measures now being taken in Japan, France, Italy, and the Netherlands, and to a lesser degree in Britain, may well prevent our exports from expanding further, or at worst actually depress them. These measures may affect not only our direct exports to these countries but also our exports to the less-developed areas whose import capacity depends considerably on their raw-material sales to other industrial countries. Needless to say, if our prices and costs were to get out of control, our entire trade and payments position would deteriorate much more seriously.

On capital account, the main problem may well be the future course of European monetary policy. The Ministerial Council of the Common Market has recently advised its members to give price stability for the time being priority over <u>all</u> other policy goals. Should the member countries decide to follow this advice, they might well take harsh restrictive measures that could disturb the international money and capital markets as badly as the German and the Netherlands revaluations did in 1961. Sharply restrictive monetary policies could raise interest rates in those countries so much that the United States might be compelled to choose between three alternatives: to raise its interest rates to levels that would be higher than considered desirable in view of the needs of our domestic economy; or to take more drastic measures than the proposed IET to isolate domestic interest rates and money and capital markets from developments abroad; or to permit a substantial rise in the outflow of U.S. funds into foreign money market instruments, loans, and securities. Each of these alternatives could interfere either with further economic growth at home or with the smooth working of the international payments system, or with both.

While the newly developed instruments of international monetary consultation and cooperation, together with the common sense of the Europeans themselves, should make impossible any such return to the beggar-my-neighbor policies of the Great Depression, this survey of payments prospects for the rest of the year indicates that despite the recent improvement our payments problem is probably far from having been solved for good. Thus, we are confronted with two basic policy questions: first, what should be the goal of our payments policy? And second, how should we try to achieve its purpose?

Payments equilibrium

Surely, the goal of payments policy is long-run payments equilibrium. The Bernstein Committee, whose report is expected to be published within the next few weeks, will presumably solve the problems of the proper statistical definition and presentation of our payments balance. But whatever definition the Committee chooses to recommend for our statistics, the problem will remain of what kind of payments equilibrium should be the objective of our policies.

One such objective might be just to avoid a decline in our gross monetary reserves, especially in the U.S. gold stock. This was a main policy goal under the so-called classical gold standard. But even today European observers assure us that the typical European banker bases his views of the U.S. economy primarily on the weekly figures of changes in the U.S. gold stock.

On the other extreme it might be contended that we should be satisfied with maintaining the international wealth of the United States intact. If this were all that was needed, we would have reached our goal long ago. For the past six years, the international wealth of the United States has actually increased, as our net foreign investments (including reinvested earnings of U.S. subsidiaries that do not appear in U.S. payments statistics) have substantially exceeded the cumulative payments deficit.

The third and most generally accepted view is that payments equilibrium refers neither to a country's gold reserve alone nor to its international wealth but to its international net liquidity position. Any individual enterprise would get into payments difficulties if it concentrated either purely on its cash assets or on its total net asset position, and neglected the relation between liquid assets and liabilities. In the same way, a country gets into payments difficulties if it concentrates either on its gold stock or on its total net international assets, and neglects its net international liquidity.

But which of the various methods of computing our net liquidity position seems to provide the best guideline for policy? We are accustomed to deduct from our gross reserves the liquid claims of all foreigners, official and non-official alike. This method was appropriate at a time when most important foreign countries had exchange controls so that dollar holdings of foreign bankers or businessmen were hardly anything but official holdings, temporarily shifted into private hands. But today this is not the case. Foreigners usually hold balances not as formal or material agents of their central banks but because they decide that they need these balances as investments and for working purposes. Thus, their liquid dollar holdings are more similar to the holdings of domestic merchants, bankers, or individual investors. They might indeed become a drain on U.S. reserves, if their holders transfer them one day to a foreign monetary authority. But, since we have full domestic convertibility, U.S. holders of dollars are also free at any time to transfer their holdings to a foreign central bank and thus to create a potential drain on U.S. reserves. There is, therefore, no longer a compelling policy reason for treating foreign private dollar holdings generally as the equal of foreign official holdings.

This consideration would lead to measuring our payments position on the so-called "official settlement" basis, i.e., by the changes in gross reserves minus liquid claims of foreign monetary authorities on us. There is only one drawback to using this concept in determining our policy goal. While foreign private holdings are in general genuine working balances, there still are important cases in which a central bank, for good or bad reasons, may increase or decrease its dollar reserves by acquiring the dollar holdings of the country's commercial banks or by shifting its own dollar holdings to the commercial banks. On the official settlement basis, such purely internal transactions of a foreign central bank would affect U.S. payments policies, although they may have obviously nothing whatsoever to do with U.S. international transactions.

For these reasons it might be preferable to aim at stabilizing U.S. international net liquidity on the broadest possible basis: considering on the liability side changes in liquid claims on the U.S. financial system of both foreign monetary authorities and foreign non-official holders; but similarly on the asset side changes not merely in U.S. official reserves but also in liquid claims on foreigners of U.S. private financial institutions. As long as foreign private dollar holdings rise in harmony with an increase in U.S. liquid claims on foreigners--say, because a U.S. bank and a foreign bank establish mutual accounts; or because a U.S. investor acquires a foreign money-market instrument or a deposit with a foreign bank; or because a U.S. bank makes a short-term loan to a foreigner --the U.S. net liquidity position is not substantially altered, and there is usually no reason for such a transaction to influence U.S. policy. Similarly, if a foreign central bank shifts some of its dollar holdings to a commercial bank, or vice versa, the U.S. payments position has not changed and U.S. policy should not usually be affected. In contrast, if aggregate foreign liquid dollar holdings rise without a comparable rise in U.S. liquid claims on foreigners--say, as a result of a U.S. deficit on current account, or because U.S. public and private long-term investments abroad exceed our surplus on current account--then the U.S. payments position seems indeed to suffer from a disturbance which, if large or persistent, would require correction.

It is interesting to note that the cumulative payments deficit for the period from mid-1963 to the spring of 1964 has remained substantial both on the conventional and the "official settlement" basis but has nearly vanished on the "total net liquidity" basis. 2/ And whereas U.S. payments statistics have adhered to an outdated method, U.S. policy has perhaps--unconsciously--recognized the validity of the broader basis. Ever since the successful tightening measures taken in July 1963, both fiscal and monetary policies have returned to an expansionary rather than restrictive posture. Thus it may be argued that the authorities have in fact acknowledged the virtual disappearance of a disruptive payments deficit.

2/ See the appended table.

Tools of payments policy

Still, as long as we must face the possibility of a renewed deterioration of our payments balance, and thus the reappearance of a deficit also on the "total net liquidity" basis, the question of the best way to correct such a deficit remains important. Barring changes in government expenditures abroad--which should be reduced to the minimum compatible with the requirements of U.S. military and diplomatic goals, regardless of our payments balance--there are only two ways in which our payments deficit can be corrected: by increasing our surplus on current account, and/or by decreasing our deficit on capital account.

Obviously, a necessary but not sufficient condition for an adequate surplus on current account is a domestic stabilizing policy, designed to maintain or improve our international competitiveness. Assuming such a policy, however, our imports will depend basically on the pace of our domestic economic expansion; and our exports on the level of economic activity abroad. Surely, nobody would recommend policy measures that would seriously retard domestic economic expansion; and there is hardly any way for domestic policy to raise the level of economic activity abroad. Hence--always taking generally stabilizing policies for granted--our current accounts are not easily susceptible to rapid improvement by specific policy action.

Thus, the main burden of measures seeking rapidly to correct the payments balance may well, at least in the short run, fall on capital movements. If the preceding analysis is correct, short-term capital movements, which create liquid assets as well as liquid liabilities, are of little longer-run importance. Adverse short-run effects, including disturbances in the exchange markets and losses of gold reserves, can easily be averted by policies affecting interest-rate differentials, and especially by such instruments of international financial cooperation as the Federal Reserve swaps. Longer-run measures may well focus mainly on avoiding excessive outflows of long-term credits and investments.

The proposed interest equalization tax may be considered as a tool of such a type of policy. The proposal has been attacked both as a disguised form of exchange controls and as a barrier to free international commerce. The first criticism seems unwarranted. Taxes are different from direct controls in that they keep the market mechanism in force. If a foreigner is willing to borrow in the United States at an effective interest rate one per cent higher than he would have to pay otherwise, he remains free to do so. The proposed tax is, in substance, a tariff rather than an import quota.

It is true, however, that the tax tends to curtail international capital movements--in fact, it is purposely designed to do so. But this curtailment seems to be less objectionable than a curtailment of the free movements of goods.

Import duties or export subsidies are harmful because they impair not only the optimum international division of labor but also the optimum distribution of domestic resources. Import duties, for instance, protect some less efficient domestic industries by raising the costs of the other more efficient industries, including those of the most efficient export industries. Thus, they tend to reduce domestic national production and income below their potential maximum.

A tax on capital exports may impinge upon the optimum international allocation of capital but it does not substantially discriminate among domestic industries. To the (negligible) extent that it tends to lower the costs of capital-intensive industries more than those of labor-intensive industries, it would usually favor the most modern and most rapidly expanding and thus probably most efficient industries. And even internationally, such a tax need not hamper the optimum division of labor in those cases in which capital may be attracted to foreign countries not because of higher productivity but on account of a higher degree of domestic protection, less equitable tax systems, or a distribution of the national income favoring capital over labor.

But if policies designed to speed adjustment to payments imbalance were to shift their emphasis from current account to capital account, many problems would have to be solved. In fact, virtually no work has yet been done on the questions under what conditions such policies would seem to be necessary or advisable; under what conditions they might be expected to be successful; how they could be made administratively effective; and what side-effects they might have on domestic and international economic activities, and especially on the relation between fiscal and monetary policy.

Any attempt at such policy reorientation may well prove impracticable. But if ways could be found to make such a policy operative, it might become possible not only to improve the correction of international imbalance but also to free our domestic policy, and especially our domestic monetary policy, from some of the restraints imposed by a payments deficit. Thus, we might be better able to concentrate our efforts on the main task of monetary policy, to promote, under conditions of price stability, "maximum employment, production, and purchasing power."

U.S. Balance of Payments, 1963/I - 1964/I
(Millions of dollars)

	1963 1st Qtr.	1963 2nd Qtr.	1963 3rd Qtr.	1963 4th Qtr.	1964 1st Qtr.
Decline in U.S. reserves	32	124	227	-5	-51
(gold)	(111)	(116)	(196)	(38)	(46)
(foreign convertible currencies)	(-33)	(6)	(-28)	(-58)	(-228)
(IMF gold-tranche position)	(-46)	(2)	(59)	(15)	(131)
plus Increase in bank-reported liquid liabilities to foreigners	320	918	187	155	-155
plus Sales of non-marketable Government bonds	413	142	80	24	-55
plus Special government receipts	45	29	346	264	150
plus Seasonal adjustment	339	89	-445	17	247
equals (1) Conventional Deficit	1,149	1,302	395	455	136
(1) minus Increase in bank-reported liquid liabilities to non-official foreigners	394	142	38	29	273
equals (2) "Official Settlement" Deficit	755	1,160	357	426	-137
(1) minus Increase in bank-reported short-term claims on foreigners (seasonally adjusted)	-63	488	8	267	434
equals (3) "Total Net Liquidity" Deficit	1,212	814	387	188	-298

Sources: Department of Commerce, Business News Reports, released May 15, 1964; Federal Reserve Bulletin, May 1964 (for liquid liabilities to non-official foreigners).