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Reconciling International and Domestic Factors in Monetary Policy

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Reconciling International and
Domestic Factors in Monetary Policy

While my subject is formulated in a general way, I want to talk to you about it in terms of the problem we have in the United States on monetary policy in relationship toward domestic policy. The United States, as you know, has a monetary system based on a fixed price of gold of $35 an ounce and coupled with that is the principle of full convertibility of the official balances held by monetary authorities abroad in dollars into gold. With this kind of a system, the central bank cannot have a balance of payments policy that is separate from its domestic policy. Nor can the U. S. Government as a whole.

At first glance this may strike you as a little bit strong and overly positive, because we have the voluntary credit restraint program to contain capital outflow, but you have to look upon this program as a temporary selective measure to buttress financial policies that have both a domestic and international orientation. The program's very existence and the prospects for its ultimate success are intricately connected with domestic developments that are in turn affected by the international aspects of financial policies. The fact that domestic economic growth cannot be long sustained if it is accompanied by persisting deficits in international transactions rests on a very simple proposition. Monetary reserves of this country in gold, and in foreign exchange to some extent, are finite and cannot be drawn down below zero. If the zero point even threatens to be approached, particularly by a country like the United States, action becomes necessary to stop the drain. If this action is delayed too long, then inevitably there will be required very drastic measures that will be disruptive of private business and financial planning, and, hence, disrupting to our own economic growth. In practice the moment of revelation concerning the connection between international and domestic demand arise at a very early stage. When a sizable payments deficit persists for more than a year or two and no temporary cures are in sight, reasonable people expect, and correctly expect, that the Government will soon have to do something to remedy the situation. They naturally watch to see whether desirable Government action will come promptly and effectively. If it does not appear to be coming, the prudent man will adapt his plans to hedge as best he can against the more drastic actions that will have to be taken later. Precautionary flows of capital goods will be set in motion. Attitudes of foreign creditors will stiffen. In serious cases, productive domestic investments will be postponed. Many of you know all too well from experience of your own and neighboring countries that this kind of thing is certain to happen. All of these rational reactions on the part of private economy hasten the day of reckoning when domestic growth and external deficit can no longer co-exist.

In the light of this predictable course of events there are great advantages to be gained from adopting a corrective policy early, when the range of actions open for policy is still wide and when policy can probe gently and experimentally and when necessary adjustments can be made rather smoothly. At later stages there may be little scope for flexibility and adjustments, as the experience of the United Kingdom shows so clearly. Even the United States, which in 1958 could draw upon enormous monetary reserves and the intangible assets of respect and admiration born of more than a decade of unrivaled economic performance, found it desirable very early to take remedial action to prevent a large emerging payments deficit from reaching disrupting proportions. The most important of all of those actions were those that helped to stop the inflation of the 1950's and these actions were of course taken as much for domestic as for international reasons. I wouldn't want to claim too much for international policy in initiating the welcome and necessary change in our domestic price trend for luck was on our side in that period, notably in the ending of the worldwide investment boom and the resolution of the Suez crisis which had given climatic inflationary impetus to the boom of the 1950's. Even so the subsequent transition was not achieved particularly smoothly. Reaction to the distortions engendered by the inflation interrupted our economic growth for a time and left us with an intolerably high level of unemployment which we found it possible to reduce only slowly. It does seem to me, however, that fiscal and monetary policy in the period can claim a fair measure of credit for the reasonable price stability that was attained and for the result of the well-balanced nature of the expansion that we have had in the 1960's that has proven to be exceptionally healthy and vigorous. It is clear that price stability has been and is an absolutely essential part of a cure for our persisting balance of payments deficit, as well as for the sustainability of our domestic growth. It was not just pure chance that last year the U. S. increased its share of world exports of manufacturers for the first time in 5 years. This is directly traceable, it seems to me, to the kind of stability that we have maintained from the late '50's through to last year.

Beginning in 1959 and 1960, a number of special actions were taken to improve the balance of payments including efforts to tie foreign aid, to trim military expenditures abroad, to promote exports, and even on occasion to apply voluntary restraint to particular foreign investment transactions. I am not going to dwell on these measures because these do not fall strictly within the area of financial policy, but also because they are necessarily temporary remedies - temporary because the efficient use of resources requires the maximum degree of market freedom and these measures conflict with market freedom. Few people would argue for tied aid or for voluntary credit restraint as a permanent way of life. Military commitments cannot be closely tailored to balance-of-payments requirements. Since 1959 monetary and fiscal policy have explicitly taken both international and domestic considerations into account, recognizing that renewed growth and favorable prospects at home were needed to insure continued improvement in our international competitive position but recognizing also that an improved payments position was essential to continued domestic expansion. Thus in the recession of 1960-61 monetary policy attempted to be as stimulative as it could be, but Treasury and Federal Reserve operations were coordinated in a way that prevented interest rates, and particularly short-term interest rates, from falling in the way in which they had in earlier recessions. In 1961, a new administration firmly committed to growth but mindful that prolonged payments deficits would frustrate growth adopted a broad range balance-of-payments program that was conceived in the light of our domestic requirements. The administration introduced the first in a series of tax proposals that were designed both to facilitate expansion at home and to reduce our payments deficit.

For the past two years both domestic and international considerations have pointed to the need for a progressive moderation of monetary ease, and monetary policy has in fact gradually become firmer. This is not the time to review these developments in detail. The record will bear out the points that I am making that from a very early stage in our 7 year old record of sizable payments deficits our national policy has had to recognize that we could not hope to attain sustainable growth unless we avoided imbalances at home and also dealt successfully with the payments problem abroad. At the same time, looking at where we are now, we have not been wholly successful in dealing with our payments deficit. At least we cannot say that we have been successful yet. We could reasonably hope at some various points that we were being successful, and we can hope that we are being successful now. There was a lot of merit in attempting to make the adjustments that we were making gradually, as a large reserve of monetary gold permitted us to do even though our friends in Europe were very doubtful about the path that we were following. The current account surplus began to revive in a very promising way in 1959 and every reading since then has indicated that it would continue to improve given the continued improvement in the relative price-cost position of the U. S. vis-a-vis other industrial countries and the uptrend in our international investment income. In 1961, our overall payments deficit diminished very sharply. While much of that change was associated with a temporary cyclical drop in our imports this still seems to be an underlying improvement. Then in late 1962 and 1963 capital outflows swelled alarmingly, but the interest equalization tax imposed just after mid-1963 and some accompanying firming of monetary policy seemed sufficient for a time to contain the outflow. Meanwhile the current account improved, at least until this year.

In 1964, the payments deficit was again swollen sharply by capital outflows especially late in the year. Thus, it was made clear to us that additional actions were necessary. Seven years of sizable deficits had reduced our reserves including our position in the International Monetary Fund by some $9 billion, a stupendous sum, one-third of the total we had earlier, and it increased our liabilities to other monetary authorities by $7 billion, or nearly half. In these circumstances many foreign creditors had become restive and more important U. S. lenders and investors were rushing to place funds abroad in anticipation of restrictive action which, it was widely felt, would have to be taken. Most important of all, though far too few noticed it, we were in serious danger of losing a large measure of the flexibility that financial policy must have. Such flexibility is needed to cope adequately with unforeseen contingencies if orderly economic growth is to be maintained with sensible cushioning of seasonal and cyclical fluctuations and international disruption avoided. It has become a currently relevant question, for example, how effectively monetary and fiscal policy can move to counter any recessionary tendencies that might develop in our own economy over the next year if our balance of payments remains in serious deficit and our payment solvency in doubt. We have, of course, powerful built-in stabilizers domestically, both fiscal and monetary. Tax burdens ease and transfer payments rise as activity slackens. Credit availability increases and interest rates decline as credit demand diminishes. However, the extent to which financial policy can supplement these automatic stabilizers or even permit them to work could be seriously limited by continued international imbalance and by the threat inherent therein. Therefore, the balance of payments program we are following this year is a crucial element of domestic financial policy. We must make a success of it for domestic reasons quite as much as for international reasons.

Gov. Robertson has reported to you that our voluntary credit restraint program is working about as well as could have been expected, and it will significantly reduce our payments deficit this year and probably also in 1966. The flow of U. S. bank credits to foreigners has been sharply reduced from last year's swollen level. Large corporations have undertaken to increase the foreign financing of investment projects that they are promoting abroad, and they have brought home a sizable volume of liquid assets that they otherwise would be holding as working or precautionary balances abroad.

Any broad-range program that is based on voluntary cooperation is necessarily a temporary program. Targets related to the performance in the past, as they must be in this kind of a program, become inequitable with the passage of time and conflicts between market incentives, economic incentives and national objectives bring inefficiency. More fundamentally, and this is also the reason why mandatory exchange control would be no solution for the U. S., the international position of the U. S. as a key trading and financial center depends on a wide measure of free play of market forces. It is in our long run interest to persuade other countries to forego and dismantle such artificial restrictions as they may have, and it is against our interests as well as against our philosophy of government to maintain direct controls that hamper competition and invite other governments to follow down the same path. Therefore, while we have bought time, valuable time, with our this year's balance-of-payments program that contains capital outflow, we must look beyond that program and ask what we have bought this time for.

How have underlying forces worked to resolve the payments problem, and what domestic financial policies are needed to ensure that they will bring a solution? There are a number of optimistic elements in the longer run outlook. The current account surplus, as I noted earlier, should increase further. Always provided that we hold our prices stable, and, I might add, keep work stoppages to a minimum. I would not expect the current surplus to increase this year, and it might even decline some. There has been some softening of the demand in a few industrial countries, and some of the less developed countries have not continued to increase their purchases at last year's high rate. Also, our imports have been perhaps overly responsive to expanding internal demand this year. In the following year and for several years our exports ought to rise as fast as our imports, and in percentage terms, which is more important perhaps than dollar terms, we should get a rise in exports relative to imports. At the same time our foreign investment income on the basis of past investment made by our corporations and through the market should continue to increase.

There are large uncertainties with regard to the future and the outlook for capital outflow. We have only had a relatively brief experience with the very much greater freedom of capital movement that has followed the restoration of convertibility of leading foreign currencies. After all, this was only attained towards the end of the 1950's. In that brief experience, we have repeatedly found that new kinds of flows can develop very rapidly in response to differentials of credit availability and interest rates. At the same time we can reasonably hope that the extreme tightness in European capital and money markets during the past year which gives extra incentive to U. S. capital outflows was partly cyclical, related as it was to the new conditions in Europe and to the strong efforts that the key European authorities were making to contain creeping inflation. Because continental European countries need to mobilize their own savings more effectively, they are now trying to develop better capital markets. Other voluntary restraint efforts, in combination with the I. E. T. and the adaptions that we have made in our domestic monetary policy, may well help to speed up this process and thus pave the way for what I would like to think of as normalization of international capital movements.

It is sometimes stated that Europe does not have sufficient savings to replace a substantial part of its inflow of U. S. funds, and in addition to supplement U. S. credit to less developed countries. Actually there are such savings. Only so far they have taken the form of the accumulation of gold and short-term dollar balances, rather than a form of investment in credits to foreigners. If European institutional rigidities can be broken down so that part of these liquid savings can be transformed into investments, European payments surpluses and corresponding U. S. payments deficits will simultaneously be reduced. In fact, our present restraints on capital outflow are obliging Europeans to rely more on their own than on U. S. funds for their own investments, and they are also inducing Japan and the less developed countries to finance a larger part of their imports from Europe through European rather than U. S. credits. In this way, these restraints are playing a vital part in helping to bring about lasting adjustments in the international flow of capital which are necessary. We may hope in conjunction with our continuing improvement in our current account these may perhaps be sufficient to restore our payments balance to a sustainable equilibrium.

There are optimistic elements, of course, in our domestic economic situation. For instance, we have weathered several months of very heavy inventory accumulation without widespread price advance, even though the advances of late last year and early spring have not been reversed, and the recent steel wage settlement, together with continued foreign competition in that area, seems to have removed the threat of a major price/cost breakthrough in that important industry. Besides these developments the outlook for plant and equipment spending has become increasingly buoyant and new fiscal stimulants are scheduled to affect our economy in the second half of this year. In the financial area, too, where some elements of credit have expanded unusually rapidly during the first part of this year, the bulge in total borrowing that had taken place now appears not to have been proportionately larger than the growth that we have had in our gross national product. Since the slight further firming of monetary policy late last year and early this year, there is some ground for thinking that bank credit expansion has been getting realigned with the needs of the economy. Each successive month since last November the rate of increase of bank credit has been lower than the rate of the month before. Thus, it is possible to construct a plausible explanation that everything is working out for the best. We have continued balance at home, accompanied by gradual adjustment toward balance in our international transactions.

It is also possible, and I think even probable, that not all of these optimistic possibilities will work out exactly in the way in which we might hope. In particular the payments deficit, which when you think about it closely, is a margin on the top of a margin, can be affected greatly by rather small changes in growth flows. Thus, it cound still be a threat to domestic growth as the time approaches to terminate the voluntary restraint program. If so, its solution will not be simply achieved by any act of will that is required to tighten credit conditions since the linkages between credit conditions and business conditions on the one hand and payments flows on the other are uncertain and are always complicated by international repercussions. What I am saying is that despite rather favorable outlook, on balance we might be prepared in this country to take alternative measures, reinforcing measures, on an <u>ad hoc</u> basis depending on the way in which developments go.

All the same, monetary policy will have to attempt whatever seems to be necessary, and it may be that if some weakening of demand domestically points toward the need of further stimulative action by government, this time we will have to get the stimulus primarily out of fiscal policy with little or no reliance on monetary policy. Monetary policy may have to be maintained even in a restrictive or quasi-restrictive posture.

In concluding my observations, let me remind you that while we have a capital outflow problem we are not faced with the challenge of stopping this capital outflow entirely, and we are not faced with the necessity of raising U. S. interest rates to European levels. With the current account surplus at its present level, we could very comfortably sustain a capital outflow as large as any that we experienced before last year. Our problem on the capital outflow side is one of containing bulges and preventing an undue expansion in any period in relation to our capacity to finance or effect a transfer of the funds through the current account. In any case, what we are talking about for the future in terms of policies, I think, is the matter of making small adjustments as we go along. We need not, in the light of the outlook as it is now, have in mind for even our contingency planning sledge hammer tactics. I think that approach is outside of any that we will or may be faced with in the period ahead. It is absolutely vital for us to be alert and to keep making adjustments at the margin, not only to sustain the domestic situation but to sustain the stability of the dollar.