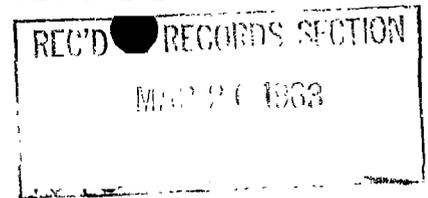




BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON



March 26, 1963.

STRICTLY CONFIDENTIAL (FR)

TO: Federal Open Market Committee
FROM: Mr. Young
SUBJECT: Additional staff paper.

Supplementing my memorandum of March 1, 1963 transmitting a group of staff papers on effects of changes in monetary policy, there is enclosed another paper, prepared by Mr. Reynolds of the Board's Division of International Finance under date of March 25, 1963, commenting on the U. S. balance of payments situation in early 1963. As indicated in my earlier memorandum distributing these papers, two copies are being given to each Reserve Bank President, one for his own use and one for the use of his chief economist.

Enclosures

RECORDS SECTION
MAR 26 1963
COPY NO. _____

STRICTLY CONFIDENTIAL (FR)

March 25, 1963.

The U.S. Balance-of-Payments Situation in Early 1963, with
Tentative Notes on the Outlook

There seems to be general agreement that a change in U.S. monetary policy towards less ease might produce some improvement in the U.S. balance of payments, but would involve some domestic risks and costs. Even if the possible gains and risks and costs, under specified conditions, can be agreed upon within a tolerably narrow range, no judgment can be made as to whether the game is worth the candle except in the light of a careful appraisal of the current situation and of prospective development, both in the balance of payments and in the domestic economy.

This note appraises the international payments situation. It argues that, as of the first quarter of 1963, the U.S. payments deficit is certainly not increasing, and may well be shrinking. It suggests that there is a good possibility of significant improvement during 1963 and into 1964. So far, this can only be described as a possibility. The uncertainties are large, and underlying trends have been temporarily obscured in recent months by U.S. longshoremen's strikes, by a bunching of capital inflows and outflows of several kinds, and by an exceptionally severe winter in Europe. Nevertheless, it seems to the author of this note (who should be classified as relatively optimistic) that there are considerably greater possibilities for improvement than for deterioration, independent of any monetary action that might be considered as potentially helpful.

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The Rationale of U.S. Policy to Date

The U.S. payments deficit first became a recognized problem in 1958, and was not explicitly attacked by the Government until 1960-61, although the policies most essential to its resolution were those adopted earlier to end inflation.

U.S. policy to deal with the payments problem since 1958 has always assumed that the elimination of the deficit would have to come gradually, over a period of several years, and would come mainly through changes in relative prices and costs, and in the relative attractiveness of investment opportunities here and abroad. There has been reason to hope that these changes would come about as a result of gentle inflation and heightened uncertainty as to investment returns in leading foreign countries while U.S. prices and costs were held stable. While drastic changes in internal or external policies (including exchange rate policy) might theoretically provide alternative -- and quicker -- ways of getting the required adjustments, such changes have not represented practical alternatives that the United States could adopt without causing disruption much worse than the cure.

A long series of more narrow and specific remedies has also, of course, been set in motion, including tying of aid, negotiation of increased foreign military procurement in this country, and export promotion drive, and support of the U.S. Treasury bill rate. But the competitive adjustment, both for its effects on current transactions and on investment incentives, has been relied upon as the fundamental one.

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Recently increased concern about the payments situation has reflected disappointment at the slowness with which that adjustment is occurring, and even doubts as to whether it is occurring at all.

Recent Doubts

The sources of these doubts are many. First of all, the 1962 payments results were disappointing to all observers. The deficit on transactions other than debt prepayments and special Treasury financing was \$3.6 billion -- higher than 1961's \$3.1 billion and only slightly below the \$3.9 billion of 1960. The disappointment has been particularly keenly felt by those who had erroneously supposed, during the summer of 1962, that the deficit was already diminishing rapidly. Doubts have been sharpened by the painful U.S. official withdrawal from an earlier prediction of payments balance by about the end of 1963. If not then, when? Will another year of substantial deficit so undermine confidence in U.S. policies as to lead to larger gold losses, to still larger capital outflow, and even, perhaps, to a crisis run on the dollar?

Secondly, doubts have arisen because of growing recognition of the possibility that even if the U.S. competitive position were to improve substantially, the beneficial effects of that improvement on current and capital transactions could be swamped by increased capital outflows, related less directly to competitiveness than to such other factors as interest rates and confidence. These doubts have recently been sharpened by the insistent urging of some Continental European officials, in Working Party 3 and elsewhere,

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and of many other observers, that a rise in U.S. interest rates was essential. They have also been accentuated by the continued heavy volume of capital outflows from the U.S. in the fourth quarter of 1962 and probably also in the early months of 1963, in which a record volume of new foreign bond issues has attracted particular attention.

A third element in recent doubts has been some second thoughts about policy prospects, and especially their timing. Last year, it was possible to argue that a tax cut was needed, that its enactment would stimulate the domestic economy, and that the stimulus would itself produce, or be allowed to produce, credit tightening which could reinforce the dampening effect on net capital outflow that would come from improved U.S. profit prospects and investment incentives. But the form which the Administration's tax proposals finally took, together with the nature of Congressional action, makes it unlikely that any tax cut can be enacted before September 1963. Hence, many people (e.g., the OECD Secretariat) now see the balance-of-payments effects of the tax cut and associated credit tightening coming almost a year later than they had been supposing as recently as last fall. They have new cause to wonder whether other action will be needed in the interim..

Recent Balance of Payments Developments

The increase in the U.S. payments deficit, adjusted for special Government transactions, from the year 1961 to the year 1962 occurred mainly during 1961. The swing in transactions with Canada during 1962, associated with the Canadian exchange crisis and stabilization, was so large that it accounted for about all of the

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increase in the over-all U.S. deficit from the first to the second half of 1962. Thus, as will be seen from Table 1, the underlying deficit (i.e., aside from special Government transactions and this Canadian swing) did not change appreciably from the first half year to the second. It was significantly smaller than in the second half of 1961 and in the second half of 1960. What made the year 1961 as a whole better than the year 1962 was the sharp recession in U.S. imports in the first half of 1961 which was so obviously temporary that it makes that period a very poor base for any comparisons.

Table 1. U.S. Payments Deficit, 1960-62
(billions of dollars, semi-annually, seasonally adjusted)

	1960		1961		1962	
	1st half	2nd half	1st half	2nd half	1st half	2nd half(p)
Over-all deficit, published	1.46	2.41	.18	2.18	.71	1.47
Debt prepayment receipts	--	--	.63	.04	.08	.59
Special U.S. Treasury borrowing	--	--	--	--	--	.25
Reclassification of military accts.	--	--	--	--	.23	.23
Deficit on all other transactions	<u>1.46</u>	<u>2.41</u>	<u>.81</u>	<u>2.22</u>	<u>1.02</u>	<u>2.54</u>
Temporary effects of Canadian crisis and stabilization, 1962	--	--	--	--	+ .7(e)	- .7(e)
Deficit on all other transactions	<u>1.46</u>	<u>2.41</u>	<u>.81</u>	<u>2.22</u>	<u>1.7(e)</u>	<u>1.8(e)</u>
(Memo: decline in U.S. gold stock, unadjusted for seasonal variation)	(.14)	(1.56)	(.20)	(.66)	(.42)	(.47)

(p) Preliminary.

(e) Very rough estimate.

Thus, the 1962 figures do not support the view that the payments deficit increased in a significant sense during 1962. Instead, they are consistent with the hypothesis of a gradual corrective process over a period of years. It is true that they show a disappointingly slow improvement. Partly, however, this resulted from adverse net effects in 1962 of Canadian actions (in addition to the swing assumed to have washed out within the year). The Canadian dollar was devalued sharply further in May 1962, to 6-1/2 per cent below its average 1961 value in terms of U.S. dollars, and to 11 per cent below its average 1959-60 value. Temporary surcharges on imports were imposed. Canadian policy was temporarily and deliberately aimed at attracting a very substantial capital inflow from the United States. Canadian reserves increased, net of special assistance received from the IMF, by \$300 million during 1962. If one is relying on a gradual adjustment in relative prices, costs, and investment incentives, one must not be surprised if a currency devaluation and capital-import drive by a major trading partner set the process back a little.

During January-February 1963, the over-all deficit (again on transactions other than special Treasury borrowing) was about \$630 million (preliminary). Weekly indicators (incomplete and preliminary) for the 3 weeks from February 28 through March 20 showed a surplus of \$70 million. The deficit for the full quarter may tentatively be guessed at about \$600 to \$700 million. If no large special influences had to be allowed for, that would be an encouraging result, significantly below the average \$900 million quarterly deficit in 1962.

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In fact, several special influences were present in the first quarter of 1963 and do have to be allowed for in judging the representativeness of the first quarter results. And unfortunately their various quantitative effects can be only very roughly appraised now. Nevertheless, those effects seem likely to have been roughly offsetting; they may not have had much net impact on the over-all first-quarter payments results.

(1) The longshoremen's strike probably had a sizeable net adverse effect on U.S. trade during the first quarter, perhaps of \$100 to \$200 million; but it may not have had very much net effect on payments. While more exports than imports were moved up from the first quarter of 1963 into December 1962, in anticipation of the strike, we do not know whether payments were similarly affected, or to what extent. (This uncertainty may never be clearly resolved.)

(2) Outflows of U.S. capital into new foreign security issues were very heavy during the first quarter, and included take-downs of \$225 million on two unusually large Canadian issues. At roughly \$400 to \$500 million, the total of such outflows may have been \$100 to \$200 million above the average quarterly rate for 1963 as a whole.

(3) On the other hand, foreign official institutions made unusually large repayments of U.S. bank loans; the Bank of Japan repaid about \$180 million and the Government of Venezuela prepaid about \$50 million. This favorable element may have roughly matched the unfavorable element in item (2) above.

(4) Bear raids on the pound sterling at the end of January and in the middle of March probably benefitted the U.S. balance of payments; the weekly indicators showed exceptional U.S. payments surpluses of over \$100 million in each of the weeks (January 31 - February 6 and March 14-20) when such raids were heavy. But it would be

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surprising if the total favorable effect for the quarter was nearly as large as \$200 million. Total British official reserve losses may have been about \$300 million. Of this amount, we know (confidentially) that more than \$100 million represented a shift of Spanish reserves out of sterling into dollars. Some further portion is thought to have swelled private British holdings, official French reserves, and perhaps the reserves of other European countries.

(5) The net seasonal factor is small in the first quarter; seasonal inflows representing the unwinding of year-end window-dressing are largely offset by unfavorable seasonal movements in other flows.

In summary, tentative first quarter payments results now available, even after rough allowance for special influences, suggest a deficit running at or below \$3 billion at an annual rate, compared to \$3.6 billion in 1962 and a rate of over \$4 billion in the second halves of 1960 and 1961.

Related Economic Developments

The cost-price adjustments relied upon in the basic rationale of U.S. policy have in fact been occurring since about 1959. Since then, prices and costs have been stable in this country, and they have been rising in almost all leading industrial countries abroad, as Table 2 indicates. So far, foreign costs have apparently risen more than prices, with a resulting squeeze on profits. But that does not necessarily frustrate the international payments adjustment. It need only mean that the adjustment comes less in current account transactions and more in capital account transactions as relative profit prospects change.

Table 2. Prices and Wages in Leading Countries
(Percentage changes, year 1959 to December 1962)

	<u>Cost of living</u>	<u>Wholesale prices</u>	<u>Hourly earnings in manufacturing</u>
United States	+ 4	0	+11
United Kingdom	+10	+ 7	+20 (Oct.)
Canada <u>1/</u>	+ 4	+ 5	+13
Germany <u>2/</u>	+ 8	+ 4	+35 (Aug.)
France <u>3/</u>	+15	+10	<u>4/</u> +28 (Oct.)
Italy	+13	+ 7	<u>4/</u> +28
Netherlands <u>2/</u>	+ 9	- 3 (Nov.)	<u>4/</u> +31
Sweden	+12	+ 8	+28 (Nov.)
Japan	+20	+ 7	<u>4/</u> +29 (Nov.)

1/ Not corrected for devaluation of Canadian dollar by 11 per cent in 1961-62.

2/ Not corrected for revaluation of German mark and Dutch guilder by 5 per cent in 1961.

3/ The French franc was devalued by 29 per cent in 1957-58.

4/ Hourly wage rates; earnings rose more than rates.

Sources: OECD Statistical Bulletins and IMF International Financial Statistics.

Note: The indexes used are not closely comparable; in particular, wholesale price indexes differ greatly in the weights given to imported goods and to agricultural products and raw materials. Nevertheless, the figures are believed to be reasonably indicative of broad trends.

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The Committee on Balance of Payments Information, in its recent sobering report to Mr. Dillon on the outlook for 1963, noted that the effects of improved U.S. competitiveness, if any, had been slow in showing up in international transactions, and could not safely be relied upon to help us much this year. But it seems to the present writer that (a) they are bound to show up sooner or later, (b) they could not have been expected to show up very strikingly before about now, and (c) some of them have already become evident.

We have the dramatic case of autos, by now a cliché but still important. This was perhaps a problem more of design and marketing than of prices and costs, but it illustrated well the time lags involved in market adjustments and also the fact that such adjustments do occur. U.S. auto companies took about two years (1957-58) to see the need, and another two years (1959-60) to meet the challenge. Sales of imported autos rose to 10 per cent of total U.S. sales in 1959, but have since declined to less than 5 per cent. One should probably expect a time-lag as long as this, or longer, in most competitive adjustments affecting trade in industrial products. Competitive pressures must be felt, products redesigned, new customer relationships developed, and so forth. Relative cost-price changes that occur only slowly are even more slowly perceived and acted upon.

In the case of investment incentives, time lags are also long. For example, U.S. corporations that decided to establish operations in Common Market countries after the restoration of

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convertibility in 1958 and after the fact that the Common Market was a going concern became apparent in 1959, may well not have completed their plans until 1960 or 1961, and in many cases are still carrying them out. The profit squeeze was not felt acutely in most Continental European countries until some time in 1962; it could have been foreseen in 1961, but could not much have affected planning before 1961.

Cost and price inflation in Europe is continuing. It has recently been dramatized in France--by the extension of paid vacations for Renault workers, and by the coal miners' strike and related strikes in public service industries in defiance of the Government. Inflation appears recently to have been about as rapid in Italy as in France, and continues in Germany to an extent that the German authorities find very disquieting. (In some of these cases, inflation may already have gone about far enough to produce--ultimately--the kind of payments adjustment needed. Therefore, current attempts by the authorities in those countries to restrain inflation are not necessarily incompatible with restoration of international balance. It is highly important that inflation in France, for example, be stopped well short of the point where yet another currency devaluation begins to seem attractive.)

Some observers have been disappointed that inflation in foreign countries with payments surpluses does not seem to be correcting international imbalances. Part of the answer lies in the necessarily long time-lags in the adjustment process, noted

above. But an important second part of the answer is that the payments situations of several leading countries have been changing, and are changing now.

(1) The German payments surplus disappeared a year ago and has not re-emerged.

(2) The Italian surplus is now much diminished, or perhaps eliminated.

(3) In Spain, South Africa, and Australia, substantial surpluses in late 1961 and much of 1962 have apparently now ended.

(4) Japan's surplus in 1962, following a large deficit in 1961, was precariously based on short-term borrowing abroad and on inventory liquidation; its continuation this year is doubtful.

(5) The United Kingdom is generally regarded as facing more difficult payments problems this year than last, when its external accounts were roughly in balance.

(6) France--the country with the largest surplus--is perhaps the biggest question mark. Through February, official reserve gains continued to be very large; their size is explainable only by capital inflows which cannot yet be analyzed in detail. Most observers (e.g., the OECD Secretariat, the U.S. Embassy in Paris) expect some shrinkage of the French surplus from 1962 to 1963, perhaps from \$1.2 billion to \$9 billion. Some observers (e.g., M. Kozul of the Bank of France, M. Ferras of the BIS) have a feeling that the French surplus could evaporate fairly rapidly if the French Government should prove unable to bring inflationary pressures under control. They remember that the large French payments surpluses of 1954 and 1955 gave way to deficits overnight early in 1956.

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(7) Canada experienced a huge swing from deficit to surplus between the first and second halves of 1962, but seems unlikely to realize or seek a continuing large over-all surplus in 1963, given its large monetary reserves and its domestic need for economic expansion and reduction of unemployment.

The prospects sketched in these capsule summaries do not, of course, rule out continuation of a large U.S. payments deficit. New surplus countries could appear, or some less developed countries could swing from deficit towards balance--a development much to be hoped for. But there is at least a real question, worth exploring carefully, as to who will have the payments surpluses in 1963 and 1964 to match a continuing large U.S. deficit.

John E. Reynolds