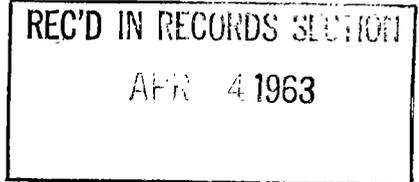




BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON



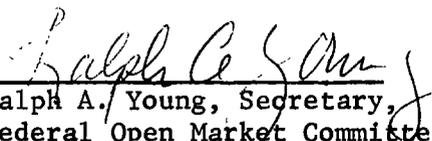
STRICTLY CONFIDENTIAL (FR)

April 3, 1963.

To: Federal Open Market Committee  
From: Ralph A. Young  
Subject: Additional staff papers.

At the Committee meeting of March 26, 1963, Governor Mitchell requested the staff to supplement the papers on effects of possible changes in monetary policy, distributed with my memoranda of March 1 and March 26, 1963, with an additional paper on balance-of-payments effects of a monetary policy directed toward moderately greater credit ease.

I enclose a paper prepared by Mr. Furth on that subject. As indicated in my earlier memoranda, two copies are being given to each Reserve Bank President, one for his own use and one for the use of his chief economist.

  
Ralph A. Young, Secretary,  
Federal Open Market Committee.

Enclosure.

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BALANCE-OF-PAYMENTS EFFECTS OF EASIER CREDIT CONDITIONS  
AND LOWER INTEREST RATES

Estimates of balance-of-payments effects of changes in U.S. monetary policy under present economic conditions are necessarily inaccurate guesses.

Financial institutions and relationships in the United States are so different from those in other countries, and especially from those in the United Kingdom and Canada, that experiences abroad cannot readily be applied to the United States. And within the United States, economic conditions at present (underemployment domestically and a large chronic deficit internationally) are so different from those prevailing on previous occasions when monetary policy was used to increase credit ease and encourage lower short-term interest rates that the results again remain incomparable.

While thus disclaiming any pretense of accuracy, this paper tries to evaluate the effects of a change in U.S. monetary policy that would result in short-term market rates falling within the next few months by about one-half of one per cent.

Comparisons of balance-of-payments effects of  
increases and declines in short-term rates

Changes in U.S. monetary policy have a two-fold effect on the U.S. balance of payments. The first (called in this paper "yield-difference" effect) results from changes in credit availability and

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in yield differences between credits and investments at home and abroad. The second (called in this paper "confidence" effect) results from changes in expectations as to the dollar exchange rate in relation to other major currencies. Such changes will reflect the views of the international financial community about the appropriateness and adequacy of U.S. monetary policy in regard to the U.S. payments problem.

Papers prepared by other Federal Reserve staff members on the possible impact of a moderate lessening of credit ease and increase in short-term rates on the U.S. balance of payments suggest broadly for the "yield-difference" effect a range between zero and \$500 million. For the "confidence" effect, the authors were unable to suggest a possible range.

Insofar as the "yield-difference" effect is concerned, the prospective impact of an equally moderate decline in U.S. short-term rates might be considered about equal (with opposite sign) to that of an increase. Insofar as the "confidence" effect is concerned, on the other hand, the impact should be considered as much greater, for reasons explained below. Thus, while the total net positive impact on the balance of payments of a moderate lessening in credit availability and increase in U.S. short-term

rates seems to fall in a range from \$500 million downwards (with \$500 million an outside figure),<sup>1/</sup> the negative effect of a corresponding increase in credit ease and decline in rates seems likely to fall in a range from \$500 million upwards (with \$500 million the inside figure).

The following sections of this paper try to evaluate, first the "yield-difference" effect (which must always be understood to include also the effect of a change in credit availability), and, second, the "confidence" effect.

"Yield-difference" effect

In line with the guesses about the effects of a moderately less easy monetary policy expressed in the papers already circulated, it would seem reasonable to assume the following order of magnitude of the "yield-difference" effect of a moderately easier monetary policy designed to lower domestic short-term interest rates by one-half of one per cent within the next few months:

Recorded outflows of short-term funds, which in 1962 amounted to about \$500 million, might be increased by up to \$250 million.

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1/ In contrast to some other estimates of possible effects (including those contained in the Treasury paper distributed to the Committee March 29 and those prepared by the staff of the New York Federal Reserve Bank, but not circulated), the present writer would put the more likely figure well under this outside estimate. First, he has more doubts than some about Canada's willingness to permit a substantial reduction in the inflow of funds based on the current, relatively wide, short-term yield differential with the U.S., and about the willingness of the U.K., in view of its comparatively thin monetary reserve position, to permit a substantial outflow of foreign funds, now retained by relatively high short rates. Thus, he thinks it more likely than some that either country would follow a less easy U.S. monetary policy with some countervailing action of its own. Second, he also has more doubts than others about the magnitude of the "confidence" effect to be expected from a gradual and moderate lessening of credit ease. Both points, however, are matters of individual judgment.

Unrecorded outflows, which in 1962 amounted to about \$1 billion and which included an undetermined amount of short-term capital movements, might also be increased by up to \$250 million.

Outflows of funds recorded as direct investments might be increased by up to \$100 million, mainly because of some shift to U.S. banks in borrowing of short-term funds for U.S. foreign subsidiaries.

Effects on other long-term flows would be negligible. It is true that, in general, long-term rates would be more significantly affected by an easier than by a less easy monetary policy. A less easy monetary policy would presumably be executed in such a way as to minimize an increase in long-term rates with its adverse impact on domestic investment. In contrast, it would be reasonable to assume that an easier monetary policy would be executed so as to maximize the reduction in long-term rates and thus a beneficial impact on domestic investment.

But long-term rates (in contrast to short-term rates, especially if the latter are computed on a "covered" basis that takes into account forward premiums and discounts) are so much lower in the United States than in most foreign countries that an increase in the differential even by the full amount of the assumed decline in U.S. short-term rates would hardly lead to a significant increase in the outflow of long-term fixed-interest capital. And any such increase might well be offset, at least in part, by larger inflows of equity funds, attracted by expectations of rising prices of U.S. shares.

The gross increase in outflows of up to \$600 million would be offset by two factors:

First, by the reduced cost of short-term interest payments to foreigners of nearly \$100 million;

Second, and possibly more important, by the effects of offsetting foreign monetary policies, particularly in the United Kingdom and Canada, which might cut the gross increase in outflows of short-term funds by as much as \$250 million.

For these reasons, the balance of the yield-difference effect of increased credit ease and short-term rates lowered by one-half of one per cent might turn out to be of the same order of magnitude that might result from lessened credit ease and a one-half per cent rise in short-term rates.

"Confidence" effect

This effect should be considered far more important in case of a reduction than in that of an increase in U.S. rates.

Many members of the international financial community (including central bankers as well as commercial bankers, merchants, and investors) believe that the U.S. payments deficit could be significantly reduced if U.S. monetary policy were directed to a lessening of ease and somewhat higher interest rates. Not all members share this belief however.

Of those members who do share it, many (possibly most) believe that the interest rate rise would need to be fairly sizeable, and to involve both long-term as well as short-term rates, in order to have a decisive impact on the U.S. payments deficit. Thus, if

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the United States pursued a policy that resulted merely in a relatively small rise in short rates and very little increase in long rates, it seems possible that a minority only of the international financial community would interpret that policy as evidence of decisiveness in U.S. policy to end the payments deficit.

On the contrary, a majority of foreign observers might fear that a policy of moderation would actually reflect unwillingness of the U.S. monetary authorities to take the decisive steps that these observers consider to be necessary. The confidence of this second group would thus be weakened, and the adverse effect of this reaction might offset, at least in part, the effect of the strengthened confidence of the first group.

Under such conditions, a relatively small increase in U.S. short-term interest rates and a still smaller increase in long rates could scarcely have any appreciable beneficial "confidence" effect on the U.S. payments balance.

On the other hand, most members of the international financial community are convinced that an easier U.S. monetary policy would have an adverse effect on the U.S. payments balance, and few, if any, could be persuaded to believe that such a policy could in any way help to eliminate the U.S. payments deficit. Moreover, many of them would consider such a change in policy almost an insult to the leaders of other major financial centers, who for some time have been strongly urging the U.S. authorities to reduce the ease of credit in U.S. markets.

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Thus, the group whose confidence would be weakened by a moderate decline in U.S. rates would be much larger than the group whose confidence would be strengthened by a moderate advance in rates. Moreover, there would be no significant group whose confidence would be strengthened by such a decline and whose reactions might help to offset the effects of the adverse reactions of the first group.

Finally, a change in U.S. monetary policy toward greater ease might induce foreign central banks to reduce the percentage of dollars in their reserve holdings. While the resulting drain on the U.S. gold stock would not in itself increase the U.S. payments deficit, it would again have unfavorable psychological repercussions on financial markets, and thus add to the outflow of private capital.

On balance, therefore, the negative "confidence" effect of a moderate increase in monetary ease would probably be much greater than the positive "confidence" effect of an equally moderate decline in ease.

#### Conclusion

Adding the "yield-difference" effect and the "confidence" effect, the most likely net result of a monetary policy leading within the next few months to a decline in U.S. short-term interest rates of one-half of one per cent, and a sympathetic decline in long rates of, say, one-quarter per cent, would be a very substantial increase in the outflow of short-term funds, and a corresponding increase in the U.S. payments deficit.

J. Herbert Furth.