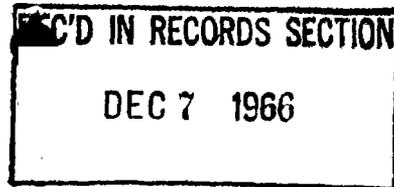




BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON



December 5, 1966.

STRICTLY CONFIDENTIAL (FR)

TO: Federal Open Market Committee
FROM: Mr. Broida
SUBJECT: Article VIII Consultation with the
United States, 1966.

CARD

The Annual Consultation of the International Monetary Fund with the United States has recently been completed. In the concluding consultation discussion with the U.S. Government Agencies represented on the National Advisory Council of October 28, the IMF representatives under the chairmanship of Dr. J. J. Polak, Director of the Research Department of the IMF, presented the substance of their summary report which will later be submitted to the Fund directly. In view of the comments in the report on U.S. monetary policy and U.S. balance of payments policy, a copy of the confidential report is circulated herewith for your information. The whole of the report is well worth your reading.


Arthur L. Broida, Assistant Secretary,
Federal Open Market Committee.

Enclosure.

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Article VIII Consultation with the United States, 1966

Concluding Remarks by J. J. Polak
for the Fund Team

December 1, 1966

Thus far, my colleagues and I have asked you many questions, both written and oral, and I want to tell you how much we appreciate the fine cooperation you have given us. Now, however, we are at the point in this Article VIII Consultation exercise where it is customary for us on the Fund side to sum up the way we see your economic situation and policies. In a sense, this summing up is intended to give you a preview of the appraisal section in our forthcoming report to the Fund's Executive Board. But let me emphasize that our appraisal is still preliminary. The current U.S. picture, as I need not tell you, is difficult to analyze, and we would very much like to have your frank reactions to the views we have formed so far.

To begin with, any balanced assessment of the U.S. economic performance in 1966 must give prominence to the achievement of full utilization of resources and to the continuation of a domestic expansion of unprecedented length. It is also true that the recent U.S. economic record compares favorably with that of most other leading nations, and that escalation of the conflict in Viet-Nam has added to the usual problems for economic management in dealing with high prosperity. But while recognizing such broad facts as a matter of over-all perspective, it will be my task here to focus on the slippages in U.S. economic performance during 1966 and on the main question marks for policy in the period ahead.

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In this context, the central development in 1966 would appear to be that the expansion of aggregate demand outran the economy's productive capability. The resulting pressure on resources led to a break-out of prices from their remarkable pattern of relative stability in previous years, to the emergence of distortions in the domestic economy, to a sharp deterioration of the trade surplus in the balance of payments, and to the creation of various problems for national economic policy in 1967.

One important result of this experience has been a shift in the U.S. official view concerning the appropriateness of trying to push unemployment below the 4 per cent level through the use of aggregate measures operating on the demand side. The application of such measures, which was so successful from 1961 through 1965, must now give way to a primary emphasis on selective measures designed to improve the quality and efficiency of the labor force. Reducing the unemployment rate substantially below 4 per cent will, for some time to come, depend vitally on manpower and related programs. Such programs have been accorded an increasing importance in U.S. economic policy in recent years, but it is apparent that they should be greatly expanded in the future.

Another significant result of economic developments in 1966 has been the damaging pressure to which the wage-price guideposts have been subjected. It seemed evident to us a year ago that the guideposts had proved of practical value, and gradually had come to affect the climate of wage and price bargaining and decision-making. From the fact that the guideposts ran into trouble in 1966, it would be premature to conclude that this instrument of policy cannot function properly under conditions of full employment. The

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United States needs an effective incomes policy, and we hope that the Administration will persevere in its efforts to establish one. Much will depend, of course, on the particular adaptations that are made in 1967 in the face of a heavy calendar of wage negotiations and the recent accelerated rise of consumer prices. However, for the functioning of the guideposts to be truly effective over the longer run, it will be necessary to achieve some significant reductions in individual prices as well as restraints on wage increases.

As we see it, the principal cause of the too-rapid expansion of aggregate demand in 1966, and the principal source of the various difficulties that followed upon this, was an insufficiently restrictive fiscal policy. The federal budget on a national accounts basis showed a surplus of \$3 billion (annual rate) in the first half of 1966, but this was actually smaller than the high-employment surplus at almost any time during the entire previous decade. That is to say, the budget would appear to have been less restrictive in the early part of this year--at a time of intense pressure on resources--than in earlier periods when the unemployment level was much higher. Moreover, a judgment given us during last year's discussions would clearly imply that a budget surplus of \$3 billion in the first half of 1966 was too small. You told us a year ago that you would consider it appropriate for the high-employment budget in the first half of 1966 to be in surplus by \$3-4 billion, at annual rates, but you were envisaging a demand situation not nearly so strong as the one which actually developed.

As things turned out, most of the burden of financial restraint in 1966 was thrust upon monetary policy. This policy grew progressively more restrictive but it did not bite quickly as, in the absence of a tighter

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fiscal policy, credit demands were soaring. By mid-summer, however, continuing concern about inflationary pressures was accompanied by monetary conditions of exceptional stringency. Housing activity was being hit particularly hard, and the financial markets were in a state of near-panic. In this setting, the package of interrelated measures taken on the fiscal and monetary fronts in early September was indeed both timely and necessary.

These measures have helped to bring about a calmer climate in the over-all economy and in the money and capital markets. Nevertheless, various uncertainties and imbalances in the current situation are likely to complicate greatly the task of economic policy-making. I have in mind here, among other things, the wide divergency of forces affecting aggregate demand, the uneven impact of tight monetary policy upon specific sectors of the private economy, and a marked weakening of the balance of payments position.

Let me give you at this point our appraisal of the present balance of payments situation, which is an important element in our further thinking on economic policy. The first thing that strikes one in the 1966 balance of payments is the sharp deterioration of the current account, contrary to your hopes and expectations a year ago for a substantial improvement. In spite of this deterioration, the over-all liquidity balance improved slightly over the first nine months of the year. This outturn may tempt one to the conclusion--to quote a recent U.S. Government press release--that "... the results thus far are reassuring: in the face of the rise in our foreign exchange costs in 1966 due to Viet-Nam, we have been able to better slightly the gains we made in 1965."

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In all frankness, I must say that we would find some difficulty in coming to the view that this year's balance of payments results are reassuring. It is the capital account, which has kept the over-all payments deficit from increasing, but the sustainability of the gains in that account is open to question. Although analysis of capital flows is admittedly difficult, certain nonrecurrent improvements are clearly evident. For instance, there was no repetition in 1966 of the disinvestment by the U.K. authorities of some \$500 million of their securities portfolio. In this year, by contrast, foreign official holders and international agencies invested some \$500 million of their reserves in a variety of *de facto* liquid assets, which happened to be just across the borderline between liquid and nonliquid U.S. liabilities. Moreover, apart from these nonrecurrent improvements, outflows of U.S. capital in 1966--net of borrowing abroad by U.S. firms to finance their direct investment abroad--were reduced only moderately. Most of the gain in the capital account came from the attraction of extraordinary inflows of foreign capital, and these inflows were attracted by unprecedented monetary conditions quite unlikely to be perpetuated.

In the remainder of my remarks, I shall take a look at some of the main issues and problems that must be considered in the formulation of economic policy for 1967.

The first question--or at least a big one--is whether or not a tax increase will be necessary to restrain inflationary forces. Tempting as it may be to join the current forecasting derby, we have concluded that it would be sheer speculation on our part if we were to try at this time to make any definitive assessment of the over-all strength of demand forces

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in 1967. Nor do we see how this could be helpful to you. In connection with the preparation of the budget, you will shortly be in a much better position to judge what is likely to happen to defense and other federal spending--which is crucial to the outlook--as well as to business spending for plant and equipment. This is not to say that your final projections of aggregate demand and related variables will not involve a substantial element of guesswork. The experience of the past year suggests that, in framing tax policy in the light of these projections, you should come down on the side of caution; if in doubt about the need for added restraint, raise taxes and then be prepared, if necessary, to use fiscal policy flexibly.

From the Consultation discussions, we have gathered that the United States has four main objectives of economic policy for 1967: to achieve an expansion in real GNP of about 4 per cent, in line with the economy's supply capabilities; to improve upon the 1966 price performance--which we take to mean that you would not be satisfied if the over-all increase of prices in the course of 1967 were to exceed, say 2 1/2 per cent; to relieve imbalances and distortions among the various private sectors; and to make renewed progress in reducing the balance of payments deficit. It is also our understanding that, particularly with respect to the objective of relieving imbalances and distortions, the Administration is giving strong consideration to an increase in income taxes in order to change the mix of fiscal and monetary policies and thus bring about somewhat easier monetary conditions.

Now, each of these objectives, including the concept of changing the policy mix, is meritorious in its own right and we probably would not want to question any of them, taken singly. However, we doubt that these objectives are mutually consistent. Specifically, the 4 per cent growth target

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may not be compatible with a better price performance; and that target, especially in conjunction with a contemplated shift in the mix of financial policies, would not appear to be conducive to an improvement in the balance of payments.

It is perhaps appropriate to make a somewhat general observation at this point. Until about a year ago the expansion of the U.S. economy was exceedingly well balanced, not only in terms of the sectors of the economy, but also in terms of price stability and wage moderation. It appeared to be feasible to steer the economy close to the desired course by means of relatively moderate changes in fiscal policy and monetary policy. The developments of the last year, however, have upset the economy's balance, and it is not obvious that in these circumstances there is available a set of economic policies that would get all the variables back on track in the short run. In other words, economic policy for the next year or so may have to settle for a combination of results that is below optimum in at least some directions. To obtain a good, if not the best, combination of results, it clearly will be necessary to make greater use of specific instruments to supplement the general instruments of fiscal policy and monetary policy. In our opinion, an intensification of direct balance of payments policy will be required. A particular role can also be played by further manipulation of the investment tax credit. In addition, the most careful attention should be given to measures for reviving the housing industry that do not rely exclusively on a substantial reduction of interest rates. Even if measures of this type could not be devised to have an immediate effect, they would at least permit in the future a freer operation of monetary policy without the extreme disturbances which this policy has produced in recent months.

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But let me now return to an appraisal of the current objectives of U.S. economic policy. As to prices, the main question is whether a 4 per cent expansion of real GNP in 1967 would mean, as many observers expect, another over-all price rise of 3 per cent or more. However, we were impressed with your arguments that the price increase will probably be smaller than that, and we also were interested and pleased to learn that if you were not confident of being able to realize a better price performance in 1967 it would be necessary for the Administration to undertake "an agonizing reappraisal" of the target for growth. Nevertheless, it is clear that the authorities feel that they must settle for a price increase in 1967 well above that which is regarded as satisfactory in the longer run.

Turning to the balance of payments, I find it difficult to visualize any marked improvement in that area under present programs and present objectives for the domestic economy. This view stems in major part from some projections we have made for the U.S. current account. These suggest, at least to us, the unlikelihood of an improvement in the current account from 1966 to 1967 on the assumptions that were incorporated into our world trade model. This model has given a pretty good reading of the U.S. current account in past years. But you can judge for yourselves how valid the calculations for 1967 may be, as we have turned over a considerable amount of worksheet material to the Treasury staff.

Here, the main points about the current account projections can be put briefly. The projections show that a growth rate in the United States of 4 per cent, in conjunction with an expected growth rate of about the same magnitude in the other OECD countries, would stop a deterioration in the private current account surplus but would still leave that surplus in 1967

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not much, if any, larger than in 1966. Such a result would mean that the total current account surplus, including military expenditures, would be even somewhat smaller than in 1966. Moreover, it would appear very improbable that this decline in the current account could be counterbalanced by a gain in the capital account. Such a view becomes stronger when one takes into account the objective of relieving imbalances and distortions in the private economy, because the reduction of interest rates that would be necessary to revive the construction industry could also be expected to eliminate the conditions that have been highly favorable to the inflow of foreign funds in 1966.

If our doubts concerning the consistency of U.S. economic objectives in 1967 are justified, then one way to establish consistency is obvious: reduce the growth target. However, we would be reluctant to suggest such a course, at least without consideration of other alternatives. But there is one point I would emphasize: the state of the arts in hitting a particular short-run growth target being what it is, policy should be framed so as to minimize the risks of going beyond 4 per cent. We feel that, from the standpoint both of domestic economic stability and of the viability of the balance of payments, aiming for a growth rate of 4 per cent in 1967 and getting 5 per cent would be worse than getting 3 per cent. At the same time, if the United States were to aim for 3 per cent and get 2 per cent, there could be no assurance--as you yourselves have emphasized--that economic policy would be able to hold the economy at that point and prevent it from slipping into a recession, with adverse effects not only for the United States but for many other countries as well. Our concern about this

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possibility is heightened by the consideration that demand forces would prove to be weaker in the latter part of 1967 than in the first part if it should turn out, as we discussed in the meetings, that the increase in defense expenditures tapers off during the year and plant and equipment spending levels out or perhaps declines. In that kind of situation, planning for a degree of restraint consistent with a 3 per cent annual growth rate could confront the authorities with some very tricky problems that might defy the maintenance of economic expansion.

Besides reducing the growth target, another possible option for the U.S. authorities would be to give up the idea of a tax increase aimed at changing the mix of fiscal and monetary policies. We recognize that such a change in the mix would have several advantages from a domestic standpoint, but it is important also to weigh its implications for the balance of payments in light of all other factors bearing on the payments situation. Moreover, the desirability of altering the policy mix will depend in part on the strength of demand forces that is envisaged. It is one thing to change the mix in a setting of a strongly expansionary situation where a tax increase is necessary in any event to restrain demand, but it is quite another thing to do this in a situation where the strength of aggregate demand is perhaps only on the borderline of being excessive. This latter type of situation would be difficult to manage, and our particular concern would be that the lowering of interest rates that would follow from a change in the mix of policies might prove especially troublesome for the balance of payments if at the same time the authorities were trying to maintain a growth rate of 4 per cent.

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In any case, we conclude from these various considerations about policy objectives that the Government's domestic program for 1967 would be feasible from the viewpoint of the balance of payments only if accompanied by a stringent balance of payments program--one aimed, as in the past, to have a minimum of direct impact on the less developed countries. This program will still be necessary even if there is no increase in income taxes to change the mix.

In pointing to the need for a tighter balance of payments program, we do not have in mind measures that would go counter to the liberal principles on trade and payments which the United States has championed over the years. As a practical matter, the program would have to be concentrated on the capital account of the balance of payments. In addition to the Interest Equalization Tax, this would mean maximum emphasis on the Federal Reserve's program for the banks and other financial institutions and on the Commerce Department's program for nonfinancial corporations.

The bank program has, of course, been only on a stand-by basis during the past year, while the banks have accumulated a large leeway under their credit ceilings; it would seem to us important that the program be formulated in such a way that the amount of net credit that the banks could extend during 1967 would be kept small. The impact of the Commerce program on the corporations has been predominantly in terms of the method of financing; there would seem to be very little evidence that the corporations have cut down on their extremely rapid expansion of plant and equipment expenditure abroad, which is estimated for 1966 at twice the amount of 1962.

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With corporations deprived of investment incentives for their domestic plant and equipment expenditure, it would not seem unreasonable to aim at a foreign investment program for 1967 (or perhaps for 1967 and 1968 combined) that might entail some slowdown in the growth of investment expenditure for these corporations abroad. A target figure for the net direct-investment outflow well below that realized for 1966 would probably have that effect, and could make a substantial contribution to the balance of payments for 1967.

Let me emphasize that our suggestion to tighten the voluntary control programs is not made lightly. Such a move would represent a regrettable sacrifice of longer-run considerations to short-term imperatives. Nevertheless, tighter controls do seem necessary if the United States is to make definitive progress over the short run in reducing its balance of payments deficit. This deficit has now gone on for many years despite repeated official proclamations about the need to eliminate it. Recent U.S. policy statements seem to put less emphasis on this need. To us, however, the importance of achieving balance in the U.S. external accounts is greater now than ever before in order to protect the key role of the dollar in the international monetary system. Also relevant here is the central focus which the negotiations on international liquidity have placed on the U.S. payments position.

In any analysis of the need to strengthen the voluntary programs, much weight should be given to a fact I have stressed earlier--that the improvement of the capital account in 1966 was not fundamentally of a character

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to furnish much comfort. Because of the extreme tightness of monetary conditions in recent months, the U.S. payments position is subject to considerable vulnerability in the short run. The degree of this vulnerability would be dependent, of course, on interest-rate developments abroad. But the resumption of a more usual pattern of interest rates between the United States and Europe could have a considerable impact on the U.S. capital account.

In this connection, if monetary conditions should ease in 1967, whether because of a tax increase and a shift in the policy mix or because of subsidizing domestic credit demands, there would be great need to avoid redundancy of bank reserves, bank credit, and general domestic liquidity throughout the system. In contrast to the 1961-62 policy, for example, the banks would have to be kept "snug" enough, as domestic loan demands subsided, to minimize the external leakage. Even so, we find it hard to envisage an easing of credit conditions sufficient to promote a revival of home building that would not at the same time encourage the banks to give up the expensive accommodation they have obtained from the Eurodollar market. Also to be borne in mind is a problem of timing, in that a deterioration in the capital account could happen with some rapidity whereas any improvement in the current account during the course of 1967 is likely to proceed gradually.

In sum, we consider the current U.S. payments position to be difficult--one which will require the closest attention of the authorities. Even with the strongest feasible programs, the outlook for the 1967 balance of payments is far from reassuring, and it would be prudent to give careful

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consideration to the issues involved in the financing of any deficit that may arise. Such financing, you will agree, should aim to preserve confidence in the dollar and put a minimum of strain on the international monetary system. How best to accomplish that objective, however, is a separate question on which views may differ. You may or may not wish to explore it further this afternoon.

The difficulty of the U.S. payments position is also evident in the structure of the external accounts. I have already spoken of the special nature of this year's improvement in the capital account, but the deterioration that has occurred in the current account seems rather ominous. If the United States is to make a significant and increasing fraction of its real saving available to the less developed world, a substantial export surplus will be required, and we think that the U.S. emphasis on this in previous Consultation discussions was entirely right. Also right was the emphasis that was given to cost-price stability as a fundamental corrective for the balance of payments. The importance of such stability for the medium or longer run can scarcely be exaggerated or overemphasized. Even for the short run, a good cost-price performance is essential to support the temporary measures through which the Administration is still trying to hold the line and buy time.

Let me close now with a general observation. In the written answer to one of our questions, you spoke of the problems of gauging the outlook for 1967 and then went on to say that flexibility of policies will be of major importance. I agree with you completely. Especially important is the need for greater flexibility in the fiscal field. Two points come to mind.

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1. The possible increase of income taxes in the next budget is in some quarters being discussed in terms of a "surtax," or some such device, that would point up the temporary and reversible nature of the action. I believe that this sort of approach, apart from its merit in present circumstances, would mark another advance in promoting general acceptance of the budget for the purpose of countering destabilizing influences in the economy.

2. We continue to feel--in line with our emphasis in previous Consultation discussions--that the traditional budgetary processes are too cumbersome to take account of rapid, short-run changes in the domestic economy or the balance of payments, and thereby to serve the principles of the "New Economics." I will not go over this ground again with you, as you are familiar with it, but we will underline the importance of this issue in our report to the Fund's Executive Board.