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U.S. Payments Deficit and Domestic Economy

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U.S. Payments Deficit and Domestic Economy ^{1/}

For the past six years, the problem of a large deficit in the U.S. balance of international payments has troubled economists concerned with the country's economic and financial health.

This preoccupation has been assailed by many of our academic colleagues. When economists stress the need to eliminate the deficit, they are accused of exaggerating the importance of an item that accounts for little more than 1/2 of 1 per cent of our gross national product, of being willing to stifle domestic economic growth for the sake of superstitious devotion to an elusive international equilibrium -- in short, of making the tail wag the dog.

It is quite true that in the United States international transactions are a smaller part of total economic activity than in any other industrialized country. Nevertheless, the absolute amounts are large enough -- \$3 billion is a lot of money, even in the U.S. national accounts --; and the payments balance may well be less like an unimportant tail than like an appendix of the economy: harmless enough when normal, but dangerous and even deadly when inflamed.

U.S. international accounts

Let us first look at a few facts. In 1963, our payments to foreigners on so-called regular transactions -- imports of goods and services, government expenditures for military and economic aid, outflow of private long and

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short-term capital -- exceeded receipts by \$3 billion. This deficit was smaller than in any other year since 1957, and in the second half of the year stood at a seasonally adjusted annual rate of only \$1-1/2 billion; nevertheless, progress toward equilibrium over the past few years has been slower than expected.

In contrast to most other countries that suffer from a payments deficit, the U.S. current balance -- the difference between sales and purchases of goods and services -- was in heavy surplus (\$7 billion in 1963). But this surplus, large as it was, was not large enough to cover the sum of our government expenditures abroad (\$6 billion annually) and the outflow of U.S. private capital (\$4 billion), including so-called direct investments (i.e., acquisition of plants abroad by U.S. enterprises), purchases of foreign securities (largely bonds issued in the New York market), and shorter-term investments such as deposits with foreign banks (mainly Canadian banks and foreign branches of U.S. banks) and purchases of money-market paper (mainly in Britain and Canada).

The United States has tried to improve its balance on all of these items. Its monetary policy has been aimed at maintaining cost and price stability, in order to avoid further deterioration in the international competitive position of U.S. industries; and it has kept short-term interest rates higher than might have seemed desirable to some observers on purely domestic grounds, in order to stem the outflow of short-term funds. Fiscal policy has tried mildly to discourage direct investments in foreign developed countries by eliminating a few of the tax advantages U.S. enterprises can derive from establishing branches and subsidiaries in the many countries with lower corporate tax rates, and more strongly to discourage purchases of foreign bonds and shares by proposing the interest equalization tax. Finally, the Administration has continually urged our European allies to

share more equitably in the common burden of military defense and economic assistance-- with some success in the military sector.

Most of the payments surpluses that correspond to the U.S. deficit have accrued to countries of Western Continental Europe, primarily France and Germany. Our current transactions with those countries produce a surplus; but the funds we transfer to less developed nations in Latin America, Africa, and Asia find their way to European countries, in spite of our efforts to "tie" our aid to purchases in the United States. Only \$1 billion of our aid is directly spent by the recipients in countries other than the United States. But indirectly, every dollar we give or lend to a less developed country releases a dollar for other uses. And the more we concentrate our aid on vitally needed foodstuffs and capital goods, the better able is the aided country to spend funds that otherwise would have been used to buy those essential goods on other less essential items, such as consumer goods that are exported by Europe rather than by the United States.

Similarly, our private investments abroad have channeled funds mainly to Europe. Continental Europe is attractive to U.S. capital not only for reasons of cost, tax, and tariff advantages but also because it has had more rapid economic growth than the United States. This growth was, in part, an inevitable consequence of the wholesale destruction of productive facilities during the war; in part, the effect of U.S. postwar aid, which enabled these countries to rebuild their industrial plant and equipment in the most modern and efficient way at little or no cost to themselves; in part, the result of the devaluation of European currencies in 1949, reinforced in France by a second devaluation of the franc in 1957-58, which reduced Europe's cost and price level in relation to the United States; and in part the consequence of a greater ability of European employers to withstand wage demands -- an ability greatly enhanced by the fact that a large part of their industrial labor

force now consists of immigrants from undeveloped European areas (Southern Italy, Spain, Greece, Turkey). Europe today has the same advantage of a nearly unlimited supply of cheap immigrant labor that the United States enjoyed before the first world war. Finally, the creation of the Common Market (under U.S. auspices) has enabled its members to stimulate their economies by greatly expanding trade among themselves, and at the same time raising import barriers against outsiders, and in particular against the United States. This was not the outcome hoped for by the U.S. sponsors of the Common Market but it was the outcome predicted by my great teacher, the late Arthur Marget.

Effects of aggregate deficit on U.S. economy

Under the present international monetary payments system, in which international transactions are generally settled in dollars and international reserves held partly in dollars and partly in gold, the domestic effects of a payments deficit are not necessarily the same as those familiar to old-timers reared in the economics of the gold standard.

Effects under gold standard -- Under the gold standard, any payments deficit was deflationary and any payments surplus inflationary since the change in monetary reserves entailed a proportionate change in domestic monetary circulation and credit availability. The cause of the deficit was of little or no importance.

Effects under reserve currency standard -- The replacement of gold by dollars in international settlements and reserves would not in itself change the impact in countries in which the domestic supply of money and credit still is made dependent upon the level of reserves.

The situation is different in countries in which money and credit are kept independent of changes in reserves, through countervailing action of the monetary authorities. But usually such action is only feasible in cases of increases or

moderate decreases in reserves. Whenever reserve losses become substantial, most countries must abandon or modify countervailing action in order to avoid running out of reserves and becoming unable to maintain either the convertibility or the established par value of their currencies.

The difference is more fundamental in a country like the United States, which is able to finance a considerable part of its deficit through foreign accumulations of its own currency. In 1963, for instance, the U.S. deficit of \$3 billion was financed as follows: foreign monetary authorities repaid half a billion of previously incurred debts (or made prepayments on future arms deliveries) -- from the point of view of international liquidity, it may be argued that these payments should be considered as reducing rather than financing the deficit. In addition, foreign authorities took half a billion in gold, half a billion in so-called Roosa bonds, i.e., U.S. government securities denominated in foreign currencies, and (net of a decline in holdings of international organizations) three-quarters of a billion in liquid U.S. dollar assets. Private foreign bankers, merchants, and investors also took three-quarters of a billion in U.S. dollars, as increases in their working balances or as short-term investments.

Financing of the deficit through foreign accumulation of the currency of the deficit country is a method available only to a reserve center, i.e., the United States and also, but only in relation to the so-called outer sterling area, the United Kingdom. According to the conventional calculation, this method of financing accounted for one-half of the U.S. deficit in 1963. If we exclude foreign debt prepayments from the deficit, and add the Roosa-bonds (which some observers regard basically as dollar debts guaranteed against exchange risk) to the dollar-financed part, the portion of the deficit financed by methods not available to non-reserve countries rises to four-fifths of the total.

Thus, in the United States last year only one-fifth of the deficit was reflected in a decline in the U.S. gold stock, and the monetary authorities had a very wide margin for counteracting gold losses and thereby preventing bank reserves from growing less fast than considered appropriate for reasons of domestic policy. As you probably know, the Federal Reserve has consistently followed a policy of such counteraction, contrary to the advice of many bankers and a few economists on this side of the Atlantic, and of almost everybody on the other side. The Federal Reserve has been as bitterly attacked by Europeans for letting bank reserves expand too rapidly as it has been by many of our domestic academic colleagues for not letting bank reserves expand fast enough. But justified or not, the policy of the Federal Reserve means that the U.S. payments deficit does not have a direct quasi-automatic deflationary effect on the domestic economy.

Effects of individual payments items

In order to analyze the actual impact of the payments deficit, we must therefore turn to a discussion of the individual items that produce the balance of our international payments.

Current accounts -- Little need be said about the effects of an insufficiency of the U.S. export surplus. If we could raise exports so as to close the gap between total receipts and payments, the foreign-trade multiplier would serve to raise our GNP by two or three times the rise in exports, i.e., by perhaps 1 per cent, increasing employment by perhaps as much as 1/2 of 1 per cent, and reducing unemployment by a welcome though not spectacular fraction.

Unfortunately, a sudden rise in net exports of that magnitude seems unlikely unless the Europeans are less successful in resisting further price and cost increases than past experience indicates. It is true that Italy, and to a lesser degree also France, have recently experienced rather sharp price and cost increases; but the m

important European country, Germany, has been able to maintain stability, and its payments surplus rose in 1963 by nearly the same amount by which those of Italy and France declined. As long as the most important member of the Common Market does not suffer from inflation, any inflationary pressure in other member countries will largely expand imports from the stable member rather than from the rest of the world, and thus will have relatively little impact on the Common Market's aggregate payments surplus, and on the U.S. payments deficit.

Government expenditures -- More interesting is the effect of those government expenditures abroad that result in an increase in foreign reserves rather than in the exports of U.S. goods and services. It makes no difference whether the reserves accrue to the aid-receiving country itself or, as usually happens, to a third country in which the aid proceeds are spent. In effect we transfer funds to a foreign country that keeps them on deposit or invested in liquid assets in the United States.

The direct monetary effect of this change is small. The account, say, of the German Bundesbank with the Federal Reserve will increase by exactly the same amount by which the Treasury's account declines. The balance-sheet total of the Federal Reserve, and thus the liquidity of the U.S. monetary and credit system, will not change at all.

Even if the German Bundesbank took all of its reserve accumulation in gold, the end result would merely be that the dollar accounts of the Bundesbank and the Treasury with the Federal Reserve would remain unchanged -- only the earmarked gold in the vaults of the Fed would change -- and that in the assets of the Fed some Treasury gold certificates would be replaced by a corresponding amount of ordinary Treasury securities.

But what about income effects? Assuming that our budget is balanced, or -- more realistically -- that the deficit is independent of the size of the foreign reserve accumulation, the Treasury assets transferred to the German Bundesbank represent funds collected from U.S. taxpayers. As long as the Bundesbank keeps its reserves intact, this means that part of the income of U.S. taxpayers is being hoarded rather than spent. This is a clearly deflationary "balanced-budget effect" in reserve. And this deflation occurs in spite of complete offsetting of the loss in reserves by the Fed.

Long-term capital -- Another interesting effect is associated with the outflow of investment funds, again insofar as these outflows do not involve actual exports of goods and services. If, say, a U.S. investor purchases a German factory, or German shares, or German bonds, he in effect transfers his savings, usually through the intermediary of a private German investor, to the German Bundesbank, which in turn converts them into a dollar balance. In this case, it is not a question of sterilizing parts of domestic incomes; it is a transformation of the demand of the domestic investor for equities or long-term securities into a demand of the foreign central bank for short-term assets.

In the United States, thanks to the flexibility of the Federal Reserve and of commercial banking, there never is a shortage of funds seeking short-term placement. But lagging investment may mean a shortage of funds seeking long-term assets. This shortage is aggravated by outflows of U.S. investment funds. The resulting tendency of short-term rates to be lower and of long-term rates to be higher than they otherwise would be, might be countered by debt management and open-market operations. But these operations must be confined to government securities and cannot directly affect investments in private long-term assets; hence, their impact will at best be indirect and lagged.

The relative increase in funds seeking short-term rather than long-term placement may well be one of the reasons for what many experts have called a deterioration in the quality of bank credit (for instance, the tendency of commercial banks to shift from commercial credits to higher-yielding mortgages and long-term securities); and in the field of equity financing for the tendency of the market to push up the value of existing real capital, e.g., the price of shares quoted on stock exchanges (purchases of which can be financed with the aid of short-term funds) rather than to promote the formation of new real capital (which would require the commitment of long-term funds).

Short-term capital -- If our interpretation of the effects of international transactions is correct, the outflow of short-term funds is the only deficit factor that has no direct restrictive effects on the domestic economy. Common sense confirms that it makes little or no difference for the economy as a whole whether a given amount of time deposits or Treasury bills is held by a domestic investor or by a foreign central bank. The liquidity position of the domestic investor himself remains unaffected since he has merely exchanged one liquid asset for another, say, a deposit with a Canadian bank for a deposit with a domestic bank, or a British Treasury bill for a U.S. Treasury bill.

Confidence effect

Nevertheless, there are good reasons for some concern about outflows of U.S. short-term capital, because these outflows reduce the ratio of U.S. gold reserves to foreign liquid claims.

The international strength of the U.S. economy is obviously not determined by that ratio but rather by its natural and man-made resources; the size and organization of its commodity, capital, and money markets; and above all the skill of its workers and entrepreneurs.

But the United States acts as the foremost banker of the free world, and the U.S. dollar is the world's foremost international currency. Hence, the U.S. economy is more dependent than that of other nations on the unquestioned confidence of its foreign depositors and customers.

Confidence can be shaken for the most arbitrary reason or for no reason at all. And if foreigners -- rightly or wrongly, because of their own bias or because of biased advice from U.S. bankers -- believe that an increase in short-term liabilities to foreigners, even though associated with a corresponding rise in short-term claims on foreigners, is a sign of weakness, their confidence will be undermined just as if such an increase were really harmful to the U.S. economy.

Some eminent economists believe that the United States should disregard these psychological factors and concentrate on policies dealing with "real" economic parameters. But a disturbance of international confidence in the dollar would probably lead to the elimination of the dollar as a means of international payments and reserve asset. The resulting disruption of the international payments mechanism would be comparable to that associated with the similar elimination of sterling in 1931. Hence, it would have the most "real" effects imaginable -- a sharp contraction of international trade and finance, resulting in a corresponding drop in domestic economic activity in those foreign countries in which international transactions account for a major part of the national income, and eventually transmitted also to those countries which, like the United States, are less directly dependent on foreign trade.

Conclusions

To sum up: in spite of all improvements in domestic monetary techniques and international monetary mechanisms, a payments deficit, now as before, tends to exert a contractive influence on the domestic economy even though its direct

deflationary effects on domestic money and credit may be offset by central banking operations.

True, the monetary authorities can try also to offset the indirect deflationary effects by further adding to domestic liquidity. But they would thereby encourage the flow of short-term funds abroad. And although this flow in itself would not be deflationary, its adverse effect on confidence would be the same as that of any other factor increasing the country's statistical payments deficit; and to a reserve center such as the United States, this confidence effect may be as harmful as a direct deflationary impact.

We may regret that it has not been possible to reduce more drastically the two most directly restrictive payments factors: government expenditures abroad and the outflow of private long-term investments. But as long as it seems politically out of the question either to cut our military and economic aid expenditures more radically or to enact fiscal measures that would make private direct investments in foreign developed countries less profitable, the monetary authorities have no choice but to try to stem the outflow of short-term funds.

Right now, for the first time in seven years, it looks as if our payments problem might be on its way to solution. If we were able not merely to keep this year's deficit at its present annual rate of \$1-1/2 billion, but to reduce it progressively at the same pace at which we reduced it between the first and the second half of 1963, we could reach equilibrium within a year. Meanwhile, however, we must accept the mild restraints that the payments problem imposes upon attempts at more rapid domestic monetary stimulation.