BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

March 29, 1963.

STRICTLY CONFIDENTIAL

TO: Federal Open Market Committee

FROM: Mr. Young

Attached for your information and consideration are two memoranda relating to the processes of a less easy monetary policy and its possible domestic and balance of payments impacts. Both were prepared in response to a request from Secretary Dillon, Chairman of the Cabinet Committee on the Balance of Payments, and have been circulated to that Committee in connection with its consideration of national policies to help correct or moderate the economy's international payments deficit.

The first of the two memoranda was prepared by the Treasury staff in consultation with a staff member of the Council of Economic Advisers and myself. As might be expected in the development of speculative projections, there were some differences of judgment in our working group as to the quantification of possible domestic impacts. The CEA staff member thought it would be helpful to prepare a fuller exploration of the quantification problem, which explains how the second memorandum came to be written.

The memoranda are being circulated to you after clearance with the source agencies and are to be regarded as strictly confidential.

Ralph A. Young

Ralph A. Young, Secretary,
Federal Open Market Committee

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TREASURY DEPARTMENT

WASHINGTON

ASSISTANT SECRETARY

March 25, 1963

MEMORANDUM TO Cabinet Committee on Balance of Payments:
Secretary of Defense
Secretary of Commerce
Under Secretary of State
Administrator of AID
Special Representative for Trade Negotiations
Director, Bureau of the Budget
Chairman, Council of Economic Advisers
Mr. Kaysen, The White House

The attached paper entitled, "Monetary Policy and the Balance of Payments", is a digest of other studies on monetary policy and the balance of payments. This paper was requested at the Committee's meeting of March 20, and was prepared by representatives of the Treasury, Federal Reserve and CEA.

It is identified as LRIPC/39.

John C. Bullitt

John C. Bullitt

cc: Secretary of Agriculture
Chairman of Federal Reserve Board

 LRIPC/39

3/25/63

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MONETARY POLICY AND
THE BALANCE OF PAYMENTS

This memorandum summarizes the possible effects of a moderate lessening of monetary ease [1] on domestic economic activity and the balance of payments. Specifically, it is assumed that the Federal Reserve takes such actions as are necessary to raise short-term interest rates by as much as one-half percentage point, or thereabouts, over a period of several months. The basic problem is to attempt to weigh the possible benefits in the form of reduced capital outflows against the possible costs of retarding domestic economic expansion. Of necessity, no precise weighing of the gains and costs of a highly complex process, involving varying credit demands and expectations, is possible. The following appraisal, therefore, combines qualitative analysis with rough guesses as to the possible magnitudes of change for the capital account.

Nature of the process

Presumably, Federal Reserve actions to raise short-term interest rates by as much as 1/2 per cent would follow a normal pattern. Open market operations would gradually reduce the net free reserve position of member banks. The operation would proceed by probing steps, which would permit continuous review of results and

1/ The analysis in this memorandum, necessarily in summary form, leans heavily on more detailed studies prepared earlier at the Federal Reserve.

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continuous flexible adaptation. Presumably the Treasury would play a supportive role by continuing to emphasize the issuance of short-term securities.

As the net free reserve position declined, banks would first be under pressure to make reserve adjustments by selling Treasury bills and other short-term securities in the market. This would put immediate upward pressure on short-term rates which would then rise above the discount rate. At this stage, banks would increasingly resort to Reserve Bank discounting to obtain reserves. The rise in such borrowing would then require an increase in the discount rate as a deterrent and as a means of reinforcing the desired advance in short-term market rates.

The discount rate rise might be in two successive steps of 1/4 per cent or one step of 1/2 per cent. Following the rise, open market operations and discount operations would be mutually reinforcing.

Domestic effects

On the basis of experience, the Federal Reserve actions would, after a time lag, retard bank credit and monetary expansion. The time lag might be less than in earlier postwar periods because the velocity of cash balances is already at high levels by historical standards. Since the actions would be moderate, bank credit would continue to expand but at a lesser rate than in 1962 ($19 billion) with the reserves for such expansion increasingly dependent on the willingness and initiative of member banks to increase their Reserve Bank indebtedness.

As the availability of reserves to banks lessened, commercial banks would apply stricter standards to loan applicants, first to their non-depositor customers, and then to their depositor customers. This would be accompanied by less aggressive competition on the part of the banks against the other kinds of savings institutions. The banks might acquire somewhat fewer bank loans, including mortgage loans, and be more selective in making investments in securities. Savings and loan associations, savings banks, and insurance companies might, however, absorb some part of any business which the commercial banks might no longer get.

The rise in short-term rates and the associated rise in the discount rate would undoubtedly affect market expectations. Portfolio managers would initiate a series of adjustments, including their holdings of longer-term securities, thus communicating some upward interest rate movement to these markets. While it is uncertain how much rise would occur, the record of variability of short-term rates in relationship to long-term rates suggests that upward adjustment of long-term rates would be small and might be tempered at the time by Treasury debt management and Federal Reserve open market techniques.

After the initial effects of the move to a less easy monetary posture, interest rate movements would depend on the pressures of supply and demand in financial markets. A reduction in the supply of funds relative to the demand could hardly occur, however, without discouraging or deferring some borrowing to finance business inventories and plant and equipment, consumer durables and housing, and State and local projects. The latter two areas were ones of substantial credit expansion in 1962 and, judging by the past, the housing area in particular might be affected by any significant rise in long-term rates. The effects of less easy borrowing conditions on domestic spending cannot be quantified and would depend on the strength of demands in these sectors, as well as to what extent the rise in interest rates is confined to the short end. In addition to the direct effects, account should be taken of the secondary (multiplier) effects on consumption and investment of a credit induced slowdown in any of these types of expenditures.

If the economy should begin to expand more vigorously, as some observers expect, demands for funds would reinforce the new interest rate level. But if the recent sluggishness of activity should continue, with incomes and savings flows maintained, the higher interest rate levels could be sustained only by further limiting the flow of bank credit and the expansion of bank deposits, or by placing an even heavier concentration of the Federal debt into very short-term securities, or both.

Effects on the balance of payments

A modest rise in U. S. interest rates of the sort envisioned in this paper might improve the U. S. payments position in two ways. First, financial incentives affecting the international movement of funds would be altered in a way tending to reduce the net outflow of private capital. Secondly, it would help to remove doubts about U. S. defense of the dollar exchange rate without direct controls and this would strengthen international confidence in the dollar.

The alteration of relative financial incentives would be important. At a minimum, the changed credit availability and interest rate differentials would help to keep the (recorded and unrecorded) short-term credit outflows down to the 1962 level, which on the basis of presently available figures appears to have been at least several hundred million dollars below that of 1960 and 1961. However, it is probable that the net outflow can be cut below that of 1962 by a significant amount, with the likelihood of as much as $1/2 billion per year. A small partial offset, ultimately amounting to perhaps as much as $80 million per year, would occur in the form of higher interest payments on the dollar securities now held by foreigners. In assessing this cutback potential, it needs to be remembered that the short-term credit outflow includes normal trade credits and U. S. bank loans to such preferred customers as central banks--transactions not much affected by interest rates.

If lessened credit ease in the U. S. enhanced international confidence in the dollar, some inflow of funds might occur, although it is impossible to give a quantitative estimate of sums that might be involved. In addition, foreign monetary authorities, if they are favorably impressed with the change in U. S. monetary policy and interpret it as an indication of U. S. willingness to pursue the orthodox steps which they have been urging, may in turn be more willing to cooperate in financing the U. S. payments deficit by means other than their gold purchases. Some foreign monetary authorities might even raise their limits on holdings of uncovered dollar reserves.

Recorded flows of long-term capital would be very little affected. There would probably be no effect on outflows into new foreign securities issued in this country ($1.0 billion in 1962). Yields on such issues are substantially higher than those on new U. S. corporate issues, and do not change much when U. S. yields change moderately. Outflows of U. S. capital into direct investment in foreign branches and subsidiaries of U. S. corporations ($1.4 billion in 1962) might be slightly reduced--perhaps by as much as $100 million a year--as a result of somewhat increased efforts to find foreign financing and a somewhat greater tendency to keep liquid corporate assets in the United States. The response of foreign and U. S. transactions in outstanding corporate stocks (which normally produce a net inflow of capital to this country but did not do so in 1962) would be more related to changing stock market prospects than to small interest rate changes, although there might be some favorable response reflecting increased confidence in the dollar.

Any guess as to the possible effect of a moderate lessening of credit ease in the U. S. on capital outflows must take into account the possibility that interest rates in some countries may rise in response to higher U. S. rates. The likelihood of such response will be minimized by the gradual probing type of monetary policy assumed.

As for Continental Europe and Japan, repercussions would likely be minimal and at worst there might be a temporary halting of the edging down of rates that has been occurring in these areas. On the other hand, there probably would be repercussions on the Canadian and the British credit markets, and in these markets some sympathetic rise in interest rates would probably take place, to some extent reducing the potential gains to the U. S. The aim, however, should be to get a balanced rate relationship in which the flow of U. S. short-term funds to both Canada and the United Kingdom would decline toward nominal levels, without disrupting those markets by attracting here a volatile quantity of their own short-term funds. Under present circumstances it would not be appropriate for either sterling or the dollar to be unduly benefited by short-term flows from each other; the strength of sterling and the dollar are inextricably interwoven.

Comment

In assessing the role that lessened credit ease might play in dealing with the U. S. payments problem it should be emphasized that the influence of these measures is limited to the capital account. To achieve the full correction of the payments problem will require other measures as well; in short, undue reliance should not be placed on monetary policy, particularly in the light of possible domestic effects under current circumstances.

ASSISTANT SECRETARY

TREASURY DEPARTMENT

WASHINGTON

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March 26, 1963

MEMORANDUM TO Cabinet Committee on Balance of Payments:
Secretary of Defense
Secretary of Commerce
Under Secretary of State
Administrator of AID
Special Representative for Trade Negotiations
Director, Bureau of the Budget
Chairman, Council of Economic Advisers
Mr. Kaysen, The White House

Attached is a paper prepared by the Council of Economic Advisers, relating to the paper entitled, "Monetary Policy and the Balance of Payments" previously distributed, which I am circulating at the Council's request for consideration in connection with the meeting of the Committee scheduled for Tuesday, March 26, at 3:00 p.m., in Room 4426, Treasury Department.

It is identified as LRIPC/40.

John C. Bullitt.
John C. Bullitt

cc: Secretary of Agriculture
Chairman of Federal Reserve Board

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CEA Staff Paper
(For Cabinet Committee on
Balance of Payments)

Effects of Monetary Policy on the Domestic Economy and on the Balance of Payments: Further Comment

1. Under present conditions, with unemployment amounting to over 6 percent of the labor force, with a gap of some $30-$40 billion between what we are producing and what we could produce at a moderate 4 percent unemployment rate, and with no prospect of significant fiscal stimulus to the economy until the tax revision program goes into effect, presumably well after midyear, there is a strong presumption against any tightening of credit.

2. This does not mean that a moderate tightening of money should be ruled out, but it does mean:

a. That the benefits (to the balance of payments) and costs (to the domestic economy) of such a policy must be most carefully weighed; and

b. That the benefits and costs of such action must be compared, as fully as possible, with the benefits and costs of other actions to reduce or to finance the balance of payments deficit.

3. Admittedly, it is very difficult to make a dependable quantitative estimate of the effects on the domestic economy of a rise of 1/2 percent in short-term interest rates. However, a rise in short-term rates of this magnitude would require some contraction of member bank free reserves, and this would produce some increase in the cost and

reduction in the availability of bank loans to business and consumers with some depressive effect on inventory investment and durable goods purchases. The magnitude of these effects would depend on the availability of alternative sources of funds and the sensitivity of these expenditures to interest rates. In addition, and more important, to the extent that the rise in short-term rates was accompanied by a sympathetic rise in yields on mortgages and long-term corporate and state and local government securities, there might be significant cutbacks in business investment in plant and equipment; in state and local government expenditures on schools, highways, and other public projects; and in household expenditures on residential construction. Private research suggests that all of these expenditures possess a significant sensitivity to changes in long-term interest rates.

4. In the last quarter of 1962, the total of residential construction, business fixed investment, and state and local government expenditures on construction amounted to roughly $85 billion (seasonally adjusted annual rate). Let us suppose that a rise of 1/2 percent in short-term interest rates produces a sympathetic rise one-half that large, or 1/4 percent, in long-term interest rates. Taking approximately 4 percent as the present average of long-term rates, this would represent a rise of about 6 percent (of itself) in the typical long-term interest rate. If the $85 billion of fixed capital expenditures were subject on the average, to an interest elasticity of -1/4 (meaning that a rise

in the interest rate of 1 percent of itself would cause a cutback of 1/4 percent in spending), the 6 percent rise in long-term rates would cause spending to be reduced directly by about 1-1/2 percent, or roughly $1-1/4 billion. This direct cut in expenditures would reduce consumer and business incomes and increase the margin of excess capacity, thus indirectly causing further cutbacks in spending (multiplier and accelerator effects). Using a factor of 3 to 4 for these effects -- which is on the same order as the estimate we have implicitly been using for the secondary expansionary effects of tax reduction -- we arrive at a rough estimate of $4 to $5 billion for the total ultimate reduction in GNP attributable to the tighter monetary policy. A decline of $4 to $5 billion in GNP, if it were to occur at the present time, would probably raise the unemployment rate by roughly .2 to .3 percentage points (e.g., from the February level of 6.1 to 6.3 or 6.4).

5. While the above calculation is very crude, it does not seem an unreasonable estimate, at least in terms of general order of magnitude, for the policy change under discussion. The sensitivity of state and local government capital expenditures, and even more particularly of residential construction, to credit tightening is widely recognized. Several recent studies have placed the interest elasticity of plant and equipment expenditures in the neighborhood of -1/2. An over-all estimate of -1/4 therefore seems conservative. And the tighter monetary policy would raise the cost and reduce the availability of bank credit to business and consumers, thus presumably producing some reduction in inventory

investment and purchases of consumer durable goods; no allowance has been made for these effects in the above calculation.

6. The restrictive effects would not all occur immediately, since there are substantial lags between a change in credit policy and the resulting change in GNP. The above estimate relates to the ultimate decline in the rate of output, after all the effects had worked their way through the system.

7. If it were decided to raise short-term interest rates by 1/2 percent for balance of payments reasons, it is extremely important that every possible effort be made to prevent the effects from being transmitted to long-term rates. There are a number of steps that could be taken to accomplish this objective:

a. The Treasury could concentrate its borrowings in the short-term sector even more than it has been doing.

b. The Federal Reserve could purchase long-term securities on a larger scale than currently, while at the same time selling short-term securities.

c. Another possibility would be a reduction in member bank reserve requirements combined with sufficient sales of short-term securities to push up short-term rates.

d. A further increase in ceiling interest rates on commercial bank time deposits by the Federal Reserve and FDIC might attract further funds to the commercial banks, which would flow into mortgages and state and local government securities, thus maintaining downward pressure on yields in those areas.

Since the relation between long-term and short-term interest rates is strongly influenced by investor expectations about future changes in interest rates, it might not prove possible to insulate the long-term market fully from the effects of higher short-term interest rates. But every effort should be made to do so, since whatever success was achieved in this regard might substantially cut down the restrictive effect on the domestic economy.

8. On the balance of payments side, the estimate of up to $1/2 billion per year for the net reduction in capital outflow does not seem unreasonable. But it should be recognized that the effects of a moderate tightening of monetary policy on the balance of payments, like the effects on the domestic economy, are very difficult to estimate. Many forces other than interest rates affect international capital flows, and the interest rate effects are difficult to isolate. Competent experts, who have studied the problem carefully, disagree with respect to the importance of interest rates as a cause of short-term capital flows. Furthermore, since a rise in U.S. interest rates relative to those abroad can be expected to cause a compensating change in the cost of forward cover, thus eliminating any net change in the incentive for the movement of covered funds, it is possible that the gain to the U.S. balance of payments might be mainly of a "one-shot" variety rather than a continuing flow.

9. It is especially important, before undertaking to raise U. S. short-term interest rates, to be assured that there will not be compensating increases in rates in foreign money centers. If, for example, Canada and/or the U. K. were to respond by raising their rates, little if any balance of payments benefits would be likely to accrue to the U. S., and we would be left with merely a contractive effect on the domestic economy. The present precarious position of the U. K. balance of payments might make the British especially likely to react by raising their interest rates. In the case of Canada, even if interest rates were not increased, a tighter monetary policy in the U. S. might have the effect of delaying the repeal of import surcharges and other measures taken to improve the Canadian balance of payments in 1962.