BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

November 1, 1965

STRICTLY CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

The Annual Consultation of the International Monetary Fund with the United States have 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, moreover, is well worth your reading.

Ralph A. Young

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

Enclosure.

Article VIII Consultations with the United States, 1965

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

October 28, 1965

The purpose of this concluding statement is twofold. First, I want to give you our understanding--based on the written answers and on last week's discussions--of how you yourselves see major features of the U.S. situation and of the policies being pursued. In preparing this analysis, we found that the knowledge we gleaned was not always certain or clear. So, as I go along, please take note of those statements about your position which you feel we have not gotten right or which require supplementation.

The second thing I want to do in this statement is to give you our preliminary appraisal of your situation and policies. Here again, we invite your discussion. I would very much appreciate your reactions to the views we have formed.

Before I go on, let me say that I believe this has been an excellent Consultations exercise. The written answers to our advance list of questions paved the way for some very fruitful discussions last week, and I feel sure you have given us the basis of a useful Staff Report to the Fund's Executive Board. We especially appreciate the candor and frankness with which you have responded to our many inquiries, and perhaps you won't mind if we give our views with equal candor and frankness.

Let us look first at the domestic economy. Obviously, it has done very well. The number of months in the expansion--I believe November will be 57!--is no longer viewed by the public as a possible sign of impending downturn. Instead, the unprecedented lengthening of the economy's advance has contributed to widespread euphoria, and it is remarkable for this time of the year that most observers, private as well as official, expect the expansion to keep going throughout all of 1966.

It is now generally recognized that the current expansion is something quite different from the cyclical upswings in the earlier postwar period. The growth of output not only has been prolonged, but it has accelerated in the past two years. Unemployment has been brought down much closer to the 4 per cent interim goal. Profit margins have been restored to a very satisfactory level. By almost any criterion, the expansion has been well balanced. The level of costs and prices has been reasonably stable, although it is in this area that one lately can find a blemish on the over-all record and some possible source of concern.

For the economy's remarkable performance in the more recent period, the major share of the credit must be given to the 1964 tax cut. We wholly agree with the assessment you rendered in the answer to Question 9, namely, that "there can be no reasonable doubt that the 1964 tax cut gave a very powerful stimulus to total demand and production and has made the difference between a brisk and sluggish economy in the last year and a half." And, of course, the tax cut has had a larger significance. It has fostered wide-spread acceptance, absent until a few years ago, of fiscal policy as a tool to regulate aggregate demand in the economy up to, and along, the full employment path.

With strong expansion of the economy powered by the tax cut, the slack in utilization of resources has now been largely absorbed. This development has brought a new situation, focusing close attention on the availability and distribution of resources as a factor in analysis of the country's vulnerability to inflation. You have explained to us why you believe that supply factors are still favorable to further noninflationary expansion. Your analysis is a reasonable one in light of the available statistics on the over-all output gap, unemployment, and operating rates in manufacturing. However, it is well to bear in mind both the limitations of this information and the difficulty of interpreting it as margins narrow. One certainly cannot rule out the real possibility that your appraisal of the supply situation--assuming a further strong expansion of demand--may prove too optimistic.

As to the demand situation, an element of uncertain dimension for 1966 is increased military spending for the war in Viet Nam. Another such element is business capital spending. Because of factors on both the supply and the demand sides, forecasting and policy-making may prove more difficult for 1966 than it was in recent years. But if the economy stays well balanced and develops along the general lines we discussed--that is, if GNP continues to go up about $10 billion a quarter and the price rise does not accelerate--real output would advance in line with the economy's estimated potential growth of 4 per cent and, as a first approximation, unemployment in 1966 might be expected to stay around the current rate of roughly 4½ per cent. However, the rate could be pushed appreciably lower, perhaps in the neighborhood of 4 per cent, through the employment-absorptive effects of the various job expansion programs and of the projected buildup in the armed forces.

It seems to us that a further 4 per cent expansion in real output for 1966 would thus represent a very satisfactory performance and would be a prudent target for Government policy. To use the general instruments of policy to push for an output expansion significantly larger than 4 per cent next year would perhaps be courting some undesirable risks. The U.S. authorities during recent years have shown great skill in using policy instruments to influence the domestic economy. But luck also may have been a factor, and there is something to be said for not attempting at this juncture to push one's luck too hard.

If we argue for a measure of caution--if, indeed, a 4 per cent rise in output is considered as such--please bear in mind that we do not range ourselves on the side of the many observers who felt that the performance of the U.S. economy in the last five years was too good to be true. We were convinced all along--and we said so to our Executive Board last year--that cyclical fluctuations in the U.S. economy were <u>not</u> inevitable, and that a carefully guided economy could expand along a continuing upward trend.

In any case, our principal concern about aiming for an expansion of real output larger than 4 per cent in 1966 is that it might upset cost and price stability. Surely, as one studies the good record of the U.S. economy over the past five years, the maintenance of stable prices and costs has been an outstanding feature. It has broadened domestic markets. It has contributed to the widening and restoration of profit margins and, with this, to the well paced growth of business fixed investment. It has permitted business to follow steady and conservative policies of inventory management, and it has been a general factor in the avoidance of distortions. In short, the U.S. economy has been doing extremely well in an environment of essentially constant prices and costs, and we feel there can be no assurance that it will continue to do as well if prices and costs go up, even if the acceleration is creeping. And all this, of course, is apart from considerations of the balance of payments, where clearly the continuation of a favorable price and cost performance is a vital element of U.S. hopes for achieving fundamental equilibrium.

Beginning with the strong pronouncements by Per Jacobsson in the 1962 Article VIII discussions, the Fund staff has urged the U.S. authorities to put a primary emphasis on maintenance of price and cost stability and has also expressed its agreement with the adoption of a voluntary incomes policy. We were interested to hear last week that you believe the wage-price guideposts already may have altered past relationships between employment gains and wage increases. This judgment did not surprise us, since we feel that the guideposts have served a practical value and gradually have come to affect the climate of wage and price bargaining and decision-making. However, in a situation of underutilized resources competition has tended to bring about the sorts of changes in wages and prices which actually have occurred, and it is likely that the severest test of the guideposts still lies ahead. For the functioning of these guideposts to be truly effective, it will be necessary to achieve some significant reductions in prices as well as restraints on wage increases.

In the discussions last week, relatively little attention was given to the subject of labor market policy. As we have emphasized in previous Consultations, we have thought it prudent for the U.S. authorities to adopt a more active policy in this field. Manpower programs designed to improve the quality, mobility, and adaptability of the labor force already have been launched in the past year or two, and a further substantial expansion in such programs would seem to be advisable for the period ahead. If effective, they would serve to facilitate growth, restrain wage and price increases, and reduce the minimum feasible level of unemployment--provided, of course, that aggregate demand proves adequate. Clearly, there is a good opportunity for labor market policy to supplement and assist the effectiveness of fiscal, wage-price, and monetary policies.

When attention is turned to fiscal policy in 1965, an important background factor was that a combination of stable expenditures and expanding revenues had brought about a rapid shift from deficit to surplus (on a national accounts basis) by the early part of the year. It was concluded at that time that a continuation of this shift might bring a slowdown in the economy, especially in view of the projected decline in steel output, and perhaps in auto production, during the latter part of 1965. Concern also was felt about the possible deflationary effects of the scheduled increase in social security taxes at the beginning of 1966. In any case, because of the various fiscal actions and developments which you have described to us, this situation has been turned around.

U.S. fiscal policy is now in an expansionary phase. From the first to the second half of 1965, the shift from surplus to deficit on a national accounts basis is a substantial one. For the first half of calendar 1966, the currently projected decline in the deficit is not large--notwithstanding imposition of the new social security taxes of $5\frac{1}{2}$ billion annually.

In fiscal 1966, therefore, the federal budget continues, on balance, to be an expansionary force, serving to reinforce the strength of private demand. Looking ahead to fiscal 1967, we gather that plans for a tax cut have faded. Whereas a tax cut might well have been indicated to help offset the well known "fiscal drag," that form of new fiscal stimulus appears to have been replaced, in effect, by increased military spending for the conflict in Viet Nam. In this connection, we have noted your emphasis that the increase in outlays for Viet Nam will not simply be added dollar for dollar to programmed expenditures for other purposes. We conclude from this that civilian programs are undergoing a thorough review, and that some of them may be trimmed or stretched out or postponed in the interest of producing a sound, noninflationary budget for fiscal year 1967.

Now all of this is to the good. But we continue to feel, as in previous Consultations, that the flexibility of the budget instrument <u>within</u> the budget year leaves something to be desired. Such flexibility may be accomplished in part through improvement in the discretionary variation of expenditures, which the answer to Question 12 states is now under examination. But the biggest potential in this area would appear to lie on the tax side.

We fully realize that this whole issue of fiscal flexibility goes to the roots of the U.S. political system. However, we believe that it is nonetheless <u>increasingly</u> important for the budget instrument to become more adaptable and precise within the mix of national economic policy. This is all the more important because of the Administration's stated objective of using the budget as the principal instrument for achieving an economy which avoids slack and operates continuously close to the limits of its capacity. To obtain an efficient instrument for supporting such an approach, considerable improvement upon present arrangements and procedures would seem to be necessary. We believe that the Administration should do all it can to push this. Without an improved fiscal instrument, we fear that there is a real risk that situations will arise where it will not prove possible to keep the economy on a steady expansionary course.

Significant as have been the recent developments in the fiscal field, probably no area of U.S. economic policy has attracted more attention in the past year or so than monetary policy. Widespread concern has centered on the higher rate of growth in bank credit. We have appreciated the opportunity of reviewing monetary developments in some detail and of trying to put this key area of policy into perspective. In your analysis, you gave emphasis to a number of points.

1. The role of commercial banks in supplying funds to the credit markets has been significantly enlarged in 1965, at the expense--relatively speaking--of both nonbank financial institutions and direct flows of capital or credit among or within the nonfinancial sectors.

2. Substantial growth of bank credit in 1965 has been required to meet business and consumer credit demands. However, the Federal Reserve has exercised a "modest but cumulatively significant degree of restraint" over the rate of bank credit expansion throughout the year. The expansion of such credit declined from an annual rate of 12 per cent in the first quarter to 10 per cent in the second quarter and to 6 per cent in the third.

3. Owing to careful Federal Reserve control of the marginal availability of reserves to the commercial banks, the current year has brought greater pressure on bank reserve positions.

4. The tighter liquidity position of the banks, coupled with a notable increase in business demands for external financing of investment outlays, has been a key factor in the progressive firming of interest rates during 1964 and 1965. Partly because of expectational influences, the upward movement of interest rates accelerated sharply after mid-1965.

5. In general, nonfinancial business sectors of the economy, as well as the banks, are much less liquid than earlier in the expansion. Therefore, they have become increasingly sensitive to changes in the cost and availability of funds.

All these interrelated developments signify an appreciable firming of monetary and credit conditions since early 1965. We welcome this firming very much. In our judgment, it has occurred without noticeable adverse impact on the domestic economy.

Needless to say, we find no difficulty in endorsing the current general objectives of U.S. monetary and debt management policies as you have described them to us--"to facilitate noninflationary domestic economic expansion while limiting the incentives for capital flows which would contribute to our balance of payments deficit." The desirability of such policies is beyond question. However, the choices and decisions faced in implementing them have become more and more difficult in certain ways as the economy has approached full use of available capacity. This fact undoubtedly calls for increased efforts to maintain an alertness of monetary posture, with a readiness to take timely and appropriate measures.

In carrying out their basic tasks, the monetary authorities must do the best they can to compensate for any unexpected events that occur after fiscal policy has been established for some distance ahead. If over the coming months the fiscal policy already set in motion were to prove too expansionary, and inflationary pressures were to arise, a tightening on the part of monetary policy would be quite consistent with the balance of payments position. If, however, the domestic economy should confound present expectations and begin to falter, monetary policy might be in a very difficult position to provide support if actions could not be taken quickly on the fiscal side. This underscores my earlier remarks about the need for a more flexible budget instrument.

I come now to the balance of payments. At least until this year, the history of the U.S. effort to deal with its payments problem has been one of occasional over-optimism and periodic disappointment. The approach of "buying time" until fundamental market adjustments took place has not gone according to schedule. With respect to the current account, the mechanism of adjustment through prices and costs has not worked so rapidly as the authorities expected three or four years ago. Nor has the continuous improvement in the domestic economic situation had the beneficial effects on the capital account that were expected from it. On the contrary, the outflow of private capital has shown a sharp tendency to increase. When first introduced as a measure to operate directly on private capital outflows, the Interest Equalization Tax had some rather obvious loopholes, notably bank lending. The approach under the February 1965 program is more comprehensive and logical, and it takes account not only of the U.S. position itself but of current attitudes abroad.

It may be helpful to make a general comment about the Government's current balance-of-payments programs. These programs have tended to be considered for the short haul. Nothing, however, in the development of the U.S. balance of payments in recent years, or in 1965, suggests that it can be taken for granted that external equilibrium could be reached quickly without reliance on restrictive measures of one kind or another, such as the voluntary controls on capital, preferences in Government spending, the tying of aid, etc. A sharp and sudden improvement in the U.S. balance of payments is, of course, not impossible, but for planning purposes it would appear safer to base policies on the assumption that it is quite likely not to occur.

In making this observation, I am ruling out--and I think there is consensus that it should be ruled out--a measure which perhaps could bring balance rather quickly, namely, a deliberate reduction in the U.S. rate of growth. We strongly believe that this should be avoided and that the greater degree of balance in world payments that could be obtained by reducing U.S. expansion below what is feasible on a noninflationary basis would not be worth the cost in terms of output both in the United States and elsewhere, particularly in the less developed countries. In this connection, attention should be drawn to the fact that the decline in the U.S. current-account balance in 1965 may be attributed in part to the decline in growth rates abroad. It is recognized that in a number of other industrial countries the growth rate has had to be slowed down either for balance of payments reasons or to contain domestic inflationary pressures. If the resulting rate of expansion abroad were taken as a datum to which expansion in the United States would have to be adjusted, the world economy would risk sinking into a recession by a series of balance of payments adjustments.

At the same time, it is necessary to strengthen the position of the dollar by the restoration of balance of payments equilibrium without delay. We fully agree with Secretary Fowler's recent statement that a weak dollar would lead to a further shrinkage of international liquidity. We have noted your statement that the United States is aiming at a further substantial reduction in 1966 of the deficit on regular transactions. This probably would mean that there would be little or no need for settlement of a deficit through official transactions.

We fully endorse your balance of payments objectives for next year and, indeed, we believe that they are indispensable. We understand from you that these objectives are going to be achieved--barring unexpected developments outside of your control--by so adjusting your various balance of payments programs as to produce the desired result in light of the best estimates of how the U.S. international accounts would work out in the absence of a reinforcement of those programs.

It would seem to us that, even if things work out in 1966 as you expect, programs in the balance of payments field will continue to be needed in order to maintain equilibrium in terms of official settlements. In such circumstances, it would appear least harmful to the world economy if these programs took the form mainly of restrictions on the outflow of U.S. capital. In this connection, we go along with the intention of the U.S. authorities to continue the voluntary control mechanism over bank credit and it is in this same context that we see a need for more effective measures to limit the net outflow of direct investment capital.

There seems to be no question thus far about the cooperation of the financial community in the conduct of the new programs of restraint upon private capital outflows. In the case of nonfinancial corporations, one would have to say in all candor that the jury is still out. To be sure, it must be recognized that, once the easy adjustments of liquid asset positions abroad have been completed, business corporations can contribute further to balance of payments improvement only through slower basic adjustments in their procurement, sales, and investment activities. While corporations may well have financial incentives to raise exports, the curtailment of foreign investment plans, or their financing from foreign rather than U.S. sources, can often constitute a real sacrifice which is probably greater than the sacrifice a bank makes when it lends at home rather than abroad. Granted that any basic adjustments take time and may be difficult, it must also be said that the information on the performance of the nonfinancial corporations to date is not entirely reassuring. This is perhaps not surprising given the fact that the guidelines which have been provided to the corporations are highly generalized.

This whole area, in our view, needs tightening. The guidelines to nonfinancial firms cooperating in the Government's program should be made more ambitious and more concrete.

We believe that it is necessary to tighten the nonfinancial corporate program for two reasons. First, progress under this program, for which there would seem to be a good potential, is one of the very few sources of improvement now visible in the U.S. payments position for 1966. Second, as time goes on, the cooperation of banks and other financial institutions under the voluntary program might be impaired if they were to get the impression that the nonfinancial corporations were operating under a looser set of arrangements and were failing to contribute "their share." Consequently, considerations of equity as well as of balance of payments improvement would seem to point to the nonfinancial corporate program as one in which some revisions are definitely indicated. We welcomed Secretary Brimmer's statement to us that the program is now undergoing a thorough review in the attempt to assure its effectiveness.

Quite briefly, I should like to mention again the belief we voiced tentatively last week that the tax method of restraining capital outflows has certain merits for direct investment as well. It marshalls the very price factor which in the longer run, through a narrowing of interest differentials, is expected to contain direct investment without controls. If guidelines are maintained in some form, it also provides a financial assist to these guidelines which, even with the best of effort, are likely to remain somewhat arbitrary. For these reasons, we feel that consideration should be given to more comprehensive use of the tax approach. We can appreciate that the application of an interest-equalization tax to corporate investment and related activities would, as you pointed out to us, pose some real complexities and difficulties. However, the administrative and procedural problems involved could be studied in the period ahead with a sufficiency of time that was not available when the February 1965 program was being formulated.

We have noted from your written answers and from last week's discussion that even for the longer run the United States is aiming at a balance of payments position that would produce--on the average--not a surplus, but approximate balance (on an official settlements basis). As we understand this, it would mean that the United States would count on achieving a gradual rise in its gross reserves outside of the balance of payments as a result of some kind of collective action for the creation of reserves.

We have noted in particular two assumptions made by the U.S. authorities concerning the world environment for achievement of their balance of payments and reserve aims over the longer run: (1) full employment with reasonable price stability and reasonably steady growth in the other major countries of the world, and (2) adequate arrangements to assure an orderly and sufficient growth in the global supply of international reserves. I have already commented on the crucial importance to the U.S. balance of payments of the rate of activity and growth elsewhere in the industrial countries--a subject calling for deeper study than has yet been undertaken. It may be useful to make a comment on the second assumption. The consequences of international reserve creation are likely to be of importance to the United States not only, perhaps not even primarily, because they would add in some measure to U.S. reserves, but also because they would affect the outturn of the U.S. balance of payments. Let me explain how I believe these factors could work out, recalling at the same time that we are dealing with a matter that is in the realm of contingency and is beyond the range for which U.S. policy in the shorter run is now being conceived.

In the absence of any deliberate measures to add to world reserves, balance in U.S. international transactions would mean that the sum of all balance of payments surpluses minus all balance of payments deficits of other countries could not exceed the net availability of gold from new production--and this quite independently of the willingness of countries to hold their reserves in the form of dollars. This is not the occasion to enter into the question whether or for how long other countries in the aggregate would be satisfied with the resulting constraint on their balances of payments. If or when a situation were to arise in which countries were not so satisfied, many countries would repeatedly find their balance of payments aspirations frustrated, ending up with either smaller surpluses or larger deficits than they had hoped for, and those countries would then have to consider what further steps to take to improve their situations for the next period. If this development were to occur, we believe that it would be reasonable to anticipate that a considerable proportion of the aggregate balance-of-payments disappointment, i.e., the difference between the hoped for increases in reserves and the actual increases, would tend to fall on the United States--because of the size of its economy, because of its relative freedom of access as a market in which to sell, and perhaps above all because of the opportunities it provides to borrow capital, if necessary even over the barrier of the Interest Equalization Tax. Therefore, it would be expected that a given set of U.S. policies capable of maintaining balance as long as the total supply of liquidity was adequate would lead to a deficit in U.S. payments in circumstances where countries as a group felt constrained by the inadequacy of liquidity.

We would conclude from all this that at some stage the ability of the United States to maintain balance without recourse to measures having an unduly severe impact on other countries, and its ability to dismantle controls as fundamental changes in competitiveness and remuneration of capital work themselves out, will to a considerable extent become dependent on actions taken in the field of international liquidity.