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The Dilemma of U.S. Monetary Policy* 5 pages

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The Dilemma of U.S. Monetary Policy[1/]

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Monetary policy in the United States has for some time been confronted with a dilemma. Underemployment in our domestic economy requires policies designed to keep liquidity ample and interest rates low. Deficits in our international payments require policies designed to reduce liquidity and to raise interest rates in order to stem and if possible reverse the outflow of capital.

Underemployment and payments deficit

We have been facing this dilemma since 1957, the last year in which unemployment remained below 5 per cent and in which our international payments were in equilibrium.

Since then, our industrial production and our gross national product (in real terms) have increased 16 per cent; but both the 1959 and the 1961 upswings petered out before achieving full utilization of labor and capital. Average earnings of production workers in manufacturing industries have also risen 16 per cent but, with declining blue-collar employment, workers' payrolls have risen only 9 per cent, cutting direct wage cost per unit of output by about 6 per cent. If prices had been flexible downward as well as upward, and if other cost factors had not increased, this cost reduction would have permitted a substantial decline in the average price of manufactured goods. Actually, average prices continued to increase until 1958, and since then have remained stable. The contrast in the behavior of wage costs and prices, incidentally, does not support the view that blames our recent economic ills on excessive wage increases.

Internationally, our payments deficit has exceeded $3 billion in every year since 1957, not counting occasional extraordinary receipts.

For the last year or so, we have had a near-record trade surplus of $5 billion annually, probably more than half of which, however, is financed by our Government (foreign aid and agricultural surplus disposal). Services yield an additional surplus of nearly $2 billion.

But our combined net receipts on merchandise and service account of less than $7 billion annually are confronted with other net payments of nearly $10 billion. Our net military expenditures abroad amount to $2-1/2 billion, and our net foreign aid to $3-1/2 billion. And we have a net outflow of long-term capital of $2 billion, and of short-term capital of nearly equal size.

The character of our international deficit is probably unique in that it is not a case of domestic inflation spilling over into surging imports and lagging exports. In relation to our national income, imports are remarkably low by historical standards, and exports have remained high.

Our payments would probably be in balance if it were not for our Government expenditures and private investments abroad. Both these factors

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are connected with the role of the United States as the military, political, and economic leader of the free world. Military and economic aid to foreigners is believed to be necessary to win the cold war; and the scale of our capital outflow reflects our function as the main center of international finance, with the dollar being internationally the general standard of economic calculation, the principal means of payment, and next to gold the most widely held monetary reserve asset.

Alternative remedies

Four alternative solutions have been proposed to deal with the dilemma.

(1) "Classical" remedy--The first alternative is to balance our international accounts by means of deflationary monetary policies at the risk of further reducing our rate of growth and increasing idleness of labor and capital. This alternative encounters three objections.

First, from the point of view of economic welfare, a serious depression would be too high a price to pay for the elimination of our international deficit.

Second, such a depression would have disastrous political implications, not only domestically, but also internationally. The deflationary policies of the Brüning Government in Germany in 1931-32, which led to the victory of Nazism, provide a horrible example.

Third, it is questionable whether deflationary policies would actually eliminate our international deficit. They would improve our current account balance and stem the outflow of capital seeking fixed interest investment, but they would stimulate the outflow of capital seeking equity investment. This outflow might well cause a deterioriation in our capital account large enough to offset the improvement on current account.

(2) "Radical" remedy--The second alternative is to stimulate our domestic economy by expansionary monetary policies even at the risk of perpetuating our international deficit.

The main objection to this policy is the danger of a large continuing deficit undermining confidence in the dollar at home and abroad; the resulting reserve losses might become large enough to require either a devaluation of the dollar or the institution of exchange controls.

Either action would eliminate the dollar as an international key currency; this would not only harm our domestic economy but also destroy the basis of the present system of international payments. For these effects, the devaluation of sterling in 1931 provides a horrible example.

(3) "Paradoxical" remedy--The third alternative is to use restrictive monetary policies to correct our international deficit and at the same time expansionary fiscal policies to stimulate our domestic economy. An ingenious theoretical argument for that proposal has been

presented in a recent article by Robert Mundell (International Monetary Fund Staff Papers, March 1962, page 70); the idea itself seems to have been conceived by the economists of the Netherlands Bank to whom we owe so many advances in the theory of monetary policy.

This is not the place to discuss the theoretical basis of this proposal. Suffice it to say that it seems questionable whether expansionary fiscal policies (or in simpler words, a large budget deficit) could have a stimulating affect on the economy if they were not supported by monetary policies permitting liquidity to increase together with the deficit. Otherwise, there would be no net increase in aggregate effective demand, and the deficit would be financed out of the savings rather than out of the idle resources of the economy.2/

From a more practical point of view, three further objections may be raised. First, for both constitutional and institutional reasons, fiscal policy, at least in the United States, is not flexible enough to carry the entire load of domestic policy needs.

Second, continuous large budget deficits would again weaken confidence in the dollar at home and abroad and thus stimulate the outflow of capital, which the restrictive monetary policies would be supposed to stem or even to reverse.

Third, when the impact of restrictive monetary policies is limited by countervailing fiscal policies to an increase in interest rates, their main international effect would be to attract volatile short-term funds from abroad. These inflows would result in a purely temporary rather than in a sustainable balancing of our international accounts and would leave our international position more rather than less vulnerable to speculative attacks.

(4) "Specific" remedies--The fourth alternative, which corresponds most closely to our present policies, is to engage in moderately easy monetary policies, which permit domestic expansion while avoiding inflationary pressures, and at the same time to eliminate specific sources of our international deficit.

Success of this policy requires that the United States avoid any increase in its cost and price level. For this reason, the prices of basic commodities have become strategic factors in our international as well as our domestic economic policy.

More concretely, we may distinguish three variants of this alternative, which might be used singly or in combination with each other.

(a) Outflow of Government funds--The first variant is to restrict the outflow of Government funds. Foreign countries may be induced to assume more equitable shares of the costs of defending the free world and of aiding its undeveloped areas. Moreover, United States aid may be tied more completely than hitherto to the financing of exports of U.S. goods and services.

2/ I have to thank Dr. Herbert Zassenhaus for this argument.

These problems are obviously more of a political than of an economic nature. Moreover, the success of our burden-sharing efforts depends on the willingness and ability of our European allies to recognize that, in the long run, a weakened U.S. international payments position would be more costly to them than an immediate expenditure of a few hundred million dollars. A recent agreement with Germany is expected to reduce the impact of military expenditures on our balance of payments.

(b) Outflow of short-term capital--A second variant is to reduce the outflow of short-term capital. This may be done by forward exchange operations, such as those recently conducted by the Treasury's Stabilization Fund. An investor who considers investing dollars abroad and wants to guard against exchange risks, will repurchase by forward contracts the dollars invested. A high forward rate for the dollar thus would reduce the attractiveness of higher foreign interest rates, and intervention in the forward exchange market might be used to raise forward dollar rates sufficiently to offset differences in interest rates.

Another way to reduce short-term capital outflows is the so-called "operation nudge." The Federal Reserve may conduct its open market transactions so as to prevent domestic short-term interest rates from falling, by selling short-term Treasury paper, and at the same time to prevent domestic long-term rates from rising, by buying long-term Government bonds. This operation is based on the assumption that international short-term movements are primarily influenced by short-term rates while domestic investment is primarily influenced by long-term rates.

Finally, foreign short-term capital may be kept in the United States by adopting an Administration proposal to exempt foreign-held bank deposits from the limits on interest rates provided in the Federal Reserve Act and under Regulation Q of the Federal Reserve Board.

The main objection to placing much reliance on any of these methods is the consideration that short-term interest rate differentials, whether covered or uncovered, do not seem to be the only or even the main influence on international flows of short-term capital. Other factors include such diverse elements as the state of bank liquidity, the level of long-term interest rates, institutional practices, the complex phenomenon of markets for Euro-dollars (which are dollar deposits with banks outside of the United States), market expectations concerning exchange rates, and prospects of capital gains.

Furthermore, movements of volatile funds seem to be effects rather than causes of balance-of-payments deficits. If the sum of all other items in our international payments is in balance, we need not worry much about shifts in these funds. If it is not, cessation of their outflow will not suffice to restore lasting equilibrium.

(c) Outflow of long-term capital--The third variant is to reduce the net outflow of long-term capital to foreign industrial countries, and especially to Western Europe, either by making investments in the United States more attractive or by making investments abroad less attractive to both domestic and foreign investors. Obviously, these measures will have greater chance of success if we can induce the European countries to remove their restrictions on outflows of investment funds — restrictions which have lost any justification since the balance of payments of these countries has turned from deficit to surplus. Reasons of international policy militate against proposals also to reduce capital outflows to undeveloped areas.

It would clearly benefit all parties to make investments in the United States more attractive. For this reason, efforts to increase the speed of our economic advance are important not only for our domestic economic welfare and our international political leadership, but also for the narrower purpose of eliminating our international deficit. However, speeding up our growth rate is necessarily a slow and uncertain process. If we wanted to achieve immediate results, we should therefore be compelled to consider making foreign investments less attractive. Short of instituting exchange controls, which would ruin the international standing of the U.S. dollar, the simplest way to accomplish this purpose would be not only to eliminate tax advantages of investments in foreign developed countries in line with the pending tax bill, but beyond that, to levy additional taxes on new investments and on that part of the yields of existing investments that is not immediately repatriated.

This proposal would aim not only at the amounts transferred from the United States to Western Europe through direct investments of U.S. corporations, through long-term credits to foreigners, and through purchases of foreign securities; but also at the much larger amounts reinvested in Western Europe out of the earnings and depreciation allowances of U.S.-owned foreign subsidiaries.

The business community, and especially the leading enterprises in industry, commerce, and finance, which have large foreign interests, strongly oppose attempts at using tax measures to reduce U.S. investments in foreign developed countries. They point out that our foreign investments are by no means a net minus item in our international balance, but are frequently tied to exports of U.S. goods and also promise large future returns. For this reason, special taxation of foreign investments could not be justified as a permanent policy, but only as a temporary crash program; all taxes imposed under the program should be reduced and abolished as fast as improvements in our balance of payments would permit.

Concluding remark--All measures designed to correct the deficit in our international payments require some painful readjustment on the part of business, labor, and consumers. The problem is not to find a method that brings the most benefits to individual interests but one that does the least damage to the economy. On this basis, we shall have to compare each proposed remedy not only with all others but also with the final alternative merely to wait and see in the hope that perhaps our international deficit will just fade away.