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John Exter on the U.S. Balance of Payments 9 pages

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Mr. John Exter, a distinguished alumnus of the Board's international economic staff, has had wide experience in international finance, both as a central banker at home and abroad and more recently as Senior Vice President of the First National City Bank of New York. His views carry great weight among bankers as well as economists, and the address he gave on May 7, 1962, at the Economic Club of Detroit under the title "What is Necessary if the United States is to Retain its Gold?" 1/ deserves the most careful consideration.

The basic problem of U.S. monetary policy

Mr. Exter believes that "we simply need less easy money, an absence of monetary expansion"; with less easy money, our balance-of-payments problem "will solve itself because equilibrium will be restored" (page 16).

Mr. Exter thus concerns himself with the basic question of U.S. monetary policy: whether or not to continue expansionary policies as long as large unemployment of labor and capital coexists with a large international deficit.

This question should be distinguished from two problems that have recently received increasing attention.

First, the question raised by Mr. Exter should be distinguished from the problem of the optimum "mix" of monetary and fiscal policy. Theoretically, at least, any desired degree of over-all financial ease or tightness might be reached by combining easier monetary policies with tighter fiscal policies, or alternatively by combining tighter monetary policies with easier fiscal policies. Under conditions such as prevail at present in the United States, it has become fashionable to advocate a "mix" of tighter monetary with easier fiscal policies (e.g., Bank for International Settlements, Thirty-second Annual Report, Basle 1962, page 24). 2/ But Mr. Exter wants to reduce the present state of over-all financial ease rather than to maintain it by means of a different "mix."

1/ Reprinted by the First National City Bank under the title "The Gold Losses."

2/ For a criticism of this approach, see my paper on "The Dilemma of U.S. Monetary Policy" (May 22, 1962).

Second, the question raised by Mr. Exter should be distinguished from that of whether the concrete operations of the Federal Reserve at any given moment were appropriate for achieving the desired degree of ease or tightness. Mr. Exter does not concern himself with the conundrum of the exact relation between changes in bank reserves, in money supply, and in economic activity. He concentrates his attack on the basic policy of continued monetary ease rather than on the adequacy of its implementation or on timing and amplitude of adaptation to day-to-day changes in the economic scene.

Mr. Exter thus deals with the substance of our monetary dilemma rather than with its more superficial appearances. Even if his position proves untenable, his initiative in having started such a discussion, and the searching and scholarly character of his arguments, merit the gratitude of all of us who are engaged in the struggle for equilibrium in the U.S. balance of international payments.

Mr. Exter's propositions

Mr. Exter bases his arguments on the following empirical and theoretical propositions:

(1) "With easy money, the Federal Reserve has for years been trying to keep the U.S. economy more liquid than other economies" (page 7).

(2) "Since the end of 1957, our Federal Reserve faucet has put new money into the American reservoir by buying $6 billion of Government securities, and we have lost $6 billion of gold" (page 4).

(3) "The new monetary reserves do not linger about to absorb the unemployed but pour out to other countries practically as fast as they are created" (page 12).

(4) "A balance of payments deficit is caused by monetary policy alone" (page 3).

(5) "It is time to put less reliance on increasing monetary demand to achieve full employment and a rapid rate of economic growth and more reliance on the sounder stimulus that comes from reducing costs" (pages 16-17).

Mr. Exter applies good economic doctrine to a situation to which it is not applicable.

His theoretical basis is solid enough: a country's balance of payments deficit tends to deteriorate when domestic liquidity increases, and to improve when domestic liquidity is reduced; therefore, reduction in domestic liquidity is the accepted "classical" remedy for a balance-of-payments deficit.

Mr. Exter's favorite simile of a reservoir in which water is poured and from which water flows out (page 3), is appropriate. If a reservoir is filled to the brim, the only way to prevent water from flowing out is to stop pouring it in. Plugging one outlet or the other will not help, because the reservoir cannot be made to hold more water than it already contains.

But this is obviously not true when the reservoir is only half filled. In this case, pouring in more water will not cause the water to flow out, provided that all outlets are plugged. If water flows out, it is quite reasonable to try to find an unplugged outlet or a leak before giving up an attempt to fill the reservoir more fully.

If the United States had the same degree of high employment as, say, the United Kingdom or Japan (or as France had in 1958), Mr. Exter's recipe would be sound. As it is, the United States is suffering from large unemployment of labor and capital. It is quite likely that a further increase in the economy's liquidity would be of little help. But the crucial question is whether a significant reduction in liquidity would do harm; and in particular, whether it would erode the economic and political world position of the United States even if it did no more than perpetuate the present state of unemployment. If the answer were yes, the United States would have to avoid such a course as long as any other alternative was available that would permit hope of correcting our deficit without threatening economic recovery.

In order to arrive at an answer to that crucial question, we shall first discuss the problems involved in Mr. Exter's five main propositions.

(1) Has the Federal Reserve made the United States more liquid than other countries?

There is no evidence that the United States has been made more liquid than other countries (and even less that the Federal Reserve has ever consciously tried to make it so).

Between the end of 1957 -- the last year in which the United States had both reasonably full employment and approximate equilibrium in its balance of payments -- and the end of 1961, liquidity in the United States (as measured by the sum of "money" and "quasi money" reported in the "International Financial Statistics," the source of Mr. Exter's statistics) increased 17 per cent. This figure was higher than the 9 per cent increase in the United Kingdom (where, however, in the base year inflationary pressures were much heavier than in the United States), but much smaller than the increase in any other leading industrial country. 3/ While the increase in "money" plus "quasi money" (time deposits) may not be an ideal measurement of an increase in liquidity,

3/ The relevant figures are: Austria 68 per cent, Belgium 29 per cent, Canada 27 per cent, France 63 per cent, Germany 69 per cent, Italy 75 per cent, Japan 115 per cent, Netherlands 53 per cent, Sweden 32 per cent, Switzerland 48 per cent.

the difference between the United States and the main surplus countries is so striking that the question of exactness of measurement becomes academic.

The increase in liquidity in the United States was no larger than the rise in national income between 1957 and 1961 -- a period in which wholesale prices increased only 1 per cent.

These indicators suggest that since 1957 domestic liquidity has not risen either absolutely or relatively to our main competitors. Our recent deficit seems, therefore, to have been caused by factors other than excessive monetary ease allegedly practiced by the Federal Reserve during that period.

(2) Have Federal Reserve acquisitions of government securities caused the outflow of gold?

Mr. Exter's statistics are not conclusive. Between the end of 1957 and of 1961, the inverse relationship between changes in Federal Reserve holdings of U.S. securities and the U.S. gold stock was indeed "almost too good to be true" (page 4). The simplest explanation is that the Federal Reserve was apparently trying to prevent the outflow of gold from having deflationary consequences, and therefore had to compensate the decline in the gold stock by an approximately corresponding increase in its holdings of government securities. Thus, the gold outflow may be considered the cause rather than the effect of the Federal Reserve action.

There is nothing inevitable in the inverse relationship between Federal Reserve holdings of government securities and changes in the U.S. gold stock. Between the end of 1950 and of 1952, for instance, Federal Reserve holdings of government securities increased by $4.1 billion and the gold stock rose by $0.4 billion. Between the end of 1953 and of 1955, Federal Reserve holdings of government securities declined by $1.0 billion and the gold stock dropped by $0.3 billion. Or to take longer periods, between the end of 1945 and of 1951, holdings of government securities were virtually unchanged (minus $0.3 billion) while the gold stock increased substantially (by $2.4 billion). In contrast, between the end of 1950 and of 1957, holdings of government securities increased considerably (by $3.6 billion) while the gold stock remained virtually unchanged (minus $0.1 billion). 4/

The lack of a constant relationship is to be expected because there is, in the absence of a deliberately compensating monetary policy, no reason to assume a one-to-one connection between Federal Reserve acquisitions of government securities and the outflow of gold. It is true that Federal Reserve action designed to make the economy more liquid tends to increase a deficit in our balance of payments and thus the probability of gold sales to foreigners in two ways: first, banks are enabled to extend more credit, and some part of the credit expansion is likely to go to foreign borrowers and thus to add to the outflow of capital; and second, economic activity is stimulated, and this is likely to increase imports (although it may also reduce costs through better utilization of capacity and more rapid technological innovations, and thus expand exports). In the U.S. economy,

4/ *Federal Reserve Bulletin*, May 1962, page 586.

however, with its relatively small foreign sector, the external impact of monetary measures is likely to be only a small part of the total effect, and the outflow of gold in turn is likely to be only a fraction of the resulting external deficit.

(3) Did our newly created monetary reserves immediately and entirely flow abroad?

Between the end of 1957 and of 1961, an increase in Federal Reserve credit of $5 billion enabled commercial banks to expand their total assets by $45 billion, including a rise in their claims on foreigners of $3.3 billion. Our Gross National Product rose $78.5 billion; non-military exports increased $0.6 billion and imports $1.6 billion so that the trade surplus declined by $0.6 billion. 5/

If the Federal Reserve had decided not to offset the gold outflow by purchasing government securities, banks might not have been able to increase their foreign credits; also, the American economy might not have been able to increase its imports and thus to reduce its trade surplus. On the other hand, the 10 per cent increase in our Gross National Product (in terms of constant purchasing power) would probably have been thwarted, too.

(4) Does monetary policy alone determine our balance of payments?

A very large part of the U.S. balance-of-payments deficit is due to circumstances that have no relation to domestic liquidity and interest rates. Moreover, domestic liquidity and interest rates are not exclusively, or even predominantly, determined by "monetary policy alone."

Our government expenditures abroad for military purposes and economic assistance, even deducting amounts reflected in exports of U.S. goods and services, have regularly been larger than our total deficit. These expenditures can be curtailed or offset, unilaterally or (preferably) by agreement with our allies, without affecting the domestic economy and without requiring a change in our monetary policy. But they represent commitments growing out of the "cold war" and cannot be reduced arbitrarily without impairing our chances of victory.

Private international transactions are more deeply affected by monetary policy but many if not all of them respond more directly and largely to other factors. This is true not only for exports and imports of goods and services but also for capital movements.

Mr. Exter errs in believing that the world has become one money and capital market. It may be true that "money moves as easily from New York to London or Paris as from New York to Detroit" (page 7). But unfortunately, it is not yet true that it moves as easily from London or Paris to New York as from Detroit.

5/ *International Financial Statistics*, June 1962, pages 270-271.

As long as all foreign countries maintain restrictions on the outflow of capital, while the United States continues to maintain a free money and capital market, interest-rate differentials will play a minor role in the international movement of capital. Long-term as well as short-term interest rates are higher in the United States than in the Netherlands or Switzerland, but foreigners cannot switch their borrowing from the United States to those two countries because those countries (whose capital markets are relatively small anyway) strictly limit issues of foreign securities and bank lending to foreigners. Short-term loans have become about as expensive in New York as in London, but Japan borrows more short-term funds in New York than in London because the British authorities still prevent their banks from extending credits to foreigners for purposes other than financing trade with the sterling area.

As long as these conditions prevail, a moderate increase in interest rates and lessened availability of credit in the United States cannot be expected to have a large deterrent effect on foreign bond issues in the United States and on long or short-term lending of our commercial banks to foreigners.

Moreover, at least some of our commercial banks reportedly follow the policy of keeping approximate balance between deposits held by foreigners and loans to foreigners. Insofar as they do so, an increase in U.S. bank rates that would attract funds from abroad would lead to a simultaneous increase in lending to foreigners and for this reason alone fail to improve the international liquidity position of the United States.

Monetary policy, by influencing money-market rates, may have a more decisive effect on flows of volatile funds seeking temporary investment in money-market paper.

Decisions on temporary investments of volatile funds, however, are frequently made on the basis of covered rather than uncovered interest-rate differentials; this means that the flows will be affected not only by changes in interest rates but equally by changes in forward premiums and discounts. While forward rates may be, within limits, influenced by central bank operations in foreign exchange, they are only indirectly susceptible to general monetary policies: for instance, if the market takes an easing of monetary policy as a symptom of an improving international financial position, the policy may cause the forward rates of the currency involved to rise. This "signal effect" explains why the reduction in the British Bank Rate in the spring of this year had the paradoxical consequence of transforming a covered differential in favor of U.S. Treasury bills into a covered differential in favor of British Treasury bills: the improvement in the forward sterling rate more than offset the British bill rate reduction.

More importantly, an inflow of volatile capital does not constitute a permanent cure of a balance-of-payments deficit. First, the amount of funds likely to move from one country to another merely in order to profit from interest-rate differentials is so limited that the flow is bound to dry up relatively soon. Second, the slightest change in market sentiment may at any time reverse the flow and uncover the basic deficit situation. Third, even from a purely statistical point of view, the flow does not change the deficit as defined by many economists.

On the latter point, in the case of the United States, an inflow of liquid foreign short-term funds does not reduce the deficit as reported by the Department of Commerce because the resulting increase in short-term liabilities to foreigners is counted as an item grouped with means of financing the deficit rather than with those transactions the balance of which constitutes the deficit. A reflux of U.S. liquid short-term funds would statistically improve our balance of payments, but only because the Department, perhaps somewhat inconsistently, does not count a decline in liquid U.S. short-term claims as an item "below the line," as it does an increase in liquid liabilities. From the point of view of realistic economic analysis, flows of foreign and of U.S. volatile funds should be treated symmetrically; such treatment would make it clear that flows of such funds do not affect a country's underlying international situation, although they may have considerable psychological effect by influencing gold transfers.

Trying to eliminate a country's deficit by inducing inflows of volatile short-term funds means "papering over the cracks" rather than correcting the basic faults of the structure. The use of monetary policy for that purpose would thus be subject to Mr. Exter's strictures (see pages 8-11) on other attempts at disguising rather than removing our deficit.

(5) Would tighter monetary policy reduce domestic costs?

Mr. Exter is right in believing that a drop in our price and cost level would increase our international competitiveness and thus help restore equilibrium in our external payments. But he is wrong in implying that moderately tighter monetary policy would result in an absolute decline in our prices and costs.

Excessively easy monetary policy indeed is likely to increase prices and costs. But it is a well-known fact of modern economic life that both prices and costs resist downward pressures more successfully than upward pressures. While this tendency should not be exaggerated, it would be unrealistic to suppose that a mild tightening of monetary policy could bring average wages and prices down so substantially as to improve our competitive position drastically and immediately.

This does not mean that our monetary policy could not affect price and cost differentials. But the main effect must be negative rather than positive: we must avoid an increase in price and cost levels rather than seek an absolute decline. In recent years, we have made some progress in that direction. The Annual Report of the German Federal Bank for 1961 (page 48) points out that wage costs in manufacturing industry have been reduced in the United States by 3 per cent since 1959, while they remained virtually unchanged in Belgium and Italy and rose between 3 and 11 per cent in the United Kingdom, France, and Germany. These divergent tendencies have not yet been strong enough to be reflected in decisive changes in price relationships but they indicate again that our recent monetary policy has, to say the least, not prevented costs from moving in the direction required for the restoration of international equilibrium.

The downward movement of unit labor costs has been the result of a continuous increase in technological productivity together with reluctance or failure of labor unions to press for wage increases fully compensating for the rise in productivity. Monetary policy could decisively increase the downward pressure only by further reducing the total demand for labor and thus the bargaining power of the labor unions, i.e., by bringing about a recession. Mr. Exter rightly rejects this kind of policy but he does not offer any alternative.

Conclusion: Can a moderately restrictive monetary policy be expected to eliminate our international deficit?

In the "classical" situation in which a country suffers from a deficit in its balance of payments because domestic demand has expanded more rapidly than available domestic supplies, a moderately restrictive monetary policy would eliminate the external deficit by reducing final demand to levels compatible with domestic productive capacity. It would not create unemployment but merely avoid excess demand for labor. It would not hamper capital formation but merely reduce investment demand to the level of domestic savings. It would not bring about an artificially high level of interest rates but merely permit interest rates to reflect the existing scarcity of capital funds.

In the United States, any reduction in final demand would, under present conditions, increase unemployment of labor and capital and would thus further reduce investment and the pace of economic growth. With ample supply of loanable and investible funds and a weak demand for loans and investments, interest rates (and especially those for medium and long-term credit that are decisive for capital market transactions) are "naturally" low. In Continental Europe and Japan, and to a lesser degree even in the United Kingdom, loanable and investible funds are relatively scarce because income still is relatively low, but investment demand is relatively (and in most of these countries also absolutely) strong. Interest rates are thus "naturally" high.

Any attempt of the monetary authorities, here or abroad, to reverse this "natural" relation of interest rates, and especially an attempt to force rates in the United States to levels comparable with those prevailing in rapidly expanding capital-poor countries such as Japan, Italy, Germany, or Austria, would fly in the face of economic reality. Such a level of at least 6-1/2 per cent (about 2-1/2 percentage points higher than present U.S. rates) would have to be supported by a truly draconic monetary policy: savings would have to be reduced until the ratio of savings to the slack demand for investment found in the United States would no longer be higher than the ratio of savings to the strong demand for investment found in those foreign countries.

National income would obviously have to be drastically reduced in order to produce such a drop in savings. That reduction would in turn depress investment demand, and this would necessitate a further reduction in savings. This vicious spiral might well end in severe deflation and recession.

Moreover, such a policy would serve to curtail only the outflow (or increase the inflow) of funds looking for fixed-interest investment. The flow of equity capital, in the form of both portfolio and direct investment, would be stimulated in the opposite direction. That is to say, the more restrictive our domestic monetary policy, the bleaker would be the outlook for equity capital at home, and the greater the inducement to invest abroad.

The only way out of this dilemma would be a large increase in the demand for loanable funds on the part of the Government, e.g., a huge increase in the budget deficit; as the small effect of "Operation Nudge" on long-term rates has shown, a mere change in debt management or open-market techniques would be unlikely to bring about the desired result. Issues of government securities would presumably have to be increased to a multiple of their recent volume ($12 billion in 1961) in order to raise medium and long-term rates in the United States to the desired level. Deficit financing in such amounts would neither contribute to confidence in the stable internal and external value of the dollar, which must be maintained at home and abroad if a speculative run on the dollar is to be avoided, nor would it be consistent with Mr. Exter's thinking.

The most sensible course thus remains to hold the line for prices and costs, while prices and costs in the surplus countries continue to rise; and simultaneously to make all possible efforts to plug specific outlets that permit the outflow of funds without benefit to the domestic economy.

These efforts promise to be successful in the field of military expenditures and perhaps also of aid expenditures. They may have to be strengthened in the field of capital outflows; obviously not by means of exchange controls (which would undermine the international status of the dollar) but through tax policies that would make capital repatriation more attractive and capital expatriation less attractive.

No spectacularly quick result can be expected from this policy. But barring a sudden emergency, there would be no reason to jeopardize our all too slow economic recovery by experiments that at best might help to reduce our balance-of-payments deficit somewhat more rapidly than the measures presently applied or recommended, and at worst might lead to world-wide recession.