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The U.S. Balance of International Payments

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This paper was presented at a meeting of the National Industrial Conference Board, held on November 16, 1962, in Chicago, Illinois. It reflects the author's personal views and must not be interpreted as representing the opinion of the Federal Reserve System.

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The U.S. Balance of International Payments [1/]

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Our payments deficit remains uncomfortably large.

According to the figures just released by the Department of Commerce, our net liquidity position (gold and foreign exchange reserves minus liquid liabilities to foreigners) deteriorated in the first three quarters of 1962 by nearly $1-1/2 billion, in spite of large prepayments of foreign debts in the U.S. Government. If it had not been for these prepayments, the decline would have been $2 billion. Moreover, the difficulties from which the Canadian dollar suffered during the first half of the year interfered with the normal movement of funds from the United States to Canada. Large flows to Canada resumed in the third quarter. But on balance, the Canadian troubles served to reduce temporarily our payments deficit for the first three quarters.

Three further comments may be made about that deficit.

First, outflows of volatile funds (hot money), which played a large role in previous years, were insignificant. The great bulk of our deficit was attributable to the so-called basic element in international transactions: our export surplus was not large enough to cover our government expenditures abroad plus the net outflow of private investment capital.

Second, our trade accounts (exports and imports of goods and services) were quite satisfactory, although the export surplus was lower in the third quarter than in the first half. By postwar standards, exports were high and imports modest in relation to our national income.

Third, even adjusting the figures for the impact of the Canadian troubles on our capital flows, the deficit in the third quarter was certainly not smaller than in the first two quarters, and only slightly smaller than last year.

Our payments deficit has resulted in a decline in our gold stock by $900 million since the beginning of the year, bringing the total drop since the end of 1957 to $7 billion. Our gold stock is still sufficient to pay on demand all liquid dollar claims of foreign monetary authorities, which alone can use their dollar claims to purchase gold from the U.S. Treasury, and to leave a considerable balance as cover for our domestic money supply. Nevertheless, a further persistent and large decline in our gold stock would be bound to increase concern about the stability of the dollar at home and abroad. For this reason, if for no other, we must do our best to reduce and eventually eliminate the deficit in our international payments.

There are some indications that economic market forces are working toward restoring equilibrium in our international payments. But we cannot expect that these forces will act rapidly enough to make additional policy efforts unnecessary.

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On trade account, the United States has recently maintained price and cost stability more successfully than the major industrial nations of Europe, and the competitive position of our export industries has improved. But so far, export prices have not risen sufficiently in those countries to reduce their exports and thus to eliminate their aggregate payments surplus. France, in particular, continues to increase its reserves rapidly at the expense of the United States.

Moreover, there is some uncertainty about prospects for a continuing economic boom in Europe. If the boom should peter out, our trade balance would suffer in three ways. Our exports to Europe, the mainstay of our foreign trade, would decline. European exporters in turn would redouble their export efforts and try not only to reduce our exports to third countries but also to raise the level of our imports. And exports of raw materials from undeveloped countries to Europe would suffer, and those countries would have to curtail their imports, including imports from the United States.

Finally, Canada has devalued its currency and introduced surcharges on a large part of its imports. These measures mainly hurt U.S. exports as the United States is Canada's largest trading partner.

For these reasons, I believe that we cannot expect an early dramatic upsurge in our exports. At the same time, we hope that our own economy will soon expand somewhat more rapidly than in recent years. Inevitably, such expansion will mean a rise in our imports. Thus, I am more pessimistic than some other Washington economists about the chances for rapid improvement in our trade balance.

Prospects are perhaps better for a reduction in our deficit on capital account. If the boom in Europe peters out, Europe might become less attractive to our investors. Conversely, if our economy starts to expand more rapidly, the United States should become more attractive not only to domestic but also to foreign capital.

But our guesses about future economic developments in Europe and in the United States are purely speculative. While we hope for steady expansion on both sides of the Atlantic, we cannot base our actions on mere hopes.

In turning from a discussion of our present payments situation to that of the effects of possible corrective action, we have first to consider three distinctive features of our balance of payments, which impose serious limitations on our choice of policies.

First, our private accounts (exports minus imports and minus net private capital outflow) are not in deficit; but the surplus on private account is not large enough to cover our net government expenditures abroad for defense and economic aid. It would be tempting to eliminate our deficit by eliminating these items. But our government expenditures abroad are, and must be, determined by our international responsibilities rather than by purely financial considerations. It would not make sense for us to try to correct our payments deficit through measures incompatible with the basic goals of our international policy.

Second, our current accounts (exports minus imports minus government expenditures) are not in deficit either; but the current surplus is not large enough to cover the net outflow of private capital. Thus, our deficit does not reflect a decline in national wealth: our investments abroad have risen faster than our net reserves have declined. It is only our international liquidity position that has deteriorated. Such a deterioration would be of little importance for most nations, which need international reserves only to make sure that a decline in exports need not be immediately reflected in a decline in imports. Our reserves still are equal to the value of our total imports for one year, a ratio much larger than in most foreign countries. But we need ample reserves not so much to finance variations in our trade -- most of which is being paid for in dollars anyhow -- but to be able to redeem on demand the liquid dollar claims of foreigners, both private and official, which reflect the role of the U.S. as the world's leading international banker. One-fourth of the monetary reserves of the rest of the free world, and the great bulk of the working balances that foreign commercial banks, traders, and investors need for the settlement of international transactions, are kept in the form of liquid dollar assets.

Our entire system of international commerce and finance rests on the assurance that these reserves and working balances can be used at any time on demand to make international payments, whatever the currency in which the obligation might have been incurred. In other words, our entire international economy rests on confidence that the dollar remains freely convertible into any other currency at a fixed rate. The main if not the only function of our gold and foreign exchange reserves is to bolster that assurance. In order to fulfill their function, our reserves need not be as large as our liabilities -- no commercial bank would or could function on the basis of a 100 per cent cash cover of its deposits. But they must remain substantial and, most important, they must not continue to show a persistent large decline.

If confidence in the convertibility of the dollar were seriously undermined, our international economy could collapse, just as it did when confidence in sterling was destroyed in 1931. Experience has taught us what such a collapse would mean, not only for the economic but also for the political stability of the free world. Thus, it would not make sense to try to remedy our deficit by means that could undermine confidence in the dollar as much as, or more than, the deficit itself would do. For this reason, if for no other, such measures as an increase in the dollar price of gold, flexible exchange rates for the dollar, or exchange controls are out of the question. Fortunately, most or all of these alleged remedies would be ineffective or harmful anyway so that this limitation is not as serious as it seems.

Third, our deficit does not reflect domestic overexpansion; on the contrary, it has been accompanied by unemployment of labor and capital and an unsatisfactory rate of economic growth. Our choice of policies would be simple if the situation were different. Whenever a payments deficit reflects domestic overexpansion, it is only necessary to slow down the pace of the domestic economy, say, by tighter monetary and fiscal policies, in order to eliminate both the domestic and the external imbalance. These methods have worked well in many recent instances of payments deficits abroad, especially in the United Kingdom, France, and Japan. It is therefore understandable that prominent theorists and practitioners alike recommend the same course for the United States. But a remedy that works well under conditions of overfull employment would work badly under conditions of unemployment.

If we started to contract our economy, we would not only further increase unemployment of labor and capital, but we would also make the United States even less attractive to both foreign and domestic capital and thereby increase our deficit on capital account. We would achieve a doubtful improvement in our payments situation at the price of a serious deterioration in our domestic economy. The customers of a bank look not only at the cash-deposit ratio but also at the state of its business; a serious recession in the United States might well impair confidence in the dollar as much as, or more than, our present payments deficit. Thus, it would not make sense to try to reduce our payments deficit by means that would seriously harm our domestic economy, such as deflationary fiscal and monetary policies.

Within these limitations, the Administration will presumably continue to take measures affecting all three main sectors of our payments balance: private current account; government account; and private capital account.

On private current account, the Administration will certainly continue to try to improve our competitive position by maintaining price and cost stability more successfully than our competitors. But these policies will have mainly long-run effects. The United States has decisively rejected the idea of improving our current account by import restrictions. Our exports are much larger than our imports; and a decision to raise our tariffs, which would obviously have led all our trading partners to raise theirs, would have tended to reduce our exports more than our imports, and thus to diminish rather than to increase our trade surplus.

On government account, the Administration will presumably continue negotiations with our friends and allies in order to lighten the burden that our military expenditures abroad and our economic assistance to undeveloped nations impose on our payments balance, both directly and through their impact on our budget. But in spite of our balance-of-payments difficulties, we are still the world's richest nation: our national income probably still is about as large as that of all other industrial nations taken together. We can ask these nations to bear a more equitable share than at present of the costs of defending the free world by military and economic means, but we cannot ask them to bear the bulk of these costs.

Thus, we must not expect dramatic results either from export policies or from policies regarding government expenditures abroad. The best hope for improving our balance of payments rapidly and substantially rests, therefore, on policies designed to reduce our deficit on private capital account.

Three main methods have been proposed for that purpose.

First, many prominent bankers and economists, both here and abroad, have urged the United States to raise interest rate levels in order to attract more foreign capital, and to retain more domestic capital, looking for fixed-interest investments. Flows of volatile short-term funds might indeed be decisively influenced by actions designed to affect covered interest-rate differentials. But these flows have not been important this year.

As far as long-term interest rates are concerned, I am afraid that an increase large enough to influence international capital flows would also be large enough to curtail domestic investment. Most international movements of medium or long-term funds are not very responsive to modest changes in interest rates. Foreigners borrow in the United States mainly because our money and capital markets are free from controls and broad enough to accommodate relatively large transactions without trouble. They are willing to borrow in New York even if they have to pay slightly higher rates than in another financial center.

An increase in our interest rate level by, say, two or three percentage points might indeed choke off foreign borrowing. But such an increase would also choke off much domestic borrowing and investing, especially in the construction industry.

Second, other prominent economists have, on the contrary, proposed expansionary fiscal or monetary policies designed to raise our domestic rate of growth and thus to attract more foreign capital, and to retain more domestic capital, seeking equity investment. Obviously, this proposal avoids the danger of harming our domestic economy; on the contrary, if the policy were successful, it would by one stroke solve both our external and our domestic economic problem. But the liquidity of our economy is apparently so high that further injections of money and credit would probably do little if any good.

This leaves only fiscal policy as a possible tool for expansion, and as you know, the Administration is expected to propose a tax cut for that purpose. But a moderate tax cut could hardly have such strong and immediate expansionary effects that investors would change right away their expectations about profit relations between the United States and other industrial countries. A radical tax cut might have such an effect but it might also lead to apprehension at home and abroad about the soundness of our financial policies, and might thereby increase rather than reduce our capital outflow.

It has recently been proposed to combine the first and the second type of policies by taking radical expansionary fiscal measures and at the same time counteracting unfavorable effects on the balance of payments by restrictive monetary measures. But I am not convinced that this so-called "new mix" would combine the favorable effects of both types of policies. Rather, I am afraid that contradictory fiscal and monetary policies would tend to cancel each other out; in the end, we would have a very large budget deficit and very high interest rates without having either expanded our domestic economy or solved our balance of payments problem.

<u>Third,</u> the expected tax revision may present an opportunity to debate the need for specific tax measures that would provide disincentives for capital outflows to foreign industrial countries and incentives for accelerated repatriation of capital, of depreciation funds, and of profits from those countries.

Obviously, such measures could not be justified on a permanent or long-term basis. Investment abroad is profitable and therefore, in principle, economically useful. But the profits and therefore the economic value of such investments lie in the future. For the moment, capital outflow is a burden on our balance of payments. Ordinarily, this does not matter. But in times of a persistent large payments deficit it matters indeed.

Discriminatory taxes designed to influence capital flows can never be a good thing. But if market forces, aided by other acceptable policy actions, do not prove sufficient to restore our international balance in the near future, such taxes might well have to be regarded as the least of the evils among which we would have to choose. Certainly, such taxes would do incomparably less harm than the collapse of the dollar as an international currency; than a serious recession; or than the abandonment of our defense of the free world.