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Mr. Exter on the U.S. Payments Deficit--II

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With admirable vigor and lucidity, Mr. John Exter continues to propound his explanation of the U.S. payments deficit. His latest effort has been an address before the Central States Group conference of the Investment Bankers Association of America, which met in Chicago, Illinois, on March 10, 1965.

According to Mr. Exter, the payments deficit is exclusively (and simply) due to two interrelated causes.

First, the Federal Reserve has "created reserves by buying too many Government securities" (page 9). This expansionary policy, and it alone, has been responsible for the deficit: "As long as a country continues an expansionary monetary policy, no other measures that the mind of man can conceive will help its payments deficit. If it stops its expansionary monetary policies, no other measures are necessary" (page 11). Mr. Exter realizes, however, that not the absolute pace of expansion but rather its relation to the pace of expansion in other countries is decisive: "In simplest terms, a balance of payments deficit appears when a central bank deliberately tries to create or expand its country's money, in the form of bank notes or bank deposits, faster than central banks elsewhere are creating or expanding theirs" (pages 6-7).

Second, this behavior of the Federal Reserve has been possible only because of the present international payments system, which is based on the use of the dollar as a monetary reserve asset: "The United States could not have run payments deficits for so many years had not foreign central banks willingly accumulated dollars and put them into U.S. Government securities or into deposits in banks" (page 8).

Mr. Exter is far too good an economist and banker to fall into some of the traps that have lured most if not all other advocates of similar ideas. He knows that it is the "growing availability of Federal Reserve credit that causes our payments deficit, not the interest rate at which it is made available" (page 10); hence, he rightly rejects the idea that some moderate change in the discount rate could eliminate the deficit (page 20)--although he cannot resist the temptation of putting in a few good words for higher interest rates.

Also, he knows that monetary policy rather than the payments system as such plays the decisive role. Hence, he rejects a formal "return to the gold standard" (page 17) and especially a doubling of the price of gold (page 16) or some other form of devaluing the dollar (page 18)--although again he cannot resist the temptation of quoting approvingly Professor Triffin's statement that "General de Gaulle can hardly be blamed for refusing to finance, through automatic and indefinite accumulations of dollar balances, all kinds of United States policies in which he has no voice and with which he profoundly disagrees" (page 17). But Mr. Exter (like Professor Triffin) fails to point out that General de Gaulle could easily have avoided that dilemma: if France had borne at least a minimum share of the cost of the common defense of Europe by reimbursing the United States for its military expenditures in France, it could not only have prevented its dollar holdings from rising but also avoided the gold purchases of late 1964 and early 1965--since between the end of 1958 (when French reserves, incidentally, were abnormally low in consequence of its payments crisis of 1957-58) and the end of 1964 French net dollar holdings (public plus private) rose by $1,155 million while U.S. military expenditures in France were close to $1.7 billion.

But Mr. Exter wants the Federal Reserve to behave as if the United States were on a gold standard, i.e., to "settle our current international deficits in gold" (page 17). Mr. Exter obviously only means deficits according to the "official settlements" calculation since he rightly abhors any interference with the working of the international private credit mechanism. Apparently, therefore, Mr. Exter does not object to continual voluntary accumulation of dollar assets by foreign bankers, merchants, and investors, for reserve, working balance, and investment purposes. He only wishes to stop accruals of dollar balances in foreign official reserve holdings.

On a previous occasion, this reviewer tried to analyze the theoretical basis of Mr. Exter's views, and especially his contention that any Federal Reserve action designed to offset the monetary effects of a decline in the U.S. gold stock necessarily creates a payments deficit. 1/ The present paper inquires into the factual basis of the application of Mr. Exter's thesis to recent U.S. experience.

Relative expansion of U.S. money supply

It would seem that the rate of increase in a country's money supply, either in absolute terms or in relation to the increase in production, would be a conclusive indicator of monetary expansion. On that basis, the United States has been by far the least rather than the most expansionary of the world's major industrial countries (see Table 1).

Between the end of 1958--when international currency convertibility became virtually universal--and the end of 1964, money supply (as defined in the International Monetary Fund's "International Financial Statistics") rose in foreign industrial countries by ratios ranging from 154 per cent

1/ "John Exter on the U.S. Balance of Payments," mimeographed paper, July 3, 1962.

for Japan to 24 per cent for Britain; for the United States, the ratio was 15 per cent.

In the same period, industrial production rose in foreign industrial countries by ratios ranging from 159 per cent (Japan) to 31 per cent (Britain); the United States was close to the median with 44 per cent. If the increase in money supply is related to the increase in industrial production, the changes range for foreign countries from an increase of 54 per cent for France to a decline of 8 per cent for the Netherlands; the United States showed a decline of no less than 20 per cent.

If the sum of "money" and "quasi-money" (as defined in "International Financial Statistics") is taken as the basis of comparison, the conclusions are the same although the differences between the United States and the other industrial countries for which comparable figures are available are not quite so dramatic. The United States again shows the lowest rate of monetary expansion, both absolutely and in comparison with the increase in industrial production.

Mr. Exter refuses, however, to accept these data as conclusive evidence of the absence of excessive monetary expansion in the United States. He argues that the U.S. money supply failed to rise only because of the outflow of excess liquidity to foreign countries. This argument is, in itself, of limited validity because--as Mr. Exter himself has stressed--a large part of that outflow has taken the form of increases in foreign holdings of U.S. dollar assets and therefore has remained a factor in U.S. monetary circulation. But even if the <u>total</u> amount of the U.S. payments deficit for the past six years were added to the increase in U.S. money supply, the adjustment would add only 12 percentage points to the increase (and only 9 percentage points to the increase in money <u>plus</u> quasi-money), and the United States would continue to show one of the smallest increases in absolute money supply and the largest decline in the ratio between money supply and industrial production.

Hence, whatever may have been the shortcomings of Federal Reserve policy during the past six years, the charge of an excessive rate of expansion of the--actual or potential--money supply, either absolutely or in relation to the "surplus" countries, can hardly be sustained by the evidence.

<u>Financing of U.S. payments deficit by foreign official dollar accruals</u>

It is true that during the six years under consideration foreign monetary authorities added nearly $4.6 billion to their holdings of short-term dollar assets. If acquisitions of marketable U.S. Government bonds and notes are added (an unknown though probably minor part of which was actually acquired by non-official foreigners), the amount rises to $5.1 billion; but deduction of the U.S. official holdings of foreign currencies reduces the net amount to $4.7 billion.

This figure represents only one-fourth of the total payments deficit of $18.4 billion. The rest was financed by a decline in the U.S. gold stock ($5.1 billion); a decline in the U.S. gold tranche position with the International Monetary Fund, which is increasingly recognized as the equivalent of a settlement in gold ($1.2 billion); the sale of the so-called Roosa bonds (all but $150 million of them denominated in foreign currencies) to foreign central banks ($1.2 billion); and the accumulation of liquid dollar holdings by international organizations ($1.3 billion) and by foreign private bankers, merchants, and investors ($4.9 billion). 2/

None of those forms of settlement would be affected by a return to the settlement principles of the gold standard. Unless the IMF were abolished--and Mr. Exter has, to the best of my knowledge, never advocated such abolition--changes in gold tranche positions would remain potential means of settlement. Similarly, unless all intergovernmental credit transactions were considered improper--and again, Mr. Exter has never advocated the elimination of all public debt transactions--borrowing of the kind exemplified by the Roosa bonds would remain possible. And finally, unless strict foreign exchange controls were reintroduced--and nobody would be more opposed to such steps than Mr. Exter--private foreigners would still be permitted to keep any dollars they believe to be more useful in their business than their own currencies. Mr. Exter would apparently be willing to let the dollar continue to function as an universal means of settlement of private international transactions; and foreign private accumulation of dollar working balances might well be encouraged rather than discouraged by a failure of foreign central banks to continue their practice of holding dollars to be made available to the financial community in case of need.

It seems doubtful, to say the least, whether U.S. domestic and international monetary policies would have been very different during the past six years if all or part of the $4.7 billion that represented the net accumulation of dollars in the hands of foreign central banks had been settled by other methods, including presumably--in addition to gold sales--the issue of Roosa bonds, drawings on the International Monetary Fund, and further accumulation of dollars by private foreigners. True, the decline in the U.S. gold stock would presumably

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2/ This calculation treats prepayments of U.S. Government debts (totaling $3 billion) as "regular" rather than "special" transactions, for reasons stated on another occasion (see "The U.S. Balance of Payments, Present and Future," Federal Reserve Bank of Philadelphia, Business Review, June 1964, page 8). On the other hand, it treats bank-reported "long-term" claims of foreigners as "liquid."

have been more dramatic. But if the Administration and the Federal Reserve have refrained from more drastic action designed to reduce our payments deficit, they have done so not because they were complacent about the deficit but rather because they were--rightly or wrongly--afraid lest such action would hinder domestic recovery and expansion so badly as to cancel the advantages to be derived from a reduction in the payments deficit.

Hence, it seems doubtful, to say the least, that the present international payments system has played a decisive role in permitting the United States to tolerate its persistent payments deficit--quite apart from the question of whether such toleration has been harmful or beneficial to the economic welfare of the United States and of the free world in general.

Net outflow of liquid funds

But Mr. Exter's arguments not only fail to be supported by evidence of excessive monetary expansion in the United States or of a decisive influence of accruals of dollars in foreign official reserves on U.S. payments policies; his basic idea of an excessive flow of dollars from the Federal Reserve through the domestic economy into foreign hands is also based on fallacious interpretation of the factual data.

It is true that foreign gross holdings of dollar assets have increased considerably. But since the rise in these holdings is paralleled by a rise in dollar liabilities of foreigners, the net outflow of funds has not been large enough to make the dollar redundant abroad (see Table 2).

Between the end of 1958 and the end of 1964, U.S. liabilities to foreign countries reported by U.S. banking institutions increased by $9,419 million. But this rise was nearly matched by increases in U.S. official holdings of foreign currencies of $432 million, and in other claims on foreigners reported by banks of $7,807 million. Hence, the net increase in foreign bank-reported claims on U.S. residents amounted to only $1,180 million--an average of less than $200 million per year. Would Mr. Exter seriously maintain that this increase was out of proportion to the needs of financing international private transactions denominated in U.S. dollars, in a period that saw world imports rise from $100.8 billion to $158.6 billion, or by an annual average of little less than $10 billion?

When this reviewer first maintained, some months ago, that the alleged world redundancy of dollar holdings was a myth, 3/ this

3/ "The Machlup Report--A Critical Evaluation" (mimeographed paper, September 8, 1964).

statement was greeted with almost universal scepticism. In the meantime, the U.S. payments balance shifted again from near-equilibrium to heavy deficit; a major foreign country took the unprecedented step of calling for a world-wide run on the dollar; the United States had to bear part of the task of supporting, by dollar credits, British efforts to repel a speculative attack on sterling; and the international situation has added to market uncertainties. If foreign bankers, merchants, and investors really had felt that their dollar holdings were excessive, the combination of all these circumstances would certainly have resulted in wide-spread flight from the dollar and a rapid decline in foreign private foreign holdings. What actually happened was that in the six months from September 1964 to March 1965 private foreigners increased their dollar holdings in the United States by about $900 million.

And when the Federal Reserve, in executing its part of the recent efforts to eliminate the U.S. payments deficit, suggested a curtailment of the expansion of U.S. bank credit to foreigners, the suggestion--although approved by the foreign governments that had long urged drastic action to cut the outflow of U.S. capital--caused concern in the private financial community, which feared a return of the black days of the "dollar shortage." This fear was unwarranted since the Federal Reserve did not suggest an actual reduction in credits (except possibly in non-export credits to Continental Europe) but merely a slowing down of the unsustainably rapid expansion that occurred in 1964 and especially in the first six weeks of 1965. But the reaction of the markets showed that the financial community, whatever its spokesmen may be saying in formal addresses, was more worried about an abrupt end than about a continuation of the outflow of dollars. And the data on the changes in the net dollar position of foreigners help to explain that attitude.

Conclusions

Mr. Exter is right--needless to say--in urging again and again that steps be taken to end the U.S. payments deficit. He is particularly right in stressing that this deficit has a deflationary and depressing effect on the U.S. economy (page 13). The future will tell whether his scepticism about the effects of the recent Federal Reserve action will prove to be right or wrong. But more generally, Mr. Exter's thesis is quite correct when applied to the--usual--cases in which a payments deficit accompanies domestic inflation and overfull employment.

This reviewer only objects to the application of Mr. Exter's thesis to a situation like that in which the United States has found itself since 1958, when a payments deficit is accompanied by domestic underemployment and by conspicuous absence of serious inflationary pressure. The figures presented in this paper may illustrate the profound difference between such a situation and the usual case, and may thereby help in the search for a better solution to the problem posed by the U.S. payments deficit.

Attachment.

Table 1

Changes in Money Supply, 1958-64
(1958 = 100)

Country	Money (end of 1964)	Money plus "Quasi Money"	Industrial production (4th quarter 1964)	Ratio of money to production	Ratio of money plus "Quasi Money" to production
Austria	162	200	145	112	138
Belgium	143	154	140	102	110
Canada	138	138	141	98	98
France	213	224	138	154	162
Germany	170	203	153	111	134
Italy	205	210	166	123	127
Japan	254	311	259	98	120
Netherlands	150	185	164	92	113
Sweden	170	155	138	123	112
Switzerland	159	200	n.a.	n.a.	n.a.
United Kingdom	124	n.a.	131	95	n.a.
United States	115	138	144	80	96

Source: *International Financial Statistics*, April 1965.

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Table 2

Bank-reported Liabilities to and Claims on Foreign Countries, 1958-64
(In millions of dollars)

	1958			1964			Increase, 1958-64		
	Liabilities	Claims	Net liabilities	Liabilities	Claims	Net liabilities	Liabilities	Claims	Net liabilities
Europe	7,710	1,090	6,620	12,365	3,342	9,023	4,655	2,252	2,403
Canada	2,019	342	1,677	2,983	1,051	1,932	964	709	255
Japan	935	192	743	2,712	3,167	-455	1,777	2,975	-1,198
Rest of World	3,953	2,280	1,673	5,976	4,583	1,393	2,023	2,303	- 280
Total	14,617	3,904	10,713	24,036	12,143	11,893	9,419	8,239	1,180

Sources: Federal Reserve Bulletin, April 1965; Supplement to Banking and Monetary Statistics, Section 15.

Notes: Figures include both short- and long-term liabilities and claims reported by banks in the United States; claims also include U.S. official holdings of foreign convertible currencies. Long-term liabilities are broken down regionally, as follows: for 1958, $2 million to Europe; for 1964, $114 million to Europe and $85 million to Rest of World.

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