BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

September 12, 1962.

TO: Federal Open Market Committee

FROM: Mr. Young

Subject: Another European view of U. S. balance of payments policy.

The attached paper by Dr. Otmar Emminger, one of the most prominent German central bankers, presents a view of the U. S. balance of payments problem that differs somewhat from the position taken in Dr. Aschinger's article (distributed to the Committee members on August 30).

In particular, the paper shows better understanding of the domestic problems of the U. S. economy that might arise in consequence of changes in the level of long-term interest rates.

The translation, by the staff of the Board's Division of International Finance, is distributed for the information of the Committee members.

Ralph A. Young

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

Attachment

Handelsblatt, Dusseldorf, Germany, August 31, 1962

Capital Market Policy in the Shadow of the Balance of Payments -- A European-American Dialogue

(by Dr. Otmar Emminger, Member of the Board of the German Federal Bank)

The textbook proposition that international capital movements usually promote equilibrium in the balance of payments, i.e., that capital normally flows from countries with persistent current surpluses to those with continuing current deficits, appears to us, after the experience of the last few years, to require confrontation with the facts. In so doing I do not mean destabilizing speculative or "hot" money movements, or the special case of the developing countries, which in most cases are not in a position to attract private commercial capital without special official assistance. Even in capital movements between industrial countries a noteworthy discrepancy often appears to arise today between the structure of the current account and that of the capital account. Surplus countries such as the Federal Republic of Germany, France, and Italy have for years had the experience of a net capital inflow on top of surpluses on current account.

On the other hand, the United States has become in the last few years a clear example of a country whose balance-of-payments deficit has been appreciably accentuated by immense capital exports. Speculative capital comprised only a small part of this movement; the bulk consisted mainly of the normal long and short-term capital exports. In the four years from 1958, when the era of large American deficits began, to 1961, the United States had a payments deficit of $13 billion. In the same period, American private capital (long and short-term) in the same total amount of $13 billion flowed abroad. In the last two years of this period, 1960 and 1961, the outflow of American private capital, amounting to nearly $4 billion yearly, of which more than half was long-term capital, became a greater burden on the foreign exchange position than foreign military expenditures and foreign aid, and thereby became an important cause of the American foreign exchange deficit. In 1961, the capital export was actually by $1-1/2 billion greater than the total deficit of about $2-1/2 billion. Recently, an important part of this capital, above all in the form of direct investment but also in the form of bank credit, went to the highly developed industrial countries of Western Europe, and thereby augmented the surplus positions of many Western European countries.

Lately, there has been a lively discussion between West European and American currency experts on this point. It is agreed that the world needs American capital exports and the New York financial market, its only freely accessible and fully operational market. But do massive capital exports from the continuing deficit country, the U.S.A., to the surplus countries of Western Europe make any sense from the point of view of international economic and payments policy? Doubts on this point have developed in the last one or two years on both sides of the Atlantic. But less agreement exists between the two sides as to what corrective steps to take. Should not the European countries, and should not even more the deficit country, the U.S.A., bring the capital flow into better harmony with the payments structure? Is it simply a matter of adverse interest differentials between Europe and the United States, or are there more complex causes?

American Appeal to Europeans

The Americans ask that the European surplus countries accelerate the dismantling of their remaining exchange and other limitations on the export of capital, and also improve the functioning of their capital markets through appropriate reforms. Instead of burdening the American payments balance through borrowing in the United States, the European industrial countries should, according to the American view, be rather in a position to relieve the U.S.A. by satisfying the demand for capital on the part of the rest of the world, and also to increase their capital investment in the U.S. At a meeting of the American Bankers Association in Rome in May of this year, in which representatives of leading European central banks and commercial banks took part, the American Secretary of the Treasury appealed to the Europeans:

> "Potential capital funds are still too often dammed up behind national boundaries by legal restrictions or institutional barriers, even when any need for these restrictions has long since passed. Capital does not--as it should--flow freely from those with ample resources to the points of greatest need.... These conditions are an anomaly in a world of convertible currencies.... But progress toward a broader, more fluid international capital market does seem to me an essential part of our American effort to achieve and sustain international payments equilibrium. At the same time, more effective means of mobilizing the huge potential for savings implicit in the dramatic economic expansion of Western Europe must be developed if Europe is to fulfill its hopes for continued rapid economic growth in the years ahead."

In the area of private supply of international capital, America will thus shift a portion of the burden it has born heretofore to the stronger shoulders of the Europeans. But can Europe really provide more capital than heretofore to the rest of the world? The President of the

Netherlands Bank, Dr. Holtrop, expresses doubts in the Bank's recently published annual report for 1961. In this respect, however, much can quickly change, once the pent-up demand in Europe, especially in the building sector, and the overextended demand for capital connected with the present boom is satisfied. One cannot deny that many European surplus countries block capital export markets, through restrictions on the free export of capital by their citizens and through restrictions on access to their capital markets by foreign countries, to an extent that cannot be brought into harmony with either their foreign exchange position or their gross savings. Nor would anyone deny that most European countries, except Switzerland and Holland, lack the organizational prerequisites and institutions necessary to undertake organized capital exports in a manner comparable to the traditionally capital-export oriented American financial market. But does the solution lie really solely, or at least predominantly, in the removal of legal and administrative obstacles and in organizational improvement? The Federal Republic has for many years had no restrictions at all on the export of capital. Nevertheless, in spite of all efforts, it has up to now been unable to induce any private long-term capital export, which could offset the inflow of long-term capital. This experience demonstrates the difficulty of this American prescription. It is true that (from a macro-economic point of view) capital formation in the Federal Republic is very high relative to other countries. But in contrast to the United States and Switzerland, it takes place only to a relatively small degree in the organized capital market. Moreover, in part as legacy of the distant past, in part as consequence of the policy of subsidizing favored investments (housing, agriculture), the prevailing level of interest rates renders a continuing stream of capital exports from Germany difficult, if not impossible. In other European countries, with the exception of the low-interest oases of Switzerland and Holland, the situation on the organized capital markets with respect to availability and interest rates is similar to that of Germany. So long as a high level of economic activity prevails in Europe, it is very unlikely that a significant reduction in interest rates will occur in most of the countries; the prevailing rates for first class bonds range from 5-1/2 to 6-1/2 per cent, a level that is about 1-1/2 per cent above the comparable level of American interest rates. Nevertheless, one must concede to the American standpoint that the highly developed countries of Western Europe can save and supply enough resources to satisfy at least their own capital requirements. On the other hand, the realization of the American proposals beyond that point will require many reforms in the European capital markets, and cannot be expected to take place overnight.

A European Counter Proposal

No wonder that the Europeans in return suggest that the Americans correct the outflow of capital by a suitable orientation of monetary and capital market policy. Thus, the Bank for International Settlements expressed itself as follows in its most recent annual report, published in June:

"Prevailing opinion in the United States appears to consider it more desirable to move towards external equilibrium by raising the trade surplus than by lowering the capital-account deficit. Besides the fact that it is not a question of 'either ... or', this is a doubtful proposition in present circumstances, because the practical possibilities of raising the trade surplus over the next year or two are likely to be considerably less than the possibilities of narrowing the deficit on capital account. This requires a tightening of financial liquidity and an appropriate incentive from a higher level of interest rates to attract foreign investment funds to the United States as well as to keep U.S. funds at home. There is ample European experience to show that the possible internal restraint of a tighter monetary policy can be alleviated by fiscal and other policy means. Over the longer run the United States, as a great financial centre, should be an exporter of capital and have an interest rate structure that facilitates the investment of its excess savings overseas. Given its other burdens, however, the United States has no excess savings on external account at the moment, and it is not appropriate that the combination of policies followed on both sides of the Atlantic should be encouraging a net flow of capital towards Europe which has to be financed by U.S. gold losses and the piling-up of short-term dollar liabilities."

Other experts, including a Swiss economist testifying before a Committee of the U.S. Congress at the beginning of August, recommend that the United States, in the interest of its balance of payments, control foreign flotations and other large foreign borrowing in the manner practiced in Switzerland since 1934.

The American Reply

Responsible Americans have steadfastly rejected any form of control of their international capital movements, even in a partial or loose form; no doubt because of their basic commitment to a free market economy, but also on account of the position of the dollar as a leading international reserve currency, and finally because such control of capital movements would probably result in far more capital flight than the measure would save. The experience of the smaller European countries cannot always be transferred to a leading world currency.

The interest argument is accepted, but only for short-term capital movements; American efforts have been directed for some time toward holding the short-term rate in New York to a somewhat higher level that would be attractive to foreigners, while trying to prevent the increase, if possible, from affecting the long-term rate. The Americans have up to now refused deliberately to tighten monetary liquidity and to raise longer-term interest rates purely on balance-of-payments grounds: This would be in their view a "distortion" of the American capital market, whose present levels of interest rates correspond to the real demand and supply situation. Moreover, one cannot expect them to raise long-term interest rates for the entire domestic capital market in the face of the requirements of the internal economic situation, only in order to prevent a few hundred million dollars of capital outflow. The balance-of-payments effect of a higher level of interest rates is too small to justify the high domestic risks and cost of such a policy.

What the probable balance-of-payments effect of higher long-term interest rates involves, is shown by the fact that in the last few years, five-eighths of the American long-term capital outflow consisted of direct investment, which can hardly be influenced by relatively small changes in the interest rate level; and also by the fact that only part of the remaining three-eighths, which included purchase of securities, bank credit, etc., can really be influenced by interest rates (not, for example, the purchase of foreign securities by Americans, an important part of trade credits, etc.). The Americans are trying, as is known, to reduce direct foreign investment by reducing or eliminating certain tax advantages to earnings retained abroad, and on the other side they are trying in the areas of depreciation and taxes to make domestic investment somewhat more attractive.

Where Lies the Solution?

Whether a restrictive monetary policy and higher interest rates in the U.S.A. would really have so little effect upon the American capital outflow, and at the same time such a deleterious effect upon the internal American economic situation, is indeed difficult to say, and no general answer can be given. The answer depends not least upon the strength of other expansionary cyclical forces and especially upon the effects of fiscal policy. An increase in interest rates that results from rising demand for capital in an economic upswing should be judged differently from a deliberate increase in a situation of stagnation. On the other hand, one can certainly also discuss whether it would not be advisable, in view of a possibly imminent cyclical slowing down in Europe, to loosen up the narrow European capital markets, and thus at the same time accommodate somewhat the American point of view.

One conclusion appears to follow from the European-American dialogue: after all, it is perhaps no easier to bring the capital relationships and interest differentials between Western Europe and North America into conformity with the new requirements of payments equilibrium than to adjust other components of the balance of payments. It is perhaps even more tedious to revise traditional attitudes and institutions in the field of capital exports and imports than to reorient foreign trade. There is also no simple formula by which to dampen the enthusiasm of American industry for expanding their European base when European factors of production appear to be still relatively cheaper than the American, and when, moreover, the financial resources of American firms usually exceed those of similar European firms.

It is very probable that the solution cannot be found only in the restricted field of interest and capital market policy, but that it rather must be sought in the area of business cycle and cost policy. Insofar as the Americans succeed in mobilizing their reserves of unused capacity while maintaining price-cost stability, and thereby improve the competiveness and the profitability of the American economy, they can kill two birds with one stone. U.S. finance would thus be more strongly attached to the domestic economy (and its stock exchange), and stronger internal demand for capital might well lead by itself, without artificial monetary restrictions, to a higher level of interest rates on the long-term capital market. On the other hand, it appears that the end of the period of overexpansion in Europe is in sight; this will reduce the demand for capital and interest rate levels there, and also diminish the pull on American capital. Thus, the economic dynamism on both sides will perhaps eventually decide the structure of the capital relationships between Europe and the United States.

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