BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
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TO: Federal Open Market Committee

FROM: Mr. Young

The IMF report on its 1963 Article VIII Consultations with the United States, conducted in mid-May, has recently been submitted to the Executive Directors for their review and consideration. The Staff Appraisal section of this report is pertinent to recent discussions in the FOMC and, accordingly, copies are being distributed to the Committee for information.

Ralph A. Young

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

Enclosure

Staff Appraisal

(Excerpt from IMF report on 1963 Article VIII Consultations with United States)

The basic problems of economic policy in the United States are, as they were during last year's Consultations, the restoration of full employment without inflation and the attainment of balance of payments equilibrium. These two problems, as mentioned at the beginning of Part I, have turned out to be more stubborn than was envisaged at the time of the 1962 discussions; and the discussions this year did not indicate expectations on the part of the Government that full employment of domestic resources and international payments equilibrium will be achieved in the relatively near future.

As described in this report, underlying economic forces in the areas of prices, wages, and productivity would appear to be moving favorably for the United States, and these would be materially assisted by the present policies of the U.S. Government which were discussed with the staff. Thus, there would appear to be a good chance that the goals of both full employment and balance of payments adjustment will be realized in due course. Meanwhile, the staff wishes to stress, neither of these fundamental goals should be de-emphasized in favor of the other; both must be dealt with in the interests not only of the United States but of other areas of the world as well.

From an international point of view, steady growth of the U.S. economy at a satisfactory rate is of no less importance than a solution to the problem of the deficit in the U.S. balance of payments. The maintenance of adequate expansionary momentum in the U.S. economy is essential to the strength of the world economy, and it affects every country in the world. The quickening in the pace of U.S. economic activity during the first half of 1963 is an encouraging development of international as well as domestic significance.

In the view of the staff, the recent improvement in business activity does not make the case for a tax cut any less valid or timely. The basic problem of the U.S. economy is to accelerate the rate of expansion over a period of years and to eliminate the gap that has developed since the mid-1950's between the economy's potential and its actual performance. A sizable tax reduction would appear to be needed both to provide direct economic stimulus and to strengthen domestic and international confidence in the U.S. business outlook.

In the current year, the Administration's economic program has appropriately focused heavily on proposals to achieve tax reduction and reform. However, the staff believes that two other sets of measures could also be of great importance for the employment and growth picture in the period ahead, namely, measures (a) to deal with "structural" unemployment and (b) to increase the flexibility of the federal budget.

The structural element of current unemployment is clearly large, however difficult it may be to gauge the relative importance of general-demand versus structural factors in contributing to the high level of unemployment that has prevailed over the past five or six years. Moreover, structural unemployment will tend to become even larger under the impact of the labor force changes and the advances in technology looming in the years ahead unless a substantial expansion of training and education programs, on which there is a long lead time, is initiated at an early date. Such a tendency for structural unemployment to grow would render more difficult, if not thwart, the Government's attempt to reduce the over-all unemployment rate to 4 per cent or less.

Greater flexibility of fiscal measures is needed in order to deal quickly with future cyclical problems and, more generally, to increase the ability of the authorities to make effective use of short-run fiscal policy and thus avoid excessive reliance on monetary policy. Because budgetary decisions (as noted in the discussions) are slow-moving and affected importantly by non-economic considerations, a very substantial degree of inflexibility characterizes the present budget instrument; this is a limitation frequently underestimated or overlooked in proposals concerning the conduct of U.S. financial policy.

When attention is turned to the balance of payments situation, and to the policies appropriate for dealing with it, reassessment is indicated by reason of the lack of further progress toward equilibrium during the past year or so. Some general observations may help to put the problem in perspective.

1. Because of the size of domestic transactions relative to international transactions in the U.S. economy, measures in the field of general demand, whether they are exercised by fiscal or by monetary policy, tend to have, at least for a long initial period, a small balance of payments effect in contrast to a large internal effect. This limits the applicability of such general measures for the solution of balance of payments problems; and in this respect the United States presents a situation different from that of other countries.

2. The transactions of many countries with the United States form so large a proportion of their total international transactions that any initial improvement that the United States could produce in its own balance of payments at the expense of these countries would trigger countereffects or counteractions, either through the normal operation of private demand or through government measures that might have to be taken in these countries to protect their reserves. Therefore, the United States has to reckon, much more than other countries, with the consideration that the ultimate net effect of many balance of payments measures it takes is much smaller than their initial effect.

3. The balance of payments effects of measures taken by countries that have close economic ties with the United States are often highly concentrated on the United States. An example is the counterpart which the unusually large surpluses of Canada and Japan had in the U.S. deficit in 1962, especially in the second half of the year.

4. Because of its weight in international trade and capital movements, the United States must be more circumspect than other countries in using certain policy measures at all for balance of payments purposes. Thus, a smaller country may be able to generate for a few months an inflow of capital by a sharp rise in its discount rate; similar action by the United States would have such serious repercussions abroad that it could hardly be considered feasible.

5. Because the United States has less scope than other countries for use of measures producing quick improvements in the balance of payments and reserves, the United States must give relatively more emphasis to longer-run measures in seeking to bring about a change in the structure of its international transactions. By the same token, it is more important in the case of the United States than in that of other countries to ensure that the remedial balance-of-payments measures which are taken fit in with longer-run economic objectives. Thus, measures to curtail for a number of years the outflow of long-term capital in order to strengthen the U.S. balance of payments would be difficult to reconcile with the policy objective of assisting in the economic development of other countries through provision of capital.

6. The United States, in particular, must be careful to weigh the effects of any action it might take on the structure of the whole international financial system that has with so much effort been achieved in the postwar period. The U.S. representatives stressed that exchange controls, a change in the exchange rate, and deviations from the accepted commercial policy rules are out of the question as tools of U.S. international economic policy. In one field where the United States did take action contrary to the more or less accepted standards of nondiscriminatory conduct, namely, in the tying of aid, the staff--while understanding the considerations which led to this--fears that aid tying will probably be very difficult to dislodge if action on this matter must await the achievement of balance of payments equilibrium. The increased domestic preference applied to purchases for U.S. Government use may also be noted in this connection.

7. Finally, it is worth recalling the degree to which objectives and programs in a variety of other fields--such as military defense, aid to less developed countries, and maintenance of the dollar as a key reserve currency--impinge upon the U.S. balance of payments.

These observations may be summarized as follows: Because its international transactions are relatively so small within the U.S. economy but bulk so large in the rest of the world, the United States encounters special difficulties in trying to solve a balance of payments problem, and these difficulties are compounded by its special undertakings and obligations in the fields of foreign military assistance, economic aid, and provision of capital. Moreover, in the circumstances which have prevailed for the past several years, the under-utilization of manpower and capital resources has also limited the freedom of action which the United States has had in improving its balance of payments.

Since the spring of 1960, maintenance of a relatively easy monetary policy has been helpful to the domestic economy in a difficult situation of sluggish investment demand; pursuit of a policy of high interest rates to bolster the capital side of the balance of payments would have been clearly inappropriate from the standpoint of the domestic economy. Deliberate curtailment of the rate of credit expansion in a period of slack or wavering in the economy would not have been advisable, and in the conditions prevailing in the summer and fall of 1962, when yet another postwar recession was feared, it was helpful that monetary action of a somewhat expansionary character was decided upon.

With the quicker pace of business activity in recent months, the question of interest-rate policy deserves fresh consideration. In the analysis of this question, the staff believes that the following points merit attention.

(a) At the outset, it should be kept in mind that the U.S. Administration's tax proposals now under discussion do not envisage a tax cut of sufficient size both to restore full utilization of resources and to allow for any large "offset" effect of a deliberate forcing up of the level of interest rates through monetary action, and it would be unrealistic to suggest that this proposal be greatly enlarged so as to enable the economy to weather the shock of <u>much higher</u> interest rates for balance of payments purposes.

(b) It seems likely, although the relevant statistical evidence is unfortunately sparse, that <u>moderately</u> higher long-term interest rates would provide relatively little benefit to the capital side of the balance of payments. With long-term capital flows between the United States and most other countries apparently rather insensitive to changes in interest rates, a substantial lifting of the whole interest-rate structure--with an impact on wide areas of the domestic economy--would be required to effect any important gain on long-term capital movements.

(c) The evidence of the past few years suggests, however, a somewhat different attitude toward short-term rates. These rates have been held up and increased through official action. This has had little adverse effect on the economy; it has not prevented a sharp expansion of bank credit (as in the second half of 1962); and it has probably helped the balance of payments considerably. So far the U.S. authorities have not pushed this policy beyond the point where the covered New York-London rate is in equilibrium. This, however, leaves U.S. rates below uncovered rates in many centers, thus maintaining a cost incentive for foreigners to borrow in the United States or repatriate short-term funds and for U.S. residents to move balances abroad. Given the sensitivity of short-term funds to small interest-rate differentials, there would, in the opinion of the staff, be merit under present conditions in pushing the policy on short-term interest rates somewhat further as a means to retain or attract private short-term funds, while using open market operations (or equivalent measures) to ensure the appropriate expansion in the banks' effective reserves.

(d) The room for pursuing such a course of policy without some effect on long-term rates may now be quite limited, as brought out in the discussions; but the policy might well be carried to the point of permitting moderate increases at the long end, with the timing and magnitude depending upon current judgment as to the relative balance-of-payments and domestic effects. If the economy were to move up rapidly under the impetus of a tax cut, demand would tend to press upon the supply of capital as the expansionary process gathered force. This would tend in itself to bring somewhat higher long-term interest rates, which the authorities have made clear would be welcomed in those circumstances.

(e) It should be remembered that interest rates abroad, as well as those in the United States, determine the interest-rate differentials which affect capital flows in the U.S. balance of payments. Further declines of short-term rates in foreign countries would benefit the U.S. payments position, as would the removal of remaining capital controls and restrictions outside the United States (especially in other industrial countries), together with the development and improved organization of foreign capital markets. Conversely, if a rise in U.S. interest rates were followed by similar increases abroad, the beneficial balance-of-payments effects could easily be negated. Interest-rate policy in the United States should therefore be based on an understanding with respect to interest-rate policy in the major centers abroad.

As evidenced by the foregoing, it is the staff's belief that U.S. interest-rate policy in the period ahead should--if the economy's pace is satisfactory--move carefully toward higher rates through official action at the short end, in order to reduce the capital outflow in the face of a probable rise in imports with expanding industrial production.

Although the setting within which policy action on the U.S. balance of payments has to be devised rules out the quick and relatively easy solutions to which other countries can often resort, basic progress toward payments equilibrium may be looked for along a number of lines.

Some important additional savings are expected to be made in governmental expenditure abroad: by the further tying of aid and the reduction of net military expenditures overseas--the latter saving being potentially of greater quantitative importance but more time-consuming to implement. Over time, government efforts in other directions, such as export promotion, can likewise be counted upon to be of help. Also, investment income has been rising steadily at a rate of about $300 million a year, and is expected to rise further even if the rate of new investment abroad declines. It would appear, on the whole, that the balance on services account will in due course be considerably enlarged, permitting to that extent a reduction in the over-all U.S. payments deficit without an increase in the trade surplus or a contraction in the net outflow of capital.

Support for the balance of payments will also come from a more fundamental determinant, provided that the United States continues to be more successful than Europe in stabilizing prices and costs. Continued restraint upon costs and prices is therefore crucial at this juncture. Stability in the commodity price level and in unit labor costs over the past several years has been achieved under conditions of substantial unemployment and overcapacity, and intensified efforts in this area probably will be necessary when full expansion is under way. These efforts could benefit from organizational arrangements that would bring labor, business, and government together on this major policy issue.

Likewise to be considered are the effects on the U.S. payments situation of policies intended to restore the domestic economy to a condition of full utilization of resources. Achievement of this objective would tend to make investment in the United States more profitable, to help improve productive efficiency and U.S. competitiveness, and (as already suggested) to reduce the interest-rate gap with other countries. As against the gains from these sources, however, imports would tend to rise with sharply advancing industrial activity as the economy progressed toward full employment.

It seems clear from this review that there is little probability that equilibrium in the balance of payments will be achieved in the relatively near future--although it must always be borne in mind that the U.S. balance of payments contains large unpredictable elements, the determinants of which lie to a considerable extent abroad. In this situation, the staff is of the opinion that is is in the interest of the United States and of other countries for the United States to continue to seek equilibrium by means of the possibly slow adjustment through basic forces and policies, rather than by precipitate actions or crash programs that might be disruptive at home and abroad and that might well overshoot the mark. There can be no question, however, that this approach involves risks and requires the determined pursuit of a wide variety of policies for balance of payments purposes over a prolonged period.

The approach also involves acceptance of the probability that the cumulative deficit to be financed before equilibrium is attained may run to a much larger total amount than was envisaged until recently. In this connection, the newly developed technique of borrowing in foreign currencies has extended other countries' preparedness to add to their international assets in the form of claims on the United States. It must be expected, however, that further large deficits would entail considerable financing of a nature that provides the countries that are in balance of payments surplus either with gold or with enlarged creditor positions in the Fund.