BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

July 30, 1963.

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Mr. Young

Attached is a brief report covering the OECD meetings which I attended in Paris--two of them of Working Party 3 on July 19-20 and July 12 and the other of the Economic Policy Committee on July 10-11.

Ralph A. Young

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

Attachment

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REPORT ON ATTENDANCE AT
RECENT OECD MEETINGS

My European trip from mid-June to mid-July included two OECD meetings of Working Party 3, and one meeting of its parent Committee--the Economic Policy Committee. The first was a WP-3 meeting on June 19-20, the agenda of which included a review of the German capital market developments, a discussion of Canada's external borrowing and a detailed review of U. S. monetary policy.

Let me comment first on the review of U. S. monetary policy. Shortly following the June meeting, you received a copy of the report on U. S. monetary policy which I made at the meeting. Suffice it to add here that this report was favorably commented on for its illumination of the internal-external problem confronting the Federal Reserve and its clarification of the System's policy actions in dealing with it.

This discussion was followed by the Chairman's bringing forward a document which could serve as a basis for arriving at a consensus of the group's thinking. In original form, which carried forward from the preceding meeting, its tone was highly critical of U. S. monetary and fiscal policy and interest rate levels. But after discussion and in the light of my presentation, the tone and substance were considerably moderated. It was then accepted by the group as an internal aide memoire, representing primarily the views of the European delegations. Its main points of emphasis were:

(1) The need for the U. S. to improve its international capital account;

(2) The need, as conditions permit, for U. S. monetary authorities to reduce the ease of both short-term and long-term U. S. credit markets;

(3) The need for other major countries to avoid offsetting credit restriction and higher interest rates in their markets; and, indeed, as conditions permit, to pursue easier monetary policies;

(4) The need for the U. S. to finance its deficit with a view to minimum disturbance on the international payments system and for it to keep its payments problem constantly before public opinion; and

(5) The need for the U. S. to keep its aid-tying policy under constant review and to improve steadily its competitive position internationally.

A copy of the Aide Memoire, of which the foregoing are highlight items, is attached for your information.

The discussion relating to the German capital market conditions yielded mainly the information that Germany's internal boom, while earlier showing signs of lessening, was most recently showing renewed strength and that under these conditions no easing of short-term or long-term interest rates in German markets could be contemplated. Much consideration had been given within the German Government, it was reported, to a change in mix between monetary policy and fiscal policy, but difficult constitutional and political problems, it was felt, obstructed any such policy shift. Meanwhile, Germany was experiencing a sharp capital inflow, in part of short-term Euro-dollars and in part of long-term funds, but this inflow was not expected to continue and German payments might still show balance or only small surplus for the year 1963 as a whole.

The discussion concerning Canada related to Canada's heavy borrowing in the U. S. and whether Canada was relying too heavily on an interest rate differential vis-a-vis the U. S. to encourage Canadian borrowing in U. S. markets and in this way to build up rapidly and unduly its monetary reserves. The Canadian delegation concurred in concern about the volume of Canada's U. S. borrowing, but thought that in recent months temporary factors had swollen Canada's volume of U. S. dollar borrowings. In any case, the delegation denied any explicit policy of encouraging U. S. borrowing for purposes of building up Canadian monetary reserves.

The EPC meeting on July 10-11 was given to round-table reports from the major member countries on the current internal and balance-of-payments developments. The reports from France, Germany, and Italy were again concerned with rising costs and prices, with France and Italy contending that, though aggregate demand was not really excessive, conditions did call for monetary measures to moderate bank credit and monetary expansion, which had become excessive because of persisting balance-of-payments surpluses. The Italians argued that the fiscal instrument under present political conditions was unavailable to the government and therefore that they had to place reliance on monetary tools, though no precipitate action was contemplated or practicable. And the French contended that the restraints they had already applied would only keep bank credit expansion at a 12 per cent annual rate and have but moderate upward impact on French interest levels.

The British delegation felt that British fiscal and monetary policy, following the U. K. business readjustment of the late fall and early spring, now had to have generally stimulative objectives; and further that the U. K.

payments balance was sufficiently strong to permit an internal financial program along such lines.

The U. S. delegation gave a hopeful report on the recent U. S. internal performance and its prospects and felt that the major U. S. problem was to reduce international capital outflow while maintaining over-all domestic expansion. Somewhat higher interest rates, mainly at short-term, were in prospect as part of a broad-front program to cope with the problem of the U. S. payments deficit shortly to be announced by the President. The Europeans were strongly urged to give the U. S. program time to be effective and not to pursue policies that would promote higher levels of interest rates in Europe.

In the midst of the U. S. discussion and to the surprise of the U. S. delegation, Chairman van Lennep of WP-3 reported to the EPC that the WP-3 consensus was that the U. S. should move as soon as practicable to significantly higher levels of short- and long-term interest rates. This evoked some confused reaction from the U. S. delegation to the effect that the U. S. monetary operations for balance-of-payments purposes were to involve increases in short rates only since long rates were to be carefully shielded. The questioning prompted by this exposition could hardly be said to have been clarified by the further commentary the U. S. delegation offered. Having been absent from the U. S. for an interval, it seemed to me that the better part of wisdom for a Federal Reserve representative was to remain silent.

This whole discussion was brought to a head by the EPC Chairman in a summary which he wanted to forward to the OECD Council, and thence to the member governments. A copy of this summary, which is formulated in very general language is also attached. As originally presented, the biggest problem for the U. S. delegation was inclusion in the first draft of an outright recommendation, based on Mr. van Lennep's WP-3 report, that U. S. interest rates--short- and long-term--be raised appreciably. In the end, however, this recommendation was reduced to one that the U. S. take such monetary action as it could to curtail the capital outflow without impairing internal growth.

The WP-3 meeting which followed the EPC meeting again devoted itself heavily to the U. S. balance-of-payments problem. The discussion began with an explanation of how the U. S. expected to finance a payments deficit of as much as $3.5 billion. This, it was stated, was to be covered by intermediate-term borrowing from European countries, as large debt prepayments as could be encouraged, some accretions of foreign dollar holdings by willing holders, and some gold outflow--possibly as much as $1 billion. But the discussion shortly became a debate about the advantages and disadvantages of Treasury intermediate-term borrowings from European partners in payments surplus vs. a U. S. drawing from the Fund. The debate elicited information from our delegation that the U. S. planned to seek a standby drawing from the Fund in the amount of $500 million for technical objectives only. This gave rise to an extended exchange of views on the confidence aspects of any U. S. drawing, with the consensus favoring a test of public psychology by a standby of modest size and technical intent.

In this part of the discussion about the financing of the U. S. payments deficit, the U. S. delegation also emphasized the importance of

European debt prepayment, where this was possible. The upshot was that both the French and Dutch delegations disclosed plans for early sizable prepayments and intimated the possibility of further prepayments later in the year.

Following consideration of the U. S. payments problem, renewal of the U. K. standby drawing right of $1 billion from the IMF was reviewed. The Europeans were highly critical of this renewal, and suggested that the standby request should be for $500 million instead of $1 billion. The British argued, however, that with the financial uncertainties likely to be associated with an election sometime during the year ahead, they could hardly feel protected with less than a $1 billion standby. They stressed particularly that over the period of a year, the U. K. could not expect to gain much by way of additional monetary reserves even though its payments balance over-all turned out to be quite favorable. In the end, the British view of their own IMF standby drawing needs prevailed.

The balance of the WP-3 meeting was given to forward plans, especially the need for WP-3 to intensify its studies of factors influencing international capital flows, the functioning of the Euro-dollar market in relation to the international liquidity problem, and the continuing problem of payments imbalance between the major trading countries. The group adjourned with the prospect of a fairly full agenda for its fall and winter work.

Ralph A. Young

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Federal Open Market Committee.

Attachments 2

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AIDE MEMOIRE

Expressing WP 3 consensus re U. S. balance of payments and related capital flow problems, following the discussion at the WP 3 (OECD) meeting in Paris on June 20, 1963

(This Aide Memoire is not intended for circulation outside WP 3, other than to interested agencies of WP 3 member governments)

1. The Working Party heard a comprehensive recapitulation of the issue of action which the United States Administration is pursuing in order to close the underlying balance of payments gap, which has been running at $3 to $3.5 billion.

2. The Working Party directed its attention particularly to the external capital account because:

(a) A balance of payments correction of the size needed can scarcely be expected without a very substantial improvement on capital account.

(b) The restoration of levels of employment and rates of growth sufficient to absorb the savings potential of the United States and to generate adequate rates of profit is the only way of ensuring a permanently healthy capital account in the long term. This underlines the importance of the tax program directed to this end, but it is unlikely that the improvement which is needed on capital account will come about quickly enough if reliance is placed on such developments alone. The effects of rising economic activity in tightening monetary conditions need to be supplemented by the actions of the monetary and fiscal authorities.

3. To the extent domestic economic conditions permit, monetary and debt management policy should be directed toward less ease both at the short term and the long term ends of the markets.

4. The Working Party agreed that it was important that such control of monetary conditions in the United States, which may be expected to bring higher rates of interest, should in themselves be allowed to have their intended effect and should not provoke frustrating increases in other countries.

5. In this connection:

(a) They noted with approval that the present policy of the Canadian authorities is not to encourage a short term capital inflow or to seek a sharp and early increase in reserves.

(b) They noted also that the inflow of capital into Germany, which has started again, is unwelcome. The authorities have not found it possible to adopt a policy of active monetary ease to discourage the inflow. This underlines the importance of fiscal and other action to reduce the excessive demand for construction.

(c) More generally they took note of the contribution which could be made by the pursuit of easier monetary policies by other countries as conditions permit.

6. The Working Party also discussed the way in which the United States is hoping to finance its external deficit. Everyone agreed on the need to do this in a way which, at one and the same time, minimizes the degree of disturbance to the international monetary system and keeps the seriousness of the balance of payments deficit constantly before public opinion in the United States.

7. The Working Party took note that the United States authorities see a reasonable compromise between these competing needs in 1963 as being that they should finance their deficit by gold sales up to $1 billion, the remainder being financed through:

(a) Accumulations of liquid dollars by willing holders;

(b) The sale of bonds denominated in foreign currencies;

(c) Special transactions such as debt prepayment, military transactions and the like.

8. The Working Party took the view that this problem needed further discussion at a future meeting in which alternative solutions also might be examined.

9. The Working Party recognizes that some departure from the desirable standard of international economic behavior (e.g. tying of aid on a very extended scale, "buy American," etc.) may be temporarily unavoidable given the large expenditure the U. S. makes abroad for defense and aid as well as the need for quick reduction of the balance of payments deficit. But such measures should not be allowed to weaken

the resolve to carry through the more fundamental measures which will make them unnecessary subsequently or to build up vested interests (including high cost producers) which will make their ultimate removal difficult.

10. In the long run, correction of the United States deficit depends on improvement of the competitive position. An active government policy will be needed in order that cost stability shall continue as activity and employment rise.

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Summary of OECD Economic Policy Committee Consensus as prepared by Committee's Chairman following the discussions at the Committee's meeting in Paris on July 10-11

(This summary intended to be reported to the OECD Council and circulated to all OECD member governments)

COUNCIL

MEETING OF THE ECONOMIC POLICY COMMITTEE ON 10th AND 11th JULY, 1963

Report by the Chairman to the Council

1. The expansion of the United States economy this year has somewhat exceeded expectations. But the Committee noted with regret that action on the President's tax reduction proposals has been delayed. They emphasized the importance of a high and sustainable level of growth in the United States. Budgetary action is needed to achieve this, all the more so in order that monetary action may contribute more to the alleviation of the balance of payments problem. The Committee felt that if it continues to prove difficult to secure such action on the side of taxation, it would be desirable to seek to achieve the same ends on the expenditure side.

2. Since the Committee last met, the United Kingdom has taken substantial expansionary action in its 1963 budget. The expansion of production and the recovery of employment appear to be progressing at only a modest rate and the full effects of the budgetary action will take some time to show themselves. There was general approval of the judgment of the United Kingdom authorities that this is something to be accepted in the interest of avoiding overstrain later on. The Committee also emphasized the importance they attached to the development of an effective incomes policy by the United Kingdom.

3. In France, Germany and Italy, the authorities are concerned with the continued rise of costs and prices. In France and Italy tighter credit conditions are being used to deal with this situation, and in Germany the authorities have not found it possible to promote the easier monetary conditions which might have contributed to the reduction of long-term interest rates desirable from an international point of view. In Italy and Germany these policies in part reflect the fact that there is strong excess demand in the field of construction (though there is not general excess of demand). In Italy, the difficulty of adopting other measures has, for the time being, left monetary action as the main instrument available.

4. It does not seem likely that the policies being pursued in France and Germany will result in any undue repression of the general level of demand. This is less certain as regards Italy, where private investment demand is still weak and where the monetary authorities seem prepared to compress demand, at least for a time. In France, Germany and the United Kingdom, there are some signs that the pause or recession in private manufacturing investment, to which the Committee devoted some attention at their last meeting, may soon be coming to an end, and that some revival is foreseeable in all three countries.

5. With conditions developing in this way in the larger countries of the Organization, there should be a reasonably favorable climate for continued growth in the other countries; in fact, recent developments in short-term prospects seem generally favorable in almost all Member countries, though in some cases the rate of growth may be lower than before. There are, however, developments in the external field which clearly require attention at the present time.

6. Although balances on international trade and current account seem generally to have been moving in directions consistent with the establishment of better equilibrium, there have been very heavy accumulations of reserves in Europe during the first half of this year, particularly in France and Germany. The origin of this has been largely on capital account. At the same time, the United States has continued to run a heavy deficit overall.

7. These reserve movements may be modified in the second half of the year by the fact that:

(a) An important element in the capital flows to continental Europe was clearly the speculative sentiment about sterling which developed in the first quarter. When this abated, the movements to which it was giving rise seem also to have stopped.

(b) The French authorities have taken certain action designed to prevent the tighter credit conditions which they have established from attracting too big an inflow of capital on either short or long term account.

8. Nevertheless, the combination of monetary and capital market conditions now ruling in the United States and in Europe is helping to general disequilibrating capital flows.

9. This led the Committee to emphasize the importance of changing monetary conditions. In particular:

(a) The United States should take further monetary action that would help reduce capital outflows without impairing its internal growth;

(b) the continental countries mentioned above which are struggling against cost inflation should not rely on monetary weapons alone, but should make increasing use of other instruments as well.

10. The Committee was encouraged to hear that the French authorities are proposing to prepay some $200 million of external public debt.

11. The Committee agreed upon arrangements to enable the Secretariat to prepare, for its next meeting, forecasts of the broad movements of the supply and use of resources in 1964. The Secretariat will be communicating with Delegations to this end.

12. The Committee noted with interest proposals by Dr. Mueller Armack for increasing the degree of co-ordination with the similar work being performed by the E.E.C. in Brussels. The Secretary-General was asked to make any necessary arrangements with the European Commission to this end.

13. The Committee agreed with the Secretary-General's proposal that its Working Party No. 2 should be requested to study and report upon the problems of agriculture within the broad framework of the Organization's growth target.

14. The Committee agreed that each of the countries for which estimates of the movement of labor costs per unit of output are given in CPE(63)3 should send technical comments to the Secretariat, and invited the Secretary-General to arrange for this work to be carried further.

15. The Committee agreed to hold its next meeting on 6th and 7th November, 1963.