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*The Regulation of Bank Credits
Abroad: Another Failure
for the Government's
Balance-of-Payments Programs?*

ALLAN H. MELTZER is professor of economics at the Graduate School of Industrial Administration, Carnegie Institute of Technology. He asserts that the voluntary restraint programs laid on United States banks and other financial institutions have increased the outflow of gold from the United States, although the programs have reduced the United States payments deficit. In the years preceding the adoption of the programs, he observes, foreigners acquired a substantial volume of liquid dollar assets, especially claims on United States banks. He argues that the voluntary program has reduced the ability of foreigners to borrow dollars in the United States, and that, consequently, they have reduced their holdings of dollars.

The United States's balance-of-payments programs have failed. Although the government's program has achieved some of its other aims—for example, raising income and reducing unemployment—it has not succeeded in balancing our international accounts without a gold outflow. The magnitude of the failure is impressive. Between 1957 and 1965, we used \$9 billion of gold—

40 per cent of the stock of gold held in 1957—to settle our accounts with foreign countries. In 1965 the gold outflow amounted to 11 per cent of the gold stock held at the end of 1964 and was the largest percentage reduction in any year since 1958. There is no other period during the last ninety years in which the percentage reduction of the gold stock has been as large as it has been in the past eight years.

The increasing reliance placed on informal controls, guidelines, and threats is evidence of the failure of prior policies to achieve simultaneously the goals of price stability, increased use of domestic resources, and equilibrium in the balance of payments. When faced with a choice, United States policymakers followed the unfortunate tradition set by many foreign governments, imposing exchange controls or other restrictions on the use of resources and threatening to impose additional controls if present controls fail to stop the gold outflow.

Controls on international capital movements and other restrictions have been justified on the ground that there is a conflict between the domestic and international aims of policy. The way in which the conflict has been resolved suggests that domestic economic goals have been given the highest priority and the avoidance of controls a much lower priority. Choosing higher employment levels in preference to a larger gold stock can be defended on both social and economic grounds; the preference for a larger gold stock, purchased at a cost measured in units of freedom, is much harder to defend. But stating the issue in this way focuses too much attention on differences of opinion about the ranking of social priorities and too little attention on the economic consequences and on the success or failure of the exchange control program. Moreover, conflicts between long-term policy goals or objectives have been discussed frequently. Much less attention is paid to the costs of seeking short-term improvements at the expense of long-term adjustment. Informal controls and “jawbone” techniques are one manifestation of the importance policymakers attach to short-term gains.

This paper discusses one set of informal controls—the Federal Reserve’s guidelines for international lending. Since these guidelines are part of a program designed to achieve a variety of domestic and international goals, I will, first, list some recent policy goals

and discuss some of the conflicts among them that led to the use of controls. I will then argue that controls on foreign loans and investments (1) reveal a preference for short-term gains at the expense of longer-term gains, (2) conflict with the aims of United States policy, (3) have failed to achieve any significant, short-run improvement in the balance-of-payments position, and (4) have delayed the long-run adjustment. Finally, I will suggest an alternative approach, designed to achieve most of the goals of United States policy without the use of exchange controls or other restrictive practices.

POLICY GOALS AND ACHIEVEMENTS

Among the stated goals that policymakers have reaffirmed periodically, the following are most relevant to the present discussion:

1. wages should be tied to productivity;
2. domestic inflation should be prevented;
3. the outflow of gold should be stopped;
4. the dollar price of gold and the exchange rate should be maintained;
5. unemployment should be reduced;
6. the European Common Market should be strengthened;
7. tariffs should be reduced and world trade liberalized and expanded;
8. the growth rate of output should be maintained at a high level.

The list is long and could be made longer by adding the desire to change the distribution of income, to aid less developed countries, to maintain military commitments, or to keep the dollar as a reserve currency. There is little point in embarking on a lengthy discussion to establish that policymakers have multiple goals, some of which conflict with other goals. Choices among goals, or ends, are inevitable in a world of limited resources. Moreover, there is little point in debating here about the goals that have been chosen or the priorities that have been assigned.

It is instructive, however, to consider how many of the stated aims have been achieved and to ask whether more would have been accomplished if different priorities had been assigned or if different means had been used to achieve the chosen ends of pol-

icy. First, I will discuss the achievements and failures of recent policy and outline the analysis that formed the basis of the choices that have been made. I will then suggest an alternative policy which would have been more successful in achieving some of the stated ends of the policymakers.

There are two clear successes and one apparent success during the past five years: the real growth rate of the economy has increased and unemployment has been reduced. While the dollar price of gold has been kept at \$35 an ounce and the official exchange rate has been maintained, the exchange rate policy has been only partly successful. The United States is not the first country that claimed to maintain fixed and uniform exchange rates while introducing a number of restrictions that increased the cost of particular foreign exchange transactions. The so-called interest equalization tax and the restrictions on loans and investments abroad are de facto changes in the exchange rate for particular commodities.

Policy has failed to achieve the other five goals on the list. Although the wholesale price index rose less in 1961-64 than in the middle or late 1950's, the increase during the last eighteen months has eliminated most or all of the improvement in price stability. Trade and capital restrictions have been increased, not reduced. Wages have increased faster than the Council of Economic Advisers' measure of average productivity.

The Kennedy administration inherited a balance-of-payments deficit, an economy in which substantial parts of the labor force and capital stock were unemployed, and commitments to fixed exchange rates, to strengthen the Common Market and to expand world trade. Their first attempts to deal with these problems were based on four main propositions: one, the domestic economy could be stimulated by a tax cut or an increase in the government's deficit; two, the balance of payments could be improved by the use of restrictive monetary policy; three, long-term interest rates could be reduced to promote domestic investment while short-term interest rates were raised to attract an inflow of short-term capital; four, tariff negotiations could be used to reduce barriers and restrictions against exports from the United States and other countries to Common Market countries and, thereby, contribute to an improvement in the United States's balance of payments, the growth of world trade, and the development of underdeveloped countries.

Some of these proposals offered short-term programs to expand the economy and to temporarily slow or stop the gold outflow. Others were steps toward a long-term adjustment of prices in the United States, relative to prices abroad, that were expected to produce a long-run adjustment of the balance of payments. Of the latter, one of the more important proposals was for negotiations leading to lower tariff barriers and liberalized trading arrangements, the so-called Kennedy round of tariff negotiations.

Unfortunately, the trade negotiations produced scarcely any result. This means that, with fixed exchange rates, United States exports could be increased only to the extent that export prices were low enough to offset the disadvantage of foreign trade restrictions. Many companies attempted to circumvent the trade restrictions by building or buying plants within the protected area. As businessmen are fond of noting, a large part of our increase in exports and our improved trade balance is owing to an increase of exports of machinery and materials to branch plants and new subsidiaries in Common Market countries.¹

Thus the failure of trade negotiations to liberalize trade contributed to an increase in capital investment in Europe. Since long-term interest rates in the United States were lower than long-term interest rates abroad, non-financial corporations borrowed in the United States to finance foreign capital outlays. Financial corporations also attempted to benefit from the difference in interest rates between the United States and Europe or Japan, so that in some (but not all) recent years, the banking sector contributed to the balance-of-payments deficit.

The policy of encouraging domestic investment by reducing long-relative to short-term interest rates conflicted with the policy-makers' desire to bring the balance-of-payments problem to an early end. A continuation of borrowing in the United States and investing abroad would, eventually, have eliminated the substantial differences in long-term interest rates between the United States and foreign countries that existed in 1961. The increased demand in

¹ For example, see the statement of Richard Fenton, president of Pfizer International, to the National Industrial Conference Board, February 17, 1966. Some of the relevant data is given in the *Survey of Current Business*, December, 1965.

the United States raised long-term rates in the United States relative to rates in major trading countries abroad; the increase in the growth rate of the domestic economy raised the expected return to investment in the United States in absolute terms and relative to the rate of return on investment in foreign countries. Some evidence that part of the adjustment of long-term interest rates had occurred by 1964 is shown by the changes in these rates between 1961 and 1964. United States long-term rates rose relative to those in Canada, the United Kingdom, France, and Japan.² The reduction of the difference between interest rates and expected returns at home and abroad was in the direction of long-run adjustment of the payments imbalance.

A widely discussed part of the government's program was based on the proposition that the domestic economy could be stimulated by a tax cut while the balance of payments was improved, temporarily, by the use of restrictive monetary policy. Three points should be noted, however. First, most of the gain from this policy was expected to come from a reduction in short-term capital movements as a result of higher short-term interest rates. This short-run gain could be expected to last only as long as differences between United States and foreign short-term interest rates remained sufficiently small. Balances that flow in to obtain more favorable yields flow out just as quickly when yields fall. Second, the longer-term effect of monetary restriction came through the reduction in United States prices relative to the prices in foreign markets. Relative price deflation offset some of the trade restrictions imposed by Common Market countries. Third, the policy of monetary restrictions was not maintained. Instead, the Federal Reserve increased the money supply by approximately \$20 billion during the three years ending in December, 1965, one of the largest and longest periods of monetary expansion in peacetime history.

The increased rate of monetary expansion stimulated the economy. Later, the 1964 tax cut supplemented the stimulus provided by expansive monetary policy. For a time, short-term interest rates were maintained at an almost constant level by a combination of

² Based on long-term government bond yields for the United States, Canada, the United Kingdom, and France, local government bond yields for Germany, and the bank lending rate for Japan.

increases in the money supply and in the government's outstanding stock of interest-bearing debt issued to finance budget deficits.³

Later, the expansion of output and the continued expansion of money spilled over to prices, and the price level began to rise.

On this interpretation, there was one major conflict between goals in the initial phase of policy. Long-term adjustment of the balance of payments would have been achieved sooner if productivity increases had been used to reduce prices rather than to maintain wages, or if long-term interest rates had increased more and employment had increased less. Prices and interest rates in the United States, relative to foreign prices and interest rates, however, moved in the direction appropriate for the long-run adjustment of the balance of payments.

The more important conflict was between the desire to stop the outflow of gold and the desire to maintain a fixed dollar price of gold. Had we chosen to abandon fixed exchange rates and the fixed \$35 per ounce price of gold in 1961, it is unlikely that we would have lost more gold than we have in the past five years.⁴ The balance-of-payments adjustment would have been completed. Instead, the government became impatient with the slow rate of adjustment and started the second phase of the program. A number of ad hoc measures were introduced, appeals to patriotism became more frequent, but most of the adjustment toward balance-of-payments equilibrium was cancelled.

The second phase of the government's program began with the introduction of a restriction on capital movements—the interest equalization tax—in the summer of 1963. The movement toward controls on capital gathered momentum in 1965 with the introduction of “guidelines” for lending and investing.

³ The policy from 1962 to 1965 can be viewed as a mirror image of the policy during 1946–51 when interest rates were pegged by the Federal Reserve. During much of the pegging period, Treasury debt retirement kept interest rates low, and thereby reduced the quantity of money that the Federal Reserve had to issue to maintain the peg. For further discussion see K. Brunner and A. H. Meltzer, “A Credit Market Theory of the Money Supply and the Explanation of Two Puzzles in Monetary Policy,” *Essays in Honor of Marco Fanno* (forthcoming).

⁴ Liquid liabilities held by foreigners were approximately \$22 billion at the end of 1960, and the monetary gold stock was approximately \$17.5 billion. Even if foreigners had been frightened into converting $\frac{1}{4}$ of their holdings, we would not have lost more gold.

Conflicts between the goals of United States policy increased during the second phase. Further reductions in the unemployment rate were obtained by maintaining and later increasing the rate of monetary expansion. Prices rose, and part of the earlier adjustments of domestic to foreign price levels was cancelled. The conflict between fixed exchange rates and other policy goals remained. A new conflict arose between short-term reduction in gold outflow and long-term balance-of-payments policies equilibrium. I will consider the last problem below, after discussing the Federal Reserve's guidelines for foreign lending in more detail.

THE FAILURE OF THE GUIDELINE POLICY

President Johnson's balance-of-payments message of February, 1965, called upon the Federal Reserve to take a major responsibility for improving the United States balance-of-payments position. As Chairman Martin said: "For the second time in less than two years, a national program to reduce and eventually eliminate a large international payments deficit has been launched. Our first program, begun with President Kennedy's message to Congress of July 18, 1963, met for a time with a measure of success, but in the course of last year, signs of fresh deterioration appeared."⁵

The new program, introduced in March, 1965, consisted of "voluntary" restrictions on foreign loans by banks and non-bank financial institutions and on investments by United States corporations abroad. Foreign loans had risen approximately 20 per cent in 1964 and were continuing to rise in early 1965. Banks were requested to limit their increase in foreign loans to 5 per cent of their 1964 year-end totals. Non-bank financial institutions had also increased their holdings of Euro-dollars and foreign loans in 1964. They were asked to limit short-term balances and investments abroad to the 1964 year-end total and to take steps toward gradually reducing such balances to the 1963 year-end total. Longer-term investments of non-bank financial institutions were permitted to increase no more than 5 per cent above the amount held at the end of 1964.

⁵ Statement of William McC. Martin, Jr., before the Subcommittee on International Finance of the Senate Committee on Banking and Currency, March 10, 1965, reprinted in the *Federal Reserve Bulletin* 51 (March, 1965): 399-404.

Later, adjustments in the "voluntary guidelines" were introduced to eliminate some of the opportunities for avoiding or evading the March guidelines, to permit banks with foreign loans of less than \$5 million in the base period to increase foreign loans by more than 5 per cent, and in December, to extend and revise the guidelines for 1966. The 1966 guidelines permit banks to increase foreign loans by an additional 4 per cent of their 1964 base, at the rate of 1 per cent per quarter. Non-bank financial institutions are requested to increase long-term investments abroad by no more than 4 per cent of the 1964 base and to restrict short-term investments to the September, 1965, total. Foreign branches and subsidiaries, including Edge Act Corporations, are included in the program.

In making loans under the guidelines, banks and other financial institutions are requested to give first priority to loans that finance exports. Second priority is given to loans made to less developed countries, and to Japan, Canada, and the United Kingdom. Loans made by the government's Export-Import Bank, and commercial banks' participation in loans guaranteed or insured by the Export-Import Bank or the Federal Credit Insurance Association, are exempt from the guidelines and are not included in the ceiling applicable to a particular bank.

The broad purpose of this program is to "defend the dollar," a vague phrase which, when defined, usually includes the maintenance of the dollar as a reserve currency. One effect of the guidelines has been contrary to this frequently stated aim of United States policy. By assigning priorities that reduce the volume of loans to finance trade between third countries, non-export loans to developed countries and local-currency expenditures outside the United States, the guidelines work to reduce the use of the dollar as a reserve currency, as I will show more fully below.

This feature of the guideline policy is typical of the government's approach to the balance-of-payments problem. Another inconsistency becomes apparent, if we consider the relation of the guidelines to the goal of maintaining fixed exchange rates. Fixed exchange rates are often defended on the grounds that they remove uncertainty and thereby promote world trade. A program that gives priority to United States exports and restricts loans to finance trade between third countries has a much less lofty purpose. The state-

ment of priorities in the guidelines suggests that the goal of increasing world trade has been replaced by a program of not hampering United States exports. In any case, it is difficult to find merit in the argument that world trade should be increased by restricting capital movements.

There has been little attempt, however, to justify the program in terms of world trade or world economic welfare. The original announcement of the guidelines makes clear that the purpose is to promote the administration's interpretation of the national interest. The announcement states: "Decisions on specific loan transactions must be made primarily with an eye to the national interest rather than profits. The achievement of the President's goal will be in the long-term interest not only of the nation, but also of the individual institutions which are being called upon to forego immediate advantage or gain."⁶

The last quotation raises the questions about the content of words such as "the national interest" and "the President's goal." I will consider this subject below. Before doing so, let me discuss the reasons for choosing a voluntary program and some of the results achieved to date.

The government chose to present its program as "voluntary" and informal, rather than mandatory and formal, for pragmatic reasons. Chairman Martin's candid statement to the Senate Banking and Currency Committee makes clear that the government considered taxes on bank loans, akin to the interest equilization tax, and formal exchange controls. These more formal methods were rejected not only because exchange controls are "repugnant to the principles of our economic system," but also because they were likely to be less effective. A "tax statute can hardly avoid some opportunities for legal escape," and "experience everywhere has shown that exchange regulations, if couched in general terms, can be avoided as easily as a special tax; and if elaborated in great detail, can become so oppressive that they also hamper business activities beneficial to our payments situation."⁷

⁶ "Guidelines for Banks and Non-Bank Financial Institutions," *ibid.*, p. 371.

⁷ *Federal Reserve Bulletin* 51 (March, 1965), see especially pp. 402-3. Note that the emphasis is placed on the United States balance of payments and not on the dollar as a reserve currency.

The desire to avoid exchange controls while restricting foreign loans meant that the meaning of "voluntary" had to be twisted. Detailed prescriptions and proscriptions are given, reports are expected, and, as already indicated, priorities are established for certain types of loans and for particular countries. Nevertheless a substantial effort has been made to present the program as a voluntary effort by bankers. Three reasons for choosing to present the program as "voluntary" are of interest.

First, it is unlikely that the program could have been introduced as quickly if it had been submitted to Congress. The program clearly discriminates in favor of banks that have been making foreign loans for some time and against new entrants, particularly banks in inland cities and non-bank financial institutions. Congress—particularly the Chairman of the House Banking Committee before whom such legislation would come—generally prefers a more uniform distribution among the states than was provided by the guidelines and might have delayed passage while awaiting the testimony of bankers in the hinterland, the managers of non-bank financial institutions, or perhaps until "more equitable" controls were designed. The administration would have been hard-pressed to defend the provision under which loans made under commitments entered into during the first two months of 1965 counted against an individual bank quota and, if in excess of the yearly quota, were to be reduced by the end of 1965. This provision was particularly offensive to the inland banks, many of whom entered the market for foreign loans in 1964. No doubt it would have been equally difficult to defend a provision discriminating against non-banks, under which non-bank institutions were told to reduce liquid and short-term assets to the 1963 or 1964 year-end total, whichever was lower, and banks were asked to refrain from increasing such assets.

Second, by making the program appear "voluntary," the Federal Reserve was able to impose controls on non-bank financial institutions. The cooperating institutions range from commercial and mutual savings banks through investment, finance, and insurance companies, to mutual funds, pension funds, college endowments, charitable foundations, and state retirement funds. Congress has been reluctant in the past to extend Federal Reserve authority to non-member commercial banks, so there is reason to believe that

it might have refused to grant authority under which the Federal Reserve could regulate all financial institutions. Moreover, the Federal Reserve had no clear idea in March, 1965, of the precise regulations that it wished to apply to the non-bank institutions. The guidelines for non-banks remained "tentative" from early March to late June, 1965, while information on the foreign asset holdings of such institutions was collected and processed.

I want to emphasize the way in which the controls on non-bank financial institutions were introduced. There is no other case to my knowledge in which controls were applied by an agency that had no authority to regulate, without a clear idea of the regulations that were to be applied and without information about the magnitude⁸ of the problem they sought to control. I hope I am correct in assuming that Congress would have been reluctant to grant authority to the Federal Reserve under these circumstances.

The administration was convinced, however, that control of commercial bank lending would prove ineffective without similar or more stringent controls on non-banks. Commercial banks had approximately \$10 billion of loans outstanding at the end of 1964 and had increased foreign loans by 18 to 20 per cent during the year. The data eventually collected from the non-banks showed that these institutions held \$9.7 billion in foreign assets and had increased their foreign assets by \$1 billion (11 per cent) in 1964. The failure of the interest equalization tax taught the administration that one form of loan is a substitute for another. Unless the more obvious substitutes were regulated, controls on commercial banks could be expected, at most, to reduce the capital outflow for a short time. After a few months, substitution of non-bank loans for bank loans would have renewed the outflow of credit to foreign countries.

A third reason for making the program appear voluntary is implicit in much of what I have said above. A minimum amount of explanation to Congress and of congressional action was required if the program could be presented as a voluntary program. The

⁸ See Robert L. Sammons, "Voluntary Restraint by Financial Institutions," "The Balance of Payments Problem," Management Bulletin No. 68, American Management Association, 1965, pp. 17-21. Mr. Sammons is Adviser, Division of International Finance, Board of Governors of the Federal Reserve System.

only formal action I have found that Congress was asked to take as part of the voluntary program was contained in a bill that exempted banks and other financial institutions from prosecution under the anti-trust laws for discussing or entering into agreements. This legislation came before the Judiciary Committees of the Senate and House, rather than the Banking Committees, and focused attention on the broad purposes of the program, while avoiding discussion of the details of the financial controls. Chairman Martin made clear that the administration hoped to avoid establishing a cartel, or some NRA-type arrangement, under which bankers would be given authority to allocate a given amount of foreign loans among themselves. To date, they have been successful.⁹

In fact, the program has been an overwhelming success when judged by the aggregate measures that have been presented by spokesmen for the Federal Reserve and the administration. Table 1 summarizes some of the information provided by the government to support their position. The table shows that, through September, 1965, banks and non-banks alike remained well within the guidelines. Preliminary data for 1965 as a whole (not shown) suggests a similar conclusion. Banks acquired no more than one-third of the \$500 million in additional foreign assets that they were permitted to acquire under the program.

TABLE 1
GUIDELINES FOR AND RESULTS OF THE REGULATION
OF FOREIGN ASSETS
(in billions of dollars)

Holder of Foreign Assets	Amount Outstanding		Ceiling
	12/31/64	9/30/65	12/31/66
Commercial banks	9.49	9.48	10.44
Non-bank financial institutions* . .	3.39	3.10	3.25
Total	12.88	12.58	13.69

* Ceiling on assets over ten years applies only to assets in developed countries other than Canada and Japan.

SOURCE: *Survey of Current Business*, January, 1966, p. 16.

⁹ Chairman Martin's statement is reprinted in *Federal Reserve Bulletin* 51 (March, 1965).

A subsidiary goal of the program was to give priority in non-export loans to underdeveloped countries, to Canada, and to Japan. The data in Table 2 suggest that this part of the program was only moderately successful. Claims against Europeans declined about 5 per cent and claims against Japan increased about 5 per cent. But loans to Latin America increased much more slowly than in the previous year, and claims against Canadians decreased most rapidly. The totals, however, do not permit any judgment to be reached about changes in the quantity of loans demanded by firms or residents in the various countries. We know that banks could have made more loans to foreigners while remaining within the guidelines, and we know that the growth rate of output declined in Europe. But the growth rate of output declined in Japan also, without a similar reduction in United States loans to Japan. Moreover, opportunities for making profitable loans within the United States were much greater in 1965, so some inland banks may have found the guidelines a convenient reason for withdrawing from the foreign loan market.

The data in Tables 1 and 2, therefore, do not permit a firm conclusion to be drawn about the success of the guidelines. All that can be said is that claims against foreigners increased much less rapidly in 1965 than in 1964. More convincing evidence that the

TABLE 2
SHORT- AND LONG-TERM BANKING CLAIMS BY REGION
END OF YEARS FIGURES, 1963-65
(in billions of dollars)

Region	Volume of Claims		
	1963	1964	1965 *
Europe	2.05	2.95	2.80
Canada93	1.33	.94
Latin America	2.76	3.51	3.59
Asia †	2.94	3.97	4.17
Other32	.47	.64
Total	9.00	12.23	12.14

* Preliminary.

† Mainly Japan.

SOURCE: *Treasury Bulletin*, February, 1966, pp. 98-99.

guidelines reduced foreign lending by banks and financial institutions can be obtained, however, by considering data for a longer period. The outflow of dollars resulting from loans and investments abroad was considerably smaller in 1965 than in any year since 1956. One would have to argue that a fortuitous decline in the rate of increase of the demand for United States bank loans in 1965 just happened to coincide with the government's program and reduced the outflow of dollars, attributable to the action of the financial system, to the lowest level in recent years. This argument is implausible.

These findings suggest that the guidelines have been effective. But they are a peculiar way in which to judge the effect of the policy. The reason is that there are two sides to a bank's balance sheet. When we look at what happened to the liabilities to foreigners of the United States banking system, it is much less clear that the guidelines contributed significantly—if at all—to achieve the aims of the United States balance-of-payments program in 1965.

Table 3 shows changes in assets and liabilities of the financial system during the past fifteen years. While these data have been collected in different ways at different times, the information is sufficiently accurate to give a reasonable summary of the contributions to the balance of payments by the financial sector. A minus sign in the table indicates an outflow of dollars that must be offset by some inflow or by a loss of gold.

During 1965, foreigners reduced their deposits in United States banks for the first time in fifteen years. The reduction was partly offset by purchases of United States securities. Column 2 of Table 3 shows, however, that net liabilities to foreigners decreased and contributed more than \$200 million toward enlarging the outflow of gold. In 1964, the increase in liabilities to foreigners contributed more than \$2.5 billion toward financing the balance-of-payments deficit. Since the deficit was not reduced by an equal amount, the net effect of the one year reduction in liabilities meant that part of the \$2.8 billion had to be paid in gold. Column 3 shows that claims against foreigners—loans and investments by the banking system abroad—contributed toward a reduction of the balance-of-payments deficit. In 1964, the rise in loans and investments abroad added \$3.16 billion to the balance-of-payments deficit. This amount fell to less than \$1 billion in 1965, a balance-of-payments "gain"

of more than \$2 billion. The gain from reducing the rate of increase in foreign loans was not sufficient, however, to offset the loss of gold resulting from a decline in foreign deposits in United States banks, shown by the net movement in column one.

On balance, the banking sector contributed more to the outflow of gold in 1965 than in any postwar year, almost twice as much as in 1964, the last full year without controls. Viewed in terms of their effects on both assets and liabilities of the banking system, the guidelines appear to hinder the government's attempt to stop the gold outflow. This interpretation may be extreme. All of the reduction in deposit balances may not be the result of guidelines or controls. Large changes in the rate of growth of deposits have occurred in prior years, as the table clearly shows. Moreover,

TABLE 3

NET MOVEMENTS OF BANKING FUNDS AND TRANSACTIONS IN
LONG-TERM SECURITIES WITH FOREIGNERS, 1951-65
(in billions of dollars)

Negative figures indicate a net outflow of dollars from the United States

Year	Net Movement (1)	Changes in Liabilities to Foreigners (2)	Changes in Claims on Foreigners (3)
1951.....	-.39	.07	-.46
1952.....	1.22	1.56	-.33
1953.....	1.28	1.09	.19
1954.....	.52	1.42	-.90
1955.....	.94	1.37	-.42
1956.....	.42	1.49	-1.08
1957.....	-.94	.37	-1.31
1958.....	-.90	.99	-1.89
1959.....	3.34	4.35	-1.01
1960.....	.48	2.27	-1.79
1961.....	-.40	1.91	-2.31
1962.....	.30	1.82	-1.52
1963.....	-.84	1.89	-2.72
1964.....	-.52	2.64	-3.16
1965.....	-1.05	-.21	-.76

Detail may not add to total owing to rounding.

SOURCE: *Treasury Bulletin*, March, 1966, p. 86.

foreigners—particularly those in Germany and France—may have withdrawn deposit balances because of differences in interest rates only partly the result of the guidelines policy, or for reasons completely unrelated to the guidelines.¹⁰ For many of the same reasons that all of the reduction in the growth of foreign loans cannot be attributed to the guidelines, the total reduction in liabilities cannot be attributed to the guidelines either. The most that we can say without much more detailed analysis is that the United States increased its deposit liabilities to the rest of the world each year prior to 1965 and that the guidelines contributed to the 1965 reduction in deposit liabilities.

The guidelines may have given a little assistance to the balance of payments in 1965, or they may have done a little harm. They are far from the overwhelming success that the proponents of the guidelines claim. By pointing to only one side of the ledger, the Federal Reserve and the administration have given a distorted picture of the effectiveness of their “voluntary” form of exchange control.

LONG-TERM EFFECTS ON THE BALANCE OF PAYMENTS

Economic theory implies that welfare is increased when individual decision units take prices and profits as their guide in allocating resources. The Federal Reserve's program of restricting foreign loans proposes a different standard, and makes explicit that the framework just described is no longer regarded as useful. Priority is now given to achieving the President's goals, since, we are told, these goals are in the long-term interest of the nation and of financial institutions.¹¹

It is not uncommon for governments to justify restrictions by asserting that the aims of national policy are of overriding importance, and it is not impossible to find or to conceive of cases in which the governments' argument can be justified. Government control of the money supply is a case in point. Much harm can be,

¹⁰ One common explanation of the increased loss of gold attributes the outflow in 1965 to the policies of the French government. The gold loss, net of shipment to France, however, was larger in 1965 than in other recent years.

¹¹ *Federal Reserve Bulletin* 51 (March, 1965): 371.

and has been done, however, in the name of the public interest.

One of the tasks of economists is to analyze the effect of government programs and to see whether the programs are likely to achieve their stated goals without considerable interference with other aims of public and private policy. More often than not, the government's longer-term goal is not stated explicitly, and the economists' task is to discover which part of "the public interest" is being promoted by the proposed restriction. The case at hand is an example of the latter. In this section I discuss the effects that the program of loan restrictions is likely to have on the ends or goals that appear to be equated with the national interest for this purpose.

The discussion in the previous section suggests that the program has not yet contributed to the short-run adjustment of the balance of payments. Moreover, the data suggested that the control program does not contribute to longer-term goals, including the desire to maintain the dollar as a reserve currency and the United States as a world banking center. Foreigners have found other banking centers in which to keep their deposits and make loans. There is no reason to expect that the position of New York as a world financial center will be restored until the controls are removed or made less severe. The goal of keeping the United States as a world banker cannot be the goal that is being equated with the national interest.

How well does the program serve the goal of achieving long-run balance-of-payments adjustment? The answer is, not well at all. I have already indicated that if the gold outflow is to be stopped while the exchange rate is maintained, balance-of-payments equilibrium can be restored only by adjustments of prices and interest rates. United States prices must fall relative to foreign prices and interest rates in the United States must rise relative to foreign rates. The exchange control, or loan restriction, program works in the opposite direction. It diverts loan demand from the United States to foreign countries and requires United States corporations to finance foreign investments abroad, raising interest rates abroad relative to interest rates in the United States. These effects are in the direction opposite to the changes required for long-run adjustment.

Furthermore, investments and loans are made abroad in the

expectation of profits. Profits on foreign investment produce a return flow of dollars to the United States. Foreign investments stimulate exports to subsidiaries and open new markets to trade, thereby reducing the balance-of-payments deficit. Behrman estimates that an outflow of dollars for foreign investment produces a *net* contribution to the United States balance of payments in about three years.¹² Repayments of bank loans presumably cancel the balance of payments "drain" caused by the loan, and interest received on the loans "improves" our balances-of-payments position. It is by no means clear, therefore, that action taken in response to the profit motive is inimical to the "national interest."

These considerations suggest that our policy is short-sighted, a conclusion that would receive support if it gave the United States a short-term advantage. About the only advantage I can find is that the proportion of foreign loans held by the United States banking system is reduced, and the proportion of domestic loans is increased, per dollar of new base money issued. The program might have been defended on these grounds a few years ago, if analysis could be developed to show that domestic employment was being harmed by the diversion of bank credit to Europe. It is doubtful that this conclusion can be supported, or even that it is supportable, and in any case, the argument is quite irrelevant at the present time. Our present problem is that the rate of growth of both the money supply and bank credit contribute to domestic inflation.

In short, I can find no long-run advantage in the program. The most that can be said for the restrictions is that they might help to maintain fixed exchange rates and temporarily reduce the gold drain. Although the restrictions did not do this in the first year—and probably did the opposite—policymakers may expect that in the second or subsequent years loans to foreigners will increase less than deposits to foreigners decrease. There is no reason to expect this result. The policy raises foreign interest rates relative to United States interest rates and thus makes foreign markets more attractive places in which to keep interest-bearing deposits and in which to buy earning assets. Moreover, the United States is inflating faster relative to foreign countries than in the past, further

¹² J. N. Behrman, "Private Foreign Investment," *Journal of World Business*, 1965.

increasing the cost of foreigners of holding dollar deposits.

Even if the restrictions manage to bring about a reduction in the gold outflow, the program cannot be regarded as successful until it achieves balance-of-payments equilibrium without controls. Here the long-run results of the program are contrary to any short-run benefits. Since the spread between foreign and domestic interest rates is increased, any gains made as a result of the controls will be lost once the controls are removed. There might be some hope of removing controls in a period of recession in Europe on the argument that interest rates abroad will fall at such times. During recession, however, prices in Europe are likely to fall, or rise less rapidly than in the past. A peculiar piece of good fortune is required to get the combination of relative interest rates and prices that permit controls to be removed.

Many countries have attempted in the past to adjust to a balance-of-payments deficit by imposing a few "temporary" controls. Generally, the first set of controls becomes permanent, and new "temporary" controls are introduced. Most experience of this kind suggests that the resolution of the problem has been found in devaluation. The United States has much greater resources than other countries which can be used to make the adjustment, but so far the resources have not been used to bring about an adjustment.

Many of the failures of administration policy appear to result from a belief that balance-of-payments equilibrium will be achieved in the near future and can be hastened by introducing ad hoc measures and controls. Cagan's recent study suggests that the opposite is true.¹³ He found that adjustments of prices and interest rates to restore balance-of-payments equilibrium, at times, required decades.

Among Cagan's results for the eighty-year period 1875-1955, one is particularly intriguing. His data show that the ratio of the monetary base (bank reserves plus currency) to the gold stock has fluctuated widely but has frequently returned to approximately two. Broad swings in the ratio, and/or in the gold stock, correspond to long-run changes in the purchasing power of gold. When the

¹³ Phillip Cagan, *Determinants and Effects of Changes in the Stock of Money, 1875-1960* (New York: Columbia University Press for the National Bureau of Economic Research, 1965), pp. 52-67.

index of the commodity value of gold rises, gold flows in, and the money supply and the domestic price level rise, unless offset by changes in other sources of the monetary base. The rise in the domestic price level lowers the commodity value of gold and induces a gold outflow. If domestic monetary expansion is too large relative to changes in the gold stock, domestic prices rise more rapidly, the commodity value of gold declines, and gold flows out sooner. This reduces the stock of money, unless offset by other monetary policies, for example, open market operations that increase the monetary base and hence increase the ratio.

TABLE 4

THE RATIO OF THE MONETARY BASE TO GOLD AND AN INDEX OF THE COMMODITY VALUE OF GOLD, 1956-65

Year	Ratio of the Monetary Base* to Gold	Index of the Commodity Value of Gold†
1956.....	2.17	98
1957.....	2.23	93
1958.....	2.31	91
1959.....	2.44	91
1960.....	2.75	90
1961.....	2.97	90
1962.....	3.19	90
1963.....	3.43	90
1964.....	3.66	90
1965.....	4.32	88

* The monetary base is the sum of bank reserves plus currency.

† The (approximate) ratio of the current dollar price of gold (\$35.00) to the price of gold in 1926 (\$20.67), 1.7, divided by the index of wholesale prices base 1926 = 100.

If we interpret a value of two as the approximate long-run equilibrium value of the ratio, we can judge the extent to which recent monetary policy has moved away from equilibrium. Table 4 extends Cagan's data for the ratio and for the index of the commodity value of gold to 1965. These data show that the commodity value of gold has declined as the monetary base has risen relative to the gold stock. The decline in the commodity value of gold is a result

of the increase in the wholesale price level brought about by the relatively high rate of increase of the monetary base and the money supply. Further increases in the domestic price level and further decline in the commodity value of gold are to be expected if the rate of growth of the monetary base continues.

The table gives no indication of price changes in other countries. Sufficient inflation abroad will, of course, drive gold back to the United States. A recent issue of the *Review* of the St. Louis Federal Reserve Bank, however, gives estimates of the growth rate of the money supply and the increase in prices for six foreign countries.¹⁴ In France, Germany, and Japan, the money supply has grown more slowly in the last year or two than in previous years, while in Italy, Belgium, and the Netherlands, the rate of monetary growth has increased. But none of these countries show a rate of price change larger than our recent increases, so these data also suggest that the gold outflow will continue.

One source of long-run adjustment is usually dismissed without much consideration—the increase in the world's stock of gold owing to increased gold production resulting from the discovery of new mines or from an increase in the purchasing power of gold. The Soviet Union has recently discovered a new source of gold that can be mined profitably at current prices. Cagan found that, on several occasions in the past, new gold production contributed to an expansion of world trade and to maintaining fixed parities. Without some increase in the world's stock of gold, it is difficult to see how the United States could restore the ratio of the monetary base to gold to two, at the present price of gold, without a major change in the current goals of policy, a severe decline in the stock of money, and increased unemployment.

CONCLUSION: AN ALTERNATIVE APPROACH

United States's balance-of-payments policy has been based on the notion that a price of \$35 per ounce of gold is a constant to which all policies—domestic and foreign—must adjust. For some, any conflict among increased use of domestic resources, price inflation, and a fixed dollar price of gold should be resolved by choosing

¹⁴ *Review*, Federal Reserve Bank of St. Louis, March, 1966.

policies that maintain the price of gold. The European restrictions against United States exports are recognized as one feature of the international economy that delays or prevents adjustment that is unlikely to be removed. Federal Reserve controls on foreign loans and other autarkic devices are justified as necessary to reduce the United States balance-of-payments deficit and the gold outflow.

The difficulty with this line of argument is that it is based on a false premise. If the analysis in this paper is valid, Federal Reserve policy—both controls and recent excessive increases in the money supply—make the balance-of-payments deficit and the gold outflow larger and delay a return to equilibrium. Other voluntary controls, guidelines, and restrictions increase our problems. One example will be cited. In 1964 the administration prevented banks from increasing prime loan rates on the grounds that higher interest rates were not in the interest of the public. Had the increase taken place, banks in the United States would have closed an additional part of the gap between foreign and domestic rates and thereby lowered the demand for loans by foreigners. Instead, the increase was prevented, loans to foreigners increased, and restrictions were imposed to reduce foreign loans.

At present, the money supply is growing at a rate of more than 6 per cent per annum. This rate of monetary growth has caused increase in the domestic price level. Continued inflation will increase the gold outflow, delay the balance-of-payment adjustment, and encourage the administration to add some of the controls they have threatened to those that they have already imposed.

It is not difficult to outline an alternative approach to the current policy problem that avoids controls, prevents inflation, maintains employment of domestic resources, and eliminates the problems posed by the continued balance-of-payments deficit. Three steps are required: First, the controls on foreign transactions should be removed; second, the growth rate of the money supply should be reduced; third, the dollar price of gold should be left to the determination of the market.

These proposals call on the government to recognize that its balance-of-payments program has failed, and that recent inflation and controls on foreign loans have offset most of the adjustment toward long-run equilibrium made during the period ending in 1964. Recent price increases generate expectations of further in-

creases. The larger the expected increase in prices, the smaller is the rate of growth of the money supply that prevents prices from rising. The longer price increases are permitted to continue, the larger is the likely reduction in domestic employment required to restore price stability.

Policymakers are fond of quoting an old saw to the effect that policy must always be made in the short run. The statement is either a truism or a mistake. The Federal Reserve's policy of domestic inflation and restrictions on foreign loans moves us away from our long-term goals and does not achieve short-term objectives. Balance-of-payments adjustment is a long-run problem; an appropriate solution is to recognize past history as it affects the dollar price of gold and to let the market make the appropriate adjustment in the exchange rate.
