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THE INTERNATIONAL BALANCE OF PAYMENTS

Dr. Carl T. Arlt

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Reviewed by: Colonel J. H. M. Smith 26 November 1962

INDUSTRIAL COLLEGE OF THE ARMED FORCES

WASHINGTON, D. C.

1962 - 1963

The International Balance of Payments

12 September 1962

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THE INTERNATIONAL BALANCE OF PAYMENTS

12 September 1962

CAPTAIN BRYCE: No study of the U. S. economy can be meaningful or complete without an examination of our international trade balance of payments and the gold question. These are subjects are are not well understood, and even much misunderstood.

The college is very happy to have with us today Dr. Carl T. Arlt of the Federal Reserve Bank of St. Louis, making his fifth appearance before an ICAF audience.

Dr. Arlt, it's a pleasure to have you back and to introduce you to the Class of 1963.

DR. ARLT: General Stoughton, and fellow worriers over the U. S. Gold Stock:

I speak with a great deal of humility with reference to the balance of payments. It's a complex subject. In fact, talking about humility, I was one time lecturing on this subject before a university class at Cornell and in the middle of my lecture some student who had attended a party the night before was a little bit loaded and he got up in the middle of my story and said, "Mr. Arlt, you're stupid." Well, I, with my professorial aplomb ignored him. In about another five minutes he got up again, he staggered forward and he said, "Mr. Arlt, you're stupid." Well, I got a little bit hot about that, but I didn't do anything. And then, finally about ten minutes before the class ended he just came right up to my desk and stuck his hand practically in my face and said, "Mr. Arlt, you're stupid." At which point I became angry and said, "Mr. Smith, you're drunk." And he said, "That may be so, Mr. Arlt, but tomorrow I'm going to be sober and you're still going to be stupid.".

Well, it is with a certain feeling of stupidity - at least humility - that I approach this subject. You can't really look at any action in public policy today without having it relate to the balance of payments situation. Why, even the Foreign Missions units of our churches have to worry about what they're going to do to the gold problem when they send money over to some foreign missionaries. It goes as far as that. And, as you know, you can't talk about a wage question in the United States without thinking of its impact on the balance of payments. The heat with which Kennedy approached the steel companies not long ago reflected the balance of payments - etc. As before, everything reminded me of women; now in public policy everything reminds me of the balance of payments.

Now, understand, you have to go through a certain amount of the mechanical details before you get a full appreciation of this balance of payments problem. So, what I want to do is go through a few of these concepts. First, this term, "Balance of Payments." What do we mean by the balance of payments? What do we mean by a balance of payments deficit? All right. You were supposed, I believe, to have brought to the lecture some reading material, and I'd like for you to turn just briefly to this Morgan Guarantee Survey of May '62 - page 4. Now, you have some other pieces of literature; you have some material from the Federal Reserve Bank of St. Louis. But this Morgan Guarantee is good too. I'd like to refer you to this schedule of payments and receipts.

Now, a balance of international payments for a given country is a summary statement of what this given country has done by way of transactions that require payment to the rest of the world. Here are these listed as "debit transactions" over on the left-hand side. These are transactions that require payment to the rest of the world. Then there is also a summary statement of the transactions that require payment from the rest of the world to the United States - "credit transactions" we call those. Now, I don't want any of you accountants to get worried about debits and credits and try to fit them into these particular categories. Just bear with me and say that this material here - any payment transaction - is going to be called a debit, and any receipt transaction is going to be referred to as a credit. We have a summary, then, of these transactions, and what we do in the course of reporting all these transactions, we total them all up, we make separate categories of different types of transactions; notice it runs from merchandise imports - goods that are bought; then, services rendered by foreigners to U. S. residents, which would include, for instance, transportation, tourism and insurance.

If you buy an insurance policy from Lloyd's of London you're importing an insurance service. If you go traveling abroad you're a tourist. You're creating a payment transaction to foreigners. Whether you know it or not you may be aggravating the gold situation, under present circumstances, when you go to France, for instance, and you visit one of these French nightclubs. You're importing beautiful memories. Well, let's get back to work here.

In addition to that, you are paying out, when we see income on investments in the United States by foreigners. Foreigners invest in U. S. securities and the American corporations have to pay interest and dividends on those securities. That is a payment transaction. And so on down the line. Some of the more important ones in addition to the merchandise import would be the net government unilateral transfers to foreigners, that I'd like to call your attention to. These are the grants in aid programs that we have. And couple that with the net U. S. Government investment abroad. This would really refer essentially to loans made by the government in its foreign aid progam. So, there are two categories of foreign aid - grants and loans, by the United States Government. These are payments abroad. And then we have another very important item that has been gaining a lot of attention lately - net U. S. private investment abroad. It may involve putting money into a plant abroad by an American corporation. It may involve you and I going out and buying securities in a foreign corporation. This is in the category of long-term investment. And then, in this thing of net U. S. private investment abroad we have all the so-called short-term capital outflows.

For instance, if you, with a beady eye see the interest rate in London a little higher than the interest rate in New York City, on Treasury Bills, you might get a sharp pencil out and figure how you might make some money by shifting some money into London assets. And you might do this for just a short period of time - two or three months. This would be termed a short-term capital outflow. Or, some people move money out of the United States if they are worried about something happening in the United States. In 1960 some people were afraid that Kennedy was going to win and they sent capital out of the country. You have situations like that developing, and when we talk about net U. S. private investment abroad we refer both to the long-term categories and the short-term categories of investment.

Now, lining it up with these credits - I won't go into any of these other items on the credit side, but I want you to see what we do then, we look at the total of recorded credits and the total of recorded debits. We find that as far as the recorded transactions are concerned we spent more than we received. If you look at that item - total recorded credits of $28 billion - $28 billion plus - and our total recorded debits; these are our payments out, of $30.7 billion. While you're doing that notice as far as your export and import of merchandise commodities are concerned. This is something you always have to do. The United States is in a unique position here. Almost without exception the United States has been able to sell more goods than it has been buying - merchandise items. In 1961, notice that it bought $14.5 billions of goods, but sold $19.9 billion, in merchandise. We had what we call a favorable balance of trade; the balance of trade represented in a surplus of exports over imports. Despite that, when you start totaling up all the other items in this balance of international payments you'll find that our balance of payments exceeded our receipts, thus giving us a differential in the total, of $1.8 billion, as far as recorded transactions are concerned.

Now, this is getting close to what we are getting at when we talk about the deficit in the balance of payments. When our payments exceed our receipts we build up a deficit. And we've been having deficits every year since 1950, with the exception of 1957 when the Suez crisis developed a tremendous volume of merchandise exports.

Now, there is a tricky gimmick here in this balance of international payments. We say, "Well, we had an excess of payments over receipts. How do we settle it? I mean, after all, somethings got to give in this thing." You turn to the other page and that short form mathematics of the balance of payments, and you find that as a measure of the deficit we did a number of things. First of all, there was a net sale of gold of $858 million. In other words, if our payments exceeded our receipts how do we settle for that differential? Well, one of the ways we did it we sold gold. That's a perfectly desirable commodity. That was an export you might say. We transferred the ownership of gold from the United States to a foreign country. It doesn't mean that the gold physically leaves the country. It usually moves from the Treasury Assay Office to a bin in the Federal Reserve Bank of New York. The Federal Reserve Bank of New York slaps a label on it and says "Bank of England." England owns it now instead of the United States. Maybe the gold moved 50 feet. But it now belongs to England, or France, or Germany.

Now, we settled part of this differential, then, in our excess of payments over receipts, by gold. One thing we did, we used some of our gold to buy some convertible currencies, so you'll notice in this particular transaction they netted our increased holdings of convertible currencies which I'll explain a little later, against the gold sales, and therefore we had official gold sales of $742 million.

How else did we settle the deficit? One of the more typical ways - and this is what you'll find - if we settle a balance of payments deficits, as far as we are concerned - what we do is we give to the foreigners increased dollar holdings in the United States. They have over here increase in liquid liabilities to foreigners. When we pay out more than we receive you'll find what that results in is an increase in dollar holdings of German banks, French banks, German individuals, French individuals; they hold bank accounts in the United States. Or, they may invest their dollars in United States short term Treasury Bills. They may put them in time deposits. But they have dollar claims against the United States. We refer to that, in a sense, as short term borrowing. How do we settle our deficit? Well, we had a whole total flow of payments which exceeded the total flow of recorded receipts. We balance that off, in part, by selling gold; another part by selling IOUs which gave the foreigners more dollar holdings in the United States.

So, we say the measure of our deficit would be the net change in gold - with this correction about convertible currencies - and the net change in foreign holdings of U. S. dollars, we'll say in New York banks. But then, any person with a pencil will say, "Now, look, Buster; you said that the difference between recorded transactions on the credit side and recorded transactions on the debit side was about \$1.8 billion. Look at what happened over here on this page six, though. You point out that there was a change in gold of 858 or so, and the increase in liquid liabilities around 1.7; that's a total of 2.4. How do you account for the difference between \$2.4 billion which represented, you might say, a net change in our liabilities in gold, and the difference between the recorded transactions - credits and debits?"

The person who makes up the balance of payments says, "What this means is, that there were some transactions that must have escaped our reporting systems." If you have lost gold of \$712 million or so, and if your dollar liabilities have increased to 1.7 to give you a total deficit of \$2.4 billion, then what must have happened in addition to the deficit on the recorded transactions of \$1.8 billion, here, you must have had what we call "unrecorded transactions." We economists have gotten away from the term "errors and omissions." Unrecorded transactions is sort of a euphemism for errors and romissions. And, actually, of course, in this complex accounting procedure the errors and omissions are unrecorded transactions and become a residual item.

But, you come to the logical conclusion that if you've lost gold and you build up the dollar liabilities to the foreigners something must have happened, namely in the form of another flow of payments out. We call those unrecorded transactions and we have here $616 million. It's called "the reconciling item" - errors and omissions. I've spent some time on this just to give you a better understanding of what we mean by the international balance of payments and what we mean by a deficit in the balance of payments, and how we measure a deficit in the international balance of payments.

Now, the meat of what I want to say is this; not so much how do we contract the deficit. We might mention a few items, but the main thing is to raise the question, "How do deficits lead to an increasing accumulation of foreign-held dollars in the United States?" Secondly, "Why does an increase in foreign-held dollars inevitably lead to a decrease in gold?" Because, I think the public worry is essentially fixed on this declining gold supply. You've got to sort through a number of transactions to be able to explain why. When you do have a deficit and a continued deficit, why do we lose gold? And remember, the decline in gold has been a serious item in the eyes of the United States, and in the eyes of the rest of the world.

We had about $23 or $24 billions of gold in 1949 - '47 to '49 - give or take a year. We're now down to $16 billion and we're still losing gold. We've lost about $800 million this year. We lost about $700 million the year before. In the period of four years prior to 1961 we lost about $6 billion. So, we're losing gold. The American public is asking the question, "How do we stop it?" Well, my first reaction is that we at least ought to know how we lose it. And what the mechanism is by which we lose it. So, let's proceed to that by answering the question why does a deficit lead to an increase in dollar holdings.

Now, briefly, I think that one can point out that the essence of international finance, if you follow through a few points here, is a trading in bank balances. When I want to buy goods from a foreign country I can't pay in dollars basically; there has got to be a conversion of one currency into another. I go to my bank. Maybe my bank holds a balance in a foreign country. The only way I can make a payment that's satisfactory to, we'll say an English exporter, is to pay him in pounds. He has to pay his workers in pounds. He can't pay them in dollars. He has to buy his groceries in pounds. He can't pay for them in dollars. So, there has to be a conversion in currency, particularly if I, as an importer, initiate the transaction and want to buy goods. I pay in dollars in the United States, and somebody in the United States sells me a chunk of a pound balance that they hold over in London, and then I can make my payment to the exporter.

Then, you may say, "Supposing the English exporter says you can write out a check in dollars and pay him?" I say okay, if you're going to pay the English exporter in dollars it's still going to require the conversion of currency because the English exporter will have a claim on dollars and what he usually does is to sell the claim on dollars to some bank in London that wishes to hold a dollar balance in the United States. And the English exporter gets his pound. What I'm getting at, then, is that either way you look at it, if there is a payment to be made from the United States to England it's going to involve a conversion of currency balances. It's going to involve a switch from dollars into pounds, or switch from dollar claims into pounds. And this is the essence of international finance, the necessity of converting one kind of currency into another. We have banks specializing in inventorying bank balances all over the world.

U. S. banks hold balances in foreign countries. Foreign countries hold balances in the United States. Now, if we are to receive payment, then it could work one way or the other. Where do we receive payment? Either claims on foreigners increase and we build up balances abroad, or, those dollar balances which the foreigners hold in the United States decrease; that is, if we are to receive payment or have a receipt transaction. So, I will make one generalization; I'm cutting through this. You've done the reading and you're experts already. I'm just hitting the high spots on this point. Generally, I mean, if you look at international trade without looking at all the institutions, payments from the United States abroad would either lead to a decline in American-held balances abroad, or an increase in foreign-held dollar balances in New York.

Payments from abroad to the United States would either lead to an increase in American-held commercial bank balances abroad or a decrease in foreign-held balances in the United States. You're still asking the question, "Well, now, how do you account for the fact that it always seems to be that when there are payments made by the United States abroad, that instead of just reducing our balances abroad it seems to always lead to an increase in foreign-held dollars in the United States?"

I merely submit that the dollar has become an important medium of exchange. Most of your international trade transactions, apparently, are denominated in dollars. So that, we've reached the point that when we want to make a payment abroad it means that foreigners get claims on dollars. If people abroad want to make payments to the United States it means that they eat into their dollar balances in the United States.

Now, the dollar is an important medium of exchange. And one of the facts of international life is to recognize that the dollar is very, very important and why it is important. In the first place, one of the characteristics of the dollar is that it has been considered as good as gold. Since 1934 the United States Treasury has been willing to sell gold at the rate of $35 an ounce. I put a parenthesis here; they are only willing to sell to official institutions - governments and central banks; not you; not me. You and I can't get gold except little bits for teeth and jewelry, but that's all. But, the United States has been willing to sell. It keeps the dollar tied to gold at $35 an ounce.

Another thing contributing to the wide acceptance of the dollar as a medium of international exchange is its record of convertibility. We've not put any restrictions on dollars. If foreigners held dollar balances they could use those balances to finance any type of transaction. This hasn't been so for foreign currencies until about 1958. If you held a balance in France in the immediate post-war period you weren't sure just how you might be able to use that balance. France might say, "Yes, you can buy champagne with that dollar; you can do that, but you can't buy goods from Germany with that balance. It would take a dim view of that. They have restrictions imposed. Just as if, for instance, you had a balance in the Riggs bank in the District and you wanted to write a check on it to buy tickets to the World Series. And suppose the Riggs Bank had a regulation and said "We don't like those Yankees and we don't approve of your going to the World Series, we just like our Washington team here, therefore you can't use the balance to buy that particular thing." That's what we had in the immediate post-war period; restrictions in the use of currencies. You couldn't convert those foreign currencies into something else. With the dollar you could always do it. Therefore, if you were going to accept payment you'd like to accept it in the form of dollars because you knew you could use the dollars all over the world.. So that, it had a good record for convertibility.

Another thing too that enhanced the status of the dollar; in 1944 was the Bretton-Woods Agreement. The International Monetary Fund gathered all the nations together and said, "Now, look. We're going to establish a structure of exchange rates. Each member country will identify its currency in terms of either gold or dollars. You see, the dollar was tied up, because the dollar was converted into gold by itself, and if you tie it up with dollars you are indirectly tying it to gold. And, you will find, for instance, that in this most recent article in September '62, of the Federal Reserve Bank of St. Louis - you can cut through some of the deathless proes; I won't tell you who wrote the article - only modesty would prevent me from telling you - but on Table I, page 7; in this case I want you to see that by the International Monetary Fund Agreements and by the European Monetary Agreement in 1958, countries have gotten together and agreed on the basic currency par of exchange.

You'll notice that now the pound is quoted at $2.80; that's the basic parity. And the Canadian dollar 92 1/2¢, and so on down the line. These parities are all expressed in terms of dollars, you might say, for purposes of international transactions. This has built up the dollar as a very important medium of exchange. Another factor that has made the dollar so important is that commercial banks - foreign commercial banks - like to hold dollar balances in the New York money market because the New York money market is so big and you can do so much with it. The people are borrowing and lending in terms of dollars and the foreign commercial banks like to get in on this. So, the dollar is an important medium of exchange.

Now, what I am getting at is, because the dollar is the important medium of exchange and everybody has his transactions denominated in terms of dollars, now if the United States' payments continually exceed its receipts, as recorded in the international balance of payments, that's going to show as a growing accumulation of foreign-held dollars. Now you raise the question, "So what? An accumulation of foreign-held dollars; how does that relate to the gold problem?" My point at this juncture is that if there is an accumulation of dollars into the hands of foreigners a considerable chunk of these dollars fall into the hands of central banks - official institutions.

I'll just call your attention to another Federal Reserve publication; the one of May 1962. In that case, on page 11, that table there, notice the total of foreign-held dollars in the United States, running from 1951 to a little bit below $8 billion, all the way up to now about 18 1/2 or 19 billion of foreign-held dollars, excluding those held by international institutions. What I'm getting at is, if you look at the total of $18 1/2 billion, and you find that of the total there are about $11 billion held by official institutions. And about $8 billion held by private institutions; private foreign institutions, commercial banks, etc.

Now, what is the significance of the official holdings of dollars? Simply this; that it is the official institution; the Central Bank of England, the Central Bank of France, that has the right to go to the Treasury and say, "Look, we've got dollars and we want gold." The Treasury recognizes that, and without batting an eyelash the Treasury sells gold to these official institutions when these official institutions are able to present dollars. And the official institutions are getting dollars because of the continuing deficit situation in the United States which has led to an over-all accumulation of foreign-held dollars.

One of the ways that the central banks get hold of them is that the commercial banks and private corporations that acquire dollars in the course of developing claims on the United States sell their excess holdings in dollars to the central banks, and the central banks will give them marks, pounds, etc. So that, the central banks get hold of these dollars. Now, the central banks like to hold dollars, and this raises another point. There is some thing the central banks like to do. They like to have reserves of an important currency. They like to hold gold. The central banks, as a matter of policy, always like to have a supplementary foreign exchange reserve - a total reserve - so that if a given country gets into difficulty and has to make a lot of payments and the commercial bank doesn't have the balance to make those payments, the central bank can unload its holdings of a key currency; it can unload gold to acquire the necessary currency or whatever it needs to finance its particular excessive transactions.

So, as a matter of policy the central banks throughout the world will hold reserves of gold and important currency. Now, the central banks are willing to hold dollars for some of the reasons I've mentioned. They're as good as gold, etc. But they also want to hold gold. This is extraordinarily important and a lot of people don't seem to get it; they have certain fixed policy requirements with respect to the holdings of gold. They say, "We hold gold; we hold dollars. We have a policy of saying we will hold $85 in gold for every $15 of a dollar balance." In other words, we're saying that this particular bank likes to have an 85% gold reserve.

Another central bank may only require a 50% gold reserve. Another one might require 93%, like Switzerland. Now, what I'm getting at is - in that particular publication - another table - that same one of May 1962, on page 10 look at the table on official reserves of gold and foreign exchange. France, in its total reserves, chooses to hold about 72% of it in gold; Germany about 56%; Italy about 65%; Switzerland about 93%; the United Kingdom 69%, and that was low for that year - ordinarily the United Kingdom holds about 85%. My point here is that the accumulation of dollars by central banks, when they become so large that the proportion of gold to dollars is such that they don't like it, when their dollar holdings get excessive they turn to the United States Treasury and draw gold out. This is really one of the big problems that we face.

If we're going to curb the rate of growth or rate of loss of gold the thing we've got to do first is arrest the growing accumulation of dollar holdings of foreigners, and secondly, as far as those central banks are concerned that acquire these dollars, we have to make sure to do something to see if those central banks will curb or give in a little bit on their demands for gold when their dollar holdings become excessive. Now, time is running short and I'm only about 1/8 of the way through - I only have about 4,000 pages of manuscript to go through yet.

There is one point, though, that I do want to stress. You can say that you understand about the central banks acquiring dollars and converting those dollars into gold, but there is an important feature of foreign exchange rates that comes in here that you have to understand. In this article on the international payments system this feature was stressed; namely, that all the central banks of the member countries of the international monetary fund have agreed to stabilize exchange rates.

The pound, for instance, $2.80 currency par value. That's the basic par value. That's the agreed upon rate, but we allow the exchange rates to rise and fall in accordance with demand and supply, but rise and fall only within certain limits.

Take a case in point; a terrific flow of payments to London. What does this mean? A great demand for pounds. The price of the pound in terms of dollars might rise from $2.80 to $2.82. Now, if nothing else happened it might go up to $2.84 or $2.86, or $3.00. But the world has agreed not to let that happen. What happens? How do we stop that exchange rate from going up any higher? The Central Bank of England has a rate that approaches what we call the upper intervention point - an agreed-on intervention point. The central bank says, "Well, now, look. I can see that the pound has been going up because there has been a demand for pounds." Or, "There's been a great selling of dollars. How do we keep that price from going up any higher? We'll go in and act as a sort of great buyer of dollars right now, or a great seller of pounds." And that's the way you can keep the price from rising.

So, the Bank of England, if there is a great pressure on dollars depressing the price of the dollar relative to the pound, the Bank of England will come in and gobble up dollars on the foreign exchange markets, and buy dollars with pounds. This keeps the rate from going up; it keeps it stable. But notice what it does to the Bank of England's dollar reserve. The Bank of England has accumulated, now, more dollars, and in the event of a heavy short-term movement of capital abroad, to keep our exchange rate stable according to agreement, that central bank has to move in and buy dollars. When that central bank buys and accumulates dollars its dollar holdings may become excessive, and the central bank has to turn around and say, "Look, Mr. Treasurer of the United States, we're up to here in dollars; we'll take the other in gold."

Now, my point - and it's only an underdeveloped point right now - is that the normal practice of foreign commercial banks unloading excessive balances on their central banks, the normal practice of central banks buying dollars when the dollar weakens relative to the currency in question - and that does happen - if we're having deficits in our balance of payments, the central banks then accumulate dollars which then leads to a drainage of gold. So, the policy implication here - and there are ever so many more points to develop - but I understand I have to stop temporarily anyway because I understand if I don't stop around 9:30 I understand this podium suddenly shoots up in the air and I get chinned, which is a very subtle signal for me to stop; but one word then; the policy implications are evident in your balance of payments. If you're worried about deficits and accumulated dollar-holdings by foreigners, then, of course, you can see why the government says, "Let's see if we can minimize the deficit by (a) trying to promote exports." Part of the promotion of exports might be "Let's see if we can stimulate more technical improvements in the United States through tax credits; through accelerated depreciation. We become more productive; keep our costs low, and thus we can compete more effectively with foreign countries.

You can also see why the government has scrutinized the payments made abroad in foreign aid and tries to make them tied loans whenever it makes a loan. In other words, we'll lend you money if you'll buy our goods. You can also understand why the government has been - maybe I shouldn't mention that here - concerned about the military expenditures for the maintenance of defense establishments abroad; and if we're putting dollars into Germany and some other countries for a total of about $3 billion a year - remember our deficit was only $2.5 billion last year - if we put in about $3 billion a year couldn't we get some of these foreign countries to take some of the load off our backs and let them share the costs of the defense installations there. This is one of the things we're working on.

And then, since short-term capital movements have led to such great payment outflows from the United States, can't we do something to make investment in foreign countries a little less attractive, maybe by making sure that our interest rates don't drop down too far. This leads to some concern over interest rates, in order to curb this outward flow of money in the form of short-term capital. And since also we know that if the price of the pound rises up to $2.82 the central bank is going to be forced to come in and buy dollars and then create a potential drain on our gold reserves, couldn't we maybe by developing a holding of convertible currencies like pounds, move in the market and dump pounds on the market to prevent the price of pounds from going up to the point where the Bank of England will come in and accumulate dollars in a support operation?

Hence central bank interest in the buying and selling of foreign exchange transactions, which was handled in this most recent article I gave you, the recent government transactions in foreign exchange.

Well, I've gone over my time. The subject was just barely scratched, but I hope I've given you some of these fundamentals with which we must be concerned if we answer the question what causes the gold outflow, and then a brief reference as to how may we arrest the outflow of gold. In the question period I hope someone asks the question, "Why are we concerned about the outflow of gold?" Because, I didn't get around to that.

Thank you.

QUESTION: I read in the paper that the ceiling on interest rates on foreign-held dollar deposits in the United States has been lifted. It appears to me that this raising of the interest rates would work against us on the balance of payments on our deficits in the long run.

DR. ARLT: Well, the purpose of raising the interest rates on foreign-held time deposits is to encourage foreigners to hold dollars in the United States; to take advantage of the higher rates of interest rather than unload dollars. You see, the process of unloading dollars would be maybe to sell of their dollars to their own central bank and then move into some more lucrative foreign currency. As I understand the proposal - and I'm not sure it's law yet - the proposal is to raise the interest on time deposits for foreign official institutions and governments, not for private. This would be done with the idea - remember the point that I mentioned, that France may look at its gold holdings and say, "Look, we'd better get rid of our dollars and get more gold." If you raise the rate of interest which they could get on dollars which they hold in the United States they might be less inclined to convert dollars into gold.

In terms of gold pressures I would say the answer to your question would be that the object of the proposed legislation is to reduce the on the gold reserve. It will not have any appreciable effect on the actual over-all payments deficit one way or the other. It has an effect on the management of reserves by central banks. That's how I would answer your question. Is that satisfactory?

QUESTION: In recent years it seems as though whenever some countries come out of balance of payments difficulties it almost inevitably forces other countries into balance of payments difficulties. What would you think would be the proper remedy for this situation?

DR. ARLT: Well, there is a problem there. For instance, we say to get out of our balance of payments difficulties we should promote exports. Well, there is just a certain volume of trade to be done. At whose expense do we promote exports? There is a problem there, and we don't want to curtail imports by any artificial restrictions like tariffs or quotas. That definitely would be what we call a "begging thy neighbor policy." If we curtail imports we are immediately reducing the exports of other countries and they'll retaliate. You just beat each other's brains out and you get nowhere economically.

What we say, in our case, is try to promote exports where we can and be very careful about expenditures that we make without putting any artificial restrictions upon our expenditures. But, to the extent that we do slow up the flow of dollars into foreign hands, this may pose a problem for some foreigners when they come to buy goods later on. There is a problem and you hope that you can work it out cooperatively on an international basis so that no one country - if you want to adjust to a balance of payments deficit you'd like to have the deficit country do the adjusting, but also the surplus countries to do some adjusting.

There is the rule of thumb, for instance, the old classic, and this is where the dilemma comes in; a deficit country, what it ought to do is to have tight money and lower its prices. You see, then you can sell more goods. And the surplus country ought to have inflation and raise prices so it couldn't sell so many goods. That way you'd get a re-dressing of the balance, or the imbalance.

Well, in the first place, our country; could you expect our country politically to urge a reduction in prices and a curtailment of employment, and go through the ringer. We're already suffering from a little bit of anemia, economically. I understand all your speakers who talk about economics have been backing the economic hearse to the door. So, we can't do that. Nor can we expect other foreign countries to just go into inflationary procedures to help our deficit. We have to work with different arrangements - some of the arrangements that are mentioned in the literature. It's not an easy problem to adjust, but they are doing some adjusting.

Now, that's not a precise answer. The only thing precise about it is that it's not possible to answer precisely. That's the only thing that I can say precisely.

QUESTION: What would happen if the United States Government refused to sell gold at $35 an ounce?

DR. ARLT: All right, that gets me to the question that I wanted you to ask. The point that is made is that the basis of the international payments system is essentially this fixed relationship between gold and dollars. The international monetary fund has already taken the position in the sense that we want all the exchange rates to be identified in terms of dollars or gold. And when we talk about dollars we mean dollars as they are convertible into gold at this fixed relationship of $35 an ounce. You've got the whole structure of rates.

And then, with the limits of fluctuation based on these currency pars set, and with all your investment - all your trade done with an eye on expected rates; also we find that the central banks are willing to hold dollars. They don't ask for every bit of their holdings in the form of gold. They're willing to hold some in the form of dollars. Why? Because the dollars are considered as good as gold to that extent.

All right. Now you raise the question, "Suppose the Treasury says, "Tomorrow morning at eight o'clock we're going to shut the window tight and we're not going to sell any more." Immediately you sever the connection, then, between dollars and gold. Because, the only way that you can keep dollars fixed at the rate of $35 an ounce for gold, is to have the Treasury willing to sell gold at $35 an ounce. Who is going to think of dollars in terms of $35 an ounce if the Treasury won't sell at $35. They'll have to wander around in the London bullion market or other markets and there will be people with gold who will sell it for maybe $40 or $50 an ounce, or $60 an ounce, if you shut up the Treasury. That just louses up your whole international balance of payments mechanism.

The central banks, if they see that happening, will be very leary of dollars. If they anticipated its happening they'd pull their gold out. In other words, they'd start a run on the dollar. And if you were investing, buying securities and engaging in international trade, you'd like to know what the exchange rates were going to be within limits. You'd stop this if the exchange rates were going to be torn asunder.

So, we say that we have a certain responsibility to the whole international payments system by trying to get and keep or hold enough gold to always be able to stand ready to convert gold into dollars. And I'll say that maybe our best protection is to let the rest of the world have a stake in this payments mechanism. Those central banks aren't deliberately trying to embarrass us. If they embarrass us too much they louse up their whole balance of payments mechanism.

We hear reports. I remember somebody said DeGaulle threatened us one time with something like, "If you don't play ball with me I'll pick up all my marbles." It was something about some atomic power plant. "If you won't let us do that, I'll just pick up all my dollars in the form of gold." And France has a fair chunk of dollar holdings. Well, these are threats that a central bank or a government can make. But generally they're all cooperative. Next week we're going to see a semblance of that cooperation when foreign experts from all over the world come - the International Monetary Fund and the International Bank; they're coming; and one of the big problems they're discussing is this gold reserve problem of the United States. They're all interested in it.

Well, now, have I answered your question as to why we are in a sweat about our gold reserves?

QUESTION: Sir, Russia is a leading producer of gold.

DR. ARLT: The second largest - yes.

QUESTION: Can her gold stock in any way be used to upset our economic stability?

DR. ARLT: I think not. There's nothing I'd like better than to have Russia dump their gold so that we could get hold of it. It would be fine. The world is suffering, we say, partially from a shortage of gold. If Russia poured gold into the market then gold becomes excessive in the holdings of a lot of central banks. If those central banks then turned the gold over to us, why, we're in business again. I'm not worried about Russia dumping gold. Russia, of course, has to pay for a lot of their stuff in gold because most nations take a dim view of the ruble balance in Moscow and elsewhere. They don't take a dim view of the dollar.

We're not quite sure what you could do with rubles if you had them. The Russians might tell us what we could do with the rubles.

QUESTION: Would you comment on the advisability of eliminating the gold reserve requirement and using our available gold stocks in the payment of our international obligations?

DR. ARLT: That's a good question. Of course, as an Officer of the Federal Reserve Bank I have to maybe be delicate with my answer, but you are referring to the 25% gold certificate requirement, as all of you know who have studied the money and banking setup. That means, then, that our existing supply of gold of $16 billion right now, that about $11 billion of it in a sense, is earmarked as a backing for the gold certificates which must be held against liabilities of the Federal Reserve System. So, there's $11 billion that's sort of sealed off to be support for the Federal Reserve liabilities.

Query: Should we knock out that 25% gold requirement and thus free $11 billion of gold. I'll answer it two ways: (a) There's no rhyme or reason right now for a 25% gold certificate requirement. We don't need it for our domestic monetary situation. The Federal Reserve manages the supply of money with little or no reference to the volume of gold certificates. It always has more gold certificates than it needs to satisfy this requirement, although it's getting closer now to this 25%. And so, from the point of view of domestic monetary management I see no reason. It's no protection against inflation. It was certainly no protection against inflation in 1949 when we had about 70% of the world's gold reserves. We were up to here in gold certificates.

We could have had one wing of an inflation if we wanted it; if the Federal reserve wanted to expand credit on the basis of the 25% gold certificate. It's prudent money management that's a protection against inflation, not the gold certificate reserve. Now, I do hesitate, however, to urge the dropping of the gold certificate requirement to free this gold, really, for a strange psychological reason. I like to work on all the other devices to protect our gold reserves rather than drop the 25% gold requirement, because I think if we drop it people will walk around saying, "Boy, we just picked up $11 billion in gold; we don't have to worry about the balance of payments situation anymore. Look at all the gold we have now; $11 billion that we couldn't count on before." I'm afraid it would make us too complacent, quite apart from the fact that to do it right now, for instance, from our discussion we'll be given an actual monetary fund - and to keep it going - it might be regarded as pressing the panic button. And pressing the panic button might then be regarded as a prelude to a run on the United States dollar.

Psychological reasons, then, are my reasons for sitting tight on the gold certificate requirement. At least it's a question of timing. Sure, remove it some time later when the heat isn't on. But I'd say now I'd hold off even though I have no regard for the gold certificate requirement as a domestic monetary protection. Does that answer your question?

QUESTION: Since you just said it's to all parties' interest to maintain the stability of international currencies, why through various pressures both fiscal and diplomatic can't we prevail upon other countries drawing down this gold, to reduce their gold balance versus their dollar interests? It seems to their advantage to maintain their dollar balances which would make the money work, whereas gold won't do them much good anyway.

DR. ARLT: Your question is good, and in answer to your question I would say that some of that pressure is going on. Also, there are a lot of other ways of international cooperation. The central banks are cooperating to relieve the pressure on our gold reserves. But we are trying to exert pressure on some of these foreign countries to do just that, up to a certain point. These are firmly ingrained policy developments within a number of central banks, to hold just a certain amount of gold. You don't go around telling other countries that they ought to change. One thing that we have done, though - I'm talking about capital movements; one of the things that has contributed to our deficit has been that foreign countries come over and borrow on the New York money market. When they borrow that means they export an IOU to us and we give them the money.

We can say, "Why don't you borrow on your own money markets?" Why did Japan borrow from the United States instead of Switzerland where the interest rate was lower than in the United States? Well, Switzerland didn't have enough money to lend Japan in her money market. It's a smaller money market. They couldn't borrow at all from France because France has a whole flock of restrictions on any sale of foreign obligations for her money.

The fact of the matter is that the United States is putting pressure - Dillon and Rosa are trying to go to these various European countries and ask "Why don't you drop your capital restrictions so that more of you can borrow in your own money markets instead of borrowing from the United States?" That's the type of pressure and that would be an indirect way of trying to protect our gold reserves.

QUESTION: The policy of this nation appears to have been to place these nations on their feet, that are now pinching us economically. Now they are coming and getting gold from us when originally we got all the gold from them. Would it not be our objective to see them, since this gold is important to them, retain this confidence in the backing of gold? Would it not be our policy, then, to flack out the rate of loss of gold so that we would not appear to weaken our position, but not to try to get that seven or eight billion dollars back from them?

DR. ARLT: I certainly do not think it is any part of Administration policy to try and get back what we had. This would be a mistake. Because the amount we had in 1949 was too much. We had it and the other countries didn't have it, and they were suffering from shortages in their reserves. Up to a point, this movement of gold into the hands of the foreign countries is the best thing that could have happened in terms of general international liquidity and general international balance. It's a question of how far. We don't want to keep up this rate of outflow because then we raise the question, "Can we continue our policy of the fixed relationship between the dollar and gold if we don't have any more gold reserve?" So, we've got to slow up the rate of outflow but not return to the previous imbalance that we had in the latter '40s. I think you're quite right.

QUESTION: With reference to your comment on the meeting of the monetary fund next week, in this morning's Press they quoted Per Jacobssen as stating (1) that he felt we'd be out of the woods by the latter part of next year with regard to the balance of payments, and (2) he rather thought that we should worry more about inflation. Would you comment?

DR. ARLT: Well, I, for one, - well, the first point, that we'd be out of the woods. It is true that our deficit averaged a little bit over $3 billion in 1958-59-60 and in '61 dropped to $2.5 billion. We are now at an annual rate of $1.5 billion, so, we're moving in the right direction to minimize the deficit and minimize the outflow of dollars into foreign hands. If things keep on going, if our exports increase, if we are able to get foreign countries to share the burden, yes, of military expenditures; if we're more careful about some of our foreign investment abroad we might be out of the woods in terms of a managpeable deficit, or even getting their surplus.

Second, on deflation I agree. This is one of the problems that we particularly face right now, in one sense. I will say that we have to worry about deflation in prices. They're sticky in a downward direction - generally quite sticky. Now, I'll put it the other way. The inflationary forces are not in evidence at the moment, except capacity, lots of unemployment - though it's unemployment in - well, I'll say a lot of unskilled workers. We don't see the possibility of prices shooting up. We have an under-utilized economy. The problem is sort of stagnation, retrenchment, or whatever it is. Some people are even talking about a decline next year.

I grant Per Jacobssen's point. But this is our problem how to stimulate our economy and at the same time meet the balance of payments problem. In fact, the very first article in this terrific publication of the Federal Reserve Bank that I just gave out to you, "Current Problems Facing the Economy," poses that very problem of how do you handle both a problem of deflation and week economic activity, and the problem of the balance of payments debt? It's not easy. We line up the various thoughts without, of course, taking a position. Of course, we don't want to cut our necks off anywhere or stick our necks out. It's still an unresolved issue to a great extent.

QUESTION: We hear discussions of, say, paper standards of money, and in that connection is there another way of paying for international transactions other than with gold? Would there be any other way?

DR. ARLT: Yes, there are other ways. You don't have to have a gold standard to conduct international trade. You would just have to have - for instance, if the United States had no gold but still wanted to conduct international trade, one alternative would be that the United States would have to get balances of other currencies in its possession in order to pay for various obligations. Or, creditor nations would have to be willing to accept larger dollar balances in the United States.

In other words, if you had acceptability of a whole host of currencies you could use foreign exchange balances as your medium of exchange. But you'd have to have everybody willing to accept foreign exchange balances. At the present time the dollar is a key currency. The pound for the Commonwealth countries is a key currency. Other currencies are just beginning to come into their own, but there are still a lot of currencies suspect.

The general feeling is, as far as international faith is concerned, gold is the greatest medium of exchange. There is never any question about whether a nation will accept gold. Most students of international finance say it's good to have gold somewhere in the picture without necessarily reverting back to an orthodox gold standard such as the type that we had prior to 1934. Yes, countries can operate on paper standards.

You can keep exchange rates stable by having central banks agree to move into and out of the market at certain times, if you have an international agreement. You could operate. And, for all practical purposes you might say that the bulk of international trade transactions are just the shifting of bank balances back and forth without the movement of gold. But there's always that gold in the background.

QUESTION: Is there enough gold? In other words, is the production of gold sufficient to keep up with the world economies as they are growing, or are we going to have to find some other equally convertible basis?

DR. ARLT: Your question is good. Some people have suggested that this is a problem, that the growth of world trade has outstripped the stock of gold. Now, the answer that I think some leaders of the Administration are taking is, that to the extent that other currencies in addition to dollars become good foreign exchange reserves for central banks it is then possible to economize on gold; that, instead of having dollars and gold - for instance, the English Central Bank would have dollars, gold, marks, francs - we are now getting to the ideal situation where we have other currencies beginning to assume the ranks of importance comparable to the dollar as a medium of exchange. Then gold might become a little less important. You could do a larger volume of business without worrying about shifts in gold reserves.

So, the answer is, we probably can manage and have enough liquidity if the liquidity is identified now in the form of a broader array of convertible currencies in addition to dollars. That's the answer. But if you don't get that we will have, I think, repeated worries about whether the gold supply is enough. You see, if a lot of people do worry, then the gold supply certainly won't be enough because everybody will be grabbing for it. And then we would be faced with a great stringency and a great difficulty in meeting our obligations, keeping it up to the price of $35 an ounce. I think that we can manage, but remember, that's just a value judgment.

CAPTAIN BRYCE: Dr. Arlt, I see that we've run out of time. On behalf of the college thank you for a very fine contribution to our course.

DR. ARLT: Thank you.