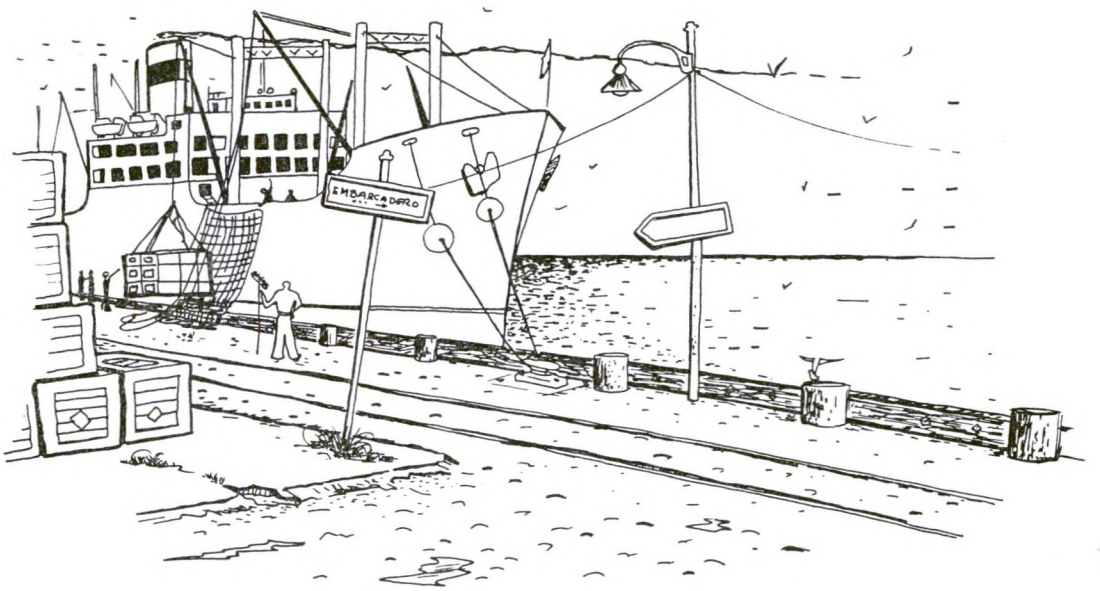
Our Balance of Payments in Perspective



THE unprecedented outflow of gold from the United States that began in 1958 and continued at a reduced rate in 1959 has focused attention on the United States balance of payments to an extent previously unmatched in the postwar period. Prior to the last two years, the balance of payments was regarded as only a minor aspect of the economic picture. Since United States exports constitute only about 5 percent of the nation's total output of goods and services, our economy is not as dependent on foreign trade as the United Kingdom, Germany, or Japan. The importance of foreign transactions is not, however, to be lightly dismissed. In 1959, for example, exports of goods and services were $23.5 billion and exceeded the value of some other significant sectors of the economy, such as total private home construction or purchases of durable equipment by United States producers.

Our gold loss of $2.3 billion in 1958 reduced the total gold stock by 10 percent from the $22.9 billion at the beginning of the year. Only $1.1 billion in gold were lost in 1959, but the aggregate amount of gold and dollars amassed by foreigners in transactions with the United States was even larger than 1958 with more of the dollar gains kept in earning assets. The overall deficit in our payments balance, as reflected in these gold and dollar outflows, was $3.5 billion in 1958 and $3.8 billion in 1959.

The 1958-59 experience was startling to a nation which assumed that we had a "favorable balance of payments." During most of the postwar period, we had become accustomed to hearing about the "dollar gap" and the "dollar shortage" and the difficulties that many foreign countries were having in building up their reserves of gold and dollars. It was therefore a shock to some of us to discover that the dollar was no longer in such short supply and that some foreign countries were adding sizable amounts of gold and dollars to their reserves through transactions with us. These developments produced a host of searching questions. Would this trend cause

foreigners to lose confidence in the dollar as an international currency? Did the failure of exports to rise between 1958 and 1959 reflect a deterioration in the competitive position of the United States abroad? Did the sharp increase in imports mean that United States producers were no longer able to compete even in their own markets? Was the United States, in other words, being priced out of both its domestic and foreign markets? Was the United States gold stock large enough to support the rising volume of short-term liabilities to foreigners? How long could the United States sustain a drain on its gold at the 1958-59 rate? Was a balance of payments deficit of this magnitude permanent or only temporary? Along with these and similar queries came proposed solutions: increased exports of goods and services, smaller imports, a reduced foreign aid program, greater participation by other countries in mutual defense expenditures, increased sharing of aid to underdeveloped areas, and cuts in our grants abroad.

So far this year, United States commercial exports have made an encouraging recovery and merchandise imports have leveled off. The trade surplus for the first six months equaled nearly $3.5 billion at a seasonally adjusted annual rate, $3.1 billion above a year ago. The overall balance of payments deficit dropped to $3 billion (annual rate), more than $400 million less than the second half of 1959 and over $1 billion smaller than the comparable period of last year when our deficit reached its peak. For the year as a whole, the deficit may decline further to $2.5 billion, which is still a sizable figure. Consequently, these "questions and answers" remain pertinent. In addition, a widening gap this year between interest rates here and abroad has suggested to some observers that the Federal Reserve System may be reluctant to encourage a further decline in interest rates because such action might result in a large-scale shift of short-term dollars out of this country. In this article, background to recent developments is presented so that the current situation can be viewed against the perspective of the whole postwar period. Its purpose is not to supply definitive answers to all the questions raised but to provide the facts and a framework within which a more accurate assessment can be made.

What is the balance of payments?

Initially, we might explain what is meant by the "balance of payments." The United States balance of payments is a set of accounts in which the dollar value of all transactions of this country with the rest of the world is recorded. Through the use of a double-entry bookkeeping system, each transaction appears both on the debit and credit sides of the accounts (the major categories are shown in the accompanying table). On the debit side are all the transactions with foreigners resulting in payment of dollars to them. When, for example, an American firm purchases rubber from Malaya, Malaya obtains a dollar claim on the United States which is paid by transfer of the dollars to the Malayan seller's account. The United States balance of payments accounts then show an increase in merchandise imports and an increase in Malayan dollar balances, to take a simplified case of settlement. It would also be possible for the Malayan company to extend a short-term credit to the American firm in lieu of immediate payment (an increase in foreign short-term claims on the United States), or the American firm could export tires to the Malayan company in payment (an increase in our merchandise exports). Other examples of dollar payments to foreigners include transactions such as the payment of social security benefits to an American worker who has retired in Italy (a government remittance) or the construction of a factory in Holland by an American firm (export of private capital) with materials and labor purchased locally (import of goods and services). On the credit side of the ledger

UNITED STATES BALANCE OF PAYMENTS, 1946-1960[1]

(in millions of dollars)

Transactions giving rise to:	1946-50 average	1951-55 average	1956	1957	1958	1959	1960[2] 1st quarter
U. S. payments to foreigners	$16,591	$20,241	$26,325	$28,033	$27,717	$29,634	$29,984
Imports[3]	9,470	16,314	19,829	20,923	21,020	23,560	23,780
Merchandise	6,920	10,982	12,804	13,291	12,918	15,315	15,188
Services	2,549	5,332	7,025	7,632	8,102	8,245	8,592
Remittances and pensions	593	442	665	702	722	779	776
Government grants and related capital outflows	5,851	3,485	2,576	2,560	2,427	2,477	2,536
U. S. private and other Government capital outflows			3,255	3,848	3,548	2,818	2,892
U. S. receipts from foreigners	$16,114	$18,624	$24,714	$27,753	$23,893	$25,025	$27,192
Exports	16,203	18,400	23,705	26,733	23,325	23,464	25,752
Merchandise	12,636	13,360	17,379	19,390	16,263	16,225	18,224
Services	3,566	5,040	6,326	7,343	7,062	7,239	7,528
Repayments on U. S. Government loans	[4]	[4]	479	659	544	1,013	680
Foreign long-term investments in the U. S.	— 89	224	530	361	24	548	760
Balance on recorded transactions net payments (—)	200	—1,617	—1,611	—280	—3,824	—4,609	—2,792
Unrecorded transactions (errors and omissions), net receipts	611	377	643	748	347	783	— 32
Increase in foreign gold and liquid dollar assets through transactions with the U. S.	—811	1,240	968	—468	3,477	3,826	2,824

[1]Excluding U. S. subscriptions to International Monetary Fund and International Bank for Reconstruction and Development.
[2]Seasonally adjusted annual rate.
[3]Including United States military expenditures.
[4]Included in net Government capital outflows.
Source: United States Department of Commerce, Office of Business Economics.

are transactions which result in the receipt of dollars by the United States, such as the sale abroad of a nuclear reactor by a private firm or the purchase of American stocks by a Canadian.

These payments and receipts constitute the recorded transactions in the balance of payments. The excess of payments or receipts is reflected in changes in the gold and dollar holdings of foreigners. Since each transaction is entered on both sides of the ledger, the balance of payments must balance. Nevertheless, the balance of payments is frequently said to be in "deficit" or "unfavorable" when foreign gold and dollar holdings increase. A fall in such holdings indicates a "surplus" or "favorable" payments position. Often, after the changes in recorded transactions and gold and dollar holdings have been added up, there is a residual called "unrecorded transactions" or "errors and omissions." This is essentially a balancing item which may include sizable movements of unreported funds moving from one country to another during economic or political crises, estimating errors, or a number of small receipts or payments which it would be impractical to report individually.

Various other terms are also commonly used to describe the relationship between different items in the balance of payments statement. The balance between merchandise exports and merchandise imports, for example, is called the balance of trade. If exports exceed imports, there is a trade sur-

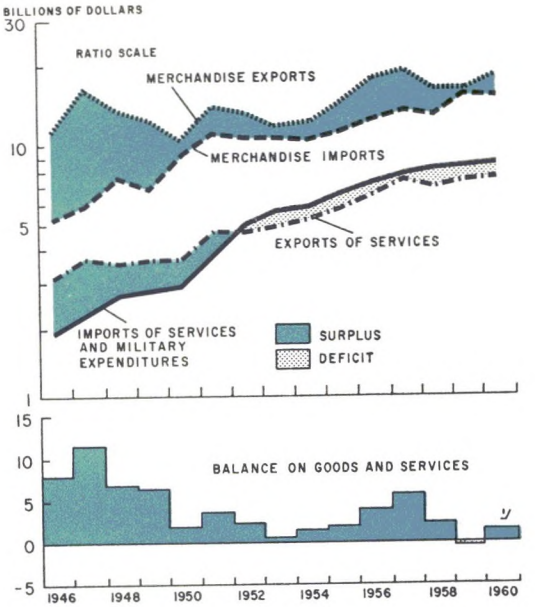
plus, and if imports are larger, a trade deficit. The merchandise and service accounts combined make up the "current account." Grants, pensions, and private remittances are designated "unilateral transfers"; these are transfers of goods and services or other transactions that do not require reimbursement. United States Government loans to foreign countries, private American portfolio or direct investments abroad, private short-term claims of various types, and foreign long-term investments in the United States comprise the "capital account." Also included in the balance of payments figures but excluded from the accompanying table are the United States subscriptions to the International Monetary Fund and the International Bank for Reconstruction and Development. These subscriptions are recorded as an export of long-term capital and an increase in the gold and dollar assets of international institutions.

Merchandise exports affected by business conditions abroad

In 1958 and 1959, United States surpluses on goods and services and on merchandise trade fell sharply from their high 1957 levels. By 1959 transactions on current account resulted in net payments to foreigners for the first time in the postwar period, and our trade surplus declined to a postwar low. Relative stability in merchandise exports and rapid expansion in imports in 1958-59, combined with large United States military expenditures[1] and a decline in net nonmilitary service receipts, were responsible for the deterioration in our goods and services accounts. The reduction of the surplus on goods was due in part to cyclical influences as imports rose in response to the upturn in domestic activity and exports lagged because of a slowdown in industrial activity abroad. Exports have also been rising more slowly than imports during most of the postwar period. In the last half of 1959 and the first half of this year, however, our current account surplus reappeared, and the trade surplus has risen sharply.

[1]See page 121.

Balance on goods and services has shifted



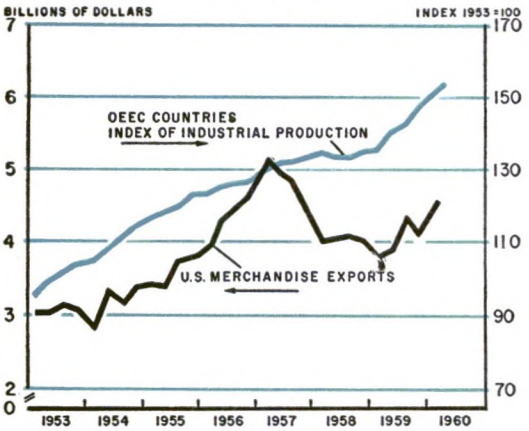
[1] 1960 figures are for first quarter at seasonally adjusted annual rate.
NOTE: This chart is plotted on a ratio or semi-logarithmic scale on which equal vertical distances represent equal percent changes rather than equal absolute amounts. A straight line indicates that a change is occurring at a constant rate.
Source: United States Department of Commerce.

Commercial exports (total exports less military grant shipments) have grown on the average of 3 percent per year from 1946 to 1959, but the rise has been interrupted periodically by fairly sharp cyclical movements when our sales responded to changes in economic activity overseas. The predominance of finished manufactured goods exports, which for the United States include such commodities as machine tools and capital equipment, has been largely responsible for much of the fluctuation in exports. These types of exports are closely tied to investment activity abroad, which tends to fluctuate markedly. An additional source of instability in recent years stems from the fact that the United States has become a marginal supplier of a number of semimanufactured and crude

materials. In the immediate postwar period, the United States was almost the sole source of supply for many industrial materials. Much of the prewar productive capacity abroad had been destroyed or damaged by war. As productive facilities overseas were restored and local supplies became more plentiful, industrial countries were less dependent upon the United States for these commodities. Now purchases from the United States of a number of materials, such as copper and steel semimanufactures, steel scrap, cotton, coal, and industrial chemicals, tend to be made only after domestic output is inadequate to meet the demand; this is generally after the upswing in industrial production has been underway for a while. The 1953-57 period illustrates this new interrelationship between United States exports and foreign economic activity; United States exports rose very strongly in 1954 following the upturn in industrial output abroad. Once the peak in business activity has been reached, however, demand is likely to drop off sharply. Thus, United States exports contracted significantly after June 1957 as industrial production in Europe leveled off. The decline was somewhat steeper than it might otherwise have been since our exports were exceptionally high in the spring of that year due to the Suez crisis, poor harvests in Europe, and the stimulus to our cotton exports from the textile boom.

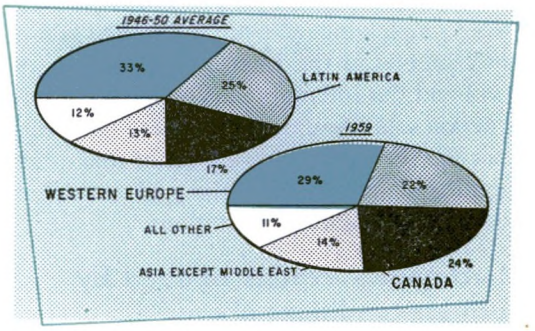
Although there have been no notable shifts in the kinds of goods we have been selling the rest of the world since 1946, there have been changes in the destination of our exports which are associated with economic recovery of the major industrial countries. The European export market declined in relative importance from 1946 to 1959 because of increased productive capacity and increased intra-European trade. Exports to Europe were further depressed in 1959 for several reasons: reduced cotton shipments as European nations waited for lower United States export prices to go into effect in August; a cutback in coal exports due to large inventories at the pits in the producing countries of Europe; and lower exports of steel and capital equipment because of the slowdown in business activity in Europe. This year, however, exports to Europe have shown a marked recovery. Canada was the largest single importer of American goods in 1959 and has ranked about equally with all of Latin America as an export outlet in the past several years. Exports to Canada, however, have been gradually gaining in importance as industrial-

Our exports affected by changes in industrial activity abroad



NOTE: United States merchandise exports are quarterly figures seasonally adjusted.
Source: United States Department of Commerce; Organization for European Economic Co-operation.

Western Europe leading export market but Canada's share growing



Source: United States Department of Commerce.

ization stimulated increased imports of capital equipment from the United States, while Latin America's share of our exports has remained relatively stable. Latin American countries, with a few exceptions, proved disappointing customers after their large dollar balances accumulated during the war were quickly spent in the early postwar period. In 1956-57, the large purchases made by Latin American nations were dwarfed by simultaneous increases in sales to other areas. In 1958-59 their difficulties with inflation and low export earnings prevented any significant increase in their purchases from us.

Are United States exports still competitive abroad?

The relatively sluggish behavior of United States merchandise exports in 1958 and early 1959 raised a question of the competitive position of United States exports. Has the United States been losing its markets because our exports can no longer compete favorably with those of other major exporting countries? The United States Department of Commerce recently published a detailed commodity by region analysis comparing our exports with those of other countries in 1958 and 1954-56.[1] In order to eliminate the effects of the general decline in world trade between the two periods, the study was conducted in terms of relative shares in various regional markets. This method provides a rough measure of changes in the United States overall competitive position in each market due to such factors as price, differences in product design, effect of sales efforts, credit terms, servicing facilities, and delivery lags.

The Department concluded that although there was some reduction in the overall United States share compared to that of other leading industrial exporters, the decline did not affect all markets or all commodities. For example, the United States share of the market for electrical apparatus fell sharply in Canada and the Far East but increased in Latin America. The increase in this country's share of textile yarn exports, however, occurred in all regional markets except the Far East. In general, the United States share of the Canadian and Latin American import market was fairly well maintained, while the greatest declines were in Eastern Hemisphere countries (mainly the Far East and Near East). In the Eastern Hemisphere, the resurgence of Japan as an exporter coupled with increased supplies from Europe reduced our share of this foreign market.

Much of the deterioration in the United States position from 1954-56 to 1958 was attributable to a few products, such as steel, automobiles, and jet aircraft, and arose from special and short-lived circumstances. The existence of substantial excess capacity in the European steel industry in 1958 cut into United States steel exports, but the recent increases in domestic demand in Europe have meant less surplus European steel. In the case of automobiles, the smaller European cars seem to be more popular with overseas buyers, an example possibly of their greater adaptability to foreign requirements. Whether our newer compact cars will be successful in recapturing some of our foreign markets remains to be seen, but at home the smaller domestic cars are competing successfully against foreign imports. The lag in United States exports of jet aircraft, on the other hand, was clearly temporary and due to the late entry of the United States into the commercial jet field. Now that the transition from conventional to jet plane production has been completed, United States exports of aircraft are showing a significant increase.

Although there was some further decline in our relative share of world markets in 1959, due partly to the steel strike, there was again no common pattern. The overall competitiveness of United States exports does not seem to have been reduced significantly, al-

[1] United States Department of Commerce, *Analysis of Changes in United States Shares of Export Markets for Manufactures, 1954-58* (November 1959).

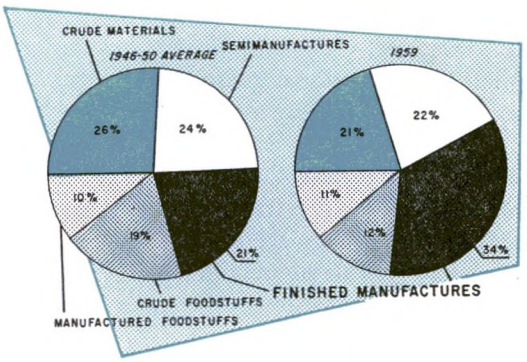
though the United States share of some foreign markets has declined. Four factors have played important roles in this development: the recovery of productive capacity in Europe and Japan and their reentry into world markets; narrowing of the technological gap between the United States and other industrial countries since the end of World War II; the postwar development of mass markets for consumer durables outside North America to which foreign production has been more closely geared; and price differentials which in some instances have reinforced the above trends. Various price indexes indicate that our prices have not risen appreciably faster than those in other major industrial countries in the past few years, but admittedly price indexes provide only a rough gauge. Hourly wage indexes show that wages in the United States have risen less than those of other major Western European countries, although the absolute level of wages in the United States is much higher. Foreign hourly wage rates, moreover, do not include certain fringe benefits which often exceed those paid in the United States. Any United States price disadvantage, on the other hand, cannot be measured by the level of wage rates alone. Generally lower raw materials costs and higher productivity have often pushed our unit costs below those of our major industrial competitors. This is still true even though the productivity gap between this country and other industrialized nations has shrunk in the past few years, as modernization and rationalization have been undertaken by many industries in Europe and Japan. As a result, the United States continues to hold a competitive edge in many commodities—many of them embodying advanced techniques; nevertheless, competition from other countries is now more vigorous.

The notion that we have generally priced ourselves out of world markets is therefore not supported by the facts. But if we continue to have much higher absolute wage levels than those abroad, and this has been the case for many years, we will have to run faster to keep our place in the productivity race because our foreign competitors are running very fast.

More imports now are finished goods, and many of them come from Western Europe

In contrast to exports, there have been significant alterations in both the country and commodity composition of our imports since 1946. Our imports have risen steadily on an average of 16 percent a year. The upsurge in imports has been stimulated by the growth in industrial production and spendable income in the United States and has been reflected in the sharp increases in our imports of industrial materials and consumer goods. Imports have also been boosted by our need to supplement domestic supplies of certain raw materials, such as nonferrous ores and petroleum. The growing availability of foreign supplies, combined with greater preference for certain foreign products, such as passenger cars, transistor radios, and portable typewriters, also helps to account for the import rise. In some cases, purchases have been motivated by attractive foreign prices for goods comparable in quality to those produced domestically.

Finished goods imports now most important



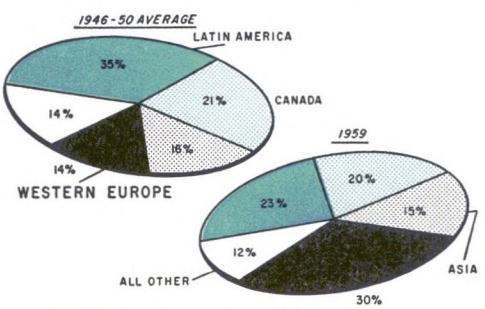
Source: United States Department of Commerce.

Finished manufactures have also become the most important category on the import side. Industrial materials (such as newsprint paper), capital equipment, and consumer goods constitute the principal types of imports in this group. Consumer goods imports, in particular, have increased sharply; a byproduct of this expansion has been a lessening in the sensitivity of our imports to recessionary tendencies in the United States. During business downturns, personal disposable income has been well maintained in the United States, and consumer buying, therefore, has not been significantly curtailed.

While the share of our imports represented by finished manufactures has risen, that of crude foodstuffs and crude materials has declined. The share of manufactured foodstuffs has also been falling, except in 1958 and 1959 when meat imports jumped sharply due to low domestic supplies. In 1959, the downward trend for semimanufactures was partly reversed as a result of domestic strikes in the copper and steel industries; and lumber imports also rose in response to a quickening in construction activity.

As the commodity composition of our imports changed, so did our sources of supply.

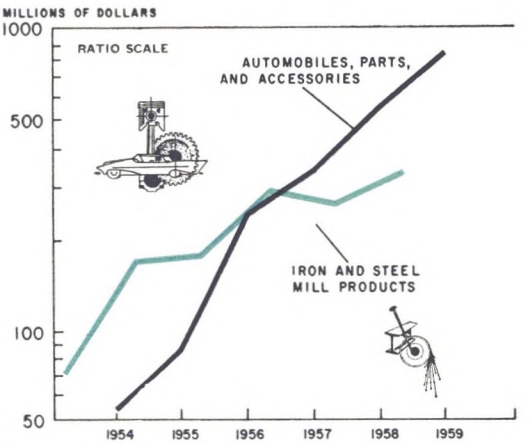
Western Europe displaces Latin America as our leading supplier



Source: United States Department of Commerce.

Western Europe became our principal supplier in 1959, despite a tripling in imports from Canada and Asia since 1946. Latin America's share dropped, however, partly because of lower prices for some of its principal exports, such as coffee. Passenger automobiles and steel products figured prominently in our larger purchases from Europe.

Automobile and steel imports increase



NOTE: This chart is plotted on a ratio or semi-logarithmic scale.
Source: United States Department of Commerce.

United States military expenditures abroad: an important source of dollars to foreigners

The sharp rise since the early 1950's in United States Government military expenditures abroad on goods and services has been a major factor in the emergence of a deficit within our current account on other than commercial exports and imports. In 1958 and 1959, this deficit reached $1 billion as net receipts on nonmilitary services fell. In the first quarter of 1960, the deficit was relatively unchanged from the comparable 1959 quarter. These military expenditures consist of payments to foreign countries for goods and services for our defense program overseas. They do not include all the costs of United States military operations in foreign countries but only those expenditures that result in payments to foreign countries. They are not to be confused with our shipments of military goods and services under the grant program which appear in the balance of payments statement as an export of goods

and services matched by unilateral transfers (an outflow of funds).

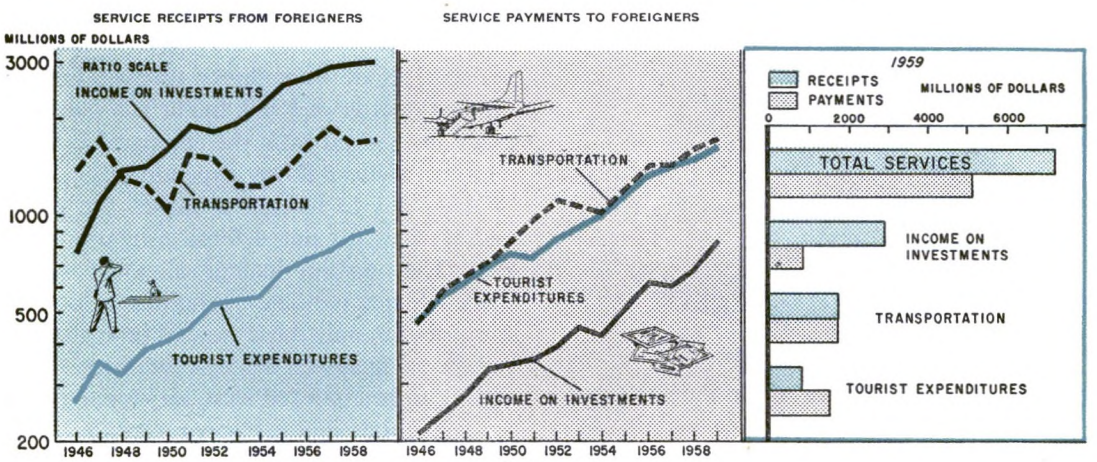
United States military expenditures abroad (or defense expenditures) have been an important source of dollar earnings for foreigners, especially since 1950 when United States military commitments overseas increased. A large part of these expenditures involved United States purchases of goods and services from one country for transfer to third countries. Through such offshore procurement activities, the exporting country benefited by receiving dollars otherwise unobtainable by a direct shipment of these goods or services to the third country, whose currency was not convertible into dollars. Japan, for example, by supplying a large volume of goods and services to Korea under the United States offshore procurement program, received dollars instead of inconvertible Korean hwan.

Our defense expenditures abroad totaled $27 billion from 1946 through 1959, with most of the spending concentrated either in those countries where our forces were stationed (Germany and Japan) or where defense installations were being constructed (Canada). The importance of our overseas defense expenditures is clear since they constituted 13 percent of total United States imports of goods and services in 1959. Offshore procurement of merchandise has accounted rather consistently for 40 percent of these expenditures. Current American purchases are principally for our own use abroad, in contrast to earlier years when a large proportion of the goods or services was transferred to third countries under various aid programs. A major share consists of expenditures by our troops and their families abroad for civilian-type goods and services. The remainder is made up of services rendered the government and expenditures for construction of bases and similar installations in foreign countries.

We still have a favorable balance on nonmilitary services

Our favorable balance on nonmilitary services from 1954 through 1959 was almost one-third larger than in the early 1950's because the dollar rise in receipts from service exports exceeded the more than threefold rise in payments for services. Income on United States investments abroad, the largest component of service receipts and consisting mainly of income from direct investments, rose steadily

Surplus on services mainly from income on foreign investments



NOTE: This chart is plotted on a ratio or semi-logarithmic scale.
Source: United States Department of Commerce.

throughout the postwar period and contributes most of the surplus on service account. Net receipts from transportation (a service export) have, on the other hand, shrunk due to the handling of a large share of the traffic in goods and passengers by foreign transportation firms. As more and more American tourists venture abroad, the rise in net payments for American tourist expenditures in foreign countries (also called "travel expenditures") has offset part of our gain in service receipts. As a result of the rise in foreign holdings of United States Government obligations and in United States interest rates, income paid to foreigners on their American investments has been the fastest growing item in our service payments.

United States military grants large

Military grants extended by the United States to other countries, which consist of goods, services, and cash payments, have been substantial. In 1959, they reached a level of some $2 billion. Western Europe received the largest share of these shipments in the early years of our military grant program, but most of the grants are now being extended to Asia and Africa where United States contributions are helping to build up military capabilities.

Military grant shipments do not affect the balance of payments statement from an accounting standpoint since the goods and services exported are counterbalanced by an offsetting debit entry under unilateral transfers. Nevertheless, the question arises whether grants might be reduced without causing a corresponding reduction in United States merchandise exports. Would foreign countries use their own resources to finance purchases of military equipment and services from the United States? The answer depends partly on the evaluation each country makes of the contribution of such goods and services to its economy. Many of the countries now accepting military grants probably would not increase their purchases of military goods and services to an amount approximating current levels if the United States program were cut back. A greater concern for their economic development and a higher standard of living would tend to divert available foreign exchange to nonmilitary uses or to building up reserves for other contingencies. In short, it is probable that only a small part of a reduction in our current outlays in this field would reappear as commercial exports.

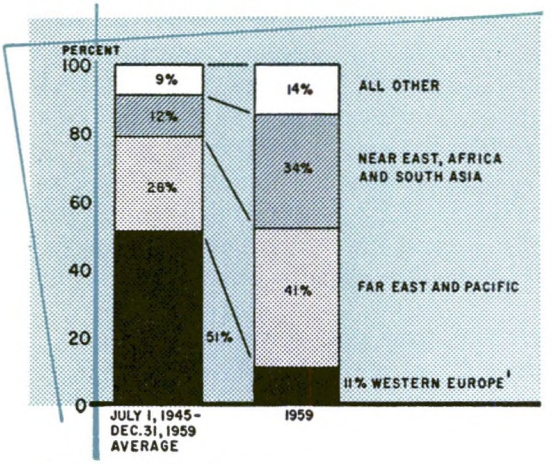
Nonmilitary grants supply more than $2 billion to foreign countries each year

The deterioration in the overall United States balance of payments in 1958-59 was due largely to the failure of our declining surplus on goods and services to cover the outflow of United States capital (both Government and private) and nonmilitary unilateral transfers.[1] The outward movement of funds from these latter two sources, less the relatively small volume of foreign long-term capital invested in the United States, ranged from a high of $7.9 billion in 1947 to a low of $2.8 billion in 1953. Subsequently, it reached a peak of $6.1 billion in 1958 but fell to $4.3 billion in 1959. Within the past four years, the average outflow has been about $5.5 billion.

Nonmilitary grants or unilateral transfers have fallen from an average of almost $4 billion in the first six years after the end of World War II to $2.4 billion during the last eight years. Private remittances by individuals and institutions for family and charitable purposes change little from year to year and have been running at a rate of some $500 million in the past several years. Pensions and other government transfer payments to residents of foreign countries, on the other hand, have been rising slowly, reaching $213 million last year.

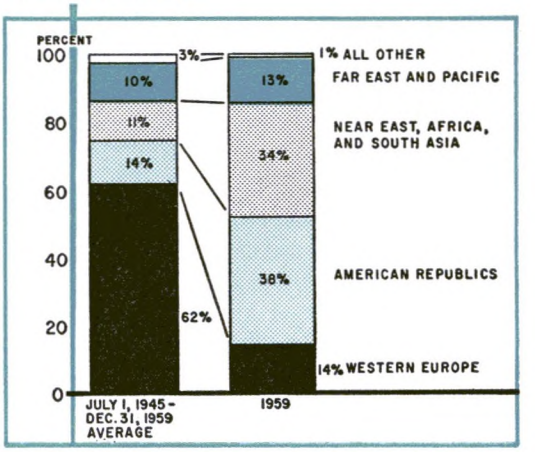
[1] See page 117 for definition.

More nonmilitary grants now made outside Western Europe



[1] Excluding Greece and Turkey.
Source: United States Department of Commerce.

Government credits shift away from Western Europe



Note: New credits plus grants converted into credits. Collections of principal excluded.
Source: United States Department of Commerce.

The bulk of the nonmilitary unilateral transfers consists of government grants made under economic and technical aid programs. Disbursements reached a peak in 1948 and 1949 under the Marshall Plan and gradually tapered off as the aims of the program were achieved and as credits were increasingly substituted for grants. Reflecting the recovery of Western Europe, more funds were directed toward countries in Asia, the Near East, and Africa in later years. A substantial part of these grants moved out in the form of exports of goods and services, but some were probably added to official reserves of these countries. In the absence of such grants, it is reasonable to assume that our exports on current account would be somewhat smaller, although how much smaller is difficult to estimate. Would India, for example, continue to employ the American technicians now over there on grants under the Mutual Security Program if our aid were discontinued? As these grants are directed increasingly to countries with limited dollar resources, or few other appreciable sources of convertible foreign exchange, it is likely that our exports would be smaller if such assistance to them were reduced. Furthermore, the cost of some of these programs, such as donations of agricultural commodities for relief, tends to be exaggerated. These exports help reduce our agricultural surpluses and the costs of storing the surplus. In addition, part of the original costs in acquiring the commodities is recovered by the Department of Agriculture from appropriations under our foreign aid program.

More United States Government capital is going abroad

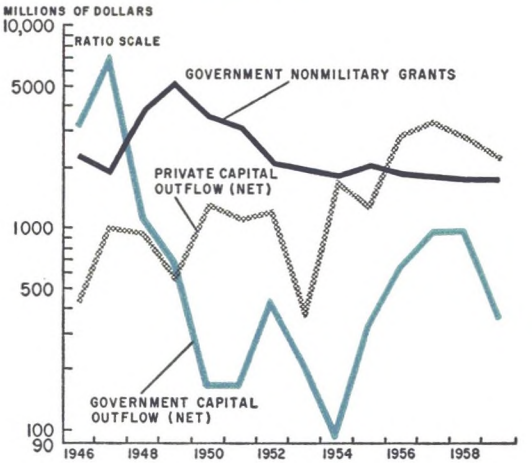
United States Government long- and short-term credits to foreign countries, totaling $17 billion in the postwar period, have been an influential factor in the financing of United States merchandise exports. Most of these loans have been used to develop productive capacity abroad or to provide basic needs, such as communications and transportation facilities. The initial flow of government funds abroad usually generates a simultaneous export of capital equipment and services for the new projects. These development loans can also have other longer term effects on our exports. Increased capacity overseas may eventually displace some United States exports to the debtor country, while newly developed resources may result in larger

American imports of industrial materials, such as ores and petroleum, from that nation. Higher levels of income and production abroad, however, generally expand markets for United States exports. The net effect of these government credits on our balance of payments position, therefore, depends on the relative strength of these divergent forces.

United States Government capital outflow since the end of World War II has followed a pattern very similar to that of nonmilitary grants. In the immediate postwar period, disbursements were large but then fell off rather sharply until 1954. In 1954 government lending activity revived as Public Law 480, providing for disposal of our surplus agricultural commodities with payment in local currencies, went into effect and as the lending authority of the Export-Import Bank was broadened. Net credits (new credits less collections of principal), however, have not been growing as rapidly as gross credits because of rising repayments on earlier loans. In 1959, for example, unprecedented advance repayments practically offset new long-term credits. Paralleling the shift in direction of United States grants and dictated by similar considerations, more government credits are now being extended to areas other than Western Europe.

The link between our merchandise exports and Government credits is usually very direct. Almost all of the loan proceeds of the Export-Import Bank must be used to buy goods and services in the United States. Credits of the Development Loan Fund, a United States Government agency authorized to make loans repayable in foreign currencies or on easier terms, also are generally made to finance purchases of United States goods under a new policy enunciated last year in response to our balance of payments deficit. Loans extended under Public Law 480 to foreign governments and private enterprises, which constitute the third largest category of government credits, do not increase our exports because

Capital exports rise while other government grants fall



NOTE: This chart is plotted on a ratio or semi-logarithmic scale.
Source: United States Department of Commerce.

the local currencies accruing from the sales cannot be converted into dollars and spent in this country by the borrowers. However, when these foreign currency loans are used to develop markets abroad for United States agricultural products, our future exports benefit.

The relatively recent rise in government short-term claims or credits primarily reflects our exports of surplus agricultural products. These short-term claims consist of foreign currencies credited to our account when the agricultural commodities are shipped. Since most of our government loans are so closely tied in with our merchandise exports, a reduction in this form of dollar outflow would have an adverse effect on our trade and would not contribute much toward improving our balance of payments position.

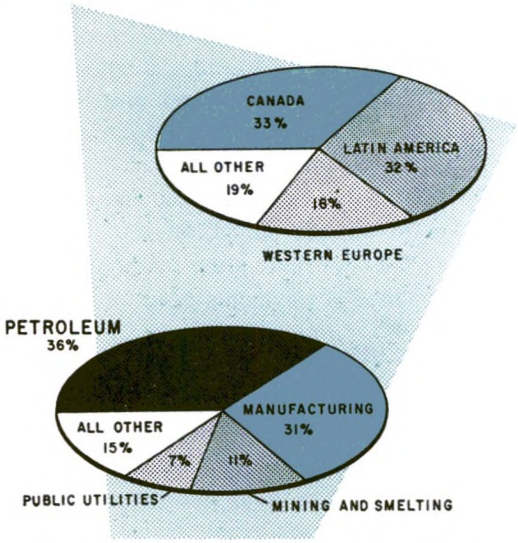
Americans are increasing their foreign investments

Exports of United States private capital totaled $21 billion from 1946 through 1959; more than half of the outflow occurred within the past four years. About three-fifths of this capital is in direct investments, i.e., equity

participation by American citizens in foreign enterprises which gives them a dominant or controlling interest or an important voice in management (generally at least 25 percent of the voting securities, although exceptions have been made to this definition). By 1958, the latest year for which data are available, direct investments comprised almost three-fourths of private long-term investments overseas, with Canada, Latin America, and Western Europe accounting for the bulk of the investments. Recently, the formation of the European Economic Community (the Common Market) has accelerated the movement of private capital into Western Europe to take advantage of the eventual removal of tariff barriers on goods moving between member countries while tariffs will still be levied on goods coming into the Common Market area from nonmember nations. Anticipated lower production costs from economies of larger scale production in the expanded market area are another reason why American firms are establishing branches in the Common Market countries. On an industry basis, rising domestic requirements for lighter crudes and inadequate local supplies during most of the postwar period have been responsible for the increased flow of funds into the petroleum industry, although manufacturing and mining investments also attracted a substantial volume of funds.

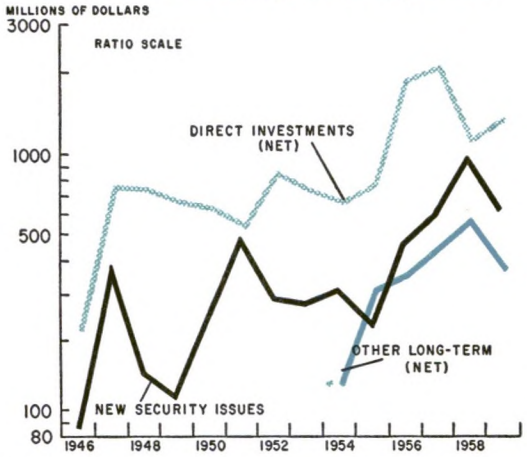
Within the past several years there has been a rise in the outflow of private capital through channels other than direct investment. Portfolio investment—purchases of newly issued foreign stocks and bonds (including refunding issues)—averaged around $600 million in the past four years compared to $250 million in the ten years preceding 1956. Placements, however, have consisted mainly of World Bank and Canadian issues. Other foreign countries have been generally inactive until recently because the New York capital market was not very receptive to their obligations during much of the postwar period. There was also strong competition from the large supply of United States private securities issued at attractive prices or favorable terms. It was not until 1958 as major European cur-

Direct investments abroad mainly in Western Hemisphere . . . and in oil and manufacturing . . .



NOTE: United States direct investments outstanding as of 1958.
Source: United States Department of Commerce.

but other types of private long-term capital exports becoming more important



*Except for 1950, negligible or net inflow.
NOTE: This chart is plotted on a ratio or semi-logarithmic scale.
Source: United States Department of Commerce.

rencies approached convertibility for nonresidents that Western European securities were offered to any significant extent in the New York market. Other types of long-term private capital exports have also increased, particularly since 1955, with rising commercial bank and other investor participation in World Bank and Export-Import Bank loans and somewhat greater interest by United States investors in outstanding stocks and bonds sold on stock exchanges abroad.

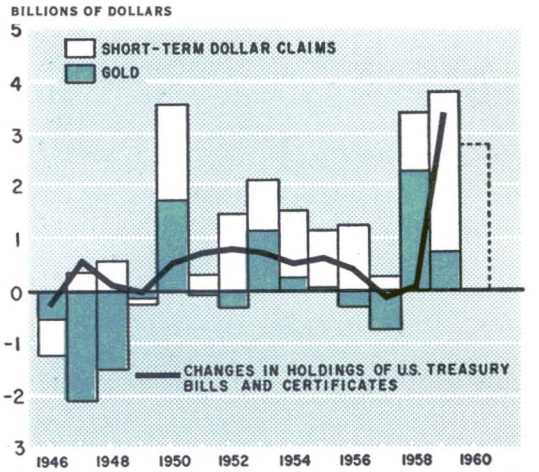
Although United States short-term private capital outflow has shown rather pronounced year-to-year variation, it is also much larger than before. The gradual relaxation of restrictions on capital movements has operated to increase the responsiveness of short-term funds both here and abroad to interest rate differentials between the United States and foreign countries.

Foreign long-term investments in the United States have reduced the net outflow of United States capital only slightly. Only in 1956 and 1959 did the inflow exceed $500 million. Last year's increase reflected, among other things, the lowering of restrictions on capital exports by major European countries.

Foreign countries have been gaining gold and dollars from us

The net effect of United States transactions in merchandise, services, unilateral transfers, and capital appears in changes in foreign gold and dollar holdings. This is the settlement item which balances our international receipts and payments. After a loss of more than $4 billion in gold and dollars to the United States from 1946 through 1949 despite substantial dollar aid, foreign countries began to gain gold and dollars from us through net receipts from travel, United States military expenditures abroad, unilateral transfers, and our capital exports. In the early 1950's, the average $1.5 billion balance of payments deficit of the United States each year was welcomed as a means of achieving a better

Foreign countries gained gold and dollars from us



NOTE: 1960 figure is first quarter at seasonally adjusted annual rate.
Source: United States Department of Commerce and *Treasury Bulletin*.

distribution of reserves. Now that the reserves of many countries have been built up to more adequate levels and their payments position has improved, this reason for a United States balance of payments deficit has certainly disappeared.

From 1950 through 1959, foreign gold and short-term dollar holdings rose about $20 billion through transactions with this country. About half of the increase accrued to foreign official institutions and strengthened their reserve positions; almost $3 billion were acquired by the International Monetary Fund and the International Bank for Reconstruction and Development; and the remainder was added to the dollar holdings of private foreign banks and other foreigners. Approximately $13 billion of the increase in total foreign gold and dollar balances is made up of foreign short-term claims on United States banks, such as deposits, United States Government obligations held in custody for foreigners, bankers' acceptances, and commercial paper. As the dollar assumed the position of an international currency, foreigners naturally kept dollar deposits and liquid assets,

such as United States Treasury bills and certificates, for ready use.

The improvement in the international reserve positions of foreign countries has permitted them to remove a number of their restrictions on current international transactions. Continued growth of reserves should encourage additional moves toward trade liberalization and some further relaxation of controls on capital movements; both actions should help the United States balance of payments. This improvement in reserves, however, has been largely concentrated among the countries of Western Europe, including the United Kingdom, and Japan. Many of the primary producing countries of Asia, Latin America, and Africa still maintain controls on trade and financial transactions because of difficulties in building up reserves and in limiting inflationary pressures.

The loss of gold by the United States does not reflect the size of our balance of payments deficit but is governed by the distribution of dollar gains between foreign private and official holdings. For official holdings, the customary practices followed by foreign central banks determine the distribution of reserve increases between gold and dollar assets. Although the Federal Reserve System has offset the deflationary impact of the gold drains, the gold outflow does reduce our ultimate reserve base. It is obvious, therefore, that the gold losses of the magnitude sustained in 1958, or even in 1959, cannot continue indefinitely.

Entirely apart from the high rate of gold loss in the last two years, the current level of our short-term liabilities to foreigners has aroused apprehension in some quarters because these liabilities represent potential claims on our gold stock. At the end of June 1960, for example, short-term liabilities of United States banks to foreigners totaled $20,337 million, while our gold stock was valued at $19,363 million. A major portion of these liabilities consists of official reserves and working balances held for trade and commercial use. As long as the United States dollar continues to serve as an international currency, and there are few other major currencies as stable in this unstable world, the need for dollar balances will remain. How much of these balances are volatile is unknown. The figure undoubtedly fluctuates with changes in economic conditions and world psychology, but our recent experience suggests that it is not a large amount.

Within the total dollar holdings of foreigners, shifts can and do occur from one asset to another. On June 30, 1960, for example, foreigners owned $9,443 million of Treasury short-term securities. Excluding $2,238 million of non-negotiable, non-interest-bearing demand notes issued to the International Monetary Fund as part of the United States subscription, these holdings constitute about 14 percent of outstanding Treasury bills and certificates. Foreigners also hold $8,978 million in deposits at commercial banks and with the Federal Reserve System. The existence of these large liabilities, which exhibit some sensitivity to interest rate movements, coupled with the recent emergence of a sizable balance of payments deficit, increases the importance of international developments in the formulation and conduct of monetary policy.

Monetary policy can contribute to a healthy balance of payments

Gold outflows and the rise in short-term liabilities to foreigners have turned the spotlight on the effect the balance of payments may have on monetary policy and vice versa. Since our foreign trade and other international business relations are a relatively small part of our total output of goods and services, developments such as gold outflows (or inflows) are ordinarily not permitted to tighten (or ease) credit conditions if the result runs counter to overall credit policy. If gold sales to foreigners were to continue so as to reduce our gold certificate holdings to the 25 percent

minimum required against System note and deposit liabilities, the requirement could be temporarily suspended by the Board of Governors. It could, of course, also be reduced by Congressional action. In 1945, for example, Congress lowered the minimum from 40 percent against notes and 35 percent against deposits to its present level. However, the ratio of gold certificates to note and deposit liabilities was still around 40 percent at the end of July, a fairly comfortable margin. The balance of payments deficit has had its main influence on monetary and credit policy only insofar as it has drawn attention to some of the underlying forces at work both here and abroad that are responsible for our unfavorable payments balance.

Monetary policy does exercise some influence on our balance of payments in the course of pursuing its principal objective, that of promoting economic growth at a sustainable rate. A monetary policy appropriate to the attainment of this goal strengthens general confidence in the dollar both at home and abroad and contributes to price stability. A relatively stable domestic cost and price structure in turn enables United States producers to remain competitive in domestic markets and overseas. To the extent that we can maintain or increase our incentive to produce and compete domestically and to have prices which reflect our productivity and technological advance, we are better equipped to compete with foreign countries.

In the shorter run, a sound monetary and credit policy helps to minimize erratic movements of both United States and foreign short-term capital and the conversion of dollar assets into gold. The structure of interest rates also influences the volume of United States capital flowing abroad into foreign securities and the movement of foreign funds into the United States. Both in the longer run and in the shorter run, however, monetary policy certainly cannot bear the whole burden of ensuring the economic well-being of the nation, including a healthy balance of payments. The fiscal authorities, business, labor, and consumers, all must cooperate in the task of maintaining a viable economy.

Summary and outlook

The narrowing of the gap between merchandise exports and imports in 1958-59 is an outgrowth of United States efforts to restore the economies of the wartorn countries and their own efforts at recovery and of cyclical developments. The dollar shortage is no longer a worldwide problem, and foreign reserve positions have been greatly strengthened. While political and economic considerations apparently dictate the continuation of aid to other countries, this is a relatively minor item in the net payments balance. United States private investment abroad will probably continue to expand, but the current outflow on long-term account is being counterbalanced by an even larger return flow of income on our total private investment abroad.

Adjustment to a new set of circumstances —enlarged productive capacity abroad and increased participation by other industrial countries in international trade—is and will be a gradual process. The United States cannot take for granted its supremacy in international commerce since others are now able and willing to supply goods and services to the rest of the world. The widespread use of the dollar as an international reserve currency places special responsibilities upon the United States, as well as upon our major trading partners and competitors, for the preservation of its standing. Larger gold and foreign exchange reserves abroad may permit larger capital exports to underdeveloped areas and a further lowering of barriers to the movement of goods and capital, with favorable repercussions on the United States balance of payments. Such developments would help to cut down the size of our deficit to more manageable proportions, but the deficit cer-

tainly cannot be eliminated overnight. The basic problem remains the overall balance of payments and not gold outflows or dollar accumulations by foreigners. We should keep our eyes on the main target, that of maintaining our competitiveness in world markets for goods and services so as to be able to accomplish other international objectives of this country.

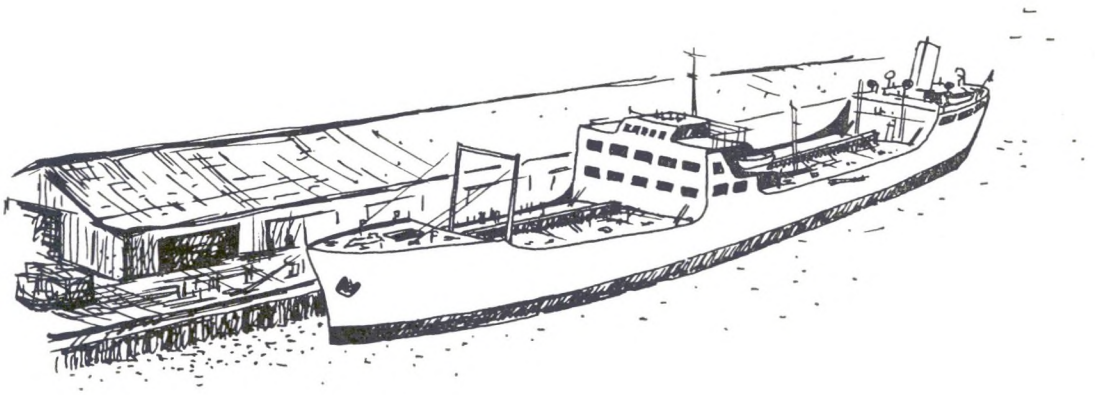
In the light of the experience of the past two years, the behavior of our commercial exports during the first six months of this year has been heartening. Shipments to overseas markets have been running at a seasonally adjusted annual rate of $19 billion, 21 percent ahead of the same period last year. More than one-fourth of the increase in dollar volume was due to larger exports of raw cotton which became eligible for higher export subsidy payments on August 1, 1959. However, almost one-third of the increase was due to increases in exports of finished manufactured goods, a large part of which was due to sales of jet aircraft to foreign countries. Exports of machine tools and capital equipment also rose significantly over year-ago levels. Exports of semimanufactured goods expanded almost as much as finished goods in value, although the improvement was spread over a larger number of commodities, such as copper, aluminum, and iron and steel semimanufactures. Much of the improvement this year indicates a reversal of the adverse developments of 1959. The peak of the cotton shipments has passed, but the sharp recovery in exports of semimanufactured commodities, construction machinery, electrical machinery, other industrial machinery, steel, tractors, and motor trucks supports the view that the boom in Europe is finally stimulating their imports from us.

Merchandise imports for the January-June period have showed only small gains over the comparable period of 1959 and no gain from the second half of 1959 (seasonally adjusted). Most of the 3-percent increase since the first half of 1959 has been concentrated in imports of finished goods, such as newsprint, cotton textiles, and consumer goods. Automobile and steel mill product imports, which were responsible for much of the import expansion in 1959, have turned down, and steel export tonnage in May exceeded that of imports for the first time since last year. The import trend thus is one of relative stability.

Complete balance of payments figures are available only for the first quarter of 1960. They show that there has been a significant turnaround in our balance of payments since the second quarter of last year when the deficit reached a peak annual rate of $4.8 billion. A small decline in imports of goods and services and a more than 10-percent rise in exports of goods and services produced a first quarter current account surplus of $2.0 billion. This was a change of almost $3.3 billion (annual rate) from our current transactions deficit in the second quarter of 1959. Part of the improvement in the current account was offset, however, by increased outflow of dollars through financial transactions and an unexpectedly large change in the "unrecorded transactions" figure. As a result, the overall balance of payments deficit declined only $2 billion from the second quarter of last year to $2.8 billion despite the significant rise in our net exports of goods and services. Preliminary data indicate that the lower rate of gold and dollar outflow recorded in the first three months of this year continued into the second quarter. The trade surplus rose from a seasonally adjusted annual rate of $3 billion in the first quarter to $3.7 billion. Larger net payments on all other transactions, however, again offset some of the gain in merchandise trade so that the overall deficit in the second quarter is estimated at nearly $3 billion, approximately the same as the first quarter.

The reduction in the size of the deficit from the second quarter of 1959 to the first quarter of 1960 illustrates how relatively small

percentage changes, such as the decrease in imports of goods and services, combined with the expansion in exports, can result in significant changes in our overall balance. Some of the current programs being undertaken to promote our exports, such as export credit guarantees or sales campaigns, may seem modest efforts, but their effect on the net or residual figures may be important. The introduction of the compact automobile in the United States, the more moderate wage settlements negotiated this year, and the increasing awareness of world competition may also help on the export side. It is through the cumulative effect of such small changes that economic progress is ordinarily accomplished, and it is hoped that the same progression will occur in our payments position.



REVISED INDEXES OF DEPARTMENT STORE SALES

As a result of a review of the factors used in adjusting the monthly indexes of department store sales for seasonal variation, the seasonally adjusted indexes have been revised for the period January 1953 to date.

The revision encompasses all of the Twelfth District cities, areas, and subareas for which indexes are prepared. Copies of tables showing revised figures may be obtained by writing the Federal Reserve Bank of San Francisco.