Chapter 3

The Balance of International Payments

THE RECOVERY AND GROWTH of the U.S. economy are not important for the United States alone. On the vigor of our economy depend in large measure the strength and stamina of the free world and the standing of freedom in the minds of men everywhere. Leadership in the world requires the support of a growing and dynamic domestic economy, using to the full its vast productive capacity. The other nations of the free world rely heavily on the United States as a market for their products and as a source of capital and technology for their economic growth. The United States has taken the lead in meeting the responsibilities of the advanced countries to foster the economic development of the low-income nations. The less developed countries need both public and private investment capital; they need full opportunity to sell their products in world markets in order to earn the industrial imports that their development programs require; and they need a democratic alternative to the communist prescription for economic development.

The U.S. balance of international payments is the outcome of countless separate transactions by governments, private businesses, and individuals. The obligations of world leadership entail large government outlays abroad. U.S. business firms and consumers pay out billions of dollars for foreign goods and services. U.S. corporations, financial institutions, and individuals acquire properties, buy securities, and lend money abroad. The United States is one of a very few countries with a long standing policy permitting residents and foreigners complete freedom to make payments abroad in its currency. For many years, the United States had little reason to be concerned whether all these payments were covered by corresponding receipts from abroad. Foreign demands for U.S. goods and services were large; the dollar was, and still is, a ticket of entry to the world's largest and most diversified market. In some periods, the surplus of receipts was so large that the United States took actions to moderate its effects both at home and abroad. And if international payments happened to exceed receipts in any year, foreigners were willing to hold most of the dollars they acquired; only a small part of the deficit had to be met from our large gold reserves.

Recently, persistent payments deficits and gold losses have made it necessary for the U.S. Government to give greater attention to the net financial outcome of its transactions, and those of its citizens, with the rest of the world. Payments need not and should not be directly controlled, but the balance must be under control. Many private international transactions depend in large part on economic circumstances at home. Consequently, domestic economic policy must be framed with an eye to the balance of payments. Action to safeguard the international position of the dollar is today an essential part of policy for full employment and growth.

The policies adopted in 1961 to strengthen the balance of payments are already beginning to take effect. The deficit in the international payments of the United States, which had averaged $3.7 billion annually in each of the three preceding years, was less than $2.5 billion in 1961, according to preliminary estimates. Gold reserves declined by less than $0.9 billion in 1961, compared with $1.7 billion in 1960. The full effects of measures under way and proposed will in time restore a sustainable balance in U.S. transactions with the rest of the world.

This chapter examines first the background for policies to improve the balance of payments and safeguard the position of the dollar: the general objectives which guide U.S. international economic and financial policies; the trading, investing, and international banking functions of the United States and their interrelations; and recent changes in the world economy affecting the U.S. balance of payments. In the final sections of the chapter, policies that are under way and proposed are discussed: measures to balance the basic international accounts; measures to limit disruptive flows of short-term capital; and measures to strengthen the international monetary system.

The United States in the World Economy

Objectives of U.S. Foreign Economic Policy

A basic objective of U.S. policy is to provide an economic environment in which the people of the United States and of all nations can steadily raise their standards of living. Economic growth at home will support, and will be supported by, progress and development abroad, provided that international cooperation and commerce distribute equitably and efficiently the fruits of productive specialization among all free nations. International financial arrangements and policies are means to this fundamental end. A stable and efficient system of international payments is essential to facilitate desirable international flows of goods, services, and capital. The dollar has become the principal international currency, and the stability of the dollar is the foundation of the international payments system which has evolved since the war. For this reason, the President has declared that the present gold value of the dollar will be maintained. To safeguard the stability of the dollar, the United States is determined to improve its balance of international payments.

Postwar progress. U.S. foreign economic policy since the war has sought to build an international economic environment in which goods, services, and capital flow freely across national boundaries. This policy has been based on the conviction that a free exchange of products and capital in world-wide markets will raise standards of living both in the United States and in the rest of the world. The example of the vast continental market of the United States attests to the economic gains afforded by geographical specialization and exchange and by the mobilization of savings in one region to finance productive investment opportunities in another. Without this huge internal market, unhampered by trade restrictions between States, American standards of living could not have risen to their present heights. Throughout the world, similarly dramatic gains can be achieved by international specialization and trade.

The framework of international economic cooperation in the free world today, especially among the industrial countries, represents a notable achievement. The great depression and the war left a legacy of national restrictions on movements of goods and capital—exchange controls, quantitative restrictions on imports, bilateral clearing and trading arrangements, discrimination against dollar goods. Since the war, the countries of the free world have been engaged in clearing away this restrictive legacy. Even before the war ended, the foundations were laid for the International Monetary Fund, the International Bank for Reconstruction and Development, and the General Agreement on Tariffs and Trade. The United States provided aid and leadership in European economic reconstruction and trade liberalization through the Marshall Plan and through association with the Organization for European Economic Cooperation. Substantial progress has been made toward a world of currencies convertible at fixed exchange rates and toward freedom from direct and discriminatory controls over trade and payments. Progress has also been made, though less rapidly, toward a world of lower tariff barriers; here is an opportunity for a major step forward.

Expanding trade: a new program. Foreign trade is not so vital to the United States as it is to most other countries. But the contributions of trade to our domestic welfare are nonetheless real and important. Net foreign purchases of our products contribute to output, employment, and economic growth in the United States. More significant, the opportunity to sell our products abroad in exchange for foreign goods enables us to specialize the structure of our production and to diversify the patterns of our consumption. By specializing in the production and export of goods in which the United States is unexcelled, Americans are enabled to import goods which would be impossible or costly to produce at home. Foreign trade raises living standards by widening the choice of goods available to the American consumer and by providing him with some goods and services at lower prices.

As other countries have recovered from the devastation of war and have rebuilt and modernized their productive capacity, they have become increasingly vigorous competitors of the United States in world markets. The most notable new source of competition is the European Economic Community, or Common Market, which now includes France, Germany, Italy, Belgium, Holland, and Luxembourg, and which shortly may include the United Kingdom and several other European countries. Members of the Common Market are committed to the rapid elimination of tariffs among themselves and the establishment of a common external tariff on imports from the rest of the world.

Still in its formative years, the Common Market has imparted amazing vitality to the economies of its members. U.S. exports to Western Europe have risen sharply in response to the rapid economic growth within the Common Market countries. We cannot be sure that this rise in exports will continue unless we can negotiate substantial reductions of the Common Market's external tariff. The evolution and enlargement of the Common Market inevitably increases tariff discrimination against U.S. exports; we must compete over this tariff barrier while members of the Common Market have steadily freer access to each other's markets.

The Administration is therefore proposing to the Congress a major revision in foreign trade policy. The President's current authority to negotiate tariff reductions has been virtually exhausted. For the first time since the original Trade Agreements Act was passed in 1934, Congress is being asked to equip the President with new kinds of bargaining instruments for negotiating with the Common Market. We must assure access of the products of our farms and factories to the world's largest market outside our own. Successful negotiations will make possible increasing specialization of production in both Atlantic markets. It will also make it possible to offer the free nations of other continents greater access to markets on both sides of the Atlantic.

Safeguarding the dollar. A stable and efficient system of international payments is an integral part of the liberal international economic environment toward which the free world has been moving. Uncertainties about the value and convertibility of the proceeds of international transactions disrupt movements of goods, services, and capital between nations. Convertible currencies and stable exchange rates as envisaged in the Bretton Woods agreements provide assurance of the value of international claims acquired by trade or investment.

The United States performs a special world banking function in the present international payments system. The dollar, alone with the pound sterling among national currencies, has come to be used as a major international currency by the free world. Private traders, banks, and governments have chosen to use dollars both as a means of payment and as a store of value. Foreign countries hold liquid dollar balances, acquired in international transactions, in much the same way that individual depositors hold balances in commercial banks. Foreign governments and central banks accept dollars as a partial substitute for gold in their international reserves because the dollar is an international currency and because the policy of the U.S. Treasury is to sell gold on demand to foreign governments and monetary authorities at a fixed price. The dollar became a "reserve currency" without any conscious international decision to establish a payments system based on key national currencies. Use of the dollar as a reserve currency has met growing needs for international reserves and economized the limited and slowly growing supply of gold.

Foreign central banks and governments hold as part of their international reserves $11 billion of short-term dollar obligations, which can be used to purchase gold from the United States. In addition, foreign private short-term dollar holdings amount to $8 billion. Whenever dollars held by foreign private banks or individuals, or dollars held by U.S. residents themselves, are sold to foreign central banks for other currencies, they become potential claims on our gold stock.

Because of the strategic role of the dollar, maintenance of its established gold value is essential to the stability and efficiency of the present system of international payments. Accordingly, when the President pledged that the gold value of the dollar would be maintained, he stated that "the full strength of our total gold stock and other international reserves stands behind the value of the dollar for use if needed." This reserve strength comprises $17 billion in gold (two-fifths of the monetary gold stock of the free world), small amounts of convertible foreign currencies, and drawing rights on the International Monetary Fund (IMF), of which $1.7 billion is automatically available under current practices of the Fund. An additional $4.1 billion could become available in accordance with Fund policies, insofar as the Fund has available resources in gold and usable foreign currencies. The recent agreement to strengthen the IMF (discussed at the end of this chapter) should do much to assure the availability of such resources.

Reducing the deficit. Deficits in the U.S. balance of payments are financed either by drawing down our gold reserves or by increasing the potential foreign claims against them in the form of liquid dollar liabilities to foreigners, official and private. Large and continuing deficits cannot be financed indefinitely. U.S. reserves, although very large, are not inexhaustible. Foreigners have accumulated large liquid dollar balances, but they will not be willing to let these balances grow without limit.

Therefore, the policy of the U.S. Government, as stated by the President in his message to Congress of February 6, 1961, is to "gain control of our balance of payments position so that we can achieve over-all equilibrium in our international payments. This means that any sustained future outflow of dollars into the monetary reserves of other countries should come about only as a result of considered judgments as to the appropriate needs for dollar reserves."

Maintaining basic objectives. These related tasks—maintaining the external value of the dollar and bringing our international accounts into balance—must be accomplished by means which promote the basic national objectives from which the tasks derive. To balance our accounts by restrictions on trade and capital movements, for example, would confuse means and ends. Such restrictions would violate the fundamental principles of international economic relations for which our policy has striven for many years with so much success. Similarly, the foreign policy of the United States calls for large loans and grants to foreign countries for development and for defense; and the maintenance of our military establishment abroad entails substantial overseas expenditures. To curtail the substance of these programs would provide no solution to the "dollar problem." Rather, the task of balance of payments policy is to find the foreign exchange resources necessary to finance them. Finally, full recovery and economic growth, primary national goals in themselves, are also essential elements in the long-run capacity of the United States to meet its international commitments and responsibilities. Measures to rectify the balance of payments must be consistent with expansion of the U.S. economy.

The United States as Trader, Investor, and Banker

The accounts. The U.S. balance of international payments over the last decade is shown in Table 17. In the table, international transactions are classified into four accounts: (1) *current account and unilateral transfers,* encompassing merchandise trade, earnings on U.S. foreign investments less foreign earnings on investments in the United States, services including tourism and ocean freight, private remittances, and government military expenditures and development grants; (2) *long-term capital account,* cover-

TABLE 17.—*United States balance of international payments, 1951–61*

[Billions of dollars]

Type of transaction	1951–55 average	1956–60 average	1958	1959	1960	1961 [1]
Current account and unilateral transfers	−0.6	0.8	−0.1	−2.3	1.5	2.4
Merchandise trade balance	2.4	3.9	3.3	1.0	4.7	5.5
Exports	13.4	17.7	16.3	16.3	19.4	19.7
Imports	−11.0	−13.8	−13.0	−15.3	−14.7	−14.2
Military expenditures, net [2]	−2.1	−2.8	−3.1	−2.8	−2.7	−2.5
Interest and dividends, net [3]	1.6	2.2	2.2	2.2	2.3	2.7
Other services, net	.2	−.1	−.2	−.2	−.3	−.4
Government nonmilitary grants	−2.1	−1.6	−1.6	−1.6	−1.6	−1.9
Pensions and remittances	−.6	−.7	−.7	−.8	−.8	−.9
Long-term capital account	−.9	−3.0	−3.5	−2.1	−3.4	−2.5
U.S. direct investment [4]	−.7	−1.6	−1.1	−1.4	−1.7	−1.7
Other private U.S. investment	−.2	−.9	−1.4	−.9	−.9	−.6
Government loans (less repayments)	−.2	−.8	−1.0	−.4	−1.1	−.7
Foreign long-term investment [5]	.2	.4		.6	.3	.4
Balance on "basic" accounts (entries above)	−1.4	−2.2	−3.6	−4.3	−1.9	−.1
U.S. short-term capital and foreign commercial credit	−.2	−.5	−.4	.1	−1.4	−1.0
Errors and omissions	.4	.3	.4	.5	−.6	−.4
Over-all balance [deficit (−)]	−1.2	−2.3	−3.5	−3.7	−3.9	−1.5

[1] First 3 quarters at seasonally adjusted annual rate.
[2] Net of foreign military purchases in the United States.
[3] Excludes subsidiary earnings not repatriated.
[4] Excludes reinvested subsidiary earnings, amounting to $1.3 billion in 1960.
[5] Excludes reinvested subsidiary earnings, amounting to $0.2 billion in 1960.

NOTE.—Minus signs indicate payments to foreigners.
Detail will not necessarily add to totals because of rounding.

Source: Based on Department of Commerce data.

ing direct investments in business enterprise abroad, private purchases of foreign securities, U.S. Government loans, and long-term investments by foreigners in the United States; (3) *short-term capital account,* including commercial credits under one year and U.S. purchases of foreign short-term securities; (4) *over-all balance,* comprising net purchases of monetary gold and convertible currencies plus decreases in U.S. liquid liabilities to foreigners.

The accounts are, of course, far more interrelated than a simple classification of transactions suggests; foreign aid, private direct investment, and private remittances often consist in shipment abroad of U.S. goods. Even dollar outflows which are not so closely linked to the purchase of U.S. goods and services frequently result in reverse payments to the United States, either directly from the immediate recipient or indirectly through transactions involving third countries. The volume of our exports and indeed the size of the trade surplus are thus not independent of the size of our government outlays and private investments overseas.

The first account covers international transactions which relate to the earning and spending of national income. A surplus in this account means that the Nation as a whole is earning more than it is spending in its relations with the rest of the world, and this "saving" leads to an increase in the net assets of the country. Throughout the period covered by the table, the United States had a substantial merchandise trade surplus which, with other current receipts, was usually enough to pay for large overseas military expenditures and government grants for foreign reconstruction and development. In the first three quarters of 1961, the surplus on current account and unilateral transfers was at an annual rate of $2.4 billion.

The second account summarizes the transactions of the United States as an investing nation. In recent years the United States, as Table 17 shows, has invested in long-term foreign assets more than its surplus on current account and unilateral transfers. It has also lent to foreigners substantial amounts of short-term capital, as the third account in the table shows. The excess of our long-term investment and short-term lending over our surplus on current account and unilateral transfers—the over-all deficit—has been financed by increasing our liquid liabilities to foreigners and by selling gold.

The present payments problem of the United States is not one of solvency. The Nation is not "living beyond its means"; rather, its means are steadily increasing. At the end of 1960, the U.S. Government owned foreign assets totaling $21 billion, in addition to its gold holdings of $18 billion; and U.S. citizens owned another $50 billion in assets abroad (Table 18). In total, U.S. net claims on foreigners (including reinvested subsidiary earnings on investments abroad) rose by $4 billion in 1960, and the increase was perhaps as much in 1961. These increases substantially exceeded our losses of gold. Our foreign assets give basic long-run strength to the dollar; but because most of these assets are either privately owned or long-term investments or both, they cannot be quickly mobilized.

TABLE 18.—*International investment and gold position of the United States, 1949 and 1960*

[Billions of dollars, end of year]

Assets and liabilities	1949	1960 [1]
Assets	55.2	89.2
Gold, IMF subscription, and short-term	28.6	26.8
Monetary gold	24.6	17.8
International Monetary Fund subscription [2]	2.8	4.1
Short-term private	1.3	4.9
Long-term	26.6	62.4
Direct investment	10.7	32.7
Other private investment	4.9	12.6
U.S. Government claims [3]	11.0	17.0
Liabilities	16.9	44.7
Liquid	9.8	26.2
Short-term, by holders:		
Foreign official [4]	2.9	10.3
International Monetary Fund [5]	1.3	2.6
Other international organizations [4]	.4	1.4
Private [6]	4.6	9.6
Foreign and international holdings of U.S. Government bonds and notes	.6	2.3
Long-term	7.1	18.4
Direct investment	2.9	6.9
Other private investment	4.2	11.5
Excess of assets over liabilities	38.3	44.5

[1] Preliminary.
[2] Under current practices of IMF, the United States has a virtually automatic right to draw the amount of its subscription less the amount of U.S. liabilities to IMF as shown in the lower part of the table.
[3] Includes U.S. Government claims in inconvertible currencies.
[4] As reported by banks in the U.S.
[5] Noninterest-bearing notes (and, in 1949, deposits).
[6] Includes estimated foreign holding of U.S. currency and other liquid claims not accounted for elsewhere.

Note.—Detail will not necessarily add to totals because of rounding.

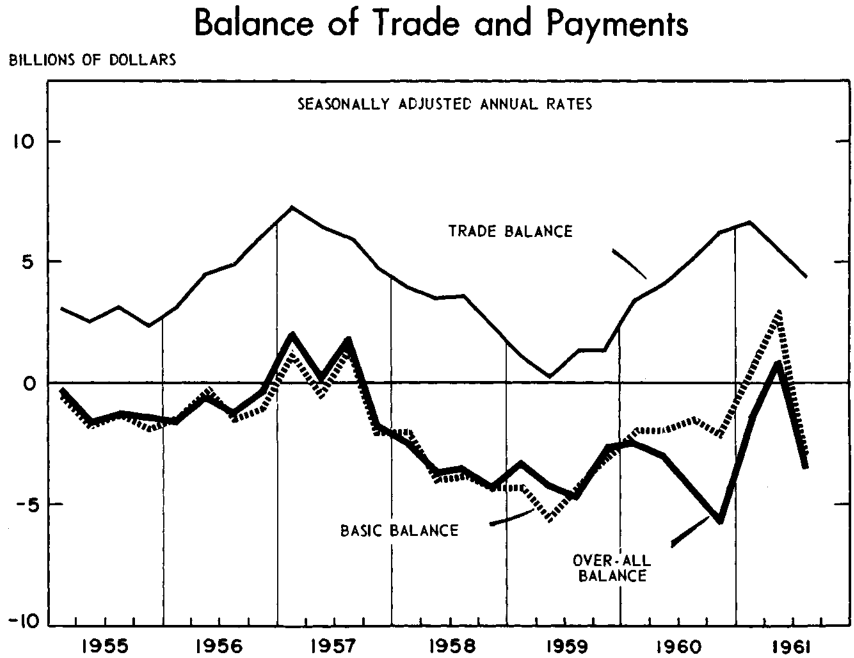
Sources: Department of Commerce and Board of Governors of the Federal Reserve System.

It is useful to distinguish net payments resulting from merchandise trade, services, unilateral transfers, and long-term investment—the so-called basic accounts—from net payments resulting from the more volatile, and sometimes substantial, flows of short-term capital. The balance on basic accounts and the over-all balance are shown in Table 17 and Chart 11. In 1959 the "basic" deficit was larger than the over-all deficit because of net inflows of short-term capital, while in 1960 and again in 1961 the over-all deficit exceeded the deficit on basic accounts as a result of net outflows of short-term capital.

The *over-all balance* exerts a significant influence on the liquidity position of the United States. The change in the U.S. position resulting from over-all deficits in the past decade can be seen from the reduction in the monetary gold stock and the increase in U.S. liquid liabilities to foreigners, shown in Table 18 and Chart 12.

Reserves and liquid liabilities. In 1949, the United States held 70 percent of the world monetary gold stock and half of the world total of official gold and foreign exchange reserves. Capital seeking haven from the political disruptions of the 1930's, followed by the import needs of war-torn Europe, produced this undue concentration of world reserves. In those

CHART 11



NOTE: FOR DEFINITIONS OF DIFFERENT BALANCES SEE TABLE 17.
SOURCE: DEPARTMENT OF COMMERCE.

circumstances, deficits in the U.S. balance of payments served the very useful function of rebuilding the depleted reserves of other countries.

Countries chose to replenish reserves largely by holding dollars rather than by purchasing gold. While cumulative deficits totaled $23 billion in the past 12 years (Chart 12), U.S. gold sales amounted to just $7 billion, of which $5 billion represented reacquisition of gold that the United States had obtained in the early postwar period. The rest of the deficit was settled by an increase in foreign dollar holdings.

Despite the continuous rise in foreign dollar holdings, the liquidity position of the United States is strong. The importance of the United States in international trade and international banking, the facilities offered by the New York money market, and the variety and quality of goods, services, and securities which dollars command within the United States make it advantageous for foreigners to hold large dollar balances. These working balances will not readily be withdrawn, although they are not entirely insensitive to yield opportunities abroad. Furthermore, as world trade expands, the size of these working balances is likely to rise.

The present position of the United States is satisfactory as long as foreign holders of dollars are confident that the gold value of the currency will be maintained. Loss of confidence can, however, result in a serious "run." Indeed—as the failures of basically sound and solvent commercial banks before the days of deposit insurance testify—there is no conceivable liquidity position which can withstand general loss of confidence.

Payments deficits and gold losses. As U.S. experience in the past 12 years indicates, there is only a loose link between external deficits and gold losses. Deficits occur when total payments to foreigners exceed total receipts from foreigners; a decline in gold reserves occurs when a foreign government or central bank converts dollars into gold at the U.S. Treasury. A deficit in the balance of payments need not, and usually does not, coincide with an equal decline in gold reserves. Foreigners may increase their dollar holdings by part or all of the deficit—or, as happened in 1956, even by more than the deficit (Chart 12). Similarly, this country may lose gold even when it has a balance of payments surplus, if foreign official institutions wish to convert dollars acquired in the past.

Payments deficits contribute indirectly to gold losses by adding to the supply of dollars in foreign hands, thus increasing the likelihood that they will be acquired by governments which may wish to convert them into gold. Moreover, the fact that there are persistent payments deficits may reduce foreigners' willingness to hold dollars.

Three years of large payments deficits contributed to a temporary decline in confidence in the dollar and to the large gold sales of late 1960. An outflow of short-term funds began in mid-1960 as a normal response to higher interest rates abroad, but it was augmented when doubts arose about the stability of the dollar, as evidenced by substantial private purchases of gold on the London market. These doubts reflected a number of factors: the large payments deficits of 1958 and 1959 and the loss of gold associated with them, the outflow of funds early in 1960 associated with differentials in interest rates, the initial rise in the London gold price, and fears that strong action to defend the dollar would not be taken. Confidence was restored when the new Administration declared and demonstrated its determination to defend the dollar, intensified measures taken by the previous Administration to reduce the payments deficit, and inaugurated new measures.

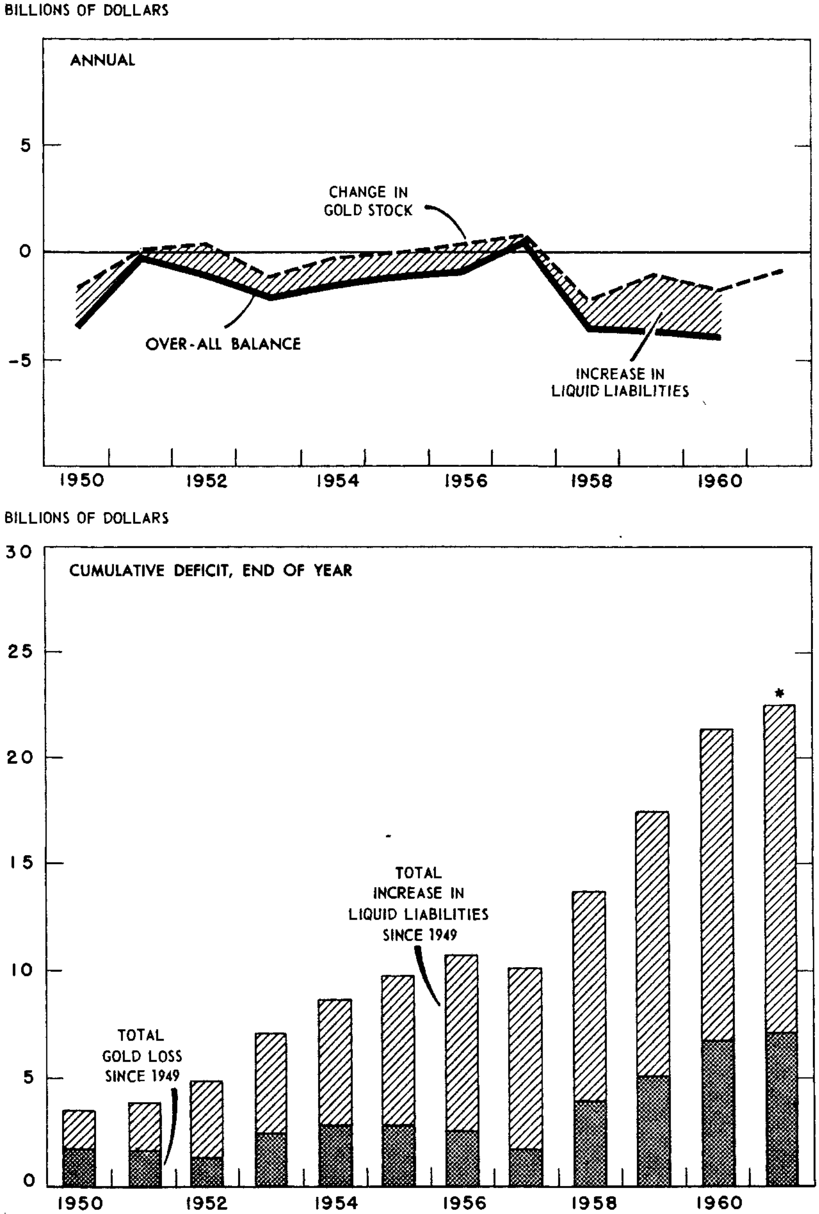
Recent Developments Affecting the U.S. Payments Position

Although the United States has been running deficits in its international accounts since 1950, these deficits were moderate in amount and did not cause concern until 1958. Concern has arisen since then, partly because of the unexpected persistence of large deficits and partly because the deficits could not be attributed to temporary developments likely to be soon reversed. Several significant new factors changed the U.S. position in the world economy: (1) The establishment of external currency convertibility by most of the European countries at the end of 1958 removed an important barrier to international capital flows. (2) The establishment of the European Economic Community promised a large, rapidly growing, tariff-free market in Europe, holding out much the same investment opportunities as the

CHART 12

Changes in U. S. Gold Stock and Liquid Liabilities to Foreigners

(Annual and Cumulative)



*FIRST 3 QUARTERS.

SOURCES: DEPARTMENT OF COMMERCE, TREASURY DEPARTMENT, AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

tariff-free internal market of the United States. (3) Intercontinental ballistic missiles and restoration of political stability in Western Europe reduced the special attractions of the United States as a haven for funds and as a location for capital investment. (4) The large overseas military expenditures and extensive foreign aid programs of the United States came to be clearly recognized as long-term commitments. (5) The decline of the U.S. trade surplus, from $6 billion in 1957 to a postwar low of $1 billion in 1959, focused attention on the long-run improvement in the competitive position of Western European countries and Japan relative to the United States—an improvement caused mainly by remarkable advances in output and productivity in those countries. (6) In addition, a sharp rise in certain key prices in the United States relative to those of major competitors weakened the competitiveness of some U.S. products in world markets. (This development is described in Chapter 4.) (7) By 1958, gold and foreign exchange reserves of many European countries had been rebuilt from their depleted postwar levels; U.S. payments deficits were no longer needed for this purpose.

These developments occurred within a short span of years and affected not only the U.S. payments position itself but attitudes and expectations about its future. The U.S. economy, which was geared to the entirely different environment of the years of "dollar shortage," suddenly had to adjust to a new situation. In brief, the required readjustment is that the United States must pay for overseas military commitments, grants, and investments to a greater extent by an export surplus earned in stiff world competition, and to a lesser extent by selling gold and accumulating liquid liabilities to foreigners. For the domestic economy, this implies changes in the structure of prices, wages, investment, and employment and a new orientation of American enterprise to world markets. A complete readjustment of this nature takes time.

Policies To Improve the U.S. Payments Position

In the new environment of the 1960's, the United States cannot continue deficits of the size of the late 1950's. The balance of payments objective for the United States is to attain, at high employment levels, a balanced position in its basic international accounts during the next few years. We must move toward equilibrium at a pace which demonstrates clearly that the balance of payments is under control.

The objective of a balanced basic position does not mean that balance must be maintained continuously. In some years, a surplus in international payments will be appropriate; in other years, a deficit. But the average position over a period of years must be strong enough to maintain confidence in the parity of the dollar.

The primary task is to improve the position of the basic accounts. Progress toward balance in these accounts will itself diminish the likelihood of sustained short-term capital outflows. Therefore, in a discussion of prospects and policies for improving the balance of payments position, it is convenient to discuss, first, the basic accounts, and then the short-term capital account.

Basic Accounts

The underlying trend of the basic accounts position is not easy to discern from current quarterly and yearly statistics. It is difficult to disentangle movements of lasting significance from changes resulting from seasonal, cyclical, and random factors. When, in the first half of 1961, slack in the U.S. economy combined with boom conditions in Europe and Japan to bring our basic accounts into temporary surplus, it would have been clearly wrong to conclude that the problem was permanently solved. Conversely, subsequent reappearance of a deficit on basic accounts, which may even rise temporarily as recovery proceeds in the United States, reflects a reversal of cyclical influences rather than a deterioration in the underlying position. Long-run improvement resulting from competitive adjustments and government policies may be masked by temporary developments here and abroad.

The dimensions of the problem facing the United States may be indicated by the basic international accounts in the six-month period embracing the second and third quarters of 1961—the latest 6 months for which complete information is available—expressed in terms of annual rates (Table 19). Overseas military expenditures, less foreign military purchases in this country, were running at $2.4 billion in mid-1961. Government grants and loans amounted to $3.7 billion, but $2.5 billion of these resulted directly in the export of U.S. goods and services, leaving $1.2 billion to be otherwise financed. Long-term private investment abroad was running at about $2.0 billion, and pensions and remittances to foreigners cost nearly $900 million.

The overseas commitments and investments, resulting in payments of $6.4 billion (2.4+1.2+2.0+0.9, rounded), must somehow be financed by net receipts from other transactions. This requirement was partially met by debt repayments by foreign governments (excluding special prepayments in April) and net earnings on services (excluding military transactions and receipts associated with government aid) amounting to $2.2 billion at an annual rate. Full balance in the basic accounts would, therefore, have required a merchandise trade surplus (excluding exports financed directly by government grants and loans) of $4.2 billion. This contrasts with the trade surplus of $2.8 billion actually achieved. The resulting deficit of $1.4 billion had to be financed by a sale of gold and an increase in our liquid liabilities to foreigners.

Without temporary cyclical factors, the gap would probably somewhat exceed the deficit of $1.4 billion on basic accounts actually experienced during this period, since our gross national product (GNP) was still far below full employment levels. At full employment, imports can be expected to be higher than they were in mid-1961.

TABLE 19.—*United States balance of international payments, 1960–61*

[Millions of dollars, seasonally adjusted]

Type of transaction	1960, fourth quarter	1961 First quarter	1961 Second quarter	1961 Third quarter [1]	1961 Second and third quarters (annual rates)
Current account and transfers, excluding major Government transactions	1,312	1,389	1,211	617	3,656
Merchandise trade balance [2]	999	1,080	911	488	2,798
Net balance on services [3]	543	519	521	340	1,722
Pensions and remittances	−230	−210	−221	−211	−864
Major Government transactions	−861	−870	[5] −713	−819	[5] −3,064
Military expenditures, net [4]	−642	−689	−611	−605	−2,432
Government grants and loans	−1,013	−1,000	−822	−1,014	−3,672
Exports of goods financed by Government grants and loans	563	580	452	605	2,114
Exports of services financed by Government grants and loans	86	107	87	115	404
Repayments of Government loans	145	132	[5] 181	80	[5] 522
Private long-term capital, net	−991	−356	−459	−542	−2,002
Balance on "basic" accounts (entries above)	−540	163	[5] 39	−744	[5] −1,410
U.S. short-term capital and foreign commercial credit	−567	−484	−31	−240	−542
Errors and omissions	−327	−25	−409	125	−568
Over-all balance [deficit (−)]	−1,434	−346	[5] −401	−859	[5] −2,520

[1] Preliminary.
[2] Excludes exports of goods financed by Government grants and loans.
[3] Excludes military expenditures, net, and exports of services financed by Government grants and loans.
[4] Includes private expenditures of foreign exchange by United States forces and their dependents; net of foreign military purchases in the United States.
[5] Excludes $649 million in receipts from foreign governments through extraordinary debt repayments.

Note.—Minus signs indicate payments to foreigners.

Source: Based on Department of Commerce data.

The payments position in the second and third quarters of 1961 reflects to only a small extent the impact of government balance of payments policies initiated during the year. The full effects of these measures, and of further measures planned or proposed, will take time. So will the full response of U.S. industry to the increased competitive challenge from abroad and to the improvement in the U.S. competitive position achieved in the past two years. But the gap to be narrowed and eventually closed is not large, less than 10 percent of our exports of goods and services and less than one-half of 1 percent of our GNP. Though it will take time to make the needed adjustments and for their effects to outweigh unfavorable cyclical factors, U.S. international reserves provide ample means to cover interim deficits on the basic accounts.

Improvement in the U.S. balance of payments is more than a U.S. problem. Our deficit is matched by corresponding surpluses elsewhere, especially in Europe. Unless the surplus countries allow their surpluses to decline, we cannot reduce our deficit without accentuating the payments problems of other deficit countries. Surplus and deficit countries bear joint responsibility for rectifying payments imbalances and for maintaining the stability of the international monetary system during the period of adjustment.

Reducing the basic deficit involves either diminishing the outflows on government and net capital account or increasing the current account surplus. Both these approaches are being taken. Measures to reduce the payments deficit must be consistent with the primary objectives of U.S. policy: to fulfill foreign economic and military obligations, to encourage the flow of goods, services, and capital among nations, and to expand the U.S. economy. There is no single dramatic cure-all for the payments problem. Accordingly, the Administration is pursuing a variety of measures on many fronts.

Military outlays. U.S. military outlays in foreign countries have averaged nearly $3 billion annually during the last six years even after foreign purchases of military equipment in the United States are deducted. These overseas expenditures by and for U.S. forces—for construction, logistical support, services, and personal purchases—are an integral part of the national defense effort. In addition, the United States provides substantial military grants in kind, valued at $1.8 billion in 1960, to the governments of friendly nations.

The Department of Defense has taken several measures to conserve foreign exchange, including increased procurement of its supplies from U.S. sources even at higher cost to the federal budget.

More than half of the military outlays are in Europe. The Berlin situation is causing an increase in these outlays. The United States is currently discussing with the Federal Republic of Germany and other NATO Allies measures which would have the effect of offsetting these dollar outlays for defense purposes. The Federal Republic of Germany is already making a substantial contribution in this regard. It is the objective of the Administration to work out arrangements which would offset as much of our overseas military expenditures as is feasible.

Government loans and grants. Government loans and grants have shifted markedly since the early 1950's from European countries and Japan to the less developed countries, and have risen from $2.5 billion annually in the mid-1950's to an annual rate of $3.8 billion during the first three quarters of 1961. Repayments on past government loans rose steadily during the 1950's, and in 1960 they exceeded $600 million.

The growing size of our aid expenditures reflects the pressing needs of the less developed countries for capital. The recent U.S. payments deficits, however, have necessitated policies to reduce the foreign exchange cost of these programs. The President has instructed the aid agencies to tie development aid directly to purchases of U.S. goods and services wherever possible. In the first nine months of 1961, before this policy had taken full effect, nearly 70 percent of government loans and grant disbursements resulted directly in the export of U.S. goods and services.

Though a policy of tied aid may be unavoidable under present conditions, it has the twofold disadvantage of reducing the efficiency of a given level of aid and of shielding some U.S. export industries from foreign competition. When the United States achieves over-all balance in its international accounts, it will be appropriate to discuss with European countries, Japan, and Canada the possibility of putting all the development aid of industrial countries on an untied basis.

The United States has encouraged other industrial countries to increase their aid efforts and to provide aid on an untied basis when their payments positions permit. Recent arrangements among several industrial countries to provide assistance for the development programs of India and Pakistan are examples of a new cooperative approach. Increased flows of development capital are of vital importance not only to the developing countries but also to the industrial countries, which will be able to sell to a vastly expanded market as the incomes and foreign exchange earnings of the less developed countries rise.

Private long-term investment. A highly developed economy like that of the United States today is quite naturally a source of capital for investment beyond, as well as within, its borders. This country is the world's largest source of savings. Since the United States is far ahead of many countries both in applied technology and in productive facilities per worker, there are bound to be attractive opportunities abroad for duplicating our advanced techniques of production.

Private long-term investment averaged $2.6 billion a year in the last five years, substantially higher than in the early 1950's. In addition, reinvested earnings of U.S. subsidiaries abroad averaged $1.1 billion annually. In 1961, U.S. private long-term investment abroad is estimated to have been about $2.3 billion.

While outflows of U.S. capital are adding to our national wealth foreign properties which may yield substantial return flows of earnings in the balance of payments over future years, these outflows increase the payments deficit in the short run.

Since 1958–59, the share of U.S. direct investment outflows going toward Europe has increased substantially. The promise of an expanding European Common Market has enhanced the attractiveness of Europe as a location for production. Flows of saving to develop productive opportunities abroad increase the efficiency of the world economy. However, capital is not allocated efficiently when it moves primarily in response to tax advantages or to restrictive or discriminatory trade barriers abroad. If the President's trade program is enacted and the new common external tariff in Europe is reduced through negotiations, artificial incentives to invest behind the European tariff wall will be reduced. This is one important way in which an expansionist trade policy will improve the U.S. payments position.

The Administration has also proposed changes in the tax treatment of foreign income which, in addition to achieving greater equity relative to tax treatment of domestic income, will ease our balance of payments deficit. Under the President's proposal, earnings on U.S. investments in other industrial countries would be taxed on the same basis as corporate earnings in the United States. This would be achieved by taxing U.S. corporations each year on their current share of the undistributed profits realized in that year by subsidiary corporations organized in economically advanced countries. Any decline in the outflow of U.S. capital resulting from a withdrawal of existing tax inducements would be consistent both with efficiency in the allocation of capital resources in the world and with equity between U.S. firms operating abroad and competing firms located in the United States. Legislation has also been proposed which would curtail tax haven privileges.

An additional proposal, discussed in earlier chapters, would provide a tax credit to spur domestic investment.

These measures, along with rising domestic activity, would increase the relative attractiveness of domestic, as opposed to foreign, investment. A higher rate of domestic economic expansion would increase the attractiveness of the United States for investment by foreigners.

The United States is urging countries in Western Europe to liberalize restrictions on the outflow of capital owned by their residents in order to permit more foreign capital issues to be offered in their markets and to permit more investment in the United States and in underdeveloped countries. Many European countries still limit foreign issues in their capital markets and control tightly purchases of foreign securities by their residents.

Services. Net exports of services, excluding military expenditures and sales, were at an annual rate of $2.3 billion during the first three quarters of 1961. These services include travel expenditures, transportation services, royalties, interest, and dividends. Repatriated earnings on U.S. investments abroad, which are counted as receipts for services in the balance of payments accounts, amounted to $3.2 billion in 1960. Our expenditures on foreign travel were $1.7 billion, and foreigners spent nearly $1.0 billion in this country.

During 1961, an Office of Tourism was established in the Department of Commerce to encourage foreign travel to the United States. In addition, the duty-free tourist allowance for returning U.S. travelers was reduced from $500 to $100 a person.

The proposed change in tax provisions regarding overseas investment should result in an increase in the repatriation of earnings from U.S. investments abroad.

Merchandise trade. Merchandise trade has earned large net receipts in every year since the war. The trade surplus has on average increased, but it has not increased sufficiently to cover the combined rise in overseas military, foreign aid, and investment outlays.

Restrictive commercial policies would be one way to try to check imports and increase the trade surplus. But raising tariffs and imposing quotas, while perhaps improving the trade position temporarily, would be inconsistent with the liberal trade objectives of the United States and would invite retaliatory action abroad, thus reversing any temporary gains.

Imports could also be checked by restraining domestic economic activity. But this would be an absurdly costly policy for the United States because imports comprise only a small part of each dollar of final demand. To obtain a $1 billion reduction in imports might require a $25–35 billion reduction of GNP. Even this decrease in imports would not result in an equivalent improvement in the trade balance, for, as the dollar earnings of other countries declined, some of our best customers would curtail their purchases in the United States. Moreover, the prospects for fundamental balance of payments improvement would be dim in a continuously slack economy beset by excess capacity and deficient in incentives to make investments at home which raise productivity and lower costs. Sacrificing recovery for a temporary gain in the balance of payments position would be shortsighted and would not inspire confidence in the dollar.

Clearly, our efforts to improve the trade position must be expansive rather than restrictive. A program has been established under the direction of the Department of Commerce to promote exports, both by increasing awareness among U.S. businessmen of sales opportunities abroad and by increasing foreign awareness of the wide array and high quality of U.S. products. The program includes regional conferences and a more active field service in the United States to provide information on foreign markets, trade exhibits and missions abroad, and an increased number of government commercial representatives to aid the U.S. businessman abroad.

In addition to improving the flow of information about export possibilities, steps have been taken to improve U.S. competitiveness in the important dimensions of credit availability and export insurance for commercial and political risks—steps designed to place the U.S. businessman on a par with foreign exporters. The Export-Import Bank has established, in cooperation with the commercial banks and a group of insurance companies, simplified and expanded opportunities for obtaining credit and export insurance. An exporter is now able to arrange for full credit and insurance advantages directly with his local bank.

A fundamental requirement for increasing our trade balance is a domestic environment of full recovery and growth without inflation. We must exploit the gains in productivity available from bringing into full use the excess capacity now prevalent in U.S. industry, and we must speed the advance of U.S. technology. The measures to accelerate the growth of productivity outlined in Chapter 2 are, for these reasons, essential elements of policy for long-run improvement in the balance of payments. In particular, the tax credit for investment proposed by the President and the revision of depreciation guidelines underway at the Treasury will promote investment at home and make American industry more competitive. It is true that economic growth, by raising incomes in the United States, will tend to increase the purchases of foreign goods by U.S. consumers and businesses. But economic growth achieved through advances in productivity and improvements in technology will also enable U.S. goods to compete more effectively with foreign products both in the United States and in foreign markets. The technological leadership and high productivity of the United States have proved in the past to be vital sources of our comparative advantage in world markets. And today, the most rapidly growing countries in the free world generally rank among those with the strongest international payments positions.

An accelerated advance in productivity will be of little help to the balance of payments, however, if the improvements are eroded away by increases in money costs and prices. The price increases of 1955–57 impaired the competitive position of several important U.S. industries in world markets. More recently, price and wage developments in the United States have been favorable relative to those in other countries. The stability of U.S. prices in the last three years, and the reasons for optimism concerning U.S. prices in the current economic recovery, are discussed in Chapter 4. Policies to avoid cost inflation at home can be reinforced by a liberal trade policy which expands the area of international competition to which U.S. producers are exposed.

The future course of exports will depend not only on U.S. policies but also on business activity, prices and wages, and commercial policy abroad. Successful international trade negotiations under the proposed Trade Expansion Act will provide increasing opportunities for U.S. exports. In addition, the United States continues to press for the elimination of open and concealed discrimination against U.S. goods—agricultural products provide outstanding examples—and against the products of third countries, many of which are good customers of the United States.

The continued expansion of the European economies is of great importance for the future of U.S. exports. And the rapid growth of all the industrial countries is of vital concern to the primary producing countries whose exports have been largely stagnant in recent years. As the exports of the primary producing countries increase, their purchases from the United States and other industrial countries will expand.

Short-Term Capital Account

Dollars are transferred to foreigners not only through deficits in the basic accounts of the United States, but also through short-term lending by Americans to foreigners. Much of this lending is commercially oriented and often provides financing for American exports. During the first half of 1961, for example, a large part of the short-term capital outflow from the United States was used to finance an increase in exports from the United States and other countries to Japan. An increase in such commercial credit will be a natural consequence of policies taken during 1961 to boost U.S. exports.

However, some flows of short-term capital are not linked directly to export financing. These flows of funds, both U.S. and foreign owned, have increased markedly since the establishment of external currency convertibility of the leading European countries in 1958, the relaxation of restrictions on capital transactions by their own nationals, and the re-establishment of confidence in the stability of European currencies.

Short-term capital movements are sensitive to differences in interest rates between major financial centers. In late 1960, for example, when yields on short-term securities were substantially higher in Canadian and European markets than in the United States, a significant volume of U.S. funds moved abroad. Again in the last few months of 1961 substantial amounts of capital moved abroad to benefit from higher yields.

Liquid funds also move in hope or fear of changes in exchange rates or regulations. For example, the revaluations of the German mark and the Dutch guilder in March 1961 led to expectations of further revaluations and resulted in large short-term capital flows. Movements of this kind often reflect objective factors related to basic balance of payments positions. But they sometimes respond to rumor and opinion unrelated to the basic situation.

A notable feature of the U.S. balance of payments in the past two years was the sharp swing in the balancing item, "errors and omissions," from a net inflow through 1959 of some $500 million a year to a net outflow of $650 million in 1960 and a further $400 million in the first half of 1961. Preliminary estimates for late 1961 also show a large unrecorded outflow. This change no doubt reflected a sizable transfer of U.S. capital abroad and a withdrawal of foreign private capital, both of which moved outside channels normally covered by our recording network.

Flows of short-term capital, although they frequently perform a useful function, can be seriously disruptive. They can be large, sudden, erratic, contagious, and self-reinforcing. Monetary authorities are gradually adjusting their policies and techniques to cope with these flows. During the past two years, several steps were taken to reduce the incentive to shift capital among financial centers. Foremost among these was increasing cooperation among central banks to avoid large differentials in short-term interest rates among countries. High interest rates in Europe were lowered in late 1960 and early 1961. U.S. monetary policy and technique have been adapted to the new international financial environment in the manner described in Chapter 1. Although the Federal Reserve has maintained generally easy money and credit conditions, U.S. short-term rates have been held above levels characteristic of previous recession and recovery periods.

In December 1961, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation raised permissible interest rates on commercial-bank time deposits. The ceiling rate for deposits exceeding 12 months was raised from 3 percent to 4 percent a year. As banks move rates up to the new ceilings, they will increase the attractiveness of holding funds in the United States.

Finally, the U.S. Treasury has, for the first time since the mid-1930's, engaged in foreign exchange operations in cooperation with foreign central banks. The Treasury this year undertook transactions in German marks and Swiss francs, both on a current basis and in the forward exchange market. The aim was to increase the cost to traders and investors of exchange risk "cover" for movements out of dollars, diminishing the incentive to shift funds abroad and increasing the incentive to move funds here.

Although these policies will moderate the disruptive flows of short-term capital, they cannot eliminate them. Further measures are therefore needed to neutralize or minimize the possible effects of such flows on the international monetary system.

Measures To Strengthen the World Monetary System

Stability of the present world monetary system depends upon confidence in the value of the dollar. Therefore, a primary aim of the United States and of other countries must be to correct the underlying conditions which result in persistent U.S. deficits and persistent surpluses elsewhere. This is fundamental, but it will take time.

While policies to achieve this fundamental adjustment are taking effect, full confidence must be maintained in the ability of the United States to meet foreign demands for gold. There are a number of measures which can strengthen the "banking" or liquidity position of the United States while the fundamental adjustment of the payments position proceeds. Some of them apply to the dollar alone; others are general measures to strengthen the world monetary system. All of them require a high degree of international consultation and cooperation.

One means of strengthening the U.S. liquidity position, as well as its payments position at a given time, is to obtain advance repayment of long-term debts owed to the U.S. Government. For example, in April the Federal Republic of Germany prepaid $587 million to the United States. This translated a long-term U.S. asset partly into a reduction of short-term U.S. liabilities and partly into a rise in U.S. holdings of German marks. The United States still has outstanding about $2 billion of long-term loans to countries that have strong payments positions.

The gross reserve position can also be strengthened by borrowing directly in foreign currencies from other governments or central banks. This device was employed recently on a small scale when the United States borrowed from Switzerland $46 million in Swiss francs in order to support forward exchange operations of the Treasury.

Recently, there has been increasing recognition that, even when large movements of private short-term capital cannot be prevented, they can be offset by reverse movements of official capital. In March 1961, several central banks agreed through the so-called Basle arrangements to extend short-term credit to the United Kingdom to offset the flight of private funds from London.

Several countries now consider their drawing rights on the International Monetary Fund as an integral part of their foreign exchange reserves. In his Balance of Payments Message of February 6, 1961, President Kennedy stated that "access to the Fund's resources must be regarded as a part of our international reserves" and that, if appropriate, the United States would use its drawing rights. The drawing from the Fund of currencies equivalent to $1.5 billion by the United Kingdom in August, and the prompt repayment of $420 million as British reserves rose, indicate the flexibility with which drawing rights on the Fund can be used to supplement reserves. Furthermore, in accordance with recent IMF policy, member countries have increasingly made drawings in currencies other than the dollar, which the Fund formerly relied on heavily for most of its operations. This policy puts to effective use the Fund's holdings of the currencies of surplus countries. But the Fund's holdings of some of these currencies may not be fully adequate to meet the potential demands for them.

Improvement of the Fund's access to the currencies of the major industrial countries was discussed at the annual Fund meeting in Vienna in September. It was announced in early January that ten industrial countries have agreed to lend amounts of their currencies totaling $6 billion, to the Fund if these resources should be required to forestall or cope with an impairment of the international monetary system. Availability of these special resources should enable the Fund better to perform its function of financing temporary payments deficits in the interests of maintaining general exchange rate stability.

In his February Message the President said, "Increasing international monetary reserves will be required to support the ever-growing volume of trade, services and capital movements among the countries of the free world. Until now the free nations have relied upon increased gold production and continued growth in holdings of dollars and pounds sterling. In the future, it may not always be desirable or appropriate to rely entirely on these sources. We must now, in cooperation with other lending countries, begin to consider ways in which international monetary institutions—especially the International Monetary Fund—can be strengthened and more effectively utilized, both in furnishing needed increases in reserves, and in providing the flexibility required to support a healthy and growing world economy."

The agreement to supplement the resources of the Fund is an important step toward strengthening the international monetary system to meet the demands which the continuing economic progress of the free world will place upon it in the future.

Finally, the newly created Organization for Economic Cooperation and Development, comprising 18 European countries, the United States, and Canada, provides a continuing forum in which payments imbalances and internal or international monetary problems of concern to all members—as well as trade, development aid and other matters of common interest—can be discussed frankly and constructively. Still another forum for international cooperation is provided by the monthly meetings of central bankers at the Bank for International Settlements in Basle. Although the United States is not a member of the Bank for International Settlements, representatives of the Federal Reserve System participate informally in the discussions.

These measures of cooperation among nations, together with the large gold reserves of the United States, give this country the time to carry through the necessary adjustment in its balance of payments—and to carry it through in ways consistent with general economic expansion at home and abroad, with promotion of a world economy in which goods, services, and capital flow freely, and with the responsibilities of world leadership. They give us time, but not time to waste.