Chapter 6

The International Economy

THE WORLD ECONOMY has shown remarkable progress during the two decades since the end of World War II. In the developed countries, economic expansion has been far more rapid and steady than ever before. The less developed countries have also experienced unprecedented growth. Yet in this latter group, absolute levels of income remain disturbingly low, and few countries show clear promise of attaining adequate, self-sustaining economic growth in the near future. The world's single most important—and most intractable—economic problem lies in the less developed countries of Africa, Asia, and Latin America.

In the period between the two World Wars, the recognized common economic problems of the industrial countries were economic stagnation, large-scale unemployment, and wide fluctuations in output and prices. Today, these problems have essentially been mastered. But these countries are now confronted with the problems of determining how their economies can successfully adjust to the requirements of an increasingly integrated world economic system and how international monetary arrangements can best serve to assist and facilitate this adjustment.

The first major section of this chapter briefly considers some of the problems of the less developed countries and ways the industrial countries can help to solve them. Next, the evolving integration of the world economy and the new problems associated with it are sketched. The chapter then discusses the changes in economic and financial policies needed to ease the mutual adjustment of countries to balance of payments disturbances and to provide for the adequate and dependable growth of international liquidity. Finally, it treats the U.S. balance of payments and the policies adopted to restore the international equilibrium of the U.S. economy.

THE LESS DEVELOPED COUNTRIES: PROGRESS, PROBLEMS, AND POLICIES

Since 1950 the less developed countries of Africa, Asia, and Latin America as a group have increased their real production at an estimated average rate of 4½ percent a year. However, population growth in these countries has also been rapid—between 2 and 3 percent a year. As a result, the annual rise in real output per person has averaged roughly 2 percent—well below the rate in the developed countries. Moreover, very few of the less developed countries could maintain even this pace of economic expansion without considerable assistance from abroad; despite this aid, there appears to have been some slowdown in their growth in recent years.

Aggregate figures conceal significant differences among the less developed countries. In a number of them—for example, Israel, Jordan, Taiwan, and Thailand—real output from 1957 to 1964 increased by 7 percent a year or more. In others—Indonesia, Lebanon, Morocco, Paraguay—output failed to keep pace with population increases.

FOREIGN ASSISTANCE

Capital

To achieve an adequate pace of economic growth, most developing areas of the world require more capital than they can accumulate from domestic savings or can raise externally on commercial terms. Foreign aid can therefore contribute to economic development. But the way the recipient countries use their resources is much more important. Consequently, as a condition for its bilateral development assistance, the United States stipulates that the recipient country adopt policies which effectively utilize local resources.

The less developed countries are themselves financing the major part of their development needs. In recent years, three-fourths of their gross investment has come from domestic savings. Table 22 shows their sources

TABLE 22.—*Net flow of long-term financial resources to less developed countries, 1960–64*
[Billions of dollars]

Source	1960	1961	1962	1963	1964
Net flow to less developed countries [1]	7.2	8.6	8.2	8.9	[2] 9.7
Bilateral flow from countries: [3]					
From DAC countries: [4]					
Official: Total	4.2	5.2	5.4	5.7	5.6
United States	2.5	3.2	3.4	3.6	3.3
Private: Total	2.3	2.6	1.9	2.0	2.6
United States	1.0	1.1	.8	.7	1.3
From other countries:					
Other industrial countries [5]	.1	.2	.2	.2	(6)
Communist countries	.2	.3	.4	.4	(6)
Flow from multilateral organizations [7]	.3	.3	.4	.7	.8

[1] Excludes loans and credits of 5 years maturity or less. Loans are net of repayments.
[2] Estimate.
[3] Bilateral grants and loans.
[4] Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) consists of Austria, Belgium, Canada, Denmark, France, Federal Republic of Germany, Norway, Portugal, United Kingdom, and United States. (Sweden joined DAC in July 1965.)
[5] Australia, Finland, New Zealand, South Africa, Sweden, and Switzerland.
[6] Not available.
[7] Disbursements by multilateral organizations to less developed countries.

NOTE.—In addition to receipts shown in this table, the less developed countries receive contributions from nonindustrial countries, notably Kuwait.
The table does not net out private capital flow from less developed countries to developed countries.
Detail will not necessarily add to totals because of rounding.

Source: Organization for Economic Cooperation and Development.

of foreign capital. Although the total has increased somewhat, official bilateral aid has been stable in recent years.

Estimates of the foreign exchange requirements of the less developed countries vary widely, but they all indicate the need for a substantially increased inflow of foreign capital. The World Bank staff recently estimated that over the next five years the less developed countries could effectively use $3–4 billion a year more than is currently available to them.

The need to finance existing foreign indebtedness is an important and growing claim on the foreign exchange resources of the less developed countries. About half of their gross capital inflow is offset by $6 billion of payments for amortization and interest on loans and dividends on investments. In July 1965, the major countries extending aid agreed in principle that more grants and softer loans are required.

The International Development Association (IDA), an affiliate of the World Bank, is one of the international organizations which meets the needs of developing countries for capital on soft terms—interest-free loans, a modest service charge, and a repayment period of 50 years. The IDA's resources are derived from contributions by the economically advanced member countries and from the earnings of the World Bank. The Association must have additional funds from its members if it is to continue even its current level of operations.

In 1965, President Johnson announced U.S. support for an intensified program of economic and social development in Southeast Asia. The United States pledged $200 million to the $1 billion capital of a new multilateral lending institution, the Asian Development Bank, designed to foster the economic development of the region. In addition, the United States has indicated its willingness to provide $100 million for a special fund for soft loans and grants for Southeast Asian development, if other countries will join in such a venture.

Private foreign investment also makes a crucial contribution to the less developed countries. It provides not only capital but associated technical and managerial skills. As economic growth begins, private investors—where they are welcome—will respond to opportunities for investment. For example, in three countries with successful growth records—Greece, Israel, and Taiwan—the inflow of private foreign capital rose from 1.8 percent of gross national product (GNP) in 1957 to 3.1 percent in 1963.

Agricultural Production and Food Aid

The recent slowdown in economic growth in some less developed countries can be ascribed to the failure of their agriculture to expand sufficiently. Indeed, in Latin America and in the Far East, per capita food production is below levels reached prior to World War II.

America's agricultural abundance has long been used to help to meet the food needs of the less developed world. Our food aid program, Food for

Peace, is also important in the promotion of economic growth and has helped by freeing resources for industrial development. But food aid must not be allowed to impede the development of agriculture, since, in many countries, agriculture may be the most rapid route to general economic growth. Moreover, such progress in agriculture is essential to the long-run solution of foreign food shortages. If the gap between food needs and production in the less developed countries continues to widen at the rate of the past few years, even the United States with its vast food-producing capacity will not be able to fill it.

This year, in addition to the Food for Peace program, the United States will institute a special assistance program to help foreign lands expand their agricultural output.

Human Resources

The less developed countries are seriously handicapped by shortages of trained manpower—indeed, illiteracy is a major problem. Since 1957, the less developed countries have increased their investment in education by an average of 15 percent a year. The United States is assisting educational development through some 350 educational projects in 65 developing countries and in the past 3 years has financed the construction of approximately 210,000 classrooms to accommodate 6.7 million students. Substantial assistance has been given to develop teacher training colleges, to modernize educational systems and curricula, and to link educational programs to the manpower requirements of these countries.

The U.S. Government is now joining a new worldwide endeavor of educational cooperation and assistance, emphasizing the educational needs of school-age children and encouraging more of our teachers and school administrators to serve abroad.

The United States has long been deeply committed to improving health conditions in the less developed countries. Major support is provided to the health programs of the United Nations, its specialized agencies, and five multilateral regional organizations. Total international health obligations of the U.S. Government will amount to approximately $270 million in the current fiscal year and are scheduled to rise substantially next year. However, our potential for technical assistance in this field is only now being fully mobilized by the Federal Government. New programs will give priority to the development of a cadre of U.S. international health workers and to helping the less developed countries train more health workers themselves. The United States will also increase substantially its support for the eradication of communicable diseases and for the provision of potable water supplies in many regions of the world.

Child malnutrition increases susceptibility to infectious diseases. In many countries, this combination kills half of all children before the age of five. Physical and mental retardation of the surviving malnourished youngsters frequently is permanent. To assist developing nations in their efforts to meet the nutritional needs of many additional millions of children, U.S. programs will be substantially expanded this year.

Rapid population growth compounds economic and social problems in the less developed countries. As a result of deliberate efforts to limit the size of families, population growth rates have leveled off or are falling in Hong Kong, Singapore, and Taiwan. Korea, Pakistan, Tunisia, and Turkey also have initiated programs. But in the less developed world as a whole, population growth is continuing at an increasing rate.

In the short run, population control can limit the number of dependent children supported by each member of the labor force. But it will be some time before it can have an appreciable impact on total numbers. Over the longer run, it can ease problems of unemployment and underemployment and raise individual productivity.

To help countries which request U.S. assistance with their population problems, the United States will mobilize and make available technical and financial resources, including the support of training programs for foreign personnel who can in turn train the thousands of individuals required to carry forward family planning programs.

IMPROVING TRADE PROSPECTS

Both the advanced and the emerging nations must give greater attention to policies to accelerate the growth of the export earnings of the less developed countries. For these countries as a group, export earnings yield four times as much foreign exchange as do all loans, grants, and direct investments from abroad. Yet these nations are not fully sharing in the tremendous growth of world trade. The reasons for this are to be found largely in the sluggish secular growth of demand for their traditional primary products. Although exports of manufactured products from less developed countries doubled between 1953 and 1964, foodstuffs, raw materials, and petroleum nevertheless accounted for 85 percent of their total shipments in 1964. Rising domestic demand, inflation, and overvalued exchange rates in some countries have also adversely affected sales abroad.

Most less developed countries are vulnerable to short-term export instability. For individual primary commodities and primary exporters, a major source of instability has been the wide and erratic movement of prices. The less developed countries need greater assurance that development programs will not be vitiated by unpredictable declines in export earnings which are beyond their control. International agreements for some commodities, such as coffee, represent one technique for dealing with this problem.

Financial arrangements to help to offset shortfalls are another technique. Three years ago, the International Monetary Fund (IMF) established a special drawing arrangement for compensatory financing of short-term fluctuations in members' export earnings. Only three countries have thus far used the facility, since price trends of primary commodities were generally favorable to producers throughout 1963 and much of 1964. In view of recent price declines, more applications may be expected. The United States and other governments are now considering new ways to provide additional short- and long-term financing to offset export shortfalls.

Liberal commercial policies by the developed countries will contribute to world economic development. A successful Kennedy Round will benefit the less developed as well as the developed countries. However, there will remain room for further tariff reductions and import liberalization of special significance for development. Many advanced countries could abolish or relax a number of import restrictions without causing economic dislocation. Recent studies indicate that general tariff reductions, even on those manufactures which are protected by low duties, might ultimately yield a significant increase in exports of less developed countries. The developed countries could also contribute to their own growth and that of the less developed countries by reducing agricultural protectionism. Moreover, nontariff barriers to imports, such as quantitative restrictions and the high consumption taxes which some countries impose on tropical products (coffee, cocoa, and bananas) for purely fiscal reasons, frequently place a serious burden on the less developed countries.

RECENT CHANGE IN THE DEVELOPED COUNTRIES

The main problem of the developed countries in the 1960's is not how to promote growth but how to avoid stunting growth in dealing with the balance of payments and domestic price stability.

The rapid postwar economic growth of the developed countries may be due to basic structural and technological changes which only future economic historians will be able to distinguish clearly. But there can be no question that growth has been spurred by two highly visible developments. First, and more important, the governments of most countries have assumed an active responsibility to promote expansion and growth, guided by a new understanding of how government policy affects economic activity. Second, in many countries of Europe and in Japan, a dynamic source of expansion and modernization has been the growth of export markets, stimulated by the dramatic postwar movement toward economic integration. Rapid growth in each country has provided expanding export markets for the products of others, in a chain of mutually supporting expansion.

A number of postwar institutions have contributed to integration: the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF), and the Organization for Economic Cooperation and Development (OECD). Through their efforts, import quotas on trade in manufactured products have been largely abandoned; tariffs have been greatly reduced; the principal currencies have become convertible. Moreover, great new free trade areas have been created, especially the European Economic Community (EEC) and the European Free Trade Association (EFTA). By the beginning of 1966, internal tariffs within the EEC and EFTA had been reduced by 80 percent.

THE GROWTH OF INTERNATIONAL TRADE

As a result of all of these developments, international commerce has flourished. In the decade from 1954 to 1964, exports of the advanced industrial economies grew by an extraordinary 117 percent, and exports of the less developed areas rose by 59 percent.

To be sure, uncertainties within Europe are now having their impact both on further integration within the EEC and on the external relations of the EEC, including the current Kennedy Round of trade negotiations. The pace of integration and especially the movement toward more liberal world trade have been slowed. The Kennedy Round is at a virtual standstill.

The American commitment to the Kennedy Round—the boldest and most significant effort to liberalize the world trading structure yet undertaken—is as firm as ever. But the protracted internal crisis of the EEC has prevented any significant negotiations with that group of states since last summer. The longer this paralysis continues, the more uncertain are the prospects. The negotiating authority provided by the Trade Expansion Act expires in less than 18 months. If these important negotiations are to yield their full potential benefits, meaningful deliberations must resume, at the latest, early this spring. Were the Kennedy Round to fail, the world would have missed a unique opportunity for further reduction of trade barriers against both industrial and agricultural products and for a further widening of world markets to the benefit of both the developed and developing nations.

The United States is also giving increased attention to the lowering of barriers to trade with the countries of the Soviet bloc. For both political and economic reasons, this country has not fully participated in the steady expansion of East-West trade during the past decade. U.S. trade with the Soviet bloc amounted to barely 1 percent of total U.S. foreign commerce in 1964. Last year, the President's Special Committee on U.S. Trade Relations with East European Countries and the Soviet Union recommended an expansion of peaceful trade with the European Communist countries and urged that the President be given discretionary authority to remove trade restrictions against those countries.

The President has indicated that he will ask Congress for selective authority to grant most-favored-nation treatment to imports from the countries of Eastern Europe, including the U.S.S.R. While no sudden expansion of trade is likely, the opportunities for increased trade may prove significant for individual firms and products.

PROBLEMS OF RAPID GROWTH AND INTEGRATION

The new economic dynamism of the developed countries of the free world has brought great gains—but also problems. These problems have both domestic and international dimensions, closely interrelated.

The main domestic problem in most countries today is that of reconciling prosperity with stability of costs and prices. This has been a problem for all the countries of Western Europe at one time or another in the past 2 decades. But even though wage rates and other money incomes rose at a rapid pace, increases in labor costs were often restrained by extremely rapid improvements in productivity. In fact, in Germany and Italy, as well as in Japan, they held stable or fell in the early 1950's as a result of the rapid gains in productivity that went with the development of new industries and processes, the modernization of obsolete equipment, and the great expansion of the size of domestic and international markets. Moreover, there were labor resources to be drawn from domestic sectors of low productivity—and often from such sectors in other countries—which restrained upward pressures on wages. But now productivity gains are slowing down from phenomenal to merely exceptional; sources of low-cost labor are harder to come by; and the income demands of labor and other groups continue to increase. Rapid growth and full employment are more generally accompanied by upward pressure on costs and prices.

Internationally, the problem of adjusting to rapid growth has taken complex forms. The closer integration of international markets and increased freedom of payments have been among the main sources of domestic growth in many countries. But they also have contributed to strains in the balance of international payments.

Growth rates, while generally high, have not been the same in all countries, and internal price levels have not changed equally. Large structural changes accompanying and responsible for growth in some of the countries have altered their international competitive position. Tax systems have been adjusted, with resulting effects on prices of imports and exports. The formation of EEC and EFTA has affected members and nonmembers differently. Profound changes associated with the termination of colonial status have affected the markets and obligations of several European nations. The costs of defense and aid commitments vary significantly among countries.

All of these factors have considerably affected the external transactions of each of the industrial countries, at times creating large surpluses or deficits in trade or government payments.

Reduction of government restrictions, the convertibility of currencies, increasing knowledge of opportunities abroad, growing confidence in existing governments, larger supplies of investible funds, and rapid growth of markets have brought a spectacular expansion of international capital movements. The flow of capital has also been affected by national policies to restrain inflationary pressures, by the differences in the development of national capital markets, by country-to-country differences in profits and interest rates, and, on occasion, by hopes or fears of currency revaluations. Although international flows of capital have contributed to world economic growth, they have at times created problems for both the importing and the exporting country.

Thus for the capital account as well as the current account, the closer economic integration of the newly dynamic Western economies has been a source of severe balance of payments strains. And measures taken by Western European Governments to deal with deficits have been a major factor behind the occasional slowdowns in the pace of economic expansion.

In the past 15 years, many potential strains have been effectively masked by large U.S. deficits. They have allowed most other countries to maintain rapid expansion while still gaining reserves. Even so, there have been serious deficits at various times in France, Canada, Italy, Japan, and the United Kingdom. Had the U.S. international payments been in equilibrium during this period, many more potential strains would have become visible. Once the umbrella of the U.S. deficit is removed, the problems of adjusting to rapid growth and change in a world of relatively free trade and payments may become more evident and more difficult to resolve.

DEVELOPMENTS IN 1965

Many of the problems of mutual adjustment were brought into sharp focus during 1965, as payments positions of major countries underwent particularly large and rapid changes. For the United States, there had been a sudden increase in the deficit in late 1964 and early 1965. Following President Johnson's program of corrective measures in February 1965, however, the balance of payments showed a major improvement.

The payments position of the United Kingdom remained precarious from the autumn of 1964 until the late summer of 1965, causing heavy speculative attacks on the pound. However, as a result of forceful measures taken by the British Government to defend the value of its currency—aided by large-scale financial assistance from the IMF and, on a cooperative basis, from major nations—pressures on the pound subsided significantly by the autumn, and the United Kingdom has continued to regain reserves. The British Government, moreover, has given convincing evidence that it will take all steps needed to bring its payments position into balance by late 1966. Meanwhile, the German surplus, which had been of serious concern for several years, was eliminated in 1965.

However, at the very time that the large deficits of the two major reserve currency countries were being reduced and the troublesome German surplus corrected, new problems of payments imbalance emerged elsewhere. Italy, in particular, developed very sizable surpluses. A surplus also appeared in Japan. At the same time, France had a surplus even larger than that of 1964.

These divergent developments were in many cases closely related to the policies adopted by the various countries to affect domestic demand. In the United States, to be sure, the payments imbalance was reduced substantially without impeding domestic expansion. For the United Kingdom, however, restrictive domestic measures were part of its program to bring the payments deficit under control, as well as to counter inflationary pressures at home. In Italy and Japan, the brakes previously applied to their expanding economies, to help counter payments deficits and domestic inflation, had proved in some respects too effective. Such policy measures as were taken in 1965 to revive demand brought only relatively slow progress. In France, also, the larger surplus position was clearly associated with a low rate of economic expansion, reflecting the Government's hesitation to take more active stimulative measures because of the fear of possible inflation. On the other hand, burgeoning domestic demands clearly contributed to the elimination of Germany's surplus.

The policies adopted by various countries to deal with domestic and balance of payments problems had, in turn, significant implications for the growth prospects of other countries, both developed and less developed. To the extent that such policies depressed export markets, there was danger that world economic growth would be impeded.

The challenge to the developed nations as a group is to find mutual arrangements and institutions that can support healthy economic growth and at the same time maintain reasonable external equilibrium in a world community of increasing interdependence.

IMPROVING THE INTERNATIONAL MONETARY SYSTEM

Soundly functioning international financial arrangements should permit countries to make necessary adjustments to changes in their external payments positions with minimum impairment of the broader objectives shared by all nations: relatively full employment, a satisfactory rate of economic growth, an efficient allocation of international resources, and reasonable price stability. These arrangements should provide for a satisfactory expansion of total international reserves and liquidity as an underpinning for a growing volume of trade and payments. And they should command such widespread confidence that international transactions will not be disrupted by excessive speculation, or by sudden and unpredictable shifts from one form of international reserve asset into another.

Balance of payments adjustment, reserve creation, and maintenance of confidence are, of course, closely interrelated. Under the prevailing system of fixed exchange rates, it usually requires time to correct payments imbalances in a way that is consistent with the achievement of basic objectives. This means that countries need sufficient reserves or credit to provide a reasonable margin of safety for dealing with actual or potential deficits. If reserves or credit facilities are inadequate, even surplus countries may feel impelled to follow unduly restrictive policies. Moreover, too small a margin of safety may encourage undesirable speculative flows, adding further to the need for liquidity. Too large a volume of liquidity, on the other hand, could be inflationary. Improvements in the adjustment process which would reduce imbalances—without sacrifice of broader objectives—would cut back liquidity needs and strengthen confidence.

During the past year, these closely related matters have received intensive consideration in discussions concerned with ways of improving the international monetary system—by the IMF, the OECD, the leading industrial countries known as the Group of Ten, and various bodies associated with the UN and the EEC.

The discussions within the Group of Ten and in Working Party 3 of OECD have been of particular importance. A report examining the issues raised by various proposals to create new reserve assets was submitted to the Group of Ten last summer by a working group under the chairmanship of Rinaldo Ossola of Italy. With this study completed, the Finance Ministers and Central Bank Governors of the Group of Ten, at the time of the Annual Meeting of the IMF Governors last September, requested their deputies to "determine and report to Ministers what basis of agreement can be reached on improvements needed in the international monetary system, including arrangements for the future creation of reserve assets, as and when needed. . . ." The deputies are to report on their progress this spring. Meanwhile Working Party 3 is to accelerate its study of ways to improve the adjustment process.

As soon as a basis for agreement has been reached among the Ten, negotiations on means to improve the international monetary system would then proceed to a second stage in which all members of the IMF would have a more direct opportunity to voice their views. The following two sections present some of the issues involved in the study of the adjustment process and in the negotiations to improve international liquidity arrangements.

THE ADJUSTMENT PROCESS

The Council's Annual Report for 1964 described at some length the balance of payments adjustment process which operated—or was supposed to have operated—in a relatively automatic fashion under the 19th century gold standard. It pointed out that this method of adjustment relied on the maintenance of a rigid link between changes in countries' gold holdings and internal monetary conditions, in nations without active fiscal policies, and could only work by subordinating domestic welfare to the requirements of external balance.

Such a system is neither possible nor acceptable in the modern world. All nations today follow discretionary policies directed toward multiple objectives, internal as well as external. Quite appropriately, they are reluctant to resolve payments problems at the expense of economic growth, high employment, and price stability. But in today's interdependent world, the independent pursuit of individual countries' objectives can often bring their policies into conflict and produce results against the interests of all. A satisfactory balance of payments adjustment process requires a high degree of international cooperation.

At any given time, some countries will be in deficit while others will be in surplus. For the world as a whole, deficits and surpluses will be roughly equal. Under existing international liquidity arrangements, the main exception reflects additions to the stock of monetary gold, which allow some surpluses not offset by deficits elsewhere.

Some swings in country payments positions are bound to occur. And when the imbalance represents only a temporary departure from equilibrium, or when appropriate corrective measures take time to become fully effective, forcing an immediate restoration of balance may involve excessive economic and social costs. Moreover, where the *level* of a country's reserves is chronically excessive (or deficient) in relation to its needs, that country may appropriately run a deficit (or surplus) over a longer period. Thus, persistent U.S. deficits during the early 1950's were clearly in the interests of all countries.

Nevertheless, if a deficit continues too long or becomes too large, the strength of the country's currency can be impaired. There is, in fact, an absolute limit of any country's ability to continue in deficit; eventually, it must run out of reserves as well as borrowing capacity.

Built-in pressures to correct surpluses are less powerful. A country that continually runs a surplus deprives itself of the real resources that would have accrued to it had it exported less or imported more. As the surplus persists, this cost becomes increasingly burdensome relative to the benefits derived from additional accumulations of reserves.

However strongly they may wish to, all or most countries cannot run surpluses simultaneously. If they try, some are bound to find their actual balance of payments positions falling short of what they had desired. Unrealistic payments targets can thus lead to destructive policy competition among countries. Countries must determine their adjustment policies in the light of balance of payments targets that are mutually compatible.

Alternative Means for Dealing with Imbalances

What are the broad strategies a country can adopt when confronted with an imbalance in its international payments?

First, it may simply let the imbalance persist, at least for some time, and rely on financing. For a deficit country, this entails either a drawing down of reserves or borrowing; for a surplus country, a rise in reserves or deliberate lending.

Second, a country can seek to correct the payments imbalance by fiscal and monetary measures that affect the total level of internal demand. For countries in deficit, a restriction of demand would be designed to reduce imports and increase exports. If monetary policy is used to achieve restraint, higher interest rates may also deter monetary outflows or even induce net capital inflows.

Third, countries can make varying use of selective measures specifically directed at external transactions—for example, import surcharges or quotas, direct restrictions on capital movements, or disincentive devices like the U.S. Interest Equalization Tax. On the other hand, surplus countries may remove existing restrictions or use special incentives to induce net capital outflows.

Fourth, a variety of other internal measures can be used. These include selective internal policies to improve a country's productivity, efficiency, or financial structure; changes in the "mix" of different kinds of policy instruments, notably as between fiscal and monetary policy; and wage-price policies.

Fifth, countries can, under the IMF Articles of Agreement, resort in some instances to adjustments of their exchange rates.

None of these options represents an ideal or fully feasible solution under all circumstances. Reliance on financing may merely postpone needed corrective action. Measures to affect total internal demand may conflict with domestic objectives. Direct restrictions on international trade and payments may interfere with efficient resource allocation. Other selective measures may not be available in time or not be sufficiently powerful to bring about the desired correction. Finally, various disadvantages are inherent in exchange rate adjustments, and governments are properly reluctant to resort to them—particularly reserve currency countries.

Criteria for Selection

Despite these drawbacks, any one of these options may prove the most desirable—or least undesirable—under particular circumstances; and in many cases, a combination of strategies may be called for. What, then, determines which policies are appropriate for a country in a given situation? Major relevant considerations include the following:

First, the nature of the underlying ailment is important. If either deficient or excessive internal demand is a major cause of the imbalance, then measures to affect such demand may provide the best solution. If part of the underlying difficulty is connected with a deterioration in a country's competitive position, various selective measures to improve productivity and resource mobility may be called for. If the difficulty stems from speculative or other unusual capital flows, use of selective instruments might be far more efficient than resort to general measures. And to the extent that the payments imbalance stems from broad structural differences in capital markets—such as those that exist between the United States and continental Europe—the longer-term solution lies in improving the efficiency of the less fully developed capital markets.

Second, any given strategy for achieving balance of payments equilibrium should as far as possible be consistent with the attainment of broader objectives. Often, this presents no problem. For example, if a country suffers from both internal inflation and a payments deficit, policies to restrict over-all demand may achieve internal and external objectives simultaneously. Similarly, a country seeking to reduce an external surplus and to expand internal demand can usually use general fiscal and monetary measures to meet both objectives.

Even in these cases, however, difficulties in the choice of instruments can sometimes arise. For example, the United Kingdom in 1965 had both an external deficit and excess domestic demand. Nevertheless, there were also indications that the country's competitive performance was suffering from low productivity. The U.K. authorities therefore combined measures to restrain domestic demand with more specific steps to improve the country's competitive position, including measures to encourage productive investment over the long run. Or a surplus country with lagging internal demand may be suffering from upward cost and price pressures. In this case, resort to incomes (price-cost) policies, reductions in tariff barriers, and other special devices may be required to avoid price increases that might inhibit vigorous use of expansionary monetary and fiscal policies.

More difficult situations arise where deficits are accompanied by domestic underemployment, or surpluses by inflation. In recent years, the first of these situations has been characteristic of the United States, the second of Germany. The United States has leaned more heavily on fiscal policy to stimulate demand, making it appropriate to use a somewhat less expansionary monetary policy than would otherwise have been desirable. This, together with the Interest Equalization Tax and voluntary restraint on foreign lending and investment, has helped to dampen capital outflows. Germany, on the other hand, has been advised by the OECD to combat its domestic inflation more actively through tighter fiscal policies and to pursue a relatively easier monetary policy in order not to attract funds from abroad.

Third, there are differences in the effectiveness of given policy instruments in various countries. For example, where international transactions constitute a relatively high proportion of total transactions, and where both exports and imports tend to be highly responsive to variations in domestic incomes, even relatively mild measures to influence total demand may rather quickly bring about the desired adjustment in the balance of payments. Thus, in a country like the Netherlands, where imports equal about 40 percent of GNP, primary reliance on instruments to affect over-all demand may frequently be entirely appropriate for payments adjustment and entail a relatively small economic cost. But in many other countries, the foreign sector accounts for a much smaller proportion of total national transactions; in the United States, for example, imports are only 3 percent of GNP. If this country were to place sole reliance on general demand measures to achieve a given balance of payments result, a relatively large change in total demand would be necessary, exposing the economy to severe inflation or unemployment. Even where *both* domestic *and* external payments conditions call for either restrictive or expansionary measures, the "dose" appropriate for the domestic economy may not be strong enough to correct the payments imbalance—or it might be too strong.

Fourth, the effects on other countries must be considered. For example, the industrial countries as a group should clearly be concerned with the impact that their measures will have on the less developed countries. Moreover, the effect of particular corrective measures taken by one industrial country could be cancelled if similar measures were taken by others, or could be sharply reduced by other "rebound" effects.

The Division of Responsibilities for Adjustment

Surplus countries tend to argue that the primary task of bringing about adjustment must necessarily lie with deficit countries, since it would be unreasonable to expect the surplus countries to suffer such inflation as might be induced by expansionary actions on their part. Deficit countries, on the other hand, argue that if they bear a greater share of the responsibility for adjustment, this imparts a deflationary bias to the world economy.

There is no *a priori* case for assigning a greater share of the responsibility to either deficit or surplus countries. Countries in either situation should be willing to use the instruments at their disposal in the most effective way. There could be specific situations where a larger share of the responsibility should be assumed by either deficit or surplus countries, but this should be subject to careful international consideration.

Possibilities for Improving the Adjustment Process

The past few years have seen significant gains in international consultation and cooperation in balance of payments adjustments. Nevertheless, the fact remains that balance of payments surpluses and deficits in recent years have often been very large and that the adjustment techniques currently used are far from perfect. There is need, and wide scope, for further improvement.

One obvious area of improvement involves the development of additional policy instruments as well as more efficient use of existing instruments. In particular, there is a major need in many countries for making fiscal policy a more flexible tool of economic policy. Much more imaginative use could also be made of different techniques of monetary management. Furthermore, surplus countries have considerably more scope for reducing trade barriers and broadening capital markets.

It may be possible to develop some general guidelines regarding appropriate balance of payments adjustment that could prove helpful in the context of international discussions. Such guidelines should be flexible and informal, and sufficiently comprehensive to permit effective selection of policy tools in the light of all the considerations set forth above: the nature of imbalances; the full range of economic objectives; differences among countries; and effects of each country's policies on other nations.

In any case, much can be done to improve further the existing mechanisms of international consultation and cooperation to help to assure that the measures used by individual countries are best suited to the interests of the international community as a whole.

INTERNATIONAL LIQUIDITY ARRANGEMENTS

Improvements in the adjustment process alone cannot assure that the international monetary system will work smoothly. In the words of Secretary of the Treasury Henry Fowler ". . . a new and crucial challenge is presenting itself with growing urgency before the nations of the free world—the challenge of assuring ample liquidity to support expanding world trade in the years ahead." He stated that ". . . there will be . . . bilateral and multilateral talks at all levels as we move ahead toward exploring this most complex problem and toward reaching some kind of workable consensus. There is . . . no fixed timetable. But we are moving ahead—and we will spare no effort to speed our progress toward a sensible and workable solution."

The Need for Adequate Growth in International Liquidity

How large is the volume and growth of monetary reserves and other forms of liquidity needed to support a smoothly functioning system of international transactions? There is no simple answer to this question. In approaching it, however, several key distinctions need to be kept in mind.

The great bulk of international transactions takes place among private traders, bankers, or other intermediaries. Predominantly, these transactions involve the major trading or "vehicle" currencies—the dollar and the pound sterling. Over the years, the volume of private working balances in these currencies has tended to grow along with the volume of international transactions. A continuing net flow of dollars into foreign private hands sufficient to satisfy such legitimate private business needs is thus likely to be desirable.

A second need for international liquidity arises from the desire of monetary authorities to hold reserves and other forms of liquidity to enable them to settle payments deficits that might develop. Of course, monetary authorities normally have the option of obtaining credit on conditional terms when the need arises. In recent years, credit facilities have been greatly expanded, notably through improvements in the medium-term lending operations of the International Monetary Fund and through cooperative arrangements among central banks; and further improvements should prove possible in the future. But countries also want "unconditional liquidity," either in the form of gold or reserve currencies or of assured lines of credit (such as the fully automatic drawing rights on the Fund).

Moreover, as the absolute volume of international transactions rises, the size of potential deficits also increases. This is why most countries seek to enlarge their reserve positions over the years, at least modestly.

There are now three principal ways in which net additions to international reserves occur: (1) through the flow of newly available gold into official national reserves; (2) through enlargement of countries' automatic drawing rights at the Fund; and (3) through increases in the holdings of U.S. dollars by the monetary authorities of other countries.

Increases in the aggregate gold holdings of monetary authorities are the oldest way of creating reserves. And they are the only way that does not usually depend on the emergence of a balance of payments deficit for one or more countries. From 1960 through 1964, gold contributed about $700 million annually to over-all reserve growth of the free world. Recognition that Fund automatic drawing rights constitute international reserves is very recent; net additions in them averaged about $150 million a year during 1960–64. The other major contribution to over-all reserve growth—increases in foreign official claims on the United States—averaged about $1 billion a year over this period. There has been virtually no net expansion since the early 1950's in official holdings of sterling, the second major reserve currency.

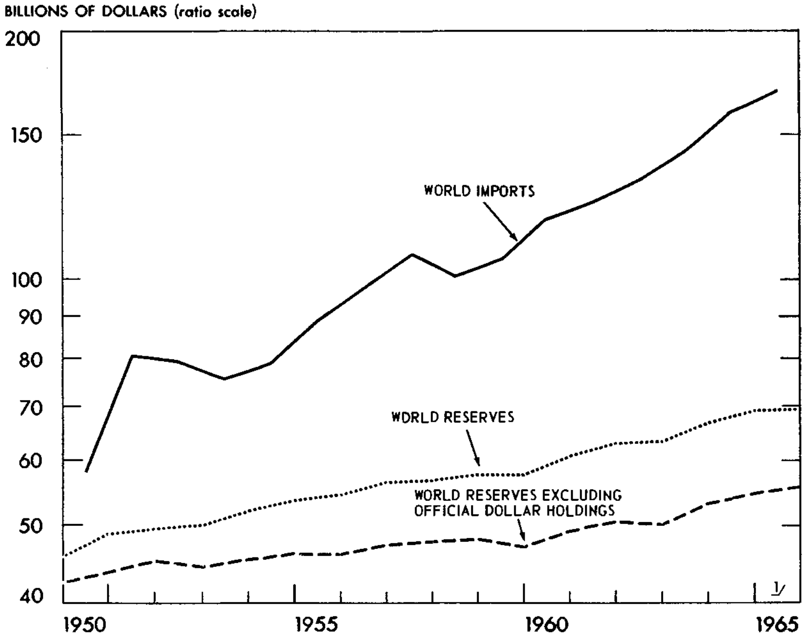
Expansion of world reserves through a growth of dollar holdings worked well in the earlier postwar years, when official reserves outside the United States were low. However, the United States can now no longer continue to run large-scale balance of payments deficits without endangering confidence in its own currency. Thus dollars cannot contribute to growth of world reserves as they have in the past. Moreover, to the extent that foreign monetary authorities convert existing dollar holdings into gold, the net volume of international liquidity actually declines.

It was against this background that the United States acted with new determination last year to bring its payments into equilibrium. As it succeeds in this effort, however, the international monetary system is faced with a dilemma. Gold alone will not add sufficiently to official reserves to insure a smoothly functioning payments system. Prudent planning, therefore, calls for the development of additional kinds of reserve assets that could add to international liquidity independently of the balance of payments deficits of particular countries.

According to preliminary indications, growth in the world's total reserve assets slowed markedly in 1965 (Chart 11). There is little to suggest that the annual growth of about $2 billion in the years prior to 1965 had been excessive. Moreover, there is a strong presumption that, over time, the growth of international trade and the world economy will be hampered unless there is a continuing expansion in the total volume of reserve assets. Hence, the United States took the initiative in the summer of 1965 in urging an intensified exploration of the possibilities for agreement on the development of a new reserve asset.

Chart 11

World Trade and Reserves



1/ ESTIMATES BASED ON DATA FOR FIRST 3 QUARTERS.
NOTE: WORLD EXCLUDES SINO-SOVIET BLOC.
SOURCE: INTERNATIONAL MONETARY FUND.

Ways of Creating Additional Reserve Assets

At least two major, and potentially complementary, approaches to the creation of additional reserve assets are likely to receive serious attention in current world discussions. The first calls for the creation of a completely new reserve unit. Each participating country would be issued given amounts of the new units from time to time, and rules would be set for their use. The unit could be backed by a guarantee against depreciation in terms of gold and would be counted in "owned" reserves. Creation of the new unit would require formal international agreement and would thus offer clear evidence that the participating countries were joined in a major and deliberate effort to provide for an appropriate growth in international liquidity.

A second method would build on the procedures for reserve creation already available in the Fund. It would expand automatic drawing rights on the Fund. The additional drawing rights would be immediately usable as new reserve assets by member countries. This approach would not necessarily require revision of the Fund's Articles of Agreement.

Under reserve unit schemes, participating countries provide backing for the unit in terms of their national currencies and undertake to accept the units from one another. In the case of new Fund automatic drawing rights, member countries might be asked to provide lines of credit to the

Fund to assure that the Fund itself could readily supply the amounts and types of currencies required by members exercising their drawing rights. In either case, however, one basic principle holds: the acceptability of the new reserve asset will fundamentally depend on the willingness of participating countries to view it as a form of international money.

Each approach—"reserve unit" and "drawing rights"—has distinctive characteristics that can make it particularly useful for certain purposes. In many respects, the two approaches need not differ greatly in effect. What is important in assessing the numerous specific versions and combinations of these two approaches that have been proposed is to see how they deal with certain key questions. These include the following:

(1) *By whom and in what manner shall decisions regarding the new reserve assets be made?*

As Secretary Fowler stated before the Annual Meeting of the Governors of the International Monetary Fund,

> It is true that only a limited number of countries hold the bulk of the official reserves of the world. No doubt these countries, including my own, have deep interests and responsibilities of a unique kind in the system by which reserves are generated and regulated. But other countries, which are not large reserve holders, also have legitimate and vital interests in these matters. This is why all the countries of the free world have a fair and reasonable claim that their views must be heard and considered at an appropriate stage in the process of international monetary improvement.

There are various types of decisions regarding international monetary arrangements that need to be made. A basic "constitutional" decision has to be taken regarding the nature of the new arrangements. Thereafter, decisions will be required from time to time on various operational matters, such as the amounts of new assets to be created. The procedures for settling these various questions might differ.

Whatever the precise arrangement, it seems highly desirable that the Fund play a central role in the decision-making process. As has been well stated in the Ossola Report, "The Fund's prestige and experience as a monetary institution make it the natural center for new functions involving deliberate creation of reserve assets and provide assurance of its capacity to conduct, and keep distinct, conditional lending and deliberate reserve creation."

(2) *To whom shall the reserve assets be distributed?*

The distribution of new reserve assets poses difficult problems which will require further discussion and study. While there is no simple answer, certain principles are clear. All countries need reserves, and an effective system of reserve creation should give all an opportunity to add to their holdings. At the same time, the large industrial countries, other developed nations, and the less developed countries have special needs and characteristics that must be reflected in any over-all arrangements. Furthermore, such arrangements should be sufficiently flexible to permit an increasing degree of participation by countries as they meet certain relevant standards.

IMF quotas provide one benchmark which might be considered in the initial distribution of new reserve assets.

While no distribution can be set forth as ideal, the nations of the world can be expected to develop an equitable plan which will meet the recognized need for growth of reserves. Every nation has a clear interest in its own share of new reserve assets, but it has an even greater stake in the development of an effective system for reserve creation that will encourage the pursuit of economic growth and liberal trade policies.

(3) *What should be the relationship between new reserve assets and existing types of reserve assets, and what techniques are required to achieve an appropriate relationship?*

Any new type of reserve asset that might be created should clearly be attractive enough so that countries will wish to hold it. But it must not be so attractive as to displace existing forms of reserve holdings, for it would then fail in its primary purpose of adding to over-all liquidity.

One proposal to enhance acceptability has been to link the *creation* of a new reserve unit in a rigid proportion to each country's gold holdings. Such a rigid link to gold in the creation of the unit is clearly undesirable, however. It would be inequitable, penalizing countries that now hold a low proportion of their total international reserves in gold. It would, moreover, provide incentives for all countries to increase the ratio of gold to total reserves. By thus affecting the willingness of countries to hold existing reserve currencies, it could lead to an undesirable shrinkage in world liquidity.

Alternatively or additionally, it has been suggested that the *use* of the new reserve unit in settlements should only be permitted in association with a specified quantity of gold. The same considerations that apply to a gold link in creation also raise doubts about the proposal for a link in use. Moreover, any rigid link with gold would tend to enhance the importance of gold in the monetary system, and thereby to assign a new reserve unit second-class citizenship.

If there is no close link to gold, what is required to make a new reserve unit readily acceptable? One possibility might be an agreement that countries would accept such units as full legal tender, to be considered "as good as gold." Or, an agreement might provide for specific limits on the obligation of creditor countries to accept the reserve units in settlement. Special procedures might also be adopted to prevent countries from using the new units to change the composition of existing reserves in a way that might lead to a reduction in total liquidity.

Creditor limits are automatically incorporated in the procedures for expansion of automatic drawing rights at the Fund. Moreover, their relationship with gold and reserve currencies poses no problems.

(4) *Does the method used in creating a new reserve asset allow for the proper expansion in liquidity, and for a flexible response to changing needs?*

Both proposals cited would permit substantial additions to liquidity. However, a separate new reserve unit may be essential as part of a program to assure adequate increases in liquidity. Such a unit might also be more easily recognized as constituting "owned" reserves, and might therefore make countries feel more "liquid" than would corresponding command over automatic drawing rights.

Expansion of drawing rights, on the other hand, might be arrangeable on a more flexible basis. Moreover, to the extent that countries may be reluctant to allow their holdings of reserve units to decline but are willing to make active use of automatic drawing rights, the latter might at times actually prove to be more "liquid," in the sense of providing resources when needed.

Concluding Comments

While reserves in the form of units and drawing rights have much in common, the characteristics that give each of the approaches special usefulness in particular situations suggest that both have a constructive role to play in reserve creation.

In any event, it is essential that the negotiations provide for (1) efficient as well as equitable rules for the creation, distribution, and use of new assets; (2) smooth integration of new assets within the existing framework; and (3) the appropriate degree of expansion in the over-all volume of international liquidity which will foster sound world economic growth.

U.S. BALANCE OF PAYMENTS

The U.S. balance of payments moved significantly closer to equilibrium in 1965. In considerable part, this reflected the effects of the President's program announced in February. The improvement was primarily manifested in a substantially reduced outflow of private capital, which more than offset a drop in the trade surplus (Chart 12).

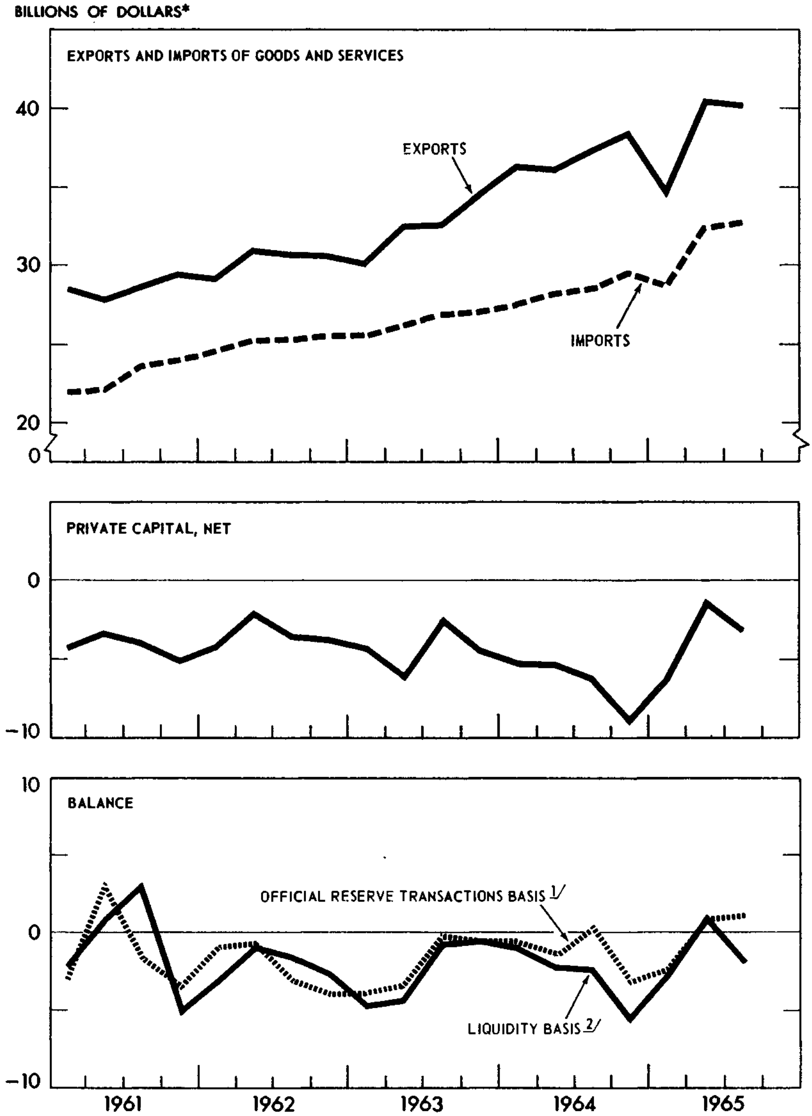
MEASURES OF DEFICIT OR SURPLUS

In a fundamental sense, a country's external payments cannot be in satisfactory equilibrium unless the domestic economy is in reasonable balance and its basic national and international economic objectives are being met. In a more immediate sense, however, equilibrium in external payments relates to a country's international reserve position and to its ability to maintain the value of its currency in international transactions. Statistics on a country's international transactions, summarized in its balance of payments accounts, bear only on the more immediate concept of equilibrium.

Balance of payments accounts summarize a system of double-entry bookkeeping. The total of debits equals the total of credits; the net difference is zero. Thus any positive or negative balance—a surplus or deficit—includes only selected payments and receipts. A variety of such measures has been used in recent years, including among others the "basic balance," the "balance on regular transactions," the "liquidity balance," and the "balance on official reserve transactions" ("official settlements"). No single concept

Chart 12

U.S. Balance of International Payments



* SEASONALLY ADJUSTED ANNUAL RATES.

1/ EQUALS CHANGES IN LIQUID AND NONLIQUID LIABILITIES TO FOREIGN OFFICIAL HOLDERS AND CHANGES IN OFFICIAL RESERVE ASSETS CONSISTING OF GOLD, CONVERTIBLE CURRENCIES, AND THE U.S. GOLD TRANCHE POSITION IN THE IMF.

2/ EQUALS CHANGES IN LIQUID LIABILITIES TO FOREIGN OFFICIAL HOLDERS, OTHER FOREIGN HOLDERS, AND CHANGES IN OFFICIAL RESERVE ASSETS CONSISTING OF GOLD, CONVERTIBLE CURRENCIES, AND THE U.S. GOLD TRANCHE POSITION IN THE IMF.

SOURCE: DEPARTMENT OF COMMERCE.

is best for all analyses. The measure that is most appropriate for one country at one time may be less appropriate under other circumstances.

All definitions of the balance of payments surplus or deficit relate to changes in a country's reserve assets. By any definition, a contribution to surplus is recorded whenever the reserve holdings of our monetary authorities are increased by gains in gold, claims on the IMF, or liquid assets in convertible currencies. But the measures of balance also take into account changes in certain claims that could be exercised against our reserves.

Various types of assets differ in the extent and directness of their claim on U.S. reserves. Liquid claims on the United States held by foreign monetary authorities may at any time be presented for gold, and thus directly expose us to the possibility of reserve losses. Privately held liquid U.S. assets of foreigners can readily be turned into official claims. And nonliquid dollar assets held by foreigners can be sold and thus converted into liquid holdings. Indeed, in a world of convertible currencies, any marketable claim held abroad is to some degree a potential claim on our reserves. Dollar holdings of Americans could even flow abroad in a crisis and flow back as a demand for gold. It is difficult to select the group of assets that should count as claims on our reserves (with an increase contributing to a U.S. deficit). It is mainly on this point that the alternative measures of the deficit or surplus divide.

In 1965, after a careful review of its present and foreseeable situation, the U.S. Government decided to place primary stress on two measures of its general balance of payments performance—the "liquidity balance" and the "balance on official reserve transactions" ("official settlements").

The liquidity balance spotlights the liquid claims of foreigners, both private and official, against the United States. The potential exposure of the United States is measured by the volume of such liquid claims, and any increase in them (not offset by a growth of reserve assets) is recorded as a U.S. deficit. Thus, the line is drawn between liquid and nonliquid foreign dollar holdings.

The official settlements balance, however, draws the line between the dollar holdings of foreign monetary authorities (whether liquid or nonliquid) and those of private foreign holders. If privately held foreign liquid claims on the United States increase (and there are no other offsetting transactions), this is treated as an inflow of private capital, rather than as an addition to the deficit, which it is under the liquidity definition. The official settlements concept, in other words, concentrates on the dollar claims that foreign monetary authorities have acquired (or relinquished)—usually in the process of maintaining the parity of their currencies.

After years of sizable deficits on liquidity balance, averaging $3 billion between 1958 and 1964, the U.S. deficit appears to have been reduced to about $1¼ billion in 1965. The deficit as measured by official settlements moved from an average of about $2 billion in the early 1960's to $1.2 billion in 1964 and remained at approximately that level in 1965.

Gold purchases from the United States in 1965 bore little direct relationship to the U.S. deficit in that year. Net sales of U.S. gold jumped from $0.1 billion in 1964 to nearly $1.7 billion in 1965. About $260 million represented a transfer to the IMF in connection with the enlargement of our quota. Primarily, however, these sales resulted from decisions on the part of a few countries to convert dollars accumulated in earlier years and a concentration of payments surpluses in countries that do not wish to increase their dollar holdings. More than half of the total could be attributed to the purchases of one country—France—although Spain and Austria also completed sizable purchase programs.

During 1958–64, the official settlements deficit was, on the average, nearly $1 billion lower than the liquidity measure, reflecting the growth in private foreign liquid claims on the United States. The two measures were very close in 1965 when private dollar holdings did not advance as rapidly. The behavior of private demands for dollars in the years ahead will provide additional evidence as to the relative significance that should be attached to the liquidity and official settlements measures in guiding the United States to a sustained external payments equilibrium.

DEVELOPMENTS AND POLICIES IN THE 1960'S

When the Kennedy Administration took office in 1961, the United States had just recorded the largest payments deficit of any year in the postwar period. The country was losing gold rapidly and incurring a large buildup of liquid claims abroad that threatened further losses. Action was imperative. The result has been a series of measures of increasing severity and scope, to meet a problem that proved more intractable than was believed earlier. The measures taken through 1964 were fully reviewed in earlier Reports of the Council. Further significant measures—discussed below—were taken in February and December of 1965.

As a result of these measures, and of other developments, the U.S. payments position strengthened. The basic trading position and earnings on investments improved especially. Over this period, the surplus on nonmilitary goods and services increased from $6.8 billion in 1960 to $9.1 billion in 1965 (Table 23). Despite rising prices and wages abroad, drastic economies were achieved in military expenditures abroad, and offsetting sales of military equipment were increased sharply; these improvements were sufficient to offset the net increase in Government grants and capital outflows. Moreover, such grants and capital outflows are now almost completely tied to the export of U.S. goods and services.

GROWTH OF PRIVATE CAPITAL OUTFLOWS

The outflow of U.S. private capital rose from $3.9 billion in 1960 to $6.5 billion in 1964. Through this outflow, the United States was acquiring a large volume of foreign assets and adding rapidly to its net international own-

TABLE 23.—*United States balance of payments, 1960–65*

[Billions of dollars]

Type of transaction	1960	1961	1962	1963	1964	1965: First 3 quarters [1]
						Seasonally adjusted annual rates
Balance on goods and services	4.1	5.6	5.1	5.9	8.6	7.1
Balance on nonmilitary goods and services	6.8	8.2	7.6	8.2	10.6	9.1
Balance on trade	4.8	5.4	4.4	5.1	6.7	4.6
Balance on services	2.0	2.8	3.1	3.1	4.0	4.5
Net travel	−1.3	−1.2	−1.5	−1.7	−1.6	[2] −1.8
Income on direct investments	2.4	2.8	3.1	3.1	3.7	4.3
Other	.9	1.2	1.5	1.7	1.9	2.0
Military expenditures, net	−2.7	−2.6	−2.4	−2.3	−2.1	−2.0
Remittances and pensions	−.7	−.7	−.7	−.8	−.8	−1.0
Government grants and capital, net	−2.8	−2.8	−3.0	−3.6	−3.6	−3.3
Government grants and capital	−3.4	−4.1	−4.3	−4.6	−4.3	−4.4
Transactions involving no direct dollar outflows from the U.S.	−2.3	−2.9	−3.2	−3.7	−3.6	−3.6
Dollar payments to foreign countries and international institutions	−1.1	−1.1	−1.1	−.8	−.7	−.8
Scheduled repayments on Government loans	.6	.6	.6	.6	.6	.8
Nonscheduled repayments on Government loans	.1	.7	.7	.3	.1	.3
Other capital, net	−3.5	−3.5	−2.4	−3.8	−5.8	−3.6
U.S. private capital, net	−3.9	−4.2	−3.4	−4.5	−6.5	−3.6
Long-term, net	−2.5	−2.6	−2.9	−3.7	−4.4	−4.7
Short-term, net	−1.3	−1.6	−.5	−.8	−2.1	1.0
Foreign nonliquid capital, net	.4	.7	1.0	.7	.7	(3)
Errors and omissions	−1.0	−1.0	−1.2	−.4	−1.2	−.5
LIQUIDITY BALANCE	−3.9	−2.4	−2.2	−2.7	−2.8	−1.3
Plus: Increase of liquid dollar claims of nonofficial foreigners	.3	1.1	.2	.6	1.6	1.0
Less: Increase in nonliquid liabilities to foreign official monetary institutions [4]			.3	−.1	(3)	
OFFICIAL SETTLEMENTS BALANCE	−3.6	−1.3	−2.2	−2.0	−1.2	−.2
						Unadjusted totals
Gold (decrease +)	1.7	.9	.9	.5	.1	1.5
Convertible currencies (decrease +)		−.1	(3)	−.1	−.2	−.5
IMF gold tranche position (decrease +)	.4	−.1	.6	(3)	.3	−.1
Foreign monetary official claims (increase +)	1.4	.7	.7	1.6	1.1	−.7
Net purchases of nonmarketable convertible bonds and notes (increase +)				.7	.4	.2
Other liquid claims (increase +)	1.4	.7	.5	1.0	.7	−.9
Net purchase of nonmarketable nonconvertible bonds and notes (increase +) [4]			.3	−.1	(3)	

[1] Preliminary indications for some components available for the fourth quarter suggest that most of the figures shown in this column are a reasonable approximation to the annual total. Significant exceptions are foreign monetary official claims, which rose substantially, and liquid dollar claims of nonofficial foreigners, which declined late in the year. Consequently, the official settlements deficit for 1965 is estimated to be approximately the same as for 1964.
[2] Estimate.
[3] Less than $50 million.
[4] Provisional.

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

Source: Department of Commerce.

ership position as well as to its future receipts of interest, dividends, and remitted profits. But the assets acquired through this investment were largely illiquid, and were obtained by parting with liquid assets that added to both private and official claims against us. The U.S. reserve position declined continually.

The growth of U.S. private capital outflow is not difficult to explain. As market integration has progressed and as individuals and businesses have become increasingly familiar with international financial operations, there has been a natural tendency for capital to become more mobile, and more responsive to market forces.

U.S. corporations have shown an increasing interest in business operations overseas and have been sending a rising flow of funds abroad to build and equip new plants and distribution facilities. The extremely rapid growth of incomes, particularly in Europe, Canada, and Japan, has greatly expanded consumer demand, especially for manufactured goods. Wage rates generally are lower abroad, and when American management and technology are exported the productivity of foreign labor is frequently brought close to the U.S. level, making American enterprises in other countries often extremely profitable. The virtual disappearance of internal tariffs in the EEC and EFTA, while external tariffs are retained, has created a large and expanding market which can be readily served by large-scale production in Europe. Of course, direct investment abroad is also made for the purpose of developing or expanding sources of raw materials, often for use in the firm's operations in the United States or elsewhere.

With few exceptions, U.S. money and capital markets are much better developed and freer from restrictions than those abroad, and this attracts foreign borrowers. In part because of this better organization, interest rates and flotation costs are considerably lower in this country. Consequently, there is a tendency for foreigners seeking capital to look to U.S. markets and for interest-sensitive funds to move abroad in search of higher returns.

Long-standing interest rate differentials, and the growing mobility of capital, were important factors in the spurt of long-term portfolio lending that occurred in 1962 and 1963. New foreign security issues in the U.S. market doubled from 1961 to 1962, and the acceleration continued in early 1963. This growth was arrested by the introduction in mid-1963 of the Interest Equalization Tax (IET), which raised the effective interest rate for most foreign borrowing here. Meanwhile, other capital flows began to accelerate, offsetting much or all of the gains from the IET. Bank loans rose sharply, from $1.5 billion in 1963 to $2.5 billion in 1964. Direct U.S. investment abroad also accelerated in 1963 and 1964.

THE FEBRUARY 1965 PROGRAM

At the beginning of 1965, it was evident that the rapid rise in capital outflows was creating growing problems for the U.S. balance of payments. Accordingly, the program announced by the President on February 10 applied the IET to most bank loans with a duration of a year or more to borrowers in developed countries, asked for a 2-year extension of the IET, and attempted in other ways to stem the outflow of private capital through the voluntary cooperation of American business.

U.S. banks and other financial institutions were asked to observe appropriate "guidelines" with respect to their foreign operations in 1965. Banks were asked by the Federal Reserve System to limit the increase in their claims on foreigners in 1965 to 5 percent of the value of their outstanding foreign credits as of December 31, 1964. Top priority was to be assigned to *bona fide* export credits, and second priority to credits to less developed countries. A related program was applied to credits and investments abroad by nonbank financial institutions.

Under the part of the program administered by the Department of Commerce, about 500 large nonfinancial corporations were asked to make a maximum effort to expand the net balance of (a) their exports of goods and services plus (b) their repatriation of earnings from the developed countries less (c) their capital outflows to such countries. They were also asked to bring liquid funds back to the United States.

Although considerable skepticism was initially expressed—particularly abroad—regarding the effectiveness of a voluntary program, it is now clear that the response was excellent. The net outflow of U.S. private capital declined from $6.5 billion in 1964 (and an annual rate of $8.9 billion in the fourth quarter) to an annual rate of $3.6 billion in the first three quarters of 1965. Short-term capital—both bank and nonbank—accounted for a great part of this dramatic shift: the movement of such funds changed from a net outflow of $2.1 billion in 1964 to a net inflow at an annual rate of $1.0 billion in the first three quarters of 1965. The success of the voluntary program in shifting the movement of short-term funds was reinforced by the intensified demand for funds in the domestic market, as a result both of sharply rising activity and some tightening of monetary policy.

The U.S. payments deficit in 1965 was adversely affected by certain unusual transactions of the United Kingdom. As a part of the U.K. program to protect the pound, the British authorities converted certain holdings of U.S. securities. Together with the deferment of payments on intergovernmental debts, these transactions reduced U.S. net receipts by well over $½ billion, on both the official settlements and the liquidity basis.

Despite good over-all results of the payments program, the volume of U.S. direct investment outflows were at a record high in 1965. In the first three quarters, they reached an annual rate of $3.4 billion, compared with a 1964 total of $2.4 billion. However, they declined substantially during the course of 1965. Since such outflows are usually planned long in advance, and businesses were not asked to interrupt projects already underway, a lag in the response to the February program was expected. Nevertheless, there was disquieting evidence that plans for direct investment in 1966 remained at a high level. With the sharp reversal in the trend of bank lending abroad, direct investment became the primary area of concern.

PROGRAM FOR 1966

By the autumn of 1965, it was clear that the February program had been successful and that a substantial improvement in the balance of payments had been achieved. Nevertheless, even further improvement was necessary if payments equilibrium was to be attained. Consequently, decisions were announced in December to reinforce and renew the existing programs for 1966. Further attention was placed on encouraging U.S. exports, on promoting foreign tourism and foreign investment in the United States, and on minimizing the effect on the balance of payments of Government transactions. But the principal focus of the supplementary steps had to be on the further containment of direct investment outflows.

Consequently, new guidelines for direct investment were developed for nonfinancial corporations. Each of about 900 individual corporations was asked to hold its combined 1965 and 1966 direct investment outflows (plus earnings retained abroad) in specified advanced countries and mineral exporting nations to no more than 90 percent of the total of these items in the years 1962–64. This will permit an increase of about 35 percent in the average annual outflow of direct investments in 1965–66 over the average annual rate in the 1962–64 base period. A joint target was set for the years 1965 and 1966 in order not to penalize firms which had cut back in 1965, and in order to seek greater restraint by those which had invested more heavily last year. Direct investment in 1966 under the program would be lower than in 1965, though it would remain high relative to outflows of earlier years.

Financial institutions were given guidelines for 1966 that permitted about the same outflow as had been suggested for 1965. The guidelines provided for nonbank institutions were somewhat more detailed than those for 1965. New arrangements with the Canadian authorities were announced on the understanding that continued exemption from the IET would not threaten the goals of the U.S. program.

Efforts to reduce even further the impact of Government activities on the balance of payments will continue in 1966. Net overseas defense expenditures have been quite successfully reduced since 1960. Unfortunately, expanding defense needs will prevent further reduction in 1966. The bulk of Government aid will continue either to be given "in kind," with no dollar flows, or tied to procurement in the United States.

U.S. TRADE POSITION

The outstanding performance of U.S. trade in the 1960's has been strongly supported by our excellent price record, as well as by the rapid expansion of output and incomes abroad. However, the slowdown of economic expansion in Europe and Japan contributed to a reduced trade surplus in 1965. The January-March dock strike not only redistributed the time pattern of sales (somewhat inflating the 1964 level), but also caused a sizable loss of export sales.

Imports showed an unusually large gain in 1965; both manufacturing goods and raw materials rose substantially. Only agricultural imports declined, primarily because of lower prices for such commodities as coffee, sugar, and cocoa. Many U.S. firms, fearing a possible steel strike, turned in part to foreign suppliers in 1965, raising steel imports to about $1.2 billion—an all-time high. In addition, the rapid expansion of the U.S. economy in 1965 brought a larger rise in our imports than in previous years. The boom in the home market may also in some cases have reduced the interest of American producers in finding or serving markets overseas, particularly where their production made full use of existing capacity or labor.

The 1965 decline in the trade surplus was not the result of any basic deterioration in our competitive position. Our price performance in 1965 continued to match that of our major trading partners, so that we retained the relative advantage achieved in earlier years.

CONCLUSION

Over the longer run, the policies required to assure equilibrium in the U.S. balance of payments will be influenced by many factors, including—among others—the growth rates of our major trading partners throughout the world, the extent to which European nations learn to rely actively on fiscal as well as monetary policy as a means of adjusting over-all demand, the development of capital markets in Europe, changes in the indispensable foreign exchange costs of national security, our rate of technological innovation, our record of productivity growth and price stability, and the progress of improvements in international financial machinery.

If our current account surplus continues to expand, a renewed growth of capital outflows could be compatible with over-all payments equilibrium. For the present, however, the volume of capital outflows likely to occur in the absence of any measures to moderate them would clearly be inconsistent with equilibrium in our external payments. Given that private capital outflows must be contained, the selective measures currently in use seem, for the present, an essential component of our policy. Compared with reliance solely on restrictive general monetary measures that might conceivably hold down capital flows to the same extent, the selective credit techniques have the obvious advantage of allowing monetary policy to respond to the needs for domestic credit, as well as to affect the 5-10 percent of total credit that flows abroad.

The selective approach is consistent with an appropriate composition of the private capital outflow. The exemptions in the IET and the priorities established in the voluntary programs protect the access of less developed countries to U.S. capital. The Federal Reserve program, moreover, gives priority to export financing, which could be squeezed under a highly restrictive monetary policy. By increasing the cost of borrowing in the United States, the IET contains its own escape valve: countries in urgent need of new U.S. capital issues are still free to enter our markets; the less urgent needs are screened out. The guideline approach of the voluntary programs tends to permit the business firms and banks themselves to select the most attractive investment opportunities; the investments foregone would yield a smaller return than the average for all new U.S. foreign investments.

The voluntary program continues to permit growth in both the ownership of U.S. productive facilities abroad and of the U.S. loans outstanding abroad. But it keeps that growth within the bounds permitted by the U.S. current surplus and the cost of essential defense and aid. The voluntary program remains the foundation of improvement in the U.S. balance of payments this year.

Our efforts to achieve full equilibrium in 1966 should also benefit from the improved situation for sterling; in 1965, special transactions by the United Kingdom accounted for roughly half of our deficit. Prospects are also strengthened by recent understandings established with Canada on the handling of its capital needs from the United States. Strong domestic expansion will continue to increase imports this year, and defense expenditures abroad will have to rise in 1966. Nevertheless, the United States has the determination and the means to continue the sharp improvement effected last year in bringing its balance of payments into equilibrium.