

Chapter 5

Growth and Balance in the World Economy

WORLD ECONOMIC EXPANSION in the first half of the 1960's has been sustained and rapid. The pace has probably been surpassed only during the period of recovery from World War II. Moreover, since the end of the war, the extreme fluctuations of earlier years have not been repeated.

But continued economic progress is not assured. Many problems remain. The most difficult and important is that of overcoming poverty in many of the less developed countries of Africa, Asia, and Latin America. A major problem for the developed countries is to cope with international financial imbalances in ways which do not inhibit sound economic growth.

This chapter records the economic progress in both the developed and less developed countries during the first part of the 1960's and outlines some major issues for international consideration during the remainder of this decade. It deals especially with the policy issues facing the United States and other developed countries in their efforts to achieve a better international balance and to pursue national policies that promote world economic progress. The worldwide economic impact of their national policies places a special responsibility on the major developed countries.

WORLD ECONOMIC GROWTH IN THE 1960'S

Two quantitative goals for economic growth in the 1960's have been fixed by international organizations:

The United Nations has set 5 percent a year as the minimum growth rate for the less developed countries over the 1960's, calling this the "Development Decade."

The Organization for Economic Cooperation and Development (OECD), which includes the countries of Western Europe, the United States, Canada, and Japan, has called for an increase in aggregate output of all member countries combined, amounting to 50 percent over the decade or an average annual growth rate of 4.1 percent.

As can be seen from Table 29, the expansion of real output in the less developed countries, estimated at $4\frac{1}{2}$ percent a year, so far has fallen somewhat short of the UN target on average, and far below it in several

TABLE 29.—*Changes in total and per capita real GNP in OECD and less developed countries since 1955*

Country	Share of total output (percent) ¹	Percentage increase per year			
		Total real GNP		Per capita real GNP	
		1955 to 1960	1960 to 1965	1955 to 1960	1960 to 1965
OECD countries: Total.....	100.0	3.2	5.0	2.0	3.7
United States.....	53.3	2.2	4.7	.4	3.2
Total excluding United States.....	46.7	5.0	5.3	3.7	4.2
Germany.....	8.6	² 6.3	³ 4.8	² 5.1	³ 3.5
United Kingdom.....	7.7	2.8	3.3	2.2	2.6
France.....	7.3	4.6	5.1	3.7	3.7
Japan.....	5.4	9.7	9.7	8.8	8.5
Italy.....	4.1	5.5	5.1	4.9	4.3
Spain.....	1.4	4.3	9.2	3.4	8.3
Greece.....	.4	5.4	8.7	4.3	8.1
Less developed countries: Total.....	100.0	⁴ 4.5	4.6	⁴ 2.2	2.2
Africa.....	12.5	(⁵)	3.3	(⁵)	1.1
Nigeria.....	1.3	(⁵)	5.0	(⁵)	3.0
Ghana.....	.7	6.1	4.0	3.5	1.3
Latin America.....	50.1	4.8	4.4	2.0	1.5
Brazil.....	11.6	5.8	3.3	2.7	.2
Argentina.....	10.7	2.6	3.0	.9	1.3
Mexico.....	10.7	6.1	5.9	3.0	2.8
Asia.....	37.4	4.5	3.9	2.4	1.5
Middle East.....	6.4	6.1	6.1	3.7	3.7
Other Asia.....	31.0	4.2	3.4	2.1	1.0
India.....	16.3	4.4	2.9	2.3	.4
Pakistan.....	3.7	3.5	5.4	1.2	2.8

¹ Share in 1963 for OECD countries and in 1960 for less developed countries.

² Excludes Saar and West Berlin.

³ Includes Saar and West Berlin.

⁴ Estimates.

⁵ Not available.

NOTE.—Totals include countries not shown separately.

Detail will not necessarily add to totals because of rounding.

Sources: Organization for Economic Cooperation and Development (OECD), Agency for International Development (AID), and Council of Economic Advisers.

of the largest of these countries. However, the table also shows that output in the OECD countries has been exceeding the growth rate of the OECD target.

DEVELOPED COUNTRIES

In the first half of the 1960's, real output in Western Europe and Japan increased by more than 5 percent a year. Contributing to the rapid expansion were government policies directed toward achieving and maintaining high levels of employment with reasonable price stability, stimulating the movement of labor from low to high productivity employment, reducing barriers to foreign trade, and encouraging the more efficient utilization of resources in other ways.

A high rate of capital formation helped to achieve this rapid growth. Investment averaged 18 percent of gross national product (GNP) in the OECD countries other than the United States; it ranged from almost 30 percent in

Japan to less than 14 percent in the United Kingdom. While much of the increase in output comes from investment in physical capital and from the incorporation of technological advances, a good deal also comes from investment in human capital—in raising the education, skills, and health of the population.

The growth of output is also benefiting from the movement of labor out of activities of low productivity to those of higher productivity. There has been a large-scale movement of labor from Southern Europe to Northwestern Europe—from areas of low productivity, low incomes, and high unemployment to areas where productivity and incomes are high and unemployment low. Within countries, the major shift has been out of employment in agriculture. The OECD estimates that this latter shift alone accounted for between 10 and 15 percent of the increase in productivity during the first half of the 1960's in France, Germany, Italy, and Japan. The United Kingdom, which by 1960 already had only a small agricultural sector, did not have this source of expanding productivity.

Internal shifts of labor have been stimulated and facilitated by the expansion of foreign trade, which has far exceeded the growth of output. The rapid growth of trade has resulted, in part, from the reduction of trade barriers, especially within the two regional groupings—the European Economic Community (EEC) and the European Free Trade Association (EFTA).

For a number of European countries and Japan, a rapid rise in exports has also directly stimulated the growth of GNP. In addition, when domestic expansion is led by export growth, the resulting rise in imports can be readily financed; there is less chance that the government will need to apply the brakes to reverse a developing balance of payments deficit.

LESS DEVELOPED COUNTRIES

The achievement of an adequate rate of self-sustaining growth in the less developed countries remains an urgent world economic problem. Over half of the 4½ percent annual growth of total output for the less developed areas has been needed just to maintain their low level of living, since their populations have been rising by 2½ percent annually. The yearly increase in per capita output has been only 2 percent, or barely \$3 a person.

Achieving rapid and sustainable growth in these countries is by no means a hopeless task, however. Self-sustaining growth has been attained in certain less developed countries—including Israel, Malaysia, Mexico, Taiwan, Venezuela, and some Central American countries. Others—such as Pakistan, South Korea, Thailand, and Turkey—are approaching that objective.

But the problems are formidable. Further efforts by both the developed and the less developed countries are required. The rapid growth of population in many less developed countries, already over-populated in relation to their economic resources, must be slowed. A number of these

nations have adopted measures to induce their citizens to limit the size of their families. Some of these programs—in Hong Kong, Singapore, and Taiwan—have already shown signs of success. Nevertheless, the growth rate of population in the less developed countries as a group is still rising.

Another major problem area is agriculture. Agricultural output has grown so slowly that food output per person in many countries is below pre-World War II levels. Unless a vigorous effort is made to redress the situation, it is likely to deteriorate further as population and need for food continue to grow rapidly. Moreover, in at least some of the less developed countries, agricultural development may be a key to general economic growth. The application of improved farming techniques can substantially improve agricultural productivity with relatively small increments of capital; increased agricultural output can be a major substitute for imports; rising farm income can provide an expanding market for domestic industrial output.

The developed countries can do much to help by providing technical assistance, food, fertilizers, agricultural equipment, and financing. But the basic responsibility rests on the less developed countries themselves. They must, among other things, improve the incentives for farmers to increase output.

Education also is a major field in which improvement is essential. Economic progress requires literacy. A modern and expanding economy needs much more—people trained to operate farm machinery, run a lathe, operate a retail store, and keep accounts. In recognition of the importance of education, the less developed countries have in recent years increased their education budgets by 15 percent annually. This effort has long been supported by the United States. More Agency for International Development (AID) technicians working abroad are employed in educational projects than in any other field. Moreover, beginning in fiscal year 1967, AID is sharply increasing its educational aid effort, as well as its work in agriculture and health. The educational efforts of our Peace Corps workers are also welcomed throughout the less developed world.

The Need for Capital

The developing countries also need capital. About one-fourth of their domestic investment is financed by capital imports. From 1961 to 1965, the net amount of this capital inflow rose by only 5 percent a year in money terms and less in real terms. Some increase continued into 1966. Since 1963, the entire increase from abroad has been in private capital flows.

This investment, to be sure, benefits the recipient countries, and the United States has taken steps to encourage it. But it has gone mainly to the extractive industries, particularly oil. Thus, it is unevenly distributed among countries. Further, investment in technologically advanced, some-

times highly automated, extractive processes does not have the same stimulating effects on general economic activity as does investment in local manufacturing. It does, however, provide much needed foreign exchange and technological know-how for those countries fortunate enough to be well-endowed with minerals.

For many developing nations, a growing burden of interest and amortization payments on external debt absorbs a large and rising proportion of gross aid receipts. In 1960, debt service charges amounted to 13 percent of the official bilateral aid receipts of less developed countries; today the figure is 19 percent. India's debt service charges on government assistance for the period of its Third Plan amounted to 26 percent of its foreign aid. In Turkey, debt service during 1963-66 was more than half as large as gross foreign aid.

For the net inflow of aid merely to remain constant, the gross inflow must rise to cover growing debt service. In fact, the gross flow of government aid from the developed countries has been rising just enough to keep net aid inflow on a plateau since 1963. Future prospects are even less encouraging. Bilateral aid commitments—pledges of actual aid disbursements to be made in the future—declined in 1965. This could foreshadow a decline in net and even in gross official aid disbursements in the years to come.

The stagnation in the net flow of official capital to the less developed countries has come at the very time that the industrial countries have reached new heights of prosperity. And it comes at a time when the pace of economic expansion achieved by the less developed countries as a group is encouraging. They are developing the skills required for a modern economy. They are capable of using more capital than they can raise domestically or borrow abroad on commercial terms. For this and other reasons, foreign aid, both bilateral and multilateral, should have a high priority claim on the resources of high-income countries.

One of the most fruitful avenues for increased aid to the less developed countries is through the multilateral lending agencies—the World Bank family and the regional development banks. The United States firmly supports these agencies as mechanisms for mobilizing both external capital and domestic resources of the developing countries themselves. Replenishment of the resources of the International Development Association (IDA), which lends on easy terms, ought to be high on the agenda of the developed countries. The IDA's resources should be substantially increased in ways which take into account the balance of payments situation of the contributing countries. The recently established Asian Development Bank represents a new stage in Asian economic cooperation, in which the United States is participating with other non-Asian countries. For Latin America, the United States continues its strong support of the Inter-American Development Bank, which serves as the financial arm of the Alliance for Progress and is helping to draw funds from inside and outside the hemisphere into

Latin American development. The African Development Bank, which has recently begun operations, will perform similar functions in its area.

Foreign aid and private foreign investment finance only one-fifth of the foreign exchange expenditures of the developing countries. The remaining four-fifths is financed by their own export earnings. After near stagnation in the late 1950's, these earnings rose by about 6 percent a year during the first half of the 1960's. The increase was produced by many factors, including strengthened prices for many primary commodities, the growing ability of the less developed countries to supply these commodities, and the rapidly expanding markets in the United States, Western Europe, and Japan. Only with continued vigorous growth in the developed world and improved access to its markets can the less developed countries earn the foreign exchange needed to support their own continuing growth.

TRADE POLICIES

The less developed countries obviously have much to gain from reductions in tariffs, quotas, and other barriers to trade in primary products, since such products constitute 85 percent of their exports. Over the longer run, satisfactory growth in the export earnings of the less developed countries will require relatively less reliance on sales of primary products and continuation of the sharp expansion in exports of manufactured goods. Such diversification will also be important for their internal growth. Reductions in tariffs and other trade barriers in developed countries can contribute much to the needed growth of manufactured exports from developing countries.

In most of the less developed countries, internal markets are too small to support efficient modern industrial plants. It is not geographic size or population but effective purchasing power that determines the size of a market. Regional cooperation can create larger markets so that the enterprises of the developing countries can benefit from the economies of scale and of specialization on which growth and efficiency depend.

Encouraging progress toward regional integration is being made in a number of areas. The Latin American Free Trade Association, despite handicaps, can form the basis for a true Latin American common market. Particular progress has been made in the Central American Common Market. The United States supports outward-looking regional integration.

The importance of trade expansion as a factor in economic growth in all countries argues strongly for more rapid trade liberalization. This proposition is effectively demonstrated by the recent experience in the new free-trade areas of Europe, just as it was earlier demonstrated in the great common market of the United States. Thus, it is essential that success be achieved in the current multilateral trade negotiations, by far the most comprehensive in history.

Kennedy Round

This success is important to both the developed and less developed countries. The substantial reduction in tariff barriers which the United States and other countries are seeking to achieve in the Kennedy Round negotiations should make an important contribution to increased world trade.

Expanding world trade encourages capital and labor to move out of those economic activities which are better supplied from abroad and into those fields which provide higher real income through greater productivity. By permitting countries to produce efficiently and on a large scale, freer trade makes a contribution to higher incomes everywhere. And through reduction of artificial shelters to laggard domestic industries, the lowering of barriers to imports spurs innovation and efficiency.

In the Kennedy Round, the major reductions in barriers to world trade are expected to be made by the developed countries—the United States, EEC, EFTA, and Japan. EFTA has now virtually eliminated barriers to industrial trade among its members while the EEC will do so for both industrial and agricultural products by July 1968. The reduction of barriers to trade with nonmember countries would now help these groups to continue their rapid pace of growth, and would avoid distortion of the normal pattern of European trade in particular and world trade generally. The less developed countries are not being asked to grant tariff concessions that would endanger their economic development programs.

Longer-Run Tasks

A successful Kennedy Round will be a great achievement, and will promote rapid and healthy economic expansion throughout the world. But the Kennedy Round cannot be the end of the road for the liberalization of world trade. In the year ahead, further study and international consultation should be directed at four remaining tasks in the trade field:

- (1) Continuing efforts to liberalize those tariff and nontariff barriers which will remain after the Kennedy Round;
- (2) Developing a better international pattern of agricultural production and trade to speed economic growth;
- (3) Achieving more stable export prices and raising the export volume of developing countries;
- (4) Improving economic relations between the countries of Eastern Europe—including the Soviet Union—and the United States.

President Johnson has emphasized the importance of this last task on several occasions. In his recent State of the Union Message, he noted that the Export-Import Bank can now extend commercial credits to Bulgaria, Czechoslovakia, Hungary, and Poland, as well as to Rumania and Yugoslavia. He called again for legislative authority to extend most-favored-nation—i.e., nondiscriminatory—tariff treatment to the countries of Eastern

Europe and the Soviet Union. Their trade with Western Europe has increased steadily in recent years, while U.S. trade with these countries has been stagnant, and constitutes less than 1 percent of all U.S. foreign trade.

U.S. BALANCE OF PAYMENTS

A country's foreign trade and payments are its main points of economic contact with the rest of the world. The balance of payments of any nation is intimately dependent on policies and developments in the outside world. U.S. exports depend heavily on European, Canadian, and Japanese growth and the foreign exchange receipts of the less developed countries as well as on U.S. growth and price stability. The flow of capital from the United States depends on profit opportunities and monetary conditions abroad as well as on those in the United States.

For most of the decade following World War II, U.S. balance of payments deficits provided needed international currency to support the rapid expansion of world trade and economic growth. Other countries were eager to hold more dollars; indeed, it was commonly known as a period of "dollar shortage." Recently, however, as foreign reserves have increased, U.S. deficits have been less welcome.

These deficits do not, of course, contradict the unmatched strength and productivity of the U.S. economy; neither do they mean that our competitive position in world markets is weak. The United States is not living beyond its means, increasing its net debt to foreign countries, or using up its international capital. U.S. ownership of assets abroad continues to grow faster than foreign ownership of assets in the United States. U.S. assets abroad, net of foreign assets in the United States, increased from \$7 billion in 1935 to \$14 billion in 1950; by 1961 they had risen to \$28 billion; and in 1965 they were \$47 billion.

The deficits have, however, resulted in a steady erosion of the U.S. stock of reserve assets, which are needed to maintain a stable value of the dollar in international transactions. At the same time, there have been steady increases in U.S. liabilities to foreigners that may be considered potential claims against our reserve assets. This combination implies a continuing decline in liquidity; it is clearly not indefinitely sustainable if confidence in the safety and stability of the dollar is to be maintained.

The U.S. balance of payments performance is now evaluated in terms of two alternative accounting definitions. Both measure an over-all U.S. deficit or surplus in terms of what is currently happening to (1) U.S. reserves and (2) certain types of claims against the United States. Both count as an increase or decrease in reserves any change in the sum of U.S. holdings of monetary gold, U.S. "gold tranche" claims on the International Monetary Fund (IMF), and U.S. official holdings of convertible foreign currencies.

They differ in how they treat changes in various outstanding claims against the United States.

One measure—the “official reserve transactions” balance—treats any increase in foreign *private* claims on the United States, liquid or illiquid, as an ordinary capital inflow. Only the change in claims on the United States held by *foreign official agencies* is counted, along with the change in U.S. reserves, as a measure of the U.S. deficit or surplus. Foreign official monetary agencies have the privilege of converting claims on the United States into gold at the U.S. Treasury; their net purchases thus add to the direct claims on U.S. reserves. Moreover, they are charged with maintaining stable exchange rates for their national currencies. They usually do this by buying or selling dollars to close any gap between normal supply and demand for dollars which might otherwise upset the exchange rate between the dollar and their currency. In this sense, the net balance of such transactions by other countries, together with changes in our own reserves, is one indicator of the size of the imbalance in U.S. payments.

The alternative “liquidity” balance attempts an assessment of changes in the U.S. liquidity position. It takes account of the fact that liquid dollar holdings of private foreigners may be readily sold to foreign central banks. It therefore treats only increases in foreign *non-liquid* claims on the United States as ordinary capital inflows. Changes in all *liquid* claims are included along with changes in U.S. reserve assets as a measure of the U.S. balance, regardless of whether the claims are acquired or sold by an official agency or by a private individual, bank, or business.

While these measures of balance are important, they must be viewed as indicators, rather than definitions, of equilibrium. In part, the limitation arises because any measure of balance must arbitrarily divide dollar assets into two distinct groups—those which are claims against our reserves and those which are not. Such a clear division does not exist in reality. To a degree, any marketable dollar asset can be indirectly exercised as a claim against U.S. reserves. Moreover, the likelihood that assets will be used as a claim against U.S. reserves depends not only on their marketability and maturity but also on the motivation and attitude of current and prospective holders. Evidence on such attitudes, including the performance of the dollar in foreign exchange markets, helps to interpret the U.S. position. But, however that position is assessed, the U.S. balance of payments clearly has not been in sustainable equilibrium in recent years and must be improved.

Where a sustainable equilibrium may lie over the long run is not completely clear. The expansion of international transactions—most of which are settled in dollars—suggests that some growth of foreign private holdings of dollars is natural and desirable and may be perfectly sustainable. Some increase in official claims on the United States may also occur over the long run, given the preference of many countries to hold all or some of their official reserves in dollars, and the fact that transactions needs of official agencies

will continue to expand. Regardless of the movement of dollar holdings abroad, however, continuing U.S. reserve losses would not be compatible with sustained equilibrium. On the other hand, any growth of either official, or official plus private liquid, holdings of dollars need not be precisely equaled by growth of U.S. reserve assets in order that sustainable equilibrium be achieved.

RECENT DEVELOPMENTS

The U.S. liquidity deficit widened slightly in 1966 while the official settlements balance registered a small surplus for the first time since 1957.

The liquidity deficit had improved markedly in 1965 and showed a slight further improvement through the first three quarters of 1966. Preliminary evidence points to a somewhat larger fourth quarter liquidity deficit which will bring the year's total slightly above the \$1.3 billion deficit of 1965. During the year, there was an extraordinary buildup of foreign private dollar holdings, which resulted in a small surplus on official settlements.

Despite the surplus on official settlements, net gold sales continued as foreign monetary authorities reduced their dollar claims on the United States. While sales to France were \$601 million in 1966, the net reduction in the U.S. gold stock for the year was \$571 million.

Full data on the U.S. balance of payments are available only for the first three quarters of 1966. Unless otherwise noted, all figures for 1966 used below represent the total of these first three quarters at a seasonally adjusted annual rate.

The structure of the balance of payments in 1965 and 1966 was markedly different from that of previous years. The surplus on goods and services, which had been rising from 1959 to 1964, dropped sharply in 1965 and 1966. On the other hand, the net outflow on capital account was also greatly reduced in both years (Chart 16 and Table 30).

These developments can in large measure be attributed to (1) the increase in the direct costs of the war in Vietnam, (2) the sharp rise in imports induced by the rapid economic expansion and the heightened pressure on domestic resources, (3) the exceptionally tight monetary conditions of 1966, and (4) the balance of payments programs inaugurated in 1965. The last two factors were important in accomplishing a large reduction in U.S. bank lending abroad and in attracting an exceptional inflow of foreign capital.

The Balance on Goods and Services

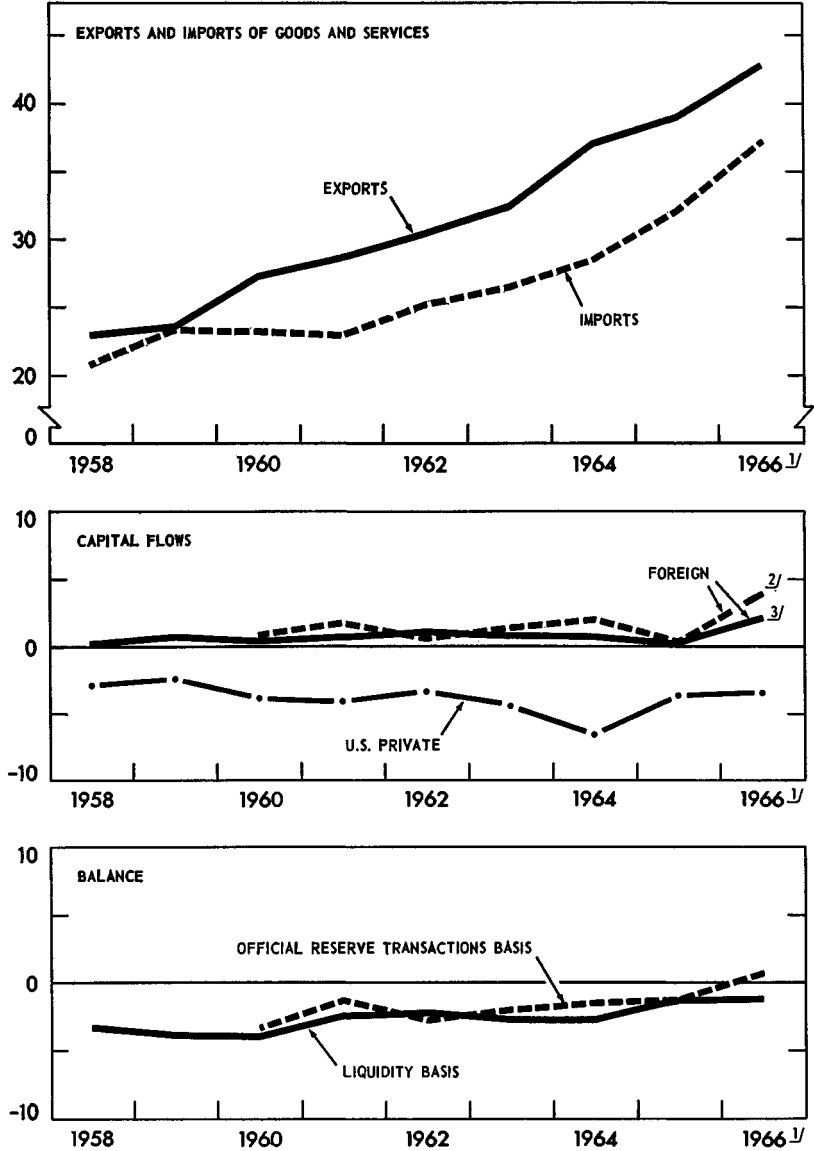
The U.S. surplus on goods and services more than doubled from 1960 to 1964, reaching an exceptional peak of \$8½ billion. Subsequently, however, the surplus declined. As the combined result of a narrowing trade surplus and sharply increased military expenditures in 1966, it fell to \$5½ billion.

Trade. The trade surplus fell through the first three quarters of 1966, to the lowest level since 1959. The most striking factor in this deterioration

Chart 16

U.S. Balance of International Payments

BILLIONS OF DOLLARS



1/ FIRST 3 QUARTERS AT SEASONALLY ADJUSTED ANNUAL RATES.

2/ EXCLUDING OFFICIAL RESERVE TRANSACTIONS.

3/ EXCLUDING LIQUID CAPITAL.

SOURCE: DEPARTMENT OF COMMERCE.

TABLE 30.—United States balance of payments, 1960–66

[Billions of dollars]

Type of transaction	1960	1961	1962	1963	1964	1965	1966 ¹
Balance on goods and services	4.0	5.6	5.1	5.9	8.5	7.0	5.5
Balance on merchandise trade	4.8	5.4	4.4	5.1	6.7	4.8	3.7
Military expenditures, net	-2.7	-2.6	-2.4	-2.3	-2.1	-2.0	-2.7
Balance on other services	2.0	2.8	3.1	3.1	3.9	4.2	4.5
Remittances and pensions	-.7	-.7	-.8	-.9	-.9	-1.0	-1.0
Government grants and capital, net	-2.8	-2.8	-3.0	-3.6	-3.6	-3.4	-3.6
U.S. private capital, net	-3.9	-4.2	-3.4	-4.5	-6.5	-3.7	-3.6
Foreign nonliquid capital, net .....	.4	.7	1.0	.7	.7	.2	2.0
Errors and omissions	-.9	-1.0	-1.2	-.4	-1.0	-.4	-.5
BALANCE ON LIQUIDITY BASIS	-3.9	-2.4	-2.2	-2.7	-2.8	-1.3	-1.2
Plus: Foreign private liquid capital, net ² .....	.5	1.0	-.2	.6	1.6	.1	2.3
Less: Increases in nonliquid liabilities to foreign monetary authorities ³ .....			.3	(⁴)	.3	.1	.5
BALANCE ON OFFICIAL RESERVE TRANSACTIONS BASIS	-3.4	-1.3	-2.7	-2.0	-1.5	-1.3	.7
Gold (decrease +)	1.7	.9	.9	.5	.1	1.7	⁵ 6
Convertible currencies (decrease +)		-.1	(⁴)	-.1	-.2	-.3	⁵ -5
IMF gold tranche position (decrease +) .....	.4	-.1	.6	(⁴)	.3	-.1	⁵ 7
Foreign monetary official claims (in- crease +)	1.3	.7	1.2	1.7	1.4	.1	⁵ -1.4

¹ First 3 quarters at seasonally adjusted annual rates, except as noted.² Includes changes in Treasury liabilities to certain foreign military agencies during 1960–62.³ Included above under foreign nonliquid capital.⁴ Less than \$50 million.⁵ First 3 quarters at unadjusted annual rates.

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

Source: Department of Commerce.

was the sharp acceleration in the growth of merchandise imports beginning in 1965, to an annual rate of about 20 percent. In 1966, imports rose to about 3.5 percent of GNP—the highest in the postwar period—from about 3.2 percent in 1965 and an average of less than 3 percent in previous years of the 1960's.

Imports of capital goods rose by about 50 percent, and accounted for more than 20 percent of the increase in imports in 1966. For the second consecutive year they rose sharply as a percentage of total domestic purchases of capital goods. As the increasing demand for capital goods began to strain domestic capacity in 1965, and even more in 1966, purchasers increasingly turned to foreign suppliers to get prompt delivery. While less than 3 percent of domestic requirements was imported in 1964, about 9 percent of the *increase* in domestic purchases of capital equipment between 1964 and 1965, and over 12 percent between 1965 and 1966, was accounted for by additional imports. The earlier strains and pressures continued to affect imports, especially for long lead-time items, in the second half of 1966, after the pace of over-all economic advance had moderated.

Export performance in 1966 was healthy despite domestic demand pressures. Exports were more than 10 percent greater than in 1965, even after adjustment for the effects of the 1965 dock strike. The U.S. share of world exports (excluding exports to the United States) remained stable, while the U.S. share of world exports of manufactured goods rose slightly.

A major source of the strength of U.S. exports in the 1960's has been the stability of the U.S. cost-price structure, while costs and prices have been rising elsewhere. Recent price developments in the United States, however, brought this relative improvement to a halt. Even so, unit labor costs in manufacturing have risen less rapidly in the United States during 1966 than in most other industrial countries. On the whole, it appears that the U.S. competitive position with respect to prices and costs was essentially unchanged in 1966.

Other Goods and Services. Overseas military expenditures increased in 1966 by more than \$700 million, after having been relatively stable for several years. The war in Vietnam, of course, was the cause of the increase. Expenditures in Europe still account for about 45 percent of the total, but have been largely offset by purchases of U.S. military equipment and by various financial transactions.

Other items in the goods and services balance behaved normally. Investment income receipts, expanding by 6 percent, showed continued strength. U.S. travel expenditures abroad also continued to increase. Foreign travel expenditures in the United States rose faster on a percentage basis, but by less in dollar amount, than the expenditures of U.S. nationals abroad.

The deterioration of the U.S. balance on goods and services during 1966, in summary, reflected primarily pressures stemming from the rapid advance of the domestic economy and the foreign exchange costs of the hostilities in Vietnam.

The Capital Account

As shown in Table 31, net U.S. private capital outflows fell from a record \$6.5 billion in 1964 to \$3.7 billion in 1965 and remained essentially unchanged in 1966.

U.S. Purchases of Foreign Securities. After a sharp rise in new issues of foreign securities in U.S. markets beginning in 1962, the United States in July 1963 imposed an Interest Equalization Tax (IET) on purchases from foreigners of securities of issuers in developed economies other than Canada. The IET was designed as a partial offset to the lower interest rates which prevailed in U.S. capital markets as a result of better organization and greater competitiveness, and of the need for the United States to press toward full employment of its resources through expansionary fiscal and monetary policies.

The IET has worked well. From 1964 through 1966, U.S. net purchases of foreign securities averaged about \$700 million annually, down

TABLE 31.—United States balance of payments: Capital transactions, 1960–66

[Billions of dollars]

Type of capital transaction	1960	1961	1962	1963	1964	1965	1966 ¹
U.S. private capital, net.....	-3.9	-4.2	-3.4	-4.5	-6.5	-3.7	-3.6
Direct investment.....	-1.7	-1.6	-1.7	-2.0	-2.4	-3.4	-3.2
New foreign security issues.....	-.6	-.5	-1.1	-1.3	-1.1	-1.2	-1.2
Other transactions in foreign securities ² ...	-.1	-.2	.1	.1	.4	.4	.7
U.S. bank claims.....	-1.2	-1.3	-.5	-1.5	-2.5	.1	.3
Other claims.....	-.4	-.6	-.4	.2	-1.0	.3	-.3
Foreign nonliquid capital, net.....	.4	.7	1.0	.7	.7	.2	2.0
Direct investment.....	.1	.1	.1	(³)	(³)	.1	-.1
U.S. securities (excluding Treasury issues).....	.3	.3	.1	.3	-.1	-.4	1.1
Long-term U.S. bank liabilities.....	(⁴)	(⁴)	(⁴)	.1	.2	.2	.8
Other ⁵	-.1	.3	.8	.4	.5	.4	.3
Foreign nonliquid capital, net.....	0.4	0.7	1.0	0.7	0.7	0.2	2.0
Plus: Foreign private liquid capital, net.....	.5	1.0	-.2	.6	1.6	.1	2.3
Less: Increases in nonliquid liabilities to foreign monetary authorities ⁶.....			.3	(³)	.3	.1	.5
Equals: Foreign capital excluding official reserve transactions, net.....	.8	1.7	.5	1.3	1.9	.2	3.9

¹ First 3 quarters at seasonally adjusted annual rates.² Includes redemptions.³ Less than \$50 million.⁴ Includes certain special government transactions.⁵ Included above under foreign nonliquid capital.

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

Source: Department of Commerce.

from the average of \$1.1 billion of 1962 and 1963. U.S. purchases of new issues have stabilized near \$1.2 billion; virtually all new issues have been by Canadians and other borrowers not covered by the tax.

U.S. Direct Investment and Bank Lending. The outflow of direct investment funds from the United States began to accelerate in 1963. By 1965, the flow was more than double that in 1960–62. The years 1963 and 1964 also saw a sharp rise in loans abroad by U.S. banks. The total outflow of U.S. capital in 1964 was more than \$2½ billion in excess of its average in 1960–61.

Although the outflow of portfolio capital and bank loans is largely explained by differentials in the cost of borrowing and the efficiency of U.S. financial markets, the increase in direct foreign investment by U.S. corporations in the last few years is somewhat more difficult to explain. The rapid increase in investment in Europe generally reflects, of course, a desire to participate in a large and rapidly expanding new market.

Earnings on investments in Europe, however, have fallen since 1962. Between 1955 and 1962, rates of return on investments of U.S. manufacturing affiliates in Europe, at 14 to 19 percent, were significantly higher each year than the 10 to 15 percent earned by U.S. manufacturers at home. However, since 1962, earnings on direct investments in Europe have varied between 12 and 14 percent, about the same as, or—in 1965—even below,

those in the United States. It is possible that long-term plans for expansion of foreign operations decided upon in the earlier period have dictated the large investment outflows of recent years.

Whatever the reasons for the sharp increase in direct investment and bank lending in 1963–64, it clearly was imposing an intolerable strain on the U.S. balance of payments.

Consequently, early in 1965, the United States introduced a program of voluntary restraint on foreign investment by U.S. corporations and banks. This program was designed to moderate the capital outflow to the developed countries, while not interfering with the flow to the less developed. The Federal Reserve program requested that banks limit their increase in claims on foreigners in 1965 to 5 percent of the outstanding claims at the start of the year; a further 4 percent increase was the suggested limit in 1966. Banks were asked to give priority to export financing and credits to less developed countries. Similar guidelines were applied to foreign lending by other financial institutions. This program—together with the effects of tight money—achieved a \$2½ billion favorable swing in bank lending from 1964 to 1965 and a further \$200 million improvement in 1966.

The Department of Commerce, early in 1965, asked large nonfinancial corporations to make a maximum effort to expand their net payments balances and to repatriate liquid funds. Late in 1965, corporations were asked to limit their average annual direct investment outflows (including reinvested earnings, but net of U.S. corporate borrowing abroad) for 1965–66 to specified developed and oil exporting countries to no more than 135 percent of the average annual flow in 1962–64.

Under the Commerce program, firms have been encouraged to obtain maximum foreign financing. An indication of the program's success is the sharp surge in U.S. corporate borrowing abroad. In particular, U.S. corporations issued more than \$500 million of securities in foreign capital markets during the first three quarters of 1966. (These issues are included in Table 31 under foreign investment in U.S. securities; it offsets a part of the debit on direct investment.) In addition, borrowing by foreign subsidiaries of U.S. corporations has increased, reducing the need for outflows from the United States.

With these adjustments in financing, U.S. corporations continued their extraordinary expansion of plant and equipment expenditures abroad. Outlays in 1965 were more than 20 percent higher than in 1964; a further substantial increase is estimated for 1966, to an amount nearly double the outlays in 1962. The increase from 1965 to 1966 in U.S. manufacturing investment in EEC countries may have been more than one-third.

Foreign Capital. Higher yields on U.S. securities in 1966 attracted a large inflow of foreign capital, particularly into Government agency obligations and certificates of deposit issued by U.S. banks. Foreign official agencies and international organizations shifted a substantial volume of liquid dollar claims into these instruments.

The inflow of foreign private liquid capital that occurred in the third quarter of 1966 was particularly large. U.S. monetary tightness provided a strong pull to such funds. Some of the inflow clearly reflected a movement out of sterling during the period of acute pressure in July and August. Although an upward trend in private foreign demand for dollar balances is to be expected, the surge that occurred in the third quarter will obviously not continue and may be partly reversed in the future.

Most of the inflow represented borrowing by U.S. banks from their foreign branches as the home offices of U.S. banks responded to tightness in their reserve positions. The foreign branches, able to offer higher rates to depositors than those allowed in the United States, gathered a substantial volume of short-term funds abroad. Although this flow of funds did not reduce the U.S. deficit on liquidity account, it did prevent what would otherwise have been a larger flow of dollars into the hands of foreign official monetary agencies, and thereby placed the official settlements account in substantial surplus in the third quarter. It probably held down the loss in U.S. reserve assets at a time when there was temporary deterioration in other parts of the balance of payments.

PROSPECTS AND POLICIES FOR 1967

The U.S. trade surplus should resume its growth in 1967. Indeed, improvement may have begun in the fourth quarter of 1966. Success of the domestic economic policies described in Chapter 1 will be essential to improvement of the trade surplus. A moderate pace and more balanced pattern of domestic economic advance should lower the ratio of imports to domestic income from the peak recorded in 1966. While imports grow at a slower rate, export expansion should continue to be strong, given favorable growth rates in foreign markets and the increase in dollar earnings enjoyed by foreigners in 1966. The easing of domestic demand pressures and more stable prices should enable U.S. producers to take full advantage of export opportunities.

In addition, the U.S. Government will undertake further active efforts to promote exports, in part through expanded credit facilities of the Export-Import Bank. Steps are also being taken to attract a substantially larger number of tourists to the United States. The special task force on travel which the President will appoint in the near future should lay the groundwork for a greatly intensified long-run effort in this area.

Military expenditures abroad will continue to be large, although they will probably grow at a slower rate than in 1966. At the same time, the excess of investment income receipts over payments should show a substantial growth. The surplus on goods and services, then, should improve in 1967.

Just as the capital account of the U.S. balance of payments last year benefited greatly from the sharp tightening of monetary conditions, relaxation of credit could create pressures in 1967 for increased private capital

outflows and reduced foreign inflows. This makes it especially important that the programs to limit capital outflows be continued and strengthened.

Strengthened Voluntary Programs

The 1967 guidelines for the Federal Reserve and the Department of Commerce voluntary restraint programs, issued last December, reflect these considerations. Commercial banks by late 1966 were more than \$1.2 billion under their Federal Reserve guideline ceilings. To limit the potential increase in total foreign lending during 1967, the Federal Reserve asked each bank to continue to observe, throughout 1967, its existing ceiling of 109 percent of the claims outstanding as of the end of 1964. Banks were also asked to use their leeway under the ceiling only gradually—not more than one-fifth of it per quarter—beginning with the fourth quarter of 1966. Moreover, to assure that such credits as are extended will be devoted primarily to the financing of exports or to meet the credit needs of developing countries, any increase in nonexport credits to developed countries is to be limited to 10 percent of the leeway existing on September 30, 1966. New and greatly simplified guidelines were also issued for nonbank financial institutions.

The guidelines for the Department of Commerce voluntary program to restrain direct investment outlays of business firms abroad were also strengthened. The ceiling on direct investment outflow plus overseas retained earnings for the average of the two years 1966–67 was lowered to 120 percent of the 1962–64 average. With the strengthened program, the total of direct investment outflows—net of borrowings abroad—and retained overseas earnings in 1967 is expected to be below the actual level now estimated for 1966. The program will continue to permit the expansion of U.S. plant and equipment expenditures in those countries covered to the extent that the expansion can be financed from foreign sources. It also remains a fully voluntary program, confined to investments in developed and oil exporting countries.

Extension of IET

As a further measure to strengthen existing programs, the President is requesting a 2-year extension of the IET, now scheduled to expire in mid-1967, and is asking for authority to vary the effective rate of the tax between zero and 2 percent a year. By present law, the tax adds 1 percentage point, in effect, to the annual interest costs of those foreigners subject to the tax who borrow at long term in the United States or who sell securities to U.S. citizens.

The discretionary authority sought by the President would permit a rapid and flexible response to changing monetary conditions at home and abroad. Although the present 1 percent rate has virtually eliminated new security issues of countries which are not exempted, the current rate could prove ineffective, if foreign countries do not lower their high interest rates while U.S. monetary conditions ease.

BALANCE OF PAYMENTS ADJUSTMENT POLICIES

As countries grow at different rates and in different ways, payments imbalances are bound to arise. The adjustment policies of each country will directly affect not only its payments balance but its own internal economic performance and the payments balances of other countries. Therefore, payments adjustment should be pursued in ways compatible with each country's major domestic objectives and with the broad interests of the entire international community.

REPORT ON THE ADJUSTMENT PROCESS

During 1966, important progress was made toward developing a greater international consensus on policies best suited for adjusting payments imbalances. A report by Working Party 3 of the OECD, prepared by representatives of the ten major industrial countries, carefully explored the nature of the adjustment process and pointed to various possibilities for improving it.

The report recommended various ways of strengthening national policy instruments and outlined a set of informal guidelines regarding appropriate adjustment policies. In addition, it suggested a number of steps to improve adjustment procedures through greater international cooperation, including collective reviews of countries' balance of payments aims; the setting up of an "early warning" system for prompter identification and better diagnosis of payments imbalances; and the strengthening of international consultations with respect to the sharing of responsibilities for adjustment. These suggestions stemmed from the report's major conclusions, which included the following:

First, countries need to formulate their balance of payments aims more clearly and base their individual and joint policies on aims that are mutually consistent as well as desirable from the viewpoint of a healthy world economy.

Second, responsibility for adjustment must fall on both surplus and deficit countries.

Third, countries need to have available and make use of a wider range of policy instruments—both general and selective—and to tailor such instruments more finely to the requirements of different circumstances and multiple policy goals. There is particular need in many cases to place greater reliance on fiscal policies, and less on monetary policies, in achieving internal economic balance, because of the important international ramifications of changes in monetary policy.

Fourth, the proper combination of policy instruments depends on the situations encountered and the particular characteristics of the country concerned. No single policy prescription is appropriate in all cases.

Fifth, countries must take continuous account of the impact of their actions on other countries. A special need for international consultation exists in the field of monetary policy to avoid inappropriate levels of interest rates.

U.S. ADJUSTMENT POLICIES

The strategy adopted by the United States to improve its international payments position can be viewed in the light of the adjustment principles outlined by Working Party 3. U.S. policy has been designed to minimize interference with basic domestic and international objectives of this Nation and with the healthy development of the world economy.

Monetary and fiscal policies were used in 1966 to restrain demand in the light of both domestic and balance of payments considerations. The United States has continued to pursue a liberal trade policy. It has maintained its flow of economic assistance to the less developed countries. Direct interference with international transactions has been essentially limited to Government transactions and restraints on the outflow of capital to the developed countries of the world.

Policy on Goods and Services

Resort to controls over private international transactions in goods and services has been avoided as harmful to both the United States and the world economy. The long and steady progress toward trade liberalization could well be reversed by even "temporary" restrictions, which could threaten to become permanent shelters of protection for economic interest groups. Thus, U.S. actions to deal with the balance of payments problem have maintained the trend toward trade liberalization in which the United States has taken strong and consistent leadership since 1934.

On the other hand, vigorous action has been taken to minimize the foreign exchange costs of U.S. Government programs. There is no precedent for the economic and military assistance extended to foreign countries and the military expenditures made abroad by the U.S. Government since World War II. The acceptance of these responsibilities has involved a major balance of payments drain.

U.S. nonmilitary foreign aid programs—which, net of loan repayments, currently amount to \$3.6 billion a year—now have only a limited net balance of payments impact. This has been achieved by tying aid so far as feasible to purchases of U.S. goods and services. Although tying is already broadly applied and probably cannot be usefully extended in any major degree, continuing effort is required to assure the effectiveness of the techniques employed.

U.S. offshore military expenditures have been substantial during the entire postwar period, reflecting national security requirements and commitments to allies in an unsettled world. The impact of these expenditures on the U.S. balance of payments was reduced from a 1958 high of \$3.4 billion to less than \$2.9 billion in 1965; the Vietnam war caused a sharp increase, to \$3.6 billion, in 1966 (first three quarters at annual rate). At the same time, deliveries of military equipment sold to foreign countries rose from about \$300 million a year in 1960 to about \$1.1 billion for the full year 1966.

The foreign exchange costs of the security program, even excluding Vietnam, remain high. The United States is prepared to play its full part in supplying the necessary real resources for the common defense. But it seems reasonable to expect those allied countries whose payments positions benefit from U.S. expenditures for the common defense to adopt measures to neutralize their "windfall" foreign exchange gains—especially when their reserve positions are strong. This could be done in many ways. Specific arrangements could be worked out within the framework of the alliance itself. Such arrangements could relieve strategic planning from balance of payments constraints which, in the extreme, could jeopardize our national security and that of our allies.

Policy on Capital Flows

Over the years, the outflow of U.S. capital has made a major contribution to world economic growth. By providing capital to areas where it is relatively scarce, U.S. foreign investment raises foreign incomes and often leads to a more efficient use of world capital resources. U.S. direct investment has provided a vehicle for the spread of advanced technology and management skills. U.S. foreign investment also has yielded handsome returns to American investors and substantial investment income receipts for the balance of payments.

Despite the advantages of U.S. foreign investment both to the recipient countries and to the United States, it can—like every good thing—be overdone. And it was being overdone in the early 1960's. Just as a person must weigh and balance opportunities for investment that will be highly profitable in the future against his current wants, so must a nation weigh the benefits of future foreign exchange income against current requirements. The costs of adjusting other elements in the balance of payments may be greater than the costs of sacrificing future investment income.

It is often true that U.S. investment abroad generates not only a flow of investment income but also additional U.S. exports. From a balance of payments standpoint, this is an additional dividend. Yet it is also true, in some cases, that U.S. plants abroad supply markets that would otherwise have been supplied from the United States, with a consequent adverse direct effect on U.S. exports.

It is sometimes held that the international flow of capital occurs always and automatically in just the economically "correct" amount, and that any effort to affect this flow through government measures constitutes a subtraction from the economic welfare of the country of origin, the country of receipt, and the entire world community. Such a position cannot be sustained.

While much of the large flow of U.S. capital to the developed countries is no doubt a response to a shortage of real capital there relative to the United States, the flow is also influenced by many other factors. These may include

cyclical differences in capacity utilization, differences in monetary conditions and financial structure, speculation on exchange rates, tax advantages, and opportunities for tax evasion—none of which necessarily leads to a more rational pattern of international investment.

High prospective returns on investment in a particular country may reflect a particular choice of policies in the recipient country that is quite unrelated to any underlying shortage of capital. If a country chooses to channel the bulk of its private saving into low productivity uses, if it employs a tight monetary policy, if it limits access of its own nationals to its capital market, it will attract foreign capital. Restraint on such capital flows may therefore merely mean that more of the adverse effect of such domestic policies on economic growth will rest—as perhaps it should—on the country that made the policy choice.

Trade restrictions may also lead to a flow of capital that would not otherwise take place. U.S. investment in the EEC has, at least in part, been induced by the desire to get within the tariff walls erected around a large and growing market. If, however, a continued movement toward trade liberalization may be expected, the economic justification for some part of these capital flows is lessened.

One major stimulant for direct investment abroad is undoubtedly the substantial advantage in technology and managerial skills which U.S. firms often possess. The international transfer of these factors may be embodied in a capital outflow independent of the relative scarcity of capital. Action would thus be appropriate, not necessarily to curtail the investment itself, which would interfere with the beneficial transfer of the scarce technology and skills, but to transfer the source of financing to the area receiving the direct investment. This, indeed, is the primary intention and the result of the present voluntary program on direct investment.

Finally, differential monetary conditions among countries can induce capital flows. But monetary policy is an important and useful instrument of domestic stabilization and growth as well as of balance of payments adjustment. During 1960–65, U.S. monetary policy was oriented to serve domestic expansion. In 1966, it contributed to a desirable restraint on internal demand and to an improved balance of payments. In 1967, relaxation of U.S. monetary policy has begun in order to help obtain a better balance of internal demand. Appropriate use of restraints on capital outflows in such forms as the voluntary programs and the IET can usefully supplement monetary policy in promoting domestic and international goals.

In summary, it is clear that balance of payments policy should not exempt capital flows from its compass. It is equally clear that the United States should be a major capital exporter. The U.S. programs have been designed to maintain a reasonable flow of capital, especially to the less developed countries. Given the alternatives and the need to improve its payments position, the United States has restrained the outflow of capital as

preferable to cutting essential international commitments, limiting international trade, or restricting domestic—and world—economic growth.

ADJUSTMENT POLICIES OF OTHER DEVELOPED COUNTRIES

Actions by the United States to improve its payments position cannot by themselves assure that the world payments pattern will be either sustainable or desirable from an international point of view. Such a result is only possible through appropriate efforts of both deficit and surplus countries.

In 1966, various other countries pursued policies to reduce payments imbalances. The most dramatic measures were taken by the United Kingdom, following renewed severe speculative attacks on the pound in the summer, which were initially met by drawings on swaps and other short-term international credit facilities cooperatively provided by the financial authorities of the major industrial countries and the Bank for International Settlements. The British increased the bank rate to 7 percent, provided a strong dose of over-all fiscal restraint, adopted selective tax measures to encourage increased productivity, and imposed a temporary freeze on wages and prices. These measures markedly reduced the earlier deficit, and the United Kingdom may soon move into surplus.

In Italy and Japan, resumption of more rapid growth in domestic economic activity, together with policies favorable to increased capital exports, succeeded in reducing payments surpluses as the year progressed. Industrial expansion in France similarly led to a shrinkage in that country's overall surplus as the trade balance narrowed; however, there continued to be a net capital inflow.

Germany, which had a payments deficit in 1965 for the first time in several years, swung back to a sizable surplus in 1966. Monetary policy was tightened mainly to contain inflation. As a result, domestic investment slowed markedly, and the trade surplus increased sharply. The payments surplus was still expanding at year end. In January 1967, Germany took a welcome step toward monetary ease by lowering the central bank discount rate.

Although somewhat reduced from the preceding year, payments imbalances continued large in 1966. In some countries, corrective policies are clearly needed to prevent imbalances from growing still larger in the current year. Moreover, considerable question remains whether the pattern of adjustment in 1967 will permit a fully satisfactory rate of economic growth in the industrial countries, and an adequate flow of capital to the less developed world.

The United States will be actively pursuing policies to strengthen its payments position in 1967. But reduction of U.S. deficits must have a counterpart in reduced surpluses or increased deficits elsewhere. If the impact of the U.S. payments improvement were to fall largely on the United Kingdom or the less developed countries, the international payments system would suffer rather than benefit. From the viewpoint of a viable

international payments pattern, consequently, there is no real alternative: it is the countries with strong underlying payments positions and large reserves which must absorb a major share of the impact of reduced U.S. and U.K. deficits. In particular, a marked reduction is needed in the chronic over-all surplus of the major industrial countries of Continental Europe.

The surplus countries also bear a significant share of the responsibility for assuring that the manner in which adjustment takes place is, to the greatest extent possible, consistent with the broad objectives of the international economic community as a whole.

Most importantly, adjustment policies should not, in the aggregate, prevent a healthy rate of worldwide economic growth compatible with reasonably stable price levels. In the United States, demand policies aiming at a slower rate of growth than that of 1966 are, of course, entirely appropriate on purely domestic grounds. But an even more marked slowdown in demand than is needed for proper domestic balance would entail serious social and economic costs at home and could risk a recession. Given the massive weight of the United States in the world economy, such a policy would risk a slowdown in trade and economic growth on a worldwide basis.

On the other hand, the objectives of international economic expansion and payments adjustment are simultaneously served when surplus countries with lagging internal demand take effective steps to spur the pace of economic activity—as was, for example, true of France, Italy, and Japan during the past year. In 1967, a number of surplus countries will be in a good position to contribute significantly to better international payments equilibrium in this fashion, without running serious risks of engendering inflationary pressures.

Surplus countries also have a special responsibility for fostering relative freedom in international transactions. As the report of Working Party 3 pointed out, it is desirable—wherever possible—that adjustment take place “through the relaxation of controls and restraints over international trade and capital movements by surplus countries, rather than by the imposition of new restraints by deficit countries.” In the past year, Italy and Japan generally followed policies that facilitated capital outflows; the recently announced intention of the French Government to liberalize capital controls is also a hopeful development. There is, however, scope for further measures by various surplus countries to liberalize the regulations that govern capital outflows and also to ease restrictions on imports. More liberal import policies would both improve payments balance and counter domestic inflation.

In 1966, there was an escalation of monetary restraint. The sharp tightening of monetary policies in the United States, undertaken largely for domestic reasons, did help significantly to contain the U.S. payments deficit during the year. Monetary action also was a key feature in the program to defend the British pound. But countries in a strong reserve position

also placed heavy reliance on restrictive monetary policies to contain domestic demand. The net effect of all these actions, and of the failure of most other countries to take active steps to avoid monetary stringency, was a dramatic upward movement in interest rates on a worldwide basis (Chart 17). Between September 1965 and September 1966, rates on 90-day Eurodollar deposits increased from 4.4 percent to 6.7 percent; yields on long-term international bond issues rose by more than a full percentage point; and there were marked increases in long-term government bond yields in all major industrial countries.

The extent to which the present high worldwide *level* of interest rates aids the process of balance of payments adjustment is doubtful. The substantial benefit to the U.S. balance of payments from the tightening of U.S. monetary conditions stemmed from *differential* monetary conditions here and abroad. The potential magnitude of such effects is reduced when surplus countries simultaneously permit or even encourage their own interest rates to rise.

From the standpoint of world economic growth, it would be preferable if payments adjustment took place at a lower average level of interest rates than has recently prevailed. Precisely what level is appropriate is a matter that deserves continuing international discussion.

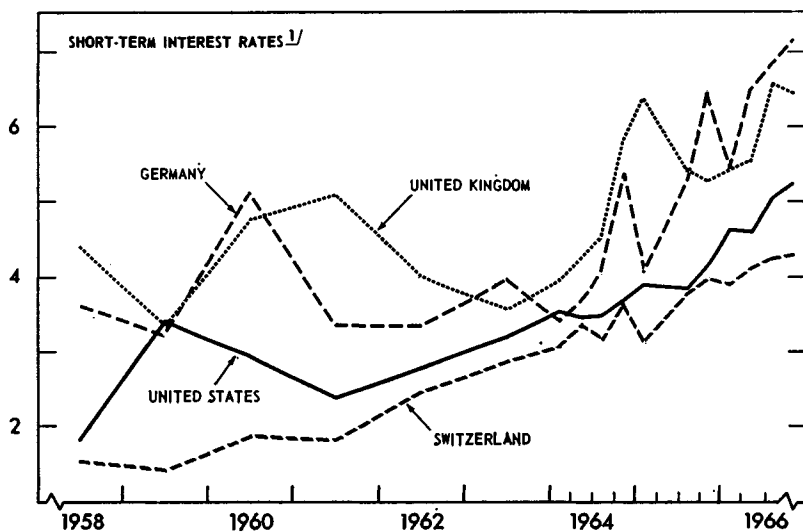
Given the key role of the United States in international financial markets, a general easing in international monetary conditions would be greatly aided by a lessening of monetary tightness in the United States. A move in this direction, already under way, will have major benefits for domestic economic balance. But if credit relaxation were confined to the United States, it would not promote a better balance of payments adjustment either for this country or for the major surplus countries of Europe. Moreover, at least in some important European economies, monetary easing would help to facilitate needed domestic economic growth. It would appear, therefore, that movement toward easier credit conditions by the countries of Western Europe would promote their own and the general welfare. Where necessary for domestic reasons, demand restraint could be maintained by greater reliance on fiscal policy.

If the major surplus countries adjust mainly by permitting their trade surpluses to decline, this can lead to a substantially improved trade surplus for the United States and permit it to maintain and even augment its role as a major capital exporter. Alternatively, if the large surplus countries—and particularly the EEC countries—wish to continue to maintain a substantial surplus on current account, they should assume a larger share of the responsibility for providing financial capital where it is needed.

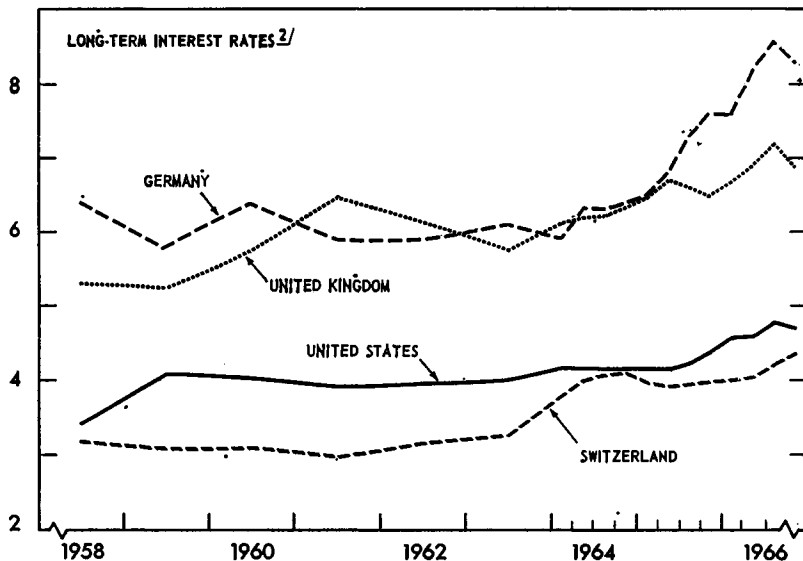
Some progress in this direction has, in fact, recently been made, partly under the spur of the more restricted access to U.S. capital markets. New international bond issues in Europe during the first three quarters of 1966, for example, were at an annual rate of about \$1.4 billion—four times the

Interest Rates in Selected Countries

PERCENT



PERCENT



^{1/} U.S. AND U.K., 3-MONTH TREASURY BILLS; GERMANY, 3-MONTH INTERBANK LOANS; SWITZERLAND, 3-MONTH BANK DEPOSITS.

^{2/} U.S., 10-YEAR TAXABLE BONDS; U.K., WAR LOANS; GERMANY, PUBLIC AUTHORITY BONDS; SWITZERLAND, GOVERNMENT BONDS.

NOTE.—DATA PLOTTED ARE ANNUAL THROUGH 1963, QUARTERLY THEREAFTER.

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

\$360 million level in 1962, the year preceding the introduction of the Interest Equalization Tax. It is highly desirable, however, that the surplus countries take stronger steps to enlarge the capacity of their capital markets and to assure an adequate volume of long-term capital exports (including foreign aid), especially to the less developed countries.

INTERNATIONAL MONETARY REFORM

The avoidance or appropriate correction of large-scale payments imbalances is of key importance in facilitating sound world economic growth and relatively unfettered international trade and payments. But better adjustment alone is not sufficient to attain these objectives.

In the long run, most countries seek some steady increase in their international reserves. With growing world transactions, this has meant that they have generally sought to have surpluses rather than deficits in their balances of payments. Obviously, however, all countries cannot attain such a goal simultaneously. At present, only the flow of new gold into monetary reserves can permit a steady accumulation of reserve assets by some countries without corresponding deficits for others.

This flow of new gold has, for many years, been inadequate. For much of the postwar period, dollars supplied through U.S. deficits served as the major supplement to gold in new reserve creation. For reasons already cited, however, the dollar can no longer be expected to perform this task in the same way; nor can it be assumed that adequate new reserves will accrue in the form of automatic drawing rights at the IMF, as the byproduct of the Fund's normal lending operations. To satisfy desires for rising official monetary reserves over the longer run and to eliminate dependence of the world economy on the vagaries of gold production, deliberate generation of new reserve assets is needed on a cooperative international basis.

In 1966, significant progress was made toward setting up a mechanism for such deliberate reserve creation. Representatives of the major industrial countries known as the Group of Ten agreed that it is prudent to begin the preparation of a contingency plan now. They also agreed that deliberate reserve creation should be tailored to global needs rather than the financing of individual balance of payments deficits; that decisions on the amount of reserves to be created should be made for some years ahead; and that reserve assets should be distributed to all members of the Fund, on the basis of IMF quotas or comparable objective standards. While the negotiations in the Group of Ten, and parallel deliberations by the Executive Directors of the Fund, did not result in complete accord on the precise form and use of new reserve assets, the exploration of technical details produced substantial agreement regarding the nature of alternative "building blocks" that might be incorporated in the final contingency plan.

A major accomplishment in 1966 was the initiation of a second stage of international monetary negotiations late in the year, involving joint dis-

cussions of the Executive Directors of the Fund and the Deputies of the Finance Ministers and Central Bank Governors of the Group of Ten. It is hoped that these meetings, which have already shown great promise, will by the time of the next Annual Meeting of the Fund lead to a wide consensus on the key remaining points at issue.

Differences of view on two of these points already seem to be narrowing. There now appears to be a widespread feeling that the needs of the international monetary system can best be served if deliberate reserve creation is effected through the development of an entirely new reserve unit, distributed to all Fund members. At the same time, there is increasing recognition that satisfactory procedures can be developed to make the new reserve asset generally acceptable without linking its use to specified payments of gold.

Probably the most important outstanding issue is the precise manner in which decisions on reserve creation are to be made. There is good reason to expect, however, that this question can be resolved in a way that takes account of the legitimate needs and interests of all the countries represented in the negotiations.

While the progress made in the negotiations thus gives ground for considerable satisfaction, it is also true that the need for developing a contingency plan for deliberate reserve creation has become more urgent.

One reason is that it can no longer be assumed that U.S. deficits will automatically increase world reserves. These deficits, which for much of the postwar period were the main element in new reserve creation, have since the end of 1964 made no net contribution to the rise in world reserves. Indeed, in September 1966, the dollar holdings in the official reserves of other countries were actually smaller than 21 months earlier, both in absolute terms and after a rough adjustment for seasonal influences. Over this period, total U.S. gold sales to other countries were more than twice as large as the accumulated U.S. balance of payments deficit on official settlements. Thus, the manner in which the U.S. deficit was financed has tended to reduce, rather than augment, the total of world reserves.

Second, the flow of gold into monetary channels has been sharply reduced recently. While final estimates for 1966 are not yet available, it is likely that there was virtually no net addition of gold to monetary reserves during the year. In 1965, only \$240 million of new gold entered into monetary stocks. This contrasts with an annual average of about \$600 million in the decade ended in 1964.

Third, it is significant that the modest increase in over-all world reserves that did occur in the recent past reflected very special circumstances. During the 21-month period from the end of 1964 through September 1966, world reserves increased by about \$1.8 billion. But the largest part of this increase was a byproduct of the difficulties experienced by the British pound, which caused the U.K. authorities to draw \$1.4 billion from the IMF; a large portion of this drawing, in turn, increased reserve claims on the Fund by

other countries. Not only can transactions of this kind no longer be counted upon to add to world reserves as the British situation improves, but repayment of Britain's debt could actually lead to a contraction of reserves.

These considerations suggest that the time when deliberately created reserves are needed may be closer at hand than is often realized. In any event, continued uncertainty regarding the nature of a contingency plan and the timing of its adoption can be a growing source of uneasiness in international financial markets and interfere with the smooth working of the adjustment process. Clear agreement on a contingency plan, on the other hand, would be a major factor in strengthening confidence in the world monetary system and in reducing gold hoarding and would help lessen the tendency of countries to pursue unattainable balance of payments aims.

The essential tasks for 1967 thus are to improve the process of payments adjustment through increased international cooperation and to move decisively toward establishing a mechanism for deliberate reserve creation. The two tasks are intimately interwoven; success in both is necessary to provide a sound climate for world economic growth and relative freedom in trade and capital transactions, as well as to assure an adequate flow of long-term capital from the developed to the less developed countries.