

The International Economy

THE EVENTS OF 1967 dramatized the importance of economic developments around the world to the progress and health of the U.S. economy. They also demonstrated both the need for international cooperation and the possibilities for achieving it. After highlighting the major developments of 1967, this chapter reviews the principles of balance-of-payments adjustment, surveys the U.S. balance-of-payments situation and policies in the light of these principles, and discusses problems and progress in the international monetary system and in the trading relations of the United States with both developed and developing nations.

A YEAR OF MAJOR DEVELOPMENTS

Developments during 1967 left a lasting imprint on the international economy. The headlines in the closing months of the year recorded the strains on the international monetary system generated by the sterling crisis and the subsequent devaluation of the pound. Anxieties and speculation in world financial markets contributed to a sharp widening of the U.S. deficit in the fourth quarter. The U.S. Government responded decisively with a major program to move our balance of payments strongly toward equilibrium.

Events earlier in 1967 paved the way for strengthening the future expansion of trade and the foundation of the international monetary system. The completion of the Kennedy Round negotiations marked the most successful effort toward reducing tariffs ever conducted under the aegis of the General Agreement on Tariffs and Trade (GATT). A major step was also taken toward the creation of a new form of international liquidity as the Special Drawing Rights (SDR) plan was agreed upon at the annual meeting of the International Monetary Fund (IMF).

Participating countries in the tariff negotiations displayed the enlightened statesmanship required to overcome particular interests for the greater general welfare of their own citizens and those of less-developed countries, which were not required to reciprocate in full. The same spirit ruled in the negotiations on liquidity, where substantial differences were resolved in the interest of international monetary progress.

During the difficult period preceding and following sterling devaluation, international consultations were conducted in the best postwar tradition;

they permitted Britain to devalue without similar actions by major competing countries which could have denied her the intended and needed benefits of the move. When nervousness and speculation threatened to disrupt world finance, the central banks of most major industrial countries expressed their determination and pledged their resources to defend the stability of the world monetary system.

The United States and other countries will continue to work cooperatively toward strengthening the foundation of world finance and expanding the network of international trade. There is a long agenda of unsolved and urgent problems. Payments adjustment still challenges the best efforts of all countries. The United States must insure the effectiveness of its balance-of-payments program and the proper management of its domestic economy. Meanwhile, countries with balance-of-payments surpluses have obligations and responsibilities to insure that they too move toward balance. All member countries of the IMF are called on to render promptly a clear verdict in favor of the creation of supplemental liquidity through the new Special Drawing Rights plan—as an unmistakable alternative to a shortage of reserves or to pressures on the price of gold. The year 1968 will be a period of testing for international financial cooperation, but it will also be a time of opportunity.

ADJUSTMENT PROCESS

Countries draw on international reserves, mostly in gold and U.S. dollars, to meet balance-of-payments needs when their payments to foreigners exceed their receipts. A country's reserve position is weakened when it incurs such deficits. On the other hand, its reserves will increase with balance-of-payments surpluses. Thus, reserves change hands as countries have payments imbalances.

Apart from the flow of gold to private holders, a deficit on the part of any country tends to have a counterpart in surpluses elsewhere in the world. Thus a loss of reserves by the United States is usually a gain for another nation; and an increase in our liabilities to official dollar-holders represents a gain in dollar reserves by some other nation. During the past decade, while the U.S. accounts have been persistently in deficit, many countries have had surpluses from time to time. But the European Economic Community (EEC) alone has had persistent surpluses of the same order of magnitude as U.S. deficits.

MUTUAL RESPONSIBILITIES

While moderate and clearly temporary deficits or surpluses need not cause concern, large and prolonged payments imbalances are normally undesirable for the proper functioning of the international monetary system. Unilateral actions by deficit countries, if forceful enough, generally can succeed in moving such countries toward balance. But the payments pattern

that results from unilateral action may not always be compatible with the broad economic objectives that all nations hold—such as high employment, sustained worldwide economic growth, a high degree of freedom of international trade and capital movements, and an adequate flow of capital to the less-developed countries.

Indeed, unless special precautions are taken to prevent such an outcome, much of the burden of corrective measures by any one deficit country could fall on countries that are already in weak payments positions, causing such countries to suffer unnecessarily and making it doubtful whether the new payments pattern could be long sustained. And there is also a danger that unilateral actions, such as tight monetary policy or restrictive budget measures, could impart a general deflationary bias to the world economy. Likewise, if corrective action is limited to surplus countries, it could in some cases add unduly to inflationary pressures.

In the light of such considerations, it is now generally recognized that the interest of all countries can best be served if payments adjustment is brought about through cooperative efforts by both deficit and surplus countries. Both types of countries bear major responsibility for such adjustments; both must seek to insure that their actions are mutually compatible and consistent with the broader aims that they share.

PRINCIPLES OF ADJUSTMENT

The particular policies and combinations of policy instruments that countries should appropriately use to achieve adjustment were outlined in the Report on the Adjustment Process by Working Party 3 of the Organization for Economic Cooperation and Development (OECD). The findings were described in the Council's 1967 Report. These policies vary, depending on the circumstances and the particular characteristics of the countries involved. There is no question, however, that deficit countries must seek to avoid excessive internal demand for balance-of-payments as well as domestic reasons. Surplus countries, similarly, have a special responsibility to maintain an adequate pace of domestic economic expansion. The Adjustment Process Report stresses, moreover, that fiscal policy needs to be given a major role in the achievement of domestic economic balance, and that there is a special need to avoid inappropriately high levels of interest rates.

There are many situations in which the choice of policies is especially difficult, because measures taken to satisfy domestic goals may run counter to international objectives, or vice versa. In such cases it may be necessary to employ new types and combinations of policy instruments. In particular, countries whose competitive position and domestic demand levels are satisfactory may have deficits due to excessive capital outflows. Such countries may find it necessary to use selective measures to limit these outflows. As the Adjustment Process Report indicated, however, "Wherever possible, it is desirable that adjustment should 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.”

The next section outlines the major actions which the United States has taken to move its payments position decisively toward equilibrium. A number of these actions are clearly of a temporary nature. While they have been designed to hold the possible damage to individual nations to a minimum, there was no choice but to move, in part, in ways that are restrictive and thus not fully compatible with the long-run aims of expansion and efficiency of the world economy. Achievement of a viable payments adjustment consistent with these goals must in part be based on the positive element of the U.S. program, which aims at a strengthening of the U.S. economic position through appropriate fiscal, monetary, and incomes policies. But it must also rest on more decisive actions by surplus countries—and particularly those in the EEC: to assure adequate economic expansion; to encourage capital outflows and increased aid to less-developed countries; to reduce barriers to trade; and to share more fully in the cost of the common defense.

THE U.S. BALANCE OF PAYMENTS

Current policies of the United States are designed to fulfill our responsibilities in the adjustment process and to the stability of the international monetary system.

The American dollar is the major reserve asset, other than gold, of world central banks; and it is the major transaction currency of international business and finance. The ability of the United States to carry out its responsibilities as the major world bank depends on the strength of its reserve position, which has been slowly diminished by continuing large deficits.

These balance-of-payments deficits arise when the sum of U.S. expenditures abroad on imports, travel, foreign securities and loans, direct investment, and other items exceeds the inflow of such payments by foreigners.

The U.S. balance-of-payments deficit records the change in our reserve position, measured as the sum of (a) losses in our reserves, and (b) increases in selected dollar claims of foreigners. The balance is statistically measured by two alternative concepts, which differ in their treatment of foreign claims. The *liquidity deficit* counts increases in the liquid claims on the United States of all foreigners—private and public—as well as losses in reserves. The *official settlements deficit* counts increases in all claims of foreign official monetary authorities—but not in private holdings of dollars—in addition to reserve losses.

Many of the transactions which contribute to the deficit involve the acquisition of productive foreign assets. The Nation does not lose wealth by such

transactions, but it does sacrifice liquidity—much like an individual drawing down his bank account to buy promising growth stocks. A nation which holds its international assets primarily in liquid form loses opportunities for productive investment. On the other hand, every nation—particularly the one that serves as the world's bank—needs an adequate margin of liquidity.

THE RECENT RECORD

The United States has had a balance-of-payments deficit almost continually since 1950. During the early part of that period, the entire U.S. deficit was beneficial to the rest of the world because it helped replenish the depleted reserves of other countries; and it could be tolerated by the United States because we had started the postwar era in an extremely strong reserve position.

Beginning in 1958–59, the situation changed. The U.S. deficit increased, while the acute shortage of dollars abroad was easing. From 1960 to 1965, the deficit was reduced progressively (Table 26 and Chart 14). But a deficit

TABLE 26.—United States balance of payments, 1961–67

[Billions of dollars]

Type of transaction	1961	1962	1963	1964	1965	1966	1967, first 3 quarters ¹
Balance on goods and services.....	5.5	5.0	5.9	8.5	6.9	5.1	5.4
Balance on merchandise trade.....	5.4	4.4	5.1	6.7	4.8	3.7	4.3
Military expenditures, net ²	-2.6	-2.4	-2.3	-2.1	-2.1	-2.8	-3.1
Balance on other services.....	2.6	3.1	3.1	3.9	4.2	4.3	4.1
Remittances and pensions.....	-.7	-.8	-.9	-.9	-1.0	-1.0	-1.4
Government grants and capital, net.....	-2.8	-3.0	-3.6	-3.6	-3.4	-3.4	-4.2
U.S. private capital, net.....	-4.2	-3.4	-4.5	-6.5	-3.7	-4.2	-5.1
Foreign nonliquid capital, net.....	.7	1.0	.7	.7	.3	2.5	3.9
Errors and omissions.....	-.9	-1.1	-.3	-.9	-.4	-.3	-.9
BALANCE ON LIQUIDITY BASIS.....	-2.4	-2.2	-2.7	-2.8	-1.3	-1.4	-2.3
Plus: Foreign private liquid capital, net ³	1.0	-.2	.6	1.6	.1	2.4	1.9
Less: Increases in nonliquid liabilities to foreign monetary authorities ⁴.....		.3	(⁵)	.3	.1	.8	1.4
BALANCE ON OFFICIAL RESERVE TRANSAC- TIONS BASIS.....	-1.3	-2.7	-2.0	-1.5	-1.3	.2	-2.9
Gold (decrease +).....	.9	.9	.5	.1	1.7	.6	1.2
Convertible currencies (decrease +).....	-.1	(⁵)	-.1	-.2	-.3	-.5	1.2
IMF gold tranche position (decrease +).....	-.1	.6	(⁵)	.3	-.1	.5	(⁶)
Foreign monetary official claims (increase +).....	.7	1.2	1.7	1.4	.1	-.8	2.6

¹ Average of the first 3 quarters at seasonally adjusted annual rates, except as noted.

² Military expenditures less transfers under military sales contracts.

³ Includes changes in Treasury liabilities to certain foreign military agencies during 1961–62 and to international non-monetary institutions.

⁴ Average of the first 3 quarters on an unadjusted annual rate basis.

⁵ Included above under foreign nonliquid capital.

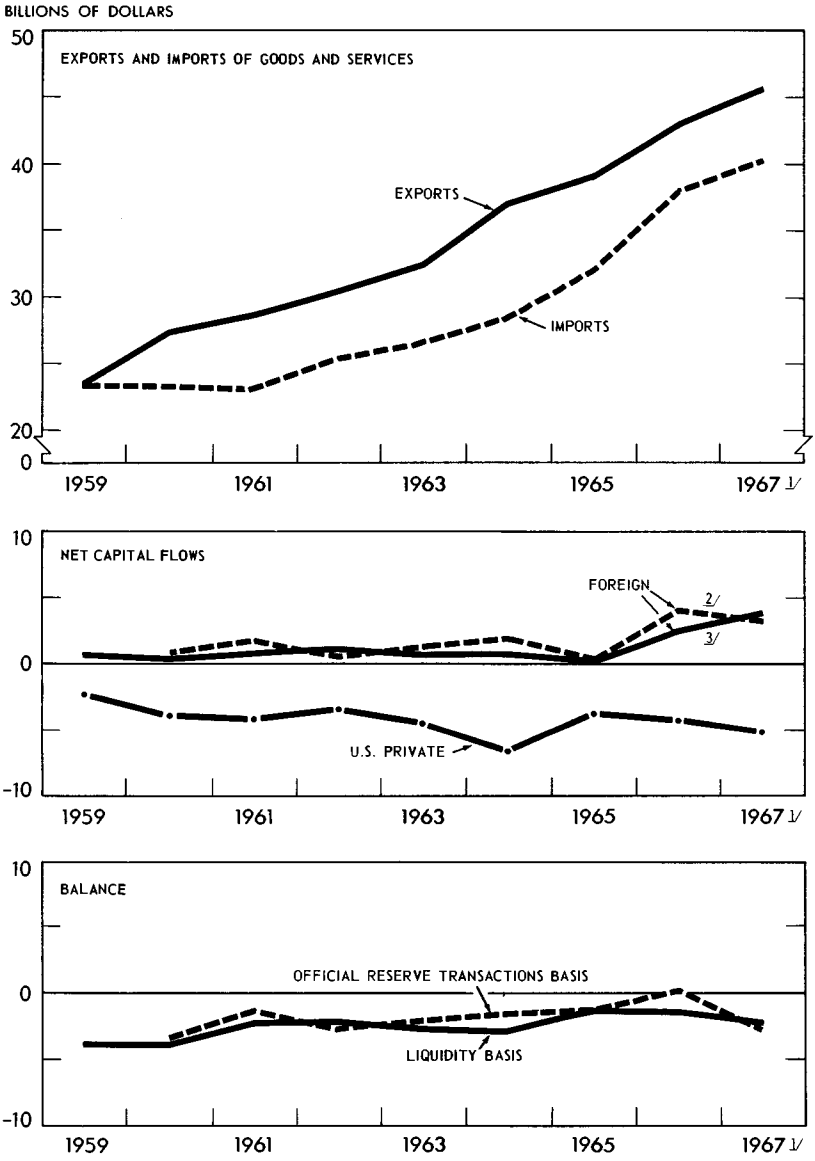
⁶ Less than \$50 million.

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

Source: Department of Commerce.

Chart 14

U.S. Balance of International Payments



1/FIRST 3 QUARTERS AT SEASONALLY ADJUSTED ANNUAL RATES.

2/EXCLUDING OFFICIAL RESERVE TRANSACTIONS.

3/EXCLUDING LIQUID CAPITAL.

SOURCE: DEPARTMENT OF COMMERCE.

continued. The improvement came from automatic adjustment forces, and from judicious use of policy measures. New measures were required from time to time as fundamental factors changed. Foreign demands on our capital markets burgeoned with the return of currency convertibility in Europe. Trade and direct investment flows were influenced by the creation of the EEC and the European Free Trade Association (EFTA).

The improvement in the U.S. balance of payments was arrested in 1966 by the greatly increased foreign exchange costs of the Vietnam war, and indirectly through the strains placed on our domestic economy. However, the impact on the payments position was largely offset by the inflow of interest-sensitive funds in response to the tightening of domestic money markets. The liquidity deficit of \$1.4 billion in 1966 essentially matched the \$1.3 billion of 1965.

In 1967, the unfavorable forces that had operated in 1966 persisted while monetary conditions eased, and the deficit widened (Table 26). Measured on the liquidity basis, the deficit was at an annual rate of \$2.3 billion during the first three quarters of the year.

The U.S. payments position in the fourth quarter deteriorated sharply, reflecting a decline in the merchandise surplus, the British devaluation, and the foreign exchange and gold speculation which it set off. Preliminary estimates indicate a liquidity deficit of about \$3.6 billion for the year as a whole. As measured by official settlements, the deterioration in the U.S. payments position was even more pronounced; the balance shifted from a \$200 million surplus in 1966 to a deficit of about \$3 billion in 1967, reflecting the especially marked effect of changing monetary conditions.

While shifts in payments can be readily identified in an accounting sense, their causes are more difficult to trace. A great deal of caution is required in making analytical judgments based on the accounts, especially while the estimates are still provisional.

To assess the underlying forces, cyclical and special factors must be disentangled from trend elements.

Cyclical Forces in 1967

Even though expansion slowed down last year, the American economy was closer to its high-employment growth path than were our major trading partners, which on average fell substantially below their normal growth performance. From 1966 to 1967, industrial production abroad rose rapidly only in Japan, increased moderately in Italy, sluggishly in Canada, hardly changed in Britain or France, and declined in Germany. The depth and persistence of the German recession dampened the total performance of continental Europe significantly, with cumulative effects on world trade.

Cyclical factors affected a number of balance-of-payments accounts, including merchandise exports and imports, income from investments abroad, and capital outflows for direct investment.

The U.S. merchandise balance improved during 1967, but the increase was held down by the sluggish state of demand abroad. Exports gained about 5 percent for the year as a whole, but they declined after midyear, primarily because of the weakness of demand in some of our largest foreign markets. Reflecting the slowdown of U.S. economic activity, imports remained at the level reached in the fourth quarter of 1966 and showed little tendency to increase until the fourth quarter of 1967. For the year as a whole, they rose about $4\frac{1}{2}$ percent. The comparison between 1966 and 1967 demonstrates the sensitivity of imports to the rate of change of U.S. economic activity and to the degree of pressure on our productive capacities. In 1966, when rapid expansion and shortages prevailed, imports increased by 6.8 percent of the gain in GNP; in the somewhat more relaxed economic conditions prevailing for most of 1967, imports increased by only about 3 percent of the advance in GNP.

Income from U.S. direct investments abroad expanded somewhat in 1967 after having increased only slightly in 1966. This disappointing performance reflected an actual decline in income from investments in Western Europe during the last two years, despite the further substantial buildup of assets there. The gradual narrowing of European profit margins that has been occurring for a number of years was aggravated by the cyclical situation—a phenomenon not confined to American-owned firms. U.S. income from private assets other than direct investments and from Government assets abroad continued to increase, however, about in line with previous years.

Some of the effects of the economic weakness in Europe and the slowdown in Canada, on the other hand, were favorable to the U.S. payments position. Along with other influences, the cyclical forces contributed to an indicated total drop in U.S. direct investment outflow during 1967 of about \$500 million (Table 27). This was the first decline in the level of outflows since 1961, although the \$3 billion level remained substantially above that of all years prior to 1965. In addition to the slowdown abroad, the substantial increase of borrowing abroad during the last two years—in response to the voluntary program—reduced considerably the outflow from the United States.

Special Factors in 1967

While the payments structure is always influenced by many special factors, 1967 produced a bumper crop. The list of those significant to the U.S. balance of payments includes Expo 67, the Middle East crisis, Vietnam intensification, and sterling devaluation.

TABLE 27.—United States balance of payments: Capital transactions, 1961–67

[Billions of dollars]

Type of capital transaction	1961	1962	1963	1964	1965	1966	1967, first 3 quarters ¹
U.S. private capital, net.....	-4.2	-3.4	-4.5	-6.5	-3.7	-4.2	-5.1
Direct investment.....	-1.6	-1.7	-2.0	-2.4	-3.4	-3.5	-2.9
New foreign security issues.....	-1.5	-1.1	-1.2	-1.1	-1.2	-1.2	-1.6
Other transactions in foreign securities ²	-.2	.1	.1	.4	.4	.7	.5
U.S. bank claims.....	-1.3	-.5	-1.5	-2.5	.1	.3	-.7
Other claims.....	-.6	-.4	.2	-1.0	.3	-.4	-.3
Foreign nonliquid capital, net.....	.7	1.0	.7	.7	.3	2.5	3.9
Direct investment.....	.1	.1	(³)	(³)	.1	.1	.2
U.S. securities (excluding Treasury issues).....	.3	.1	.3	-.1	-.4	.9	1.3
Long-term U.S. bank liabilities.....	(⁴)	(⁴)	.1	.2	.2	1.0	1.1
Other ⁴.....	.3	.8	.4	.5	.4	.5	1.3
Foreign nonliquid capital, net.....	.7	1.0	.7	.7	.3	2.5	3.9
Plus: Foreign private liquid capital, net ⁵	1.0	-.2	.6	1.6	.1	2.4	⁶ 9
Less: Increases in nonliquid liabilities to foreign monetary authorities ⁷.....		.3	(³)	.3	.1	.8	⁶ 1.4
Equals: Foreign capital excluding official reserve transactions, net.....	1.7	.5	1.3	1.9	.3	4.1	3.3

¹ Average of the first 3 quarters at seasonally adjusted annual rates, except as noted.² Includes redemptions.³ Less than \$50 million.⁴ Includes certain special Government transactions.⁵ Includes changes in Treasury liabilities to certain foreign military agencies during 1961–62 and to international non-monetary institutions.⁶ Average of the first 3 quarters on an unadjusted annual rate basis.⁷ Included above under foreign nonliquid capital.

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

Source: Department of Commerce.

Expo. U.S. travel expenditures, which had been increasing on the average about 10 percent a year, jumped about 20 percent (or \$500 million) in 1967. The acceleration was accounted for by tourist spending in Canada, which rose more than 50 percent, reflecting the attraction of Expo 67. Meanwhile, U.S. receipts from travel expenditures, which has been increasing about 15 percent a year, rose only about 4 percent last year. There was no increase in receipts from Canadians, who usually contribute one-third of U.S. travel earnings.

Middle East. The Middle East crisis and its aftermath also, on balance, had some adverse effects. While not of great magnitude, the contrast with the favorable balance-of-payments consequences of the 1956–57 Suez crisis is very marked. Net payments increased as the result of lower merchandise exports to the area, higher payments for transportation, greater personal remittances, and larger new issues of foreign securities in the U.S. market. These outweighed the gains in petroleum trade and some increase in earnings of American-owned international oil companies.

Southeast Asia. The intensification of the hostilities in Vietnam had an additional impact on the U.S. balance of payments. U.S. overseas military expenditures increased further by about \$700 million in 1967, to a level more than \$1.4 billion above the plateau prior to mid-1965.

Sterling. The events surrounding the devaluation of sterling had many immediate consequences for the U.S. balance of payments. Some are easily identified but others harder to evaluate. Prior to the devaluation, speculation against sterling forced the United Kingdom to liquidate all of its remaining long-term government-owned assets in the United States, in order to reconstitute official reserves. This action increased the U.S. liquidity deficit by about \$500 million in the fourth quarter. The deficit may have been increased further indirectly by the flurry of private gold purchases; it was also widened to whatever extent funds moved out of the United States for purposes of speculation or hedging in the period of stress and uncertainty.

In combination, cyclical and special factors account for much of the deterioration in the U.S. balance of payments during 1967, particularly in the fourth quarter. However, against the history of a persistent U.S. deficit, the sterling devaluation and its aftermath posed a threat to the stability of the dollar and consequently to the stability of the international monetary system. Thus new U.S. balance-of-payments measures became necessary in order to strengthen the international monetary system, insure that the 1967 deterioration of the U.S. balance of payments is decisively reversed, and improve the underlying strength of the U.S. payments position enough to bear the heightened military costs in Southeast Asia.

THE 1968 PROGRAM

The monetary and fiscal measures outlined in Chapters 1 and 2 and the continued efforts to increase efficiency and to encourage responsible price and wage behavior discussed in Chapter 3 provide the broad base for improvement in our international payments position and are an integral part of our balance-of-payments program. In addition, the President set forth on New Year's Day a major new program of measures specifically directed at the balance of payments.

The new program is directed at improvement in five separate areas: (1) capital outflows for American direct investments abroad; (2) loans to foreigners by American financial institutions; (3) Government net expenditures abroad; (4) net travel expenditures; and (5) merchandise trade. Most of the measures included in the program will have an immediate impact on the balance of payments. Some are intended to be temporary; others are long term in character. Some have been put into effect by administrative actions, others require legislation by Congress, and still others require co-operative action by our allies and trading partners.

Regulations on Foreign Direct Investment

On January 1, 1968, the President issued an Executive order which basically transformed the Commerce Department's previously existing Voluntary Direct Investment program into a mandatory program with much lower levels of permitted capital outflows. The voluntary program, which began in 1965, called on the business community to reduce capital transfers for direct investment in developed countries; it also sought additional contributions to the balance of payments through such means as expanding exports and remittances of earnings abroad. The program stressed the desirability of financing investments abroad through foreign borrowing.

The largest needs for cash by American affiliates abroad are for financing plant and equipment expenditures. Foreign plant and equipment outlays by American firms in 1967 were an estimated \$10.2 billion, up from \$6.2 billion in 1964. These expenditures are financed out of many sources. In 1966, capital outflows for direct investment accounted for about 32 percent of the total; reinvested earnings were 20 percent; long-term borrowings abroad amounted to 8 percent; short-term borrowings abroad and depreciation allowances on existing foreign assets represented the remainder—about 40 percent. As had been the case previously, the new program is directed only at new outflows of funds from the United States and reinvested earnings. It does not aim to curb plant and equipment expenditures as such, although they are bound to be affected. Long-term funds borrowed abroad are specifically exempted.

Despite excellent business cooperation with the voluntary program, a mandatory program is necessary to achieve the large improvement required in 1968 and to insure equality of burdens among all direct investors.

The new program provides three basic limitations on direct investors: (1) annual limits are placed on their new direct investment—capital outflow plus reinvested earnings—in foreign subsidiaries or branches; (2) a minimum share of total earnings from their direct investments must be repatriated—generally equal to the same percentage that they repatriated during 1964–66; and (3) their short-term financial assets held abroad must be reduced to the average level of 1965–66 and held at or below that level.

The annual limits on direct investment are determined in the following way:

- (1) For less-developed countries, as a group, new capital transfers and reinvested earnings, in combination, may not exceed 110 percent of a direct investor's average new direct investment in less-developed countries in 1965–66.
- (2) For developed countries to which U.S. capital inflow is essential—including Canada, Japan, Australia, New Zealand, the United Kingdom, and some oil-producing countries—the maximum permitted allowance is 65 percent of the annual average of capital outflow plus reinvested earnings in 1965–66.

- (3) For all other countries, principally continental Western Europe, a moratorium is imposed on any new capital outflows for direct investment. However, a direct investor may normally plow back each year into his existing direct investments in these countries as a group the same percentage of his earnings as he reinvested in the years 1964-66.

The program exempts small direct investments not exceeding \$100,000 in the aggregate. It also establishes administrative procedures whereby the Secretary of Commerce may authorize in exceptional cases direct investments in excess of those allowed under the general rules.

The direct investment program is designed to achieve a \$1 billion improvement in the balance of payments. The impact is to be concentrated on the surplus countries of continental Europe, with a minimum effect on other countries. It requires an important sacrifice by U.S. international corporations, but it is designed to keep interference in the details of business decisions to a minimum. Normal international trade among affiliate companies will not be restricted, nor will other usual business transactions be disturbed. The program is intended to be temporary, subject to relaxation as soon as world payments conditions permit.

Foreign Credits by Financial Institutions

The Board of Governors of the Federal Reserve System issued new suggested guidelines on foreign credits of financial institutions. The President gave the Board authority to make the guidelines mandatory if that should prove necessary. The new guidelines, covering both banks and other financial institutions, represent a major tightening of the program begun in 1965. They aim at a substantial inflow of \$500 million in credits subject to the program in 1968. There was an outflow of such credits of about \$400 million in 1967.

Three types of restrictions were placed on the extension of foreign credits by banks. (1) Ceilings on credits for most large banks were reduced to 103 percent of foreign credits outstanding on December 31, 1964. Priority within the ceiling is to be given to credits for financing American exports and for supplying capital to less-developed countries. (2) In addition, banks are called on not to renew at maturity outstanding term loans to developed countries of continental Europe and not to relend the repayments of such loans to residents of those countries. (3) Banks are also to reduce the amount of short-term loans outstanding to developed countries of continental Europe by 40 percent of such credits outstanding on December 31, 1967, bringing them down at a minimum rate of 10 percent a quarter.

Parallel restrictions were also placed upon activities of nonbank financial institutions such as insurance companies, finance companies, trust companies, and employee retirement and pension funds. It is expected that all financial institutions will continue to cooperate fully in the program.

Government Expenditures Abroad

The impact of the Government's own expenditures abroad will be reduced as part of the new program while still maintaining essential functions. The President has directed

- the Secretary of State to negotiate with our NATO allies to minimize the foreign exchange costs of keeping our troops in Europe;
- the Secretary of Defense to take steps to reduce further the foreign exchange impact of personal spending by U.S. forces and their dependents in Europe;
- the Director of the Bureau of the Budget and the Secretary of State to reduce by at least 10 percent the number of Government civilian personnel working overseas and to curtail overseas travel abroad to the minimum consistent with the orderly conduct of Government; and
- the Administrator of the Agency for International Development to reduce expenditures abroad by \$100 million and take measures to insure that goods exported from the U.S. under AID loans are additional to U.S. commercial exports.

These measures are aimed at saving \$500 million in the balance of payments.

Travel Account

In order to reduce the net travel deficit by \$500 million, the President has asked Americans to defer all nonessential travel outside the Western Hemisphere for two years; he also directed the Secretary of the Treasury to explore with the appropriate congressional committees legislation to help achieve that objective. Long-term efforts to attract more foreign visitors to the United States are being intensified.

Trade Expansion

The new program also includes several long-range measures of improved export financing and export promotion. Congress will be asked to earmark \$500 million of the Export-Import Bank's lending authority for a new export expansion program designed to guarantee, insure, and make direct loans for exports which do not fall under the Bank's existing criteria. The Bank will also expand and liberalize its rediscount program to encourage private banks to increase their financing of exports. Congress will also be asked to support a five-year, \$200 million program in the Department of Commerce to promote the sale of U.S. goods abroad. The Department plans to initiate a program of joint export associations to provide direct financial support to American firms joining together to sell abroad.

PROSPECTS FOR 1968

The new program will have a major impact in reducing the U.S. deficit this year. It should cut private capital outflows by more than \$1½ billion from 1967 levels. It aims to reduce net travel outflows by \$500 million. The impact of Government expenditures abroad will be reduced and American exports stimulated. Moreover, the prompt and decisive action taken by the United States should help to halt the speculation and anxiety that led to some short-term capital outflows in the closing months of last year. Long-term capital outflows in the form of security purchases will continue to be restrained by the Interest Equalization Tax, which was extended in 1967 with new authority for the President to vary the rate of tax within specified margins.

The condition of the U.S. domestic economy will have very great importance for the balance of payments. Prompt enactment of the tax surcharge by the Congress and responsible wage and price decisions by American labor and management are essential to insure that the growth of imports will be moderate and that American business firms will have incentives to market exports actively and competitively.

General business conditions abroad will also have a significant influence on the balance of payments in 1968. As appraised by OECD and leading private experts, European economic growth is expected to improve from the disappointing sluggishness of 1967.

To be sure, the new U.S. program will tend to reduce investment demand and to tighten monetary conditions in Europe. However, most countries on the continent are in a position to counter this tendency effectively with more expansionary monetary and fiscal policies. Both balance-of-payments conditions and the state of domestic demand call for more stimulative policies on their part. As indicated in the discussion of the adjustment process, surplus countries have a world responsibility to manage their economies in such a way as to insure growth and to encourage expansion.

The possibility of a major improvement in U.S. trade this year, however, is limited by several factors, including the improvement in the competitive position of Britain provided by devaluation, the indicated forthcoming bulge in steel imports in anticipation of a possible strike, and the recent good agricultural harvest in many countries which will limit the growth of exports of farm products. Furthermore, a number of European countries, including Germany, the Netherlands, and Austria, are instituting major changes in their border tax arrangements this year in ways likely to encourage exports and inhibit imports—contrary to the needs of world payments adjustment. Diplomatic consultations have been initiated to mitigate the disadvantages to our trade which arise from differences in national tax systems. The Administration is preparing legislative measures in this area; their scope will depend on the outcome of these consultations.

Finally, the Common Market at midyear is scheduled to remove all remaining internal tariffs and to complete the adoption of a common external

tariff. The consequences of this action on U.S. trade will be moderated, however, by the simultaneous implementation of the first tariff cuts by the EEC under the Kennedy Round.

LONG-TERM PROSPECTS

A key element in the balance-of-payments outlook for the long run is our ability to maintain and improve the competitive position of the United States. It is difficult to trace the connection between competitive changes and trade movements, but there is little doubt that an increase in relative costs—which, in turn, raises relative prices—can impair a country's trade performance, while reductions in relative costs can enhance its trade surplus.

Empirical evidence on costs is limited to manufactured goods, and even there it is far from satisfactory. The data do make clear that, during much of the decade of the 1950's, U.S. costs and prices rose faster than those of our major competitors. We lost ground in international markets during that period. Within recent years, however, the situation with respect to costs was reversed. In manufacturing, U.S. unit labor costs (the largest element in total costs) declined between 1961 and 1965, while costs in other countries except Canada increased substantially (Table 28). As a result, our share of foreign markets in manufactured products stabilized, when intra-EEC and intra-EFTA trade are excluded. In 1966, our costs increased about as rapidly as the average of other countries. Comprehensive data are not yet available for 1967, but our costs continued to rise, probably at a rate exceeding that of most European countries.

TABLE 28.—Unit labor costs in manufacturing for selected industrialized countries since 1961¹

[1961=100]

Country	1962	1963	1964	1965	1966 ²
United States.....	99	98	98	97	99
Canada.....	99	98	97	99	103
France.....	107	112	117	119	116
Germany.....	107	110	110	117	123
Italy.....	107	118	123	120	118
Japan.....	109	114	111	118	125
United Kingdom.....	103	102	103	108	113

¹ Ratio of wages, salaries, and supplements to production; national currency basis.

² Preliminary.

Note.—Data relate to wage earners in Italy and to all employees in other countries.

Sources: Department of Labor and Council of Economic Advisers.

Many of our trading partners are facing fundamental structural changes in their economies. The labor supply situation that permitted the period of extremely rapid growth in Europe has altered fundamentally. The growth of the European labor force in the next decade will be much smaller than in the recent past, and less scope remains for shifting European labor out of less efficient pursuits, such as agriculture, or out of unemployment into industrial activity. This will mean greater European demands for labor-

saving machinery, in which U.S. producers hold a marked competitive edge; it may also increase pressures in the European labor market and strengthen the bargaining power of European workers. Finally, with the elimination of all tariff barriers this year, internal EEC trade will no longer receive the further benefit of periodic duty reductions. Therefore, with proper economic management at home, the United States has an excellent opportunity to strengthen its trade surplus over time.

The development of European capital markets has proceeded at a substantial pace in the past few years, spurred partly by the U.S. voluntary programs and the Interest Equalization Tax. The new program will provide added incentives for the mobilization of long-term funds in European capital markets. This should, in the years ahead, tend to moderate the basic demand for capital from the United States. The recent vast expansion in U.S. business holdings overseas should also help by increasing the inflow of earnings, dividends, royalties, and fees in the years ahead.

THE INTERNATIONAL MONETARY SYSTEM

Because dollars are used as reserve assets, the U.S. balance of payments is closely linked to the stability of the entire international monetary system.

THE GOLD-EXCHANGE STANDARD

In major part, existing international monetary arrangements are based on the rules and institutions developed at the Bretton Woods Conference in 1944, which established the IMF. The basic principles underlying the Bretton Woods system call for the convertibility of one currency into another at essentially fixed exchange rates, with fluctuation around declared parities limited to a narrow range. Changes in parities are to be made only in cases of fundamental payments disequilibrium and upon prior consultation with the Fund.

Because demands for a nation's currency vary from time to time, and thus receipts and payments do not balance exactly, a nation needs monetary reserves to support the value of its currency in a fixed exchange rate system. Under the so-called gold-exchange standard, these "owned" reserves are held both in gold and in certain foreign currencies. In fact, the dollar is the principal reserve currency for most nations of the world, although the pound sterling and the French franc also serve this purpose on a smaller scale. Currencies are useful as reserve assets because they are convertible amongst themselves, are claims on the real resources of issuing countries, and can be held in interest-yielding, but still highly liquid, form. All countries other than the United States meet their IMF obligations by buying and selling currencies, mostly dollars. The United States meets its basic commitment under the Fund rules by freely buying and selling gold to foreign monetary authorities at a fixed price of \$35 an ounce. Gold maintains its reserve asset status by being linked to the dollar and the IMF, and by tradition .

Reserves are the main line of defense for any nation which is seeking to correct a payments deficit through an orderly adjustment. Multilateral credit facilities serve as a further line of defense. The Fund provides medium-term credits to assist members in overcoming temporary payments deficits without resort to unduly restrictive international or domestic measures. This system has been strengthened by the recent creation of a network of short-term credit facilities among central banks and by the development of the General Arrangements to Borrow, which enlists additional resources from major industrial nations to help the Fund meet large credit needs.

These various credit facilities supplement but are not a substitute for owned reserves. As has been clearly demonstrated in the past, in a world of growing trade and payments, nations desire to hold a growing quantity of monetary reserve assets. In order to increase their reserves, nations aim for payments surpluses. If successful, the efforts of some countries to attain surpluses must be reflected in deficits for other countries. Under present arrangements, such a competitive effort to build reserves can lead to undesirably restrictive actions on domestic economies and on trade and capital flows.

In fact, world trade and output have grown rapidly in recent years. But monetary reserves have increased slowly. If that sluggish pace continues, it could inhibit the growth of economic activity. Total world reserves have grown at an annual rate of 2.7 percent since 1960 (Chart 15), far below the 7.4 percent annual rate of expansion of world trade.

Of the major types of reserves, the dollar has contributed most of the increase in the total stock of monetary reserves. Gold has made very little contribution in the 1960's, and none at all in the past two years. Certain drawing rights in the IMF, which are created as a byproduct of the credit operations of the Fund, are automatically available to member nations and are thus properly classified as reserve assets. These "super gold tranche" reserve assets have achieved some quantitative importance in recent years, but they are also extinguished through specific credit operations.

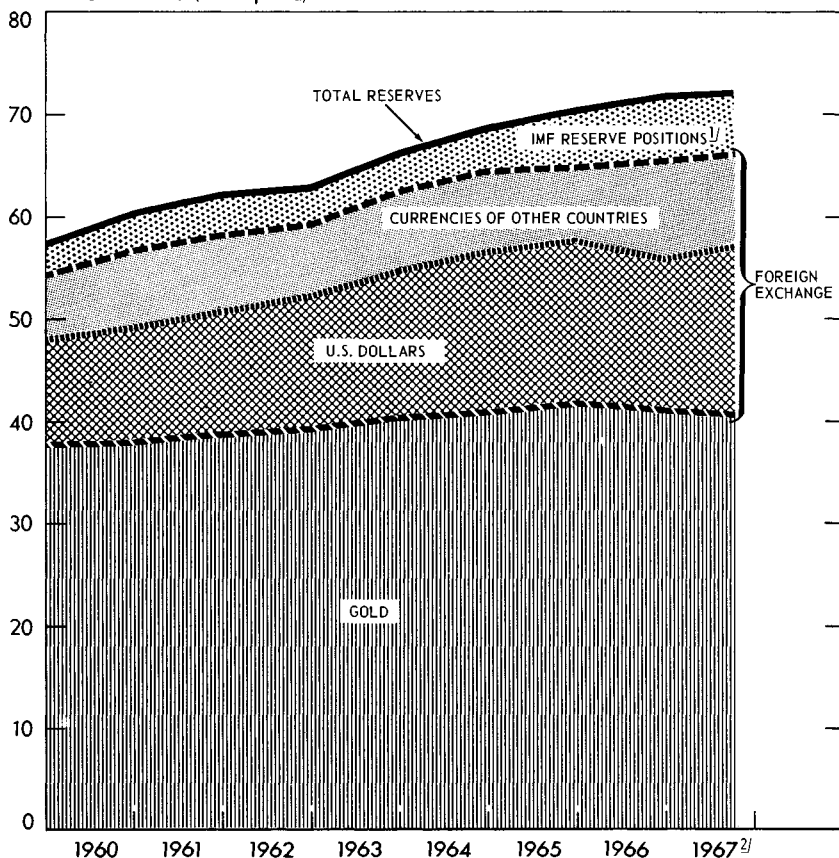
A survey of future prospects makes it clear that neither gold nor the dollar can be counted on to add substantially to total world reserves in the years ahead.

GOLD RESERVES

Gold constituted 56 percent of total world monetary reserves in 1967 (excluding the Soviet Union and other Communist countries), a decline from 72 percent in 1948. The supply of newly mined gold has been small in relation to existing monetary stocks, and a large portion of new supplies has been absorbed into private uses and holdings.

World Monetary Reserves

BILLIONS OF DOLLARS (end of period)

^{1/}INCLUDES IMF GOLD HOLDINGS.^{2/}DATA ARE FOR END OF THIRD QUARTER 1967.

SOURCE: INTERNATIONAL MONETARY FUND.

Historical Background

In many respects, the recent decline in the importance of gold is an extension of a trend that began after World War I. That trend, in turn, reversed the developments of the preceding half century when gold first achieved a preeminent role.

Following the discovery of important new deposits in the middle of the 19th century, gold replaced silver as the standard of international finance and became the predominant basis of the monetary system of most major trading countries. Even in this period, the slow increase in monetary gold threatened to act as a brake on economic development. However, new dis-

coveries, chiefly in South Africa, provided enough additional gold to keep the system going.

After World War I, the gold standard was transformed into a less rigid system. Gold holdings were increasingly concentrated in the hands of central banks, while the public relied increasingly on paper currency and checking accounts for domestic transactions. Many central banks kept all or part of their international reserves in the form of claims on "key currencies"—primarily the pound sterling and the dollar—themselves convertible into gold. This system is the gold-exchange standard, which, after an interruption during the 1930's, has survived to the present day.

Private Demands

By developing the use of financial claims as reserves, the world has learned to avoid the constraints imposed by the slow growth of gold stocks. In the last few years, the importance of this development has become especially great because gold production has leveled off, while the nonmonetary consumption of gold has increased rapidly. The physical properties of gold, such as electrical conductivity and resistance to corrosion, have proved to be increasingly attractive in industrial applications. The use of gold in jewelry and dentistry has more than kept pace with the rise in world income. Commercial gold consumption in the United States amounted to \$220 million in 1966, and is rising at an annual rate of more than 10 percent. While there are no accurate worldwide data, gold consumption in industry and the arts appears to be absorbing about \$¾ billion a year. Production of newly mined gold (outside of Communist countries) now amounts to about \$1½ billion a year, intermittently augmented by Russian gold sales.

Hoarding and speculation also contribute to the private demand for gold. Even if it were not illegal, most Americans would find gold an unattractive asset because it earns no interest and is expensive to store safely or to insure. But many foreigners have reasons for thinking otherwise. Gold can be more easily carried in emergencies or hidden (especially from the tax collector) than bulkier assets. Also, in some parts of Asia, gold is the only asset that a wife may own beyond the control of her husband. Furthermore, there has also been some net acquisition of gold by private speculators who were betting on an increase in the price of gold.

Quite apart from speculation, it is clear that gold can supply, at most, a small fraction of the needed growth in world monetary reserves. The monetary gold stock could grow no more than 2 percent a year on the basis of present rates of mining less consumption in industry and the arts. Given the prospect of growing commercial use, even that rate of growth may not be achievable over time. Indeed, the world cannot count on any sustained increase in monetary gold reserves in the long run. In fact, it is possible that, over time, gold may gradually lose even its present importance as a monetary reserve asset.

DOLLARS AS RESERVES

At the present time, liquid dollar holdings of foreign monetary authorities amount to about \$16 billion and are larger than the U.S. gold stock. The United States could provide substantial further increases in foreign reserves only by running continued large deficits. The persistence of such deficits would impair confidence and thus endanger the link between gold and the dollar, which is the essence of the gold exchange standard. The U.S. commitment to move toward payments equilibrium is designed to assure the strength of the link, preserving the high quality of the dollar as a reserve asset by limiting the increase in the quantity of dollars held abroad.

As another step to insure the strength of the dollar and thus of the gold exchange standard, the President has proposed legislation to remove the current "gold cover" requirement on domestic currency.

Removal of the Gold Cover

Under existing legislation, the Federal Reserve System is required to hold a 25-percent reserve in gold against Federal Reserve note liabilities. Increasing amounts of gold are brought under the gold cover as the volume of Federal Reserve notes expands to meet the needs of a growing economy. As a domestic requirement, the gold cover is an anachronism. Appropriate monetary policy is related to the over-all needs of the economy; and the Federal Reserve Board exercises its authority in relation to those needs, not in relation to our gold holdings.

The only real purpose for the United States to hold a gold stock is to insure the international convertibility of the dollar. The growing amount of gold needed to satisfy the gold cover requirement is approaching the level of U.S. gold holdings. While there are provisions permitting the gold stock to dip below the gold cover requirement, the retention of this statutory limit serves no useful purpose. And its removal will make unmistakably clear that our entire gold stock is available to defend the international convertibility of the dollar at its present parity.

MEETING RESERVE NEEDS

In view of the limited possibilities for gold and the dollar to provide additional international monetary reserves, it is clear that positive action must be taken to assure the growth in reserves essential to support expanding world trade.

That need must be met in a more constructive way than by an increase in the price of gold. As the President has repeatedly stated, the United States is unalterably opposed to a rise in the price of gold. Such an action would be both inefficient and inequitable. Its primary impact on reserves would be achieved by a large "one-shot" write-up of the nominal value of gold reserves, rather than by an assurance of continued steady growth. It would stimulate a limited increase in gold production, but only by diverting scarce

resources into the production of a commodity for which there is no shortage in nonmonetary use. It would give unearned windfall gains to major gold producing nations, such as South Africa and the Soviet Union, while penalizing those countries, such as Japan and Sweden, which have supported the gold exchange standard by holding reserves in dollars. It would not only reward speculators but—more important—would encourage them in the belief that further price rises were inevitable.

In rejecting an increase in the gold price as a means of expanding reserves, the United States can point toward a far more constructive alternative. Just as the gold exchange standard added key currencies as reserve assets supplementing gold, now the key currencies must be supplemented by appropriate new reserve assets. The decision to create such new reserve assets is needed promptly. The threat that total reserves may not grow adequately in the future is a source of strain and uncertainty in the international monetary system and an encouragement to speculation in gold and foreign exchange markets.

To encourage the orderly progress of world trade and economic growth, and to maintain confidence in international monetary arrangements, the nations of the world must show decisively and promptly their determination to meet the need for growing reserves by creating an adequate supplement to gold and the dollar. The development of a supplemental reserve asset, backed by the full faith and credit of participating nations, is the ideal way to solve the problem. Such an asset can be universally accepted as a supplement to gold and dollars and can be issued in quantities sufficient to insure adequate growth of total monetary reserves. The outline plan for international monetary reform, unanimously endorsed at the 1967 annual meeting of the IMF in Rio de Janeiro, is a major forward step toward a solution.

THE RIO AGREEMENT

The plan agreed upon in Rio represents the outcome of four years of intensive study and negotiation, involving the major industrial countries in the so-called "Group of Ten" as well as the wider forum of the Fund. It provides for the establishment, within the IMF, of a new reserve facility for the creation of Special Drawing Rights (SDR's), designed to "meet the need, as and when it arises, for a supplement to existing reserve assets." SDR's will be created by deliberate decision of IMF members and will be distributed to all participants in proportion to their Fund quotas. Countries receiving these rights will be able to count them as part of their reserves. Subject to certain rules described below, they can use them to settle balance-of-payments deficits or satisfy reserve needs by drawing on (i.e., exchanging them for) convertible currencies of other countries. An amendment to the Fund's Articles of Agreement that will express the new scheme in precise legal terms is to be prepared by the Executive Directors of the IMF not later

than the end of March of this year, and will be submitted to member countries for ratification.

As President Johnson has indicated, the Rio agreement constitutes the greatest forward step in the improvement of the international monetary system since the creation of the Fund itself. For the first time in history, the great majority of the world's nations, comprising all the members of the IMF, has agreed to cooperate in the conscious and deliberate creation of a new and permanent reserve asset, in amounts and at a pace systematically geared to assure adequate growth of total international reserves.

Nature of the New Reserve Asset

Essentially, SDR's are claims giving their holders the unconditional right to obtain convertible currencies from other members of the Fund to meet balance-of-payments needs or unfavorable developments in a country's total reserves. These claims are backed by the obligation of member countries to accept them in exchange for convertible currencies up to certain limits.

In the design of the new asset, every effort has been made to assure that it will be a true supplement to existing reserve assets and will, in fact, add to the *total* of world reserves. In line with these considerations, SDR's will carry a gold value guarantee and will be "as good as gold" for the settlement of international payments. Indeed, since they can be used *only* for such settlements, any newly created SDR's constitute a permanent addition to the world's official monetary reserves. Unlike gold, they cannot be drained into private hoards, and, unlike super gold tranche drawing rights, they cannot be extinguished as the by-product of other Fund operations.

The new reserve asset will also have an advantage over gold in bearing interest; at the same time the rate will be much lower than is available on dollars and other reserve currencies. And they will, of course, not share the dollar's unique role of serving simultaneously as a reserve asset and as the world's principal transactions currency.

While SDR's will have all the essential characteristics of reserve assets, the framers of the plan realized that it may take some time until participating countries become fully accustomed to this new asset. The plan therefore places certain limitations on the ability of individual participating countries to use SDR's and on their obligation to accept them. As the new asset becomes more familiar to the world through experience, it should become increasingly possible to reduce or even eliminate such limitations.

The initial rules are designed to assure that the new reserve asset will be smoothly integrated into the monetary system with existing assets. Under them, the Fund will frequently act as a traffic policeman guiding transfers.

The rules require, first, that SDR's should be used only for balance-of-payments needs or to meet reserve losses and not merely for the purpose of shifting from one reserve asset into another.

Second, when SDR's are used for the acquisition of convertible currencies, the countries drawn upon should normally be in a solid balance-of-payments position—as a result of either surpluses or strong reserves. And the drawings are to be guided toward such countries in a way that will, over time, provide a more or less proportionate relationship of the new asset to total reserves. Thus it is assured that the holdings of the new asset will be widely dispersed among participating nations.

Third, each participating country is obligated to accept SDR's in exchange for convertible currency only up to the point where its total holdings are three times the amount of such reserve assets that have been cumulatively allocated to it. This limits the obligation of any individual nation while insuring ample scope for the effective use of the new asset.

Fourth, countries which have used SDR's in large amounts over an extended period will have a limited obligation to reconstitute their holdings over time. The rule provides that, during the first five years of the operation of the plan, a country's average holdings should be at least 30 percent of its average allocation over this period. In a very rough way, this requirement can be compared to a minimum average balance that a bank may require on checking accounts.

Decisionmaking and Distribution

Following ratification of the Rio plan, the activation of the new facility will require a separate set of decisions. Activation can only occur when the Managing Director of the Fund, after careful study and upon consultations with Fund members to assure him of the need for additional reserves, makes a specific proposal as to the timing and the amount of SDR's to be created. Final approval of the proposal requires an 85-percent majority of the voting power of the participating countries, somewhat more than the 80-percent vote required for quota increases in the Fund. In effect, it gives a veto power not only to the United States but also to the countries of the Common Market, should they choose to vote as a group.

Since SDR's are designed to assure an adequate over-all growth of international reserves over time, decisions regarding the amount of SDR's to be created will normally be made for a basic period ahead (such as five years), with equal amounts to be issued during each of these years. The task of satisfying short-term variations in liquidity needs will thus continue to be left to such existing mechanisms as the credit facilities of the Fund and the network of central bank swap arrangements.

The new facility will be universally available to Fund members, without discrimination—an important principle on which the United States placed great stress during the course of the negotiations. Under this arrangement, the United States would receive about \$250 million out of each \$1 billion of SDR's created. The share of the Common Market countries as a group would be about \$180 million; of the United Kingdom, \$116 million; of

Canada and Japan, about \$35 million each; of other developed countries, \$107 million; and of the less-developed countries, \$280 million.

In effect, the new drawing rights are to be created by the stroke of a pen, but that stroke will commit the full faith and credit of participating countries behind the asset that they have jointly established. As is true in the case of domestic money, the general and unconditional acceptability of such monetary assets reflects confidence in the issuing agent. No one could ask for a stronger issuing agent than the nations of the IMF banded together.

Paper monetary reserves are by no means new—sterling and dollars have served as reserves for generations. What will be new is the reliance on a reserve asset backed by a group of nations rather than a single one and capable of being created by international decision.

The ratification of the Rio plan is still to come. And the implementation and actual creation of SDR's are a further step away. Even when they are created, it will take time for them to become established as a customary usable reserve asset. But the world is now taking the decisive step of choosing to travel this route. It is adopting, as a means of meeting the need for growing reserves, a clear alternative to a rise in the monetary gold price.

The potentialities for this reserve asset are obvious and enormous. It need not and will not displace gold and the dollar as reserve assets. But it will free the world from concern about the supply and demand for gold.

While the creation of SDR's will not, in itself, solve the balance-of-payments problems of the United States or any other country, it will enable countries to increase their reserves without pursuing mutually incompatible payments goals. Thus, it should facilitate an orderly adaptation of other countries' payments positions as the United States reduces its deficit, and contribute to the general health and strength of the international monetary system.

The Tasks Ahead

The developments of late 1967 have given special urgency to the early ratification of the SDR facility. Indeed, activation of the facility in the relatively near future may prove highly desirable to insure that the international monetary system will function with full effectiveness.

Several aspects of the current situation point toward the need for early action. The world's monetary gold stock actually declined in 1967. There are indications that inadequate reserve expansion may already be inhibiting economic growth and the freedom of international transactions. Moreover, successful implementation of the British devaluation will require a sharp shift in Britain's payment position from a large deficit to a sizable surplus; this will in turn call for reductions in surpluses and the incurring of deficits by other major countries. Additional adjustments in the payments positions and structures of major surplus countries will also be needed as a counterpart to improvements in the U.S. balance of payments. These difficult adjustments will be greatly facilitated if an adequate growth of total world reserves is assured.

TRADE POLICIES

World trade has grown spectacularly in recent years. Between 1953 and 1966 it expanded by almost two and a half times, while world output of primary and manufactured products doubled. The growth of trade relative to output has been an important factor in making this period the most prosperous one in recorded history. It was fostered by the progressive liberalization of the commercial policies of the major trading nations. The United States can take pride in its leading role in this liberalization.

KENNEDY ROUND

The Kennedy Round was the sixth venture at multilateral trade negotiations undertaken by the GATT since its creation in 1947. The growth of regional trading blocs in Europe and elsewhere introduced a special urgency and significance to the latest negotiations. The major nations of Europe had divided themselves into two trading groups, the EEC and the EFTA. Each group provided for eventual free trade among its members, accompanied by a continuation of tariffs and other restrictions against nonmembers. While these organizations have many desirable features, they can pose a threat to the development of more liberal trading relations among nations that belong to different groups and between group members and nonmembers like the United States.

The United States' response to this challenge was the passage of the Trade Expansion Act of 1962 which became the stimulus for the Kennedy Round. This act permitted the President greater flexibility in bargaining for lower tariffs and provided for adjustment assistance to American workers and business firms that might be injured as a result of tariff concessions. The negotiations were formally begun in May 1964 and were concluded after many difficulties on June 30, 1967. Although some problems could not be adequately overcome within the Kennedy Round, a remarkable degree of tariff reduction was achieved. The results have been widely and accurately acclaimed as a major accomplishment.

Features of the Agreement

The agreement includes tariff concessions covering about \$40 billion of world trade; the United States gave concessions on about \$8.5 billion of its imports while concessions by others cover the same amount of U.S. exports. Tariff reductions of 50 percent were applied to numerous manufactured products and significant but smaller reductions were applied to many others. For the four largest participants—the United States, the EEC, the United Kingdom, and Japan—the weighted average reduction of tariffs on manufactured products was about 35 percent. The U.S. tariff reductions will generally take effect in five equal annual installments, the first of which became effective on January 1, 1968. Some of our trading partners took a

similar step at the same time, but others will wait until midyear and then make 40 percent of their reductions.

Certain manufactured products required special negotiations; these included chemicals, cotton textiles, and iron and steel. Chemical products posed a particularly difficult problem, which was resolved by making two separate agreements. The first is incorporated in the multilateral tariff-reducing agreement providing for a stipulated unconditional reduction of chemical tariffs by the United States and other countries.

The second is conditional upon legislative action by the United States to remove the special valuation method now applied by U.S. tariff regulations on benzenoid chemicals. Under legislation adopted in 1922, when the American chemical industry was still in an "infant" stage, the U.S. tariff rate for competitive benzenoid chemicals is applied to the price of similar products made by domestic producers rather than to the actual price of imports. If the United States adopts the normal valuation practice on these items, certain of its major trading partners will further reduce chemical tariffs and will also lower some nontariff barriers.

Agricultural products were also considered in the Kennedy Round and proved to be especially troublesome. However, significant tariff concessions were finally agreed upon. Those by other nations cover about \$870 million of U.S. exports. Our concessions covered about the same amount of U.S. imports. The other major accomplishment in agriculture was the negotiation of a grains agreement. It provides for a higher minimum price for wheat than existed under the old International Wheat Agreement, and involves an increase of about 15 percent in U.S. export prices. It also provides for a multilateral food aid program equivalent to 4.5 million tons of cereals a year, of which the United States would contribute 42 percent.

While these steps are encouraging, the degree of restriction remaining on international trade in agricultural products—particularly through nontariff barriers—still greatly exceeds that on manufactured goods. Nevertheless, the Kennedy Round went further than previous negotiations in the agricultural area. Furthermore, the principle embodied in the food aid agreement may have great significance over the long run, because it recognizes that responsibility in the international war on hunger extends to all countries, not just to the United States and the other major food exporting nations. If the world's need for food should outrun supplies in the years ahead, this agreement could become the pattern for an international corrective program.

The United States made particular efforts to reduce tariffs on products of special interest to less-developed countries. It granted concessions on more than \$900 million of such products without attempting to obtain full reciprocity.

Another element in the Kennedy Round package was the successful negotiation of an international antidumping code. This accord is consistent with existing American laws which safeguard our industry, and it commits

our trading partners to insure fair procedures to American exporters. Also as part of the negotiation, a three-year extension of the long-term cotton textile arrangement was concluded.

Consequences of the Tariff Reductions

The amount of existing trade covered by tariff cuts in the Kennedy Round does not reflect the potential expansion of trade which is one of the key benefits of the tariff reductions. New U.S. export opportunities will be created. Moreover, American producers will experience lower costs as a result of reduced tariffs on many inputs. The welfare of American consumers will be enhanced by lower prices of goods of both domestic and foreign origin.

Exports. American exports will be stimulated from two sources. First, as tariffs abroad are reduced, our exporters will have an opportunity to compete on a more equal footing in the domestic markets of foreign producers. Second, the tariff advantage in favor of member nations over non-members within the EEC and EFTA will be reduced, thereby enabling American exporters to compete more effectively in these large markets. For example, because the EEC tariff on pumps and compressors will be reduced from 12 to 6 percent when the Kennedy Round reductions are completed, German pumps will have only a 6-percent preferential edge over American pumps in the Dutch market as compared to the 12 percent they now enjoy.

Inputs. A second major gain from the Kennedy Round will come from the reduction of American tariffs on materials and components used by American manufacturers. Both the imported items and the competing domestic materials will be cheaper, and production costs will thereby be reduced. As a consequence, the competitive position of American manufacturers using these inputs will be improved in both export and domestic markets.

To cite only one example, tariffs on a wide range of steel alloying materials will be progressively reduced. This should reduce the costs of producing alloy steels, and of machine tools, machinery and equipment manufactured from such steels, thus strengthening the competitive position of our machinery industries in export markets.

Consumer Goods. The Kennedy Round also provides benefit to American consumers from U.S. tariff reductions. Consumers will enjoy reduced prices on imported goods and also on American products that compete with imports. If the full reduction is passed on, for instance, the 50-percent drop in tariffs on wooden furniture is the equivalent of price reductions of 5 to 10 percent. Further, in the climate of more liberal trade, foreign producers will be encouraged to market new products to American consumers.

Adjustment Strains. A full evaluation of the impact of the Kennedy Round must recognize that there may be some adverse effects as well. The increases in imports resulting from reduced U.S. tariffs can cause discom-

fort for certain American industries. Imports, however, still amount to only 3 percent of our GNP, and can hardly pose insuperable adjustment problems, even in the short run. The overwhelming majority of American industries that face brisk competition from imports can adjust in stride. American business knows how to respond to shifting domestic and international competitive pressures, and its responses are generally beneficial to the entire economy. But a few American industries may need help to meet the competitive challenge; and that aid should be given through temporary Government support to improve efficiency. Adjustment assistance is essential to meet the limited costs the Kennedy Round may impose in a few areas while maintaining its large benefits for the entire Nation.

Legislative Tasks

The 1962 act provided for adjustment assistance in cases of injury arising from tariff reductions, but the legislated criteria for eligibility have proven to be excessively restrictive. These criteria can and should be liberalized without opening the door to possible abuse, and the President is asking for the necessary congressional action to this effect.

Assistance for workers includes the payment of readjustment allowances directly to those who are obliged to seek alternative employment as a result of tariff reductions. The allowances can also be paid while workers are taking part in on-the-job training. The Government can also provide for testing, counseling, training, and placement services to promote a swift and smooth transfer. Adjustment assistance can be provided to injured firms to permit them to adapt their product lines or lower their costs in order to meet new competitive conditions. Such a solution within the affected firms is particularly desirable because it avoids dislocation in the employment of workers and in the use of capital. The offices of the Department of Commerce can make technical assistance available. Financial aid can be provided through loans or loan guarantees. Tax relief is offered through extension of the provisions of the Internal Revenue Code for the carryback and carryforward of business losses.

A second urgent legislative requirement is the elimination of the American selling price system. This action is needed to assure the full benefit of lower chemical tariffs abroad and to win important concessions on certain foreign nontariff barriers, as well as to provide the United States with a uniformly rational valuation system.

It is essential that Congress *not* enact legislation that would reverse or jeopardize our long-term efforts and policies to promote liberal trade. Bills were introduced into the Congress in 1967 to impose new legislated quotas on textiles, apparel, steel, meat and meat products, mink furs, lead and zinc, groundfish fillets, baseball gloves and mitts, consumer electronic products, scissors and shears, hardwood plywood, ferro-alloys, potash, flat glass, ball and roller bearings, and stainless steel flatware. Other bills sought to tighten restrictions on petroleum and petroleum products and dairy products. The value of the imports covered by specific bills amounts to over \$6 billion. If

general quota provisions were adopted along lines proposed in some bills, \$12 billion or more of imports would be affected.

If enacted, quota bills could severely harm our economy in several ways. Quotas would deprive American producers and consumers of flexible import supplies that help to moderate shortages. Quotas also would exert upward pressures on prices at a time when price stability is a critical national objective. Furthermore, protected American industries would be insulated from competitive forces abroad. Many of these industries need the invigorating influence of foreign competition, and should not be permitted to relax behind high protective barriers.

Finally, and perhaps most seriously, our exports would certainly suffer from quota restrictions on imports. Some exports would be lost simply because importing countries would have less foreign exchange. But more importantly, foreign governments would surely take advantage of their rights under the GATT to retaliate against whichever American products they may choose. In the end, we would have sacrificed the interests of more efficient industries and businesses for the sake of protecting less competitive elements in the economy; we would have jeopardized the creation of higher paying jobs in order to preserve low-wage jobs; and we would have traded international cooperation for international economic warfare. A move toward protectionism would also hurt our balance of payments. The rising trade surplus counted upon to help achieve payments equilibrium would be impossible in a world of widespread trade restrictions. For all of these reasons, a liberal commercial policy is the only rational policy for the United States.

TRADE WITH LESS-DEVELOPED COUNTRIES

It is of vital interest to the United States and other developed countries that less-developed countries achieve an adequate rate of economic growth. Probably the most important way that the developed countries can support this goal is to maintain healthy rates of growth of their own economies. The higher rate of growth of the industrialized nations in the 1960's as compared with the 1950's was a major factor in the more rapid growth of less-developed countries' exports (Table 29). But the developed countries can also promote development of poor nations through their trade and aid policies.

TABLE 29.—*Growth of exports of less-developed countries in two selected periods*

Export group	Percentage change per year in export value	
	1953-54 average to 1959-60 average	1959-60 average to 1965-66 average
All commodities.....	3.5	5.9
Primary products.....	3.4	5.3
Manufactured products.....	4.7	12.6

Source: General Agreement on Tariffs and Trade.

UNCTAD

The United States will soon participate with about 130 other nations in the second session of the United Nations Conference on Trade and Development (UNCTAD) in New Delhi. This conference takes as its starting point the recognition that access to the markets of the industrialized countries is essential to the economic growth of less-developed countries.

The industrialization of a poor country enlarges its need for foreign exchange. It generates increased demands for goods which can be produced domestically only at great cost. This is especially true of countries with small markets, which cannot support the efficient production of many manufactures, such as basic metals, machinery, and transport equipment. Only seven less-developed countries have gross national products in excess of \$10 billion—less than the output of the State of Connecticut. But even the larger less-developed countries must look abroad for their supplies of most technically complex manufactured goods.

The export performance of less-developed countries depends in part on the policies followed by these countries themselves. In the area of manufactured exports, a few developing nations have been quite successful, particularly in those goods requiring relatively large amounts of unskilled labor. Other countries could probably follow suit if they pursue well-designed policies to provide education and training for labor, and to encourage investment in export-oriented industries.

Realization of the potential also depends on commercial policies of the developed countries. According to calculations made by the research staff of the UNCTAD secretariat, the average tariffs on manufactured products of particular interest to the less-developed countries are somewhat higher and were reduced somewhat less in the Kennedy Round than the average rates of duty on other products. Furthermore, some of the manufactured exports of interest to less-developed countries are restrained by quantitative restrictions and other nontariff barriers.

In order to improve the access of the less-developed countries to the markets of the industrial nations, the OECD countries have approved the outline of a scheme of generalized nonreciprocal tariff preferences to be granted by all developed member nations to all less-developed countries. This outline will be presented to the less-developed countries at the meeting in New Delhi. It is hoped that the task of working out the elements of such a preferential scheme can then be undertaken. The adoption of a system of generalized preferences would help to check the proliferation of discriminatory preferences and to keep the world trading community from fragmenting into preferential trading blocs.

The proposed trade preferences should be viewed as a supplement to other efforts by advanced nations to assist the development of poor countries. For many countries, economic growth and export capabilities require foreign aid in the form of developmental capital as well as improved trading

opportunities. Foreign aid from the United States and the encouragement of increased aid by others—particularly countries in balance-of-payments surplus—is and will continue to be an important aspect of U.S. foreign policy. The replenishment of the capital funds of the International Development Association is currently being negotiated, and the United States hopes that its resources will be increased substantially.

Stabilizing Export Earnings

The development programs of less-developed countries have often been hampered by the uncertainties arising from wide variations in earnings from primary products. The uncertainties can be reduced by commodity agreements and by special financing arrangements to meet temporary reductions in export earnings.

Commodity Agreements. Most underdeveloped countries have relied on primary products for the bulk of their export earnings. A number of these countries have had unfortunate experiences with their primary product exports, either because of export instability, or because of slow long-term growth, or even long-term decline, of export receipts from particular products.

New exports are frequently not introduced even when the value of traditional exports is declining. In part, this is because the natural resources (agricultural land, mineral deposits) on which certain primary exports are based have few alternative uses. The low skill level of workers and the technological backwardness of industry make it difficult for these countries to break into the market for manufactured goods and some primary products. Exchange rates and monetary policies may also discourage development of new exports. It is encouraging to note, however, that in the 1960's some less-developed countries whose main export products have been stagnant have achieved high rates of growth of other exports.

Countries experiencing highly fluctuating or declining prices for their exports have attempted to set up commodity agreements. A typical agreement creates a buffer stock, which purchases the commodity when the price falls below a predetermined floor, and sells from the stock when the price rises above a predetermined ceiling. Such agreements can help primary producers achieve more stable prices, although they cannot insure stable export proceeds for individual countries when supplies vary. The United States favors commodity agreements designed to stabilize prices and stands ready to support efforts by less-developed countries to move resources out of the production of commodities in chronic surplus.

Primary producers sometimes attempt through commodity agreements to raise prices above the long-term equilibrium level. They rarely succeed. Maintenance of a price above long-run cost requires restrictions on supply; the necessary export quotas are extremely hard to negotiate and to enforce.

Financing. Multilateral financing facilities can help less-developed countries formulate and carry out development plans in the face of export uncertainties. A step in this direction was taken in 1963 when the IMF created its compensatory finance facility. Under this program, as liberalized in 1966, a less-developed country may borrow for a term of three to five years, up to 50 percent of its IMF quota when its exports fall below a medium-term trend for reasons beyond its control. Under new proposals for "supplementary finance", which will be discussed at UNCTAD, countries experiencing deep or protracted shortfalls disruptive of development could receive longer term loans on concessional terms.

CONCLUSION

The course of international economic relations in the postwar period justifies a basic optimism about the future, but it also suggests that careful action is needed if this favorable experience is to continue. The gold exchange standard, reinforced by the Bretton Woods agreements, has proved to be flexible enough to support a prodigious expansion of world trade, which was also stimulated by a gradual reduction in tariffs and other restrictions.

Under present circumstances, there is a clear need for a new demonstration of the flexibility of the system. The creation of adequate reserves has come to depend on a deficit in the U.S. balance of payments which has long been a matter of concern but which now has to be dealt with decisively. This will require a resolute and continuing attack on inflationary pressures in our domestic economy and various measures in the field of international transactions. The present situation calls for the cooperation of all countries, especially those with persistent surpluses, in bringing about better equilibrium in international payments. It is also essential to provide for new reserve assets to supplement gold and the dollar.

There are still many obstacles to overcome before the international monetary system is fully adapted to the needs of the present and the foreseeable future, but fortunately there is increasing awareness that these obstacles can and must be surmounted through multilateral cooperation. The hopes of the free world depend on our success in meeting this challenge.