CHAPTER 5

The United States in the International Economy

THE VAST EXPANSION OF INTERNATIONAL TRADE AND CAPITAL MOVEMENTS has produced an increasingly complex network of relationships linking domestic economic conditions and domestic economic policies across national boundaries. New and urgent questions have therefore emerged concerning the management of domestic economic policies and the international machinery developed to make it easier for national economies, with their differing policies and objectives, to adjust to each other. The first part of this chapter is devoted to examining the ways in which the various subdivisions of our balance of payments have been affected by changes in economic policies and conditions during 1970.

The relative calm imparted to the international monetary system by the recent correction of persistent disequilibria in several major currencies provides an opportunity to evaluate the system without the pressure of emergency conditions. Such an analysis, placing special emphasis on the unique role of the U.S. dollar in the international monetary system, comprises the second part of this chapter.

A third section reviews international trade policy, which became an urgent issue again in 1970 because protectionist pressures were building up in a number of industrialized countries and threatened to reverse the broad trade-liberalization movement of the postwar years. Two policy problems were particularly important. One was the future of U.S. trade policy, and the other stemmed from the proposed enlargement of the European Economic Community and its implications for the future of an open world trading system.

The final section of this chapter focuses on the continuing search for more effective ways to aid the economic development of the lower income countries and the role played by transfers of both official and private capital in this process. The President's Foreign Aid Message of September 1970 suggested a number of wide-ranging measures to increase the effectiveness of the total U.S. aid effort.

DOMESTIC ECONOMIC CONDITIONS AND THE BALANCE OF PAYMENTS

CURRENT ACCOUNT

There is an important relationship between the domestic economy and the balance of trade. Policies that stimulate the domestic economy tend to raise imports and restrain exports. With domestic economic expansion, increases in personal incomes and prices as well as greater pressures on productive capacity at home cause a growing proportion of rising domestic demand to be taken care of through purchases from abroad. And such factors as higher domestic prices, buoyant demand in the convenient and more familiar domestic market, and lengthening delivery schedules limit the rise in exports. Economic policies in other countries also have an important impact on the U.S. balance of trade. For example, the deterioration in the trade balance resulting from a rapid domestic expansion is greater when other countries are not using their own productive resources fully or expanding as rapidly. Moreover, such developments as the long-term decline in the relative importance of transportation costs, the reduction of barriers to international trade, and the increasing similarity of cost structures among industrial nations have tended to increase the responsiveness of trade flows to price and income fluctuations. The composition of U.S. exports and imports has shifted toward finished manufactured goods, the demand for which is more responsive to movements in incomes and relative prices prevailing among the different economies. Finished manufactured goods accounted for only 41 percent of U.S. imports in 1965, a figure which rose to 56 percent in the first 11 months of 1970 (Table 32). And the share of finished manufactured goods in total U.S. exports increased from 58 percent to 62 percent in the same period of time.

TABLE 32.—*Composition of U.S. exports and imports, by major categories, 1965–70*

[Percent of total value]

Category	1965	1966	1967	1968	1969	1970[1]
Total domestic exports (excluding military grant-aid)	100.0	100.0	100.0	100.0	100.0	100.0
Crude foods	9.8	11.0	8.5	6.9	5.7	6.4
Manufactured foods	6.0	5.4	5.2	5.0	4.8	4.6
Crude materials	10.9	10.8	10.7	10.3	9.5	10.5
Semimanufactures	15.6	15.0	14.6	15.2	15.7	16.4
Finished manufactures	57.7	57.7	60.9	62.6	64.3	62.1
Total imports	100.0	100.0	100.0	100.0	100.0	100.0
Crude foods	9.4	8.3	7.4	6.9	5.9	6.5
Manufactured foods	8.8	9.0	9.4	8.7	8.4	8.8
Crude materials	17.3	15.2	13.8	12.1	11.4	10.3
Semimanufactures	23.2	21.9	20.8	21.5	18.8	18.1
Finished manufactures	41.4	45.6	48.7	50.9	55.4	56.4

[1] Based on first 11 months.

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

Source: Department of Commerce.

Inflation and relatively full employment in the U.S. economy from 1965 through 1969 and underutilization of resources in several other major industrial countries at various times during that period contributed to a striking deterioration in the U.S. trade balance in the latter half of the 1960's. Beginning with the second quarter of 1969, the U.S. merchandise trade surplus rose sharply. The surplus was $2.7 billion (on the Census basis) in 1970 compared to $1.3 billion in 1969. Since mid-1970, however, the trade surplus has declined irregularly. To a considerable degree, the levels of exports and imports in 1969 were affected by temporary distortions arising from the dockworkers' strike. When adjusted to eliminate the effect of these distortions, the figures indicate a somewhat smaller improvement in the trade balance in 1970 over 1969.

Superficially, it would appear that the slowdown in the domestic economy which began in the second half of 1969 failed to exercise a restraining influence on the growth of imports. The value of recorded merchandise imports was 11 percent more in 1970 than in 1969, compared with annual increases of 8.5 percent in 1969 and 23.6 percent in 1968. However, when adjustments are made for strike-related distortions in the flow of imports during both 1968 and 1969, the growth of imports in 1970 shows a slowdown from that of the previous year. Moreover, an unusually large part of the increase in the recorded value of imports in 1970 compared to the previous year—about two-thirds—was accounted for by price increases as measured by the unit value index. The rise in the price index of imports was much sharper than the increase in the U.S. wholesale price index in 1970, suggesting a possible decline in the price competitiveness of foreign goods on the domestic market.

A marked acceleration in the growth of exports (excluding shipments under military grants) occurred in 1970, from an average annual rate of increase of 8.7 percent in the period 1965–69 to an increase of about 14 percent in 1970 over 1969. While continued high levels of economic activity abroad and the slowdown in the U.S. economy undoubtedly helped sustain the growth of exports, the acceleration in this growth in 1970 can be attributed largely to the gain in agricultural exports, initial deliveries of jumbo jets, and recovery from the 1969 dockworkers' strike.

Recent price and cost developments here and abroad appear to favor U.S. exports. From 1960 to 1965, labor costs per unit of output in manufacturing declined in the United States, while they rose in each of the ten other major industrial countries except Canada. This trend was reversed in the latter half of the 1960's. As capacity utilization rose to high levels in the United States, unit labor costs increased at an average annual rate of 3.6 percent in the period 1965–69, substantially higher than in the economies of other major industrial nations, with the exception once again of Canada. Since 1969, labor costs per unit of output have risen faster in several major U.S. trading partners—notably Germany, Italy, and the United Kingdom—than in the United States. There is also some evidence that since the end of

1969 U.S. manufacturing export prices have risen at a slower rate than the comparable export prices and wholesale prices of competitor nations, in marked contrast to the earlier performance. If these developments continue, they should help improve the international competitiveness of U.S. export industries.

The net effect that divergent cyclical movements at home and abroad during 1970 have had on other items in the current account (as defined in Table 33) is unclear. Improvement in the transportation account during the first three quarters reflected in part a large rise in U.S. port expenditures by foreign shippers and in freight receipts by U.S. shippers, both accompanying the surge in trade. The easing of monetary conditions in the United States and the general tightening of credit conditions abroad tended to decrease the rate of interest on foreign-held claims on the United States and raise the rate of interest paid on U.S. claims on foreigners. However, the balance on investment income showed only a slightly larger surplus in the first three quarters of 1970 than during the corresponding period of 1969. Military spending abroad showed little increase as higher living costs and wages in other countries were largely offset by troop reductions, the shutdown of a number of military bases, and smaller outlays for military construction projects. Overall, the current account in the first three quarters of 1970 showed a surplus of $0.7 billion (seasonally adjusted), an improvement of $1.6 billion over the corresponding period of 1969.

On the whole, the improved U.S. performance on the current account in 1970 can be attributed to progress in restabilizing the economy and the price-cost level, and to the probability that we were more advanced in this process than much of the rest of the industrial world. Undoubtedly the excess of exports over imports in 1970 would have been smaller under conditions of full employment in the United States and less intense demand pressures abroad. In fact, the irregular decline in exports from the peak reached in mid-1970 may be attributable to a general flattening out of the economic cycle in Canada, Europe, and Japan during the latter part of the year.

CAPITAL FLOWS AND MONETARY CONDITIONS

The lessening of demand pressures in the market for goods and services in the United States during 1970, together with an easing of monetary policy, were gradually reflected in the financial markets. In a number of other important countries, however, demand pressures continued to increase, at least in the first part of 1970, with the result that financial conditions abroad continued to tighten after they had begun to ease in the United States. This shift in relative monetary conditions contributed to substantial net outflows of private liquid capital from the United States during 1970.

Tight monetary conditions in France, Italy, the United Kingdom, and, most particularly, Germany, encouraged large capital inflows into those nations. Much of these came from the United States via the Eurodollar mar-

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ket, despite German efforts to discourage such inflows by imposing additional reserve requirements on increases in the foreign liabilities of German banks. The largest such flow occurred in November, when the Bundesbank's reserves rose by $1.6 billion. In an apparently successful effort to halt these inflows, the German authorities reduced the discount rate by 1 percentage point in two successive cuts within a 3-week period.

U.S. banks reduced their borrowing from their foreign branches substantially during 1970. The liabilities of U.S. banks to their foreign branches were lowered by about $1 billion during the first quarter of the year, as the easing of credit conditions in the United States made less expensive funds available in this country while interest rates in the Eurodollar market remained higher than comparable U.S. rates throughout most of 1970. In late June, the Federal Reserve suspended the interest-rate ceiling on 30- to 89-day large-denomination certificates of deposit. American banks increasingly tapped this source of funds, and their borrowings of Eurodollar deposits from their foreign branches fell sharply, from $11½ billion to $7 billion, during the second half of 1970.

There were also substantial changes in long-term capital movements between 1969 and 1970. U.S. direct investment outflows increased from $2.8 billion during the first three quarters of 1969 to $3.6 billion during the corresponding period of 1970, reflecting the projected 16-percent increase in plant and equipment expenditures for 1970 by foreign affiliates of U.S. corporations. At the same time foreign direct investment inflows to the United States increased to $0.8 billion. Net foreign purchases of U.S. stocks and bonds (exclusive of U.S. agency bonds) declined substantially, from $1.9 billion during the first three quarters of 1969 to $1.1 billion during the comparable period in 1970. This decrease was largely a response not only to a sharp decline in U.S. security prices during the spring but to the difficulties experienced by several of the large offshore investment funds and the consequent regulations imposed by several European nations. Net U.S. purchases of foreign securities also declined dramatically, from $1.4 billion during the first three quarters of 1969 to $0.6 billion during the corresponding period in 1970.

OVERALL DEFICIT

The net effect of changes in the current and capital accounts during 1970 was a considerable reduction in the recorded U.S. liquidity deficit but a marked deterioration in the official reserve transactions balance. In response to the latter, the Federal Reserve Board took steps in December to discourage further repayment of Eurodollar borrowings by U.S. banks. This action was undertaken partly because of concern that the capital inflows which were causing some countries to gain dollar reserves might undermine the efforts of their monetary authorities to maintain restrictive monetary policies for domestic purposes.

Preliminary estimates indicate that the U.S. liquidity deficit in 1970 was somewhat less than $4 billion, or more than $4½ billion excluding the allocation of Special Drawing Rights (SDR's), a sharp reduction from the 1969 liquidity deficit of $7.0 billion. Preliminary estimates of the 1970 balance on the official reserve transactions basis indicate a deficit of about $9½ billion, including the allocation of SDR's, as compared with a surplus of $2.7 billion in 1969. (These figures differ from those in Table 33, which are figures for the first three quarters of 1970, seasonally adjusted, stated at annual rates.)

While the recorded liquidity deficit showed a sharp improvement in 1970, this balance was distorted by special financial transactions and flows of U.S. funds to the Eurodollar market which, particularly in 1969, enlarged the "errors and omissions" item. In addition, the 1970 figure included the initial allocation of SDR's to the United States. If adjustments are made for these factors, the underlying deficit in the first three quarters of 1969 was about $4½–$5 billion and about $3½–$4 billion in the corresponding period of 1970. This moderate improvement largely reflected the increase in the trade surplus, partly offset by larger net outflows of private capital.

The sharp deterioration in the official reserve transactions balance in 1970, despite the improvement in the liquidity balance, reflected the very sharp shift in the flow of foreign private liquid funds—from a net inflow of $8.7 billion in 1969 to an outflow of $3.3 billion in the first three quarters of 1970. (This is shown in Table 33, but the 1970 figures there are reported at annual rates.) These flows were largely associated with the shift, referred to earlier, in U.S. banks' Eurodollar borrowings through their foreign branches.

The U.S. official reserve transactions deficit in 1970 was financed partly by decreases in our total stock of reserve assets. Such assets registered a decline of $2.5 billion during 1970, even with a nearly $1 billion increase in holdings of SDR's that largely reflected the $867 million initial allocation in January. The remainder of the deficit was financed by increases in liquid liabilities to foreign official agencies.

Despite the substantial buildup of dollar balances in the hands of foreign official holders, 1970 was a year of general calm in the foreign exchange markets. It was free of any crises like those that had occurred intermittently in preceding years.

MANAGING CAPITAL MOVEMENTS

The large capital movements occurring, as described above, in response to changes in relative interest rates and monetary conditions are the outgrowth of the increasing internationalization of capital markets, especially the development of the Eurodollar market. The increasing mobility of capital is a reflection of the growing flexibility and responsiveness of capital markets, which contribute to the efficient international allocation of investment and production. This mobility nevertheless involves some problems. The responsiveness of short-term capital flows to variations in timing and degree in the use of monetary policy can both undermine the effectiveness of monetary policy as a domestic stabilization tool and produce significant balance-of-payments disturbances. It is possible to argue that such short-term capital flows are largely temporary and usually self-reversing, and therefore that one need not be concerned about their balance-of-payments consequences. Traditionally, however, several courses of action have been suggested to alleviate problems arising from international movements of interest-sensitive funds. One is to offset these capital flows through flexible official financing; another is to reduce reliance on monetary policy as an internal stabilization tool; and a third is to insulate domestic money markets by direct control of capital movements.

Important steps to facilitate the offsetting of large international flows of liquid capital through international cooperation have been taken by developing flexible arrangements for short- and medium-term official financing, and by other forms of cooperation among national monetary authorities and such international institutions as the International Monetary Fund (IMF), the Bank for International Settlements, and the Organization for Economic Cooperation and Development. But the experience so far with such arrangements indicates that, while they are helpful in preventing balance-of-payments difficulties arising from such flows, in general they cannot completely offset the problems that such flows pose for domestic monetary management.

The second alternative would imply achieving a domestic fiscal-monetary mix that would place heavier reliance on fiscal measures for the achievement of domestic goals; monetary measures would then be directed more toward international goals. Whether such a shift in the policy mix is desirable is a question which must be decided with reference to its domestic effects rather than on the grounds of balance of payments alone. There are, moreover, rather obvious practical limitations to this option. Changes in tax rates and in the level of Government expenditures are difficult and time-consuming. Even more important, any major effort to rely more heavily on changing the "mix" of domestic monetary and fiscal policies presupposes a more precise knowledge than now exists of the different effects of monetary and fiscal policies on internal stability and external balance.

The third alternative is to take policy actions which directly affect capital movements. The United States, for balance-of-payments purposes, instituted three programs to control capital outflows during the 1960's. One was the Interest Equalization Tax in 1963, which applies to securities sold in U.S. capital markets by developed countries (except new Canadian issues) and long-term bank loans (with similar exemptions). The second was the Federal Reserve's Voluntary Credit Restraint Program, initiated in 1965, which provides guidelines for capital flows from banks and other financial institutions. Also in 1965, voluntary restraints on direct investment were established under the direction of the Department of Commerce; this program was converted into the mandatory Foreign Direct Investment Program at the beginning of 1968.

Controls on capital movements are widely used; they are permitted by the International Monetary Fund Articles of Agreement and are generally regarded as less undesirable than controls on current account transactions. But they involve some economic costs of their own, and their duration poses problems. With respect to the Foreign Direct Investment Program, for example, the passage of time is likely to bring more and more ways of bypassing the controls. Insofar as the controls are effective, the longer they remain the greater will be the potential capital outflow when they are lifted and corporations attempt to repay foreign lenders. Finally, there is some concern about what effect the heavy foreign borrowing, induced by the direct investment controls, might have on the debt structure of foreign affiliates of U.S. corporations.

This Administration has affirmed its view that such controls are temporary measures and must not become part of the permanent tool kit of policy instruments because they distort the efficient allocation of capital. The relaxation of the Foreign Direct Investment Program which began in 1969 has been continued with due regard to the balance-of-payments situation. In 1970, the "minimum allowable investment" (i.e., the amount not subject to restraint) was increased from $1 million to $5 milion per year, provided that the additional $4 million was used in the designated group of lower income countries. Changes in the regulations concerning foreign borrowings which may be offset against direct investment expenditures permitted greater flexibility in financing foreign investment projects, as did new provisions regarding the amount of earnings which may be reinvested and the conditions under which earnings may be transferred among designated groups of countries. In January 1971 the annual investment amount not subject to the controls was raised from $1 million to $2 million without geographical restriction and the proportion of the previous year's earnings which may be reinvested was increased.

Offsetting official financing, changes in the mix of monetary and fiscal policies, and the use of direct controls on capital movements do not, however, provide a fully satisfactory answer to the policy problems posed by the increasing integration of capital markets, and this fact has led to a growing interest in finding alternative solutions. One answer might lie in no longer trying to insulate national capital markets but substituting instead a greater conscious international coordination of monetary policies. A solution relying on international coordination is often limited, however, by the fact that it implies restrictions on the freedom to direct monetary policy toward domestic economic problems. Where full coordination is not practicable, one mechanism for providing greater insulation of domestic capital markets, and therefore a somewhat more independent monetary policy, would be greater flexibility of exchange rates within the framework of the present system established at Bretton Woods. If there were more scope for changing exchange rates in response to market forces, the sensitivity of short-term capital movements to differences in national monetary conditions might be somewhat reduced.

While the concern about how the balance of payments is affected by interest-sensitive flows of short-term capital may be exaggerated, it must be recognized that major countries will continue to rely heavily on monetary policy to influence the domestic economy. The management of the resulting flows of short-term capital will therefore continue to occupy monetary and financial authorities.

THE UNITED STATES IN THE INTERNATIONAL MONETARY SYSTEM

The U.S. dollar plays a number of key roles in the international monetary system. It is widely used to finance private international transactions, even if no American is involved. It is also the currency used by national authorities in their operations in foreign exchange markets, and dollar holdings are an important component of world reserves. Because of its international roles, the dollar further serves as the yardstick by which the values of many free world currencies are measured. As a result, developments in the United States economy and balance of payments, and the attitudes other countries take toward these developments, are of key importance in the smooth functioning of the international monetary system.

MEASURES OF THE U.S. BALANCE-OF-PAYMENTS POSITION

The measures of our payments balance officially published by the U.S. Government tend to be widely interpreted as indicators of how close to—or far from—the most desirable situation we stand at a given time, even though there is no clear consensus on how the optimum situation is to be defined. A great deal of attention has been devoted to assessing the adequacy of the two overall measures of the payments balance now used. One is the liquidity balance, which is equal to the change in our holdings of international reserve assets less the change in our liquid liabilities to all foreigners, official and private. The second is the official reserve transactions balance, which is equal to the change in our stock of international reserve assets less the change in liquid and certain nonliquid claims on the United States by foreign official monetary institutions. From the search for improved measures has emerged increasing agreement that no one measure can adequately summarize the changes in this country's international financial position.

The most commonly used measure of the U.S. payments position, the liquidity balance, was originally intended as a measure of changes in this country's ability to maintain conversions of dollars into gold at a fixed price ratio. There has been considerable discussion as to whether the statistical presentation of the liquidity balance is the best possible reflection of its underlying concept. This problem was discussed in detail in the 1970 *Economic Report of the President.*

More fundamentally, however, some liquidity deficit will normally arise when a reserve country acts as an international banking center. Foreigners tend to accumulate short-term claims on such a country, and in turn the country may build up a growing net investment in foreign countries at longer term. At the same time, a continuing liquidity deficit means that the ratio of reserves to liquid foreign claims is being lowered. The present situation results partly from the growth of world liquidity which was necessary to accommodate the expansion of world trade and investment over the past two decades—that is, in part it reflects the successes of the international economy. Variations in the volume of our liquid liabilities relative to their reserve backing are therefore not the primary determinant of how desirable the dollar is as a reserve asset.

The U.S. responsibility for converting foreign liquid claims into other reserve assets is limited to the holdings of foreign official institutions. Since the adoption in March 1968 of the two-tier gold system, the possibility of flows of gold from the U.S. reserve stock through foreign official institutions into private hands has been eliminated. As a result, the liquidity balance has lost much of its significance.

In recent years, increasing attention has been focused on the official reserve transactions balance. This balance, with appropriate adjustments, measures the quantity of claims on the United States which foreign authorities have acquired or given up in the process of maintaining the exchange value of their currencies within the prescribed margins. There are considerable difficulties in reading the signals given by the official reserve transactions balance, however. For one thing, it is volatile, exhibiting wide year-to-year swings as shown in Table 33. Moreover, a movement of dollars from foreign private accounts to foreign official accounts will increase the official reserve transactions deficit; movement in the other direction will decrease it. Such movements may in some cases signal shifts in the degree of foreign confidence in the dollar relative to other currencies. In other cases they may simply be due to changes in monetary conditions and interest rates which alter the attractiveness of dollar assets to foreign private holders, quite apart from speculative considerations. Because of the obligation to keep their countries' exchange rates within 1 percent or less of the par value, central banks are essentially passive in such transactions. In still other cases, shifts of dollar holdings between the central bank and commercial banks may represent the deliberate exercise of selective measures designed to reduce or to enlarge published reserves.

For all these reasons, no single concept of the balance will suffice for all purposes. Beyond the liquidity and official reserve transactions balances, at least two other "balance" concepts can be useful. One is the balance on current account or balance on goods, services, and unilateral transfers (both government and private). Such a balance indicates the extent to which our country is currently earning the foreign exchange it needs to carry out its international lending and investment expenditures. Properly adjusted for

TABLE 33.—*U.S. balance of payments, 1961–70*

[Billions of dollars]

Type of transaction	1961–65 average	1966	1967	1968	1969	1970 first 3 quarters [1]
Merchandise trade balance	5.4	3.9	3.9	0.6	0.6	2.7
Exports	23.0	29.4	30.7	33.6	36.5	42.1
Imports	−17.6	−25.5	−26.8	−33.0	−35.8	−39.4
Balance on investment income	3.5	4.1	4.5	4.8	4.4	4.3
U.S. investments abroad	4.9	6.3	6.9	7.7	8.8	9.6
Foreign investments in the United States	−1.3	−2.1	−2.4	−2.9	−4.5	−5.3
Balance on other services	−2.5	−2.7	−3.2	−2.9	−3.1	−3.1
BALANCE ON GOODS AND SERVICES [2]	6.5	5.3	5.2	2.5	1.9	3.9
Unilateral transfers, net; transfers (−) [3]	−2.7	−2.8	−3.0	−2.8	−2.8	−2.9
BALANCE ON CURRENT ACCOUNT	3.8	2.5	2.2	−.3	−.9	1.0
Balance on direct private investments	−2.2	−3.6	−2.9	−2.9	−2.2	−3.8
U.S. direct investments abroad	−2.2	−3.7	−3.1	−3.2	−3.1	−4.8
Foreign direct investments in the United States	.1	.1	.3	.3	.8	1.0
Transactions in securities	−.8	.4	.3	3.1	1.6	1.0
Transactions in U.S. long-term assets	−.6	.2	(4)	.1	−.1	−.6
Transactions in U.S. long-term bank liabilities to other than official foreign agencies, and all long-term nonbank liabilities	.1	.4	.2	.8	.8	.9
Certain transactions in U.S. Government assets [5]	−1.8	−2.0	−2.4	−2.5	−2.1	−1.8
BALANCE ON CURRENT AND LONG-TERM CAPITAL ACCOUNTS [6]	−1.4	−2.0	−3.1	−1.7	−2.8	−3.3
Transactions in U.S. short-term assets	−.9	−.4	−1.2	−1.1	−.6	−.3
Nonscheduled repayments on U.S. Government credits	4	.4	(4)	.2	−.1	.3
Long-term bank liabilities to foreign official agencies	(4)	.8	.9	.5	−.8	−.8
Transactions in U.S. short-term nonbank private liabilities, and nonmarketable liabilities of U.S. Government	.5	.4	.9	2.7	.2	.9
Errors and unrecorded transactions	−.9	−.5	−1.1	−.5	−2.8	−2.0
Allocations of special drawing rights	....	....	....	....	....	.9
BALANCE ON LIQUIDITY BASIS	−2.3	−1.4	−3.5	.2	−7.0	−4.4
Less: Certain nonliquid liabilities to foreign official agencies	.1	.8	1.3	2.3	−1.0	−.2
Plus: Foreign private liquid capital, net	.7	2.4	1.5	3.8	8.7	−4.5
BALANCE ON OFFICIAL RESERVE TRANSACTIONS BASIS	−1.8	.3	−3.4	1.6	2.7	−8.7
Addendum:						
Special financial transactions	.6	1.6	1.3	2.7	−.6	.5
BALANCE ON LIQUIDITY BASIS EXCLUDING SPECIAL FINANCIAL TRANSACTIONS AND SDR ALLOCATIONS	−2.9	−2.9	−4.8	−2.6	−6.4	−5.8

[1] Average of the first 3 quarters at seasonally adjusted annual rates.
[2] Excludes transfers under military grants.
[3] Excludes military grants of goods and services.
[4] Less than $0.05 billion.
[5] Transactions in U.S. Government assets, excluding official reserve assets, net, less nonscheduled repayments on credits (including sales of foreign obligations to foreigners).
[6] One version of the "basic balance" under consideration. Another variant is the "nonmonetary balance" used by the International Monetary Fund.

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

Source: Department of Commerce.

earnings reinvested abroad, for errors and omissions, and for changes in the valuation of domestic and foreign assets, the current account also indicates changes in our net international investment position or "net worth," which may well be considered more meaningful than any other measure of changes in the basic strength or weakness of our international financial position. At the end of 1969, for example, our net foreign assets amounted to $67 billion, an increase of $1.5 billion over the total a year earlier.

Another concept, currently being considered for inclusion in the Government's table of balances, is the basic balance. Such a balance would measure our net position on current account plus "nonliquid" or "nonvolatile" capital transactions, treating changes in private liquid assets and liabilities as financing items. The aim underlying the basic balance is to group together those balance-of-payments items which best reflect broad, persistent forces or underlying trends, treating more volatile classes of transactions among the financing items. Because of the difficulties of approximating such a distinction with available statistical data, several variants of the basic balance have been suggested as best reflecting the fundamental concept.

The four balances just discussed—the liquidity balance, the official reserve transactions balance, the current account balance, and the balance on current and long-term capital accounts, which is one of several versions of the basic balance currently under consideration—are shown for the past decade in Table 33. Despite their conceptual and statistical differences, all these measures of our payments balance suffer from a common difficulty, namely, that none of them can give more than one side of the picture. The other side, which because of measurement problems does not appear in any presentation of the U.S. balance of payments, is the demand side: the number of dollars foreigners want to add to their reserve stocks in any given year. Rather than the quantity of dollars flowing into foreign hands, it is the difference between this amount and the amount they want to hold, given existing conditions, that would be a true indicator of disequilibrium in the international economic and financial position of the United States.

The Composition of Reserves

It is generally thought that, aside from political considerations and questions of confidence, the quantity of dollars foreign authorities want to add to their reserves depends partly on the desired rate of growth of aggregate international reserves and partly on the availability and desirability of alternative sources for increasing reserves. The expansion in the supply of monetary gold has for some time been erratic and insufficient to meet the increasing reserve needs which have accompanied the rapid growth of world trade and capital transactions. Under these circumstances, a steady accretion of foreign exchange, primarily dollars, to world reserves has filled this gap and prevented a general inadequacy of international reserves.

With the IMF's decision to allocate $9.5 billion of Special Drawing Rights to member countries over the 3-year period 1970–72, an important alternative source of new reserves was created. A first allocation of $3.4 billion was made on January 1, 1970, a second allocation of $2.9 billion was distributed at the beginning of 1971, and a third allocation of $3.0 billion is planned for the beginning of 1972. It is envisaged that SDR's will eventually supplant dollars as the major source of reserve growth, although the SDR allocations for the 1970–72 period were determined with the expectation that dollars and other traditional sources of increases in official reserves would supplement this new reserve "money."

The question of the size of foreign official demand for dollars, however, involves another complication. In addition to wanting growth of reserves, foreign official institutions generally have preferences concerning the composition of their reserve stocks: what proportion will be represented by gold, SDR's, and dollars (as well as, in some cases, smaller amounts of other convertible currencies). In part these preferences may arise from the differing characteristics of the three major reserve assets. The yield, for example, is zero on gold holdings, 1.5 percent on SDR's, and substantially higher on dollar holdings. Also, unlike dollars, SDR's and monetary gold (since the institution of the two-tier gold system) can be transferred only among central banks or other official institutions; they cannot be used for commercial transactions. Much more important, however, is that most industrial countries would apparently like to run some sort of basic balance surplus or a current account surplus with the rest of the world. The demand for reserve dollars, therefore, seems to be affected not only by countries' reserve goals but also by their balance-of-payments goals, measured "net" of new SDR allocations. SDR's help to satisfy the first of these goals but not the second, unless the goals themselves are modified.

The combined growth of official and private foreign demand for dollars determines the equilibrium size of the liquidity deficit of the United States. How much the private component of this demand grows will also depend both on the rate at which nonofficial holders want to increase their aggregate working balances of international currencies and on the desired composition of these balances.

A number of characteristics have made the U.S. dollar particularly suited to its role as the most widely used currency for international transactions. Among them are the scale and efficiency of the American banking system, the size and depth of our capital markets, and the freedom of the dollar both from changes in its foreign-exchange value and from exchange controls affecting foreigners. So far, the development of European capital markets seems to have enhanced rather than reduced the role of the dollar as a vehicle currency, although it is too early to tell what ultimate effect the European Economic Community's proposed movement toward a currency union will have through the decade of the 1970's.

The economic well-being of the United States does not require that foreign demand for dollar balances continue growing at any particular rate. What is important is to distinguish clearly between measured U.S. deficits and the strength or weakness of our international financial position. Throughout most of the 1950's, while the United States had a measured deficit in its balance of payments nearly every year, there was widespread concern about a worldwide "dollar shortage." This concern suggested that the measured U.S. deficit during those years was below its equilibrium size as determined by the growth of world demand for dollar reserves. The point is that it is essential that consideration of the foreign demand for dollars should temper any use of measured balance-of-payments deficits as the basis for policy decisions affecting our domestic economy or our international economic relationships.

Balance-of-Payments Goals

In the present international monetary system, in which the dollar serves as a yardstick, other countries, by selection of their exchange rates, in effect determine the exchange value of the dollar. The balance-of-payments position of the United States, however it is measured, depends therefore not only on the state of our domestic economy and on the economic behavior of our citizens and Government but on the economic performance and policies of other countries, including their decisions about exchange rates. Individual countries take actions that they consider appropriate to their particular circumstances. Collectively, those actions are not always easily reconciled with other countries' statements about the most desirable payments position for the United States. During the 1960's, for example, there were frequent expressions of foreign concern about the size and persistence of the U.S. deficit. Yet the net result of exchange-rate changes by leading industrial countries was a very slight actual appreciation of the dollar—a development which would inevitably have some tendency to weaken our current account balance.

The United States has full responsibility for maintaining a noninflationary expansion of its domestic economy. This responsibility was not met in the latter half of the 1960's, and U.S. performance during this period clearly contributed to the deterioration of our balance of payments. Nevertheless, regardless of our domestic performance, there are no measures which the United States can take to satisfy balance-of-payments demands of various countries if these demands are fundamentally inconsistent. No matter what constraints the Government imposes on the domestic economy, and no matter how many measures it adopts to alter or control individual categories of international transactions, the United States will not be able to abolish its balance-of-payments deficits if most of its major trading partners establish exchange rates and follow other balance-of-payments policies that enable them to run surpluses over and above their SDR allocations.

This problem of the possible inconsistency of balance-of-payments goals cannot, in short, be solved through unilateral policy action by the United States. Instead it requires multilateral action by the members of the International Monetary Fund—the present framework for international monetary relationships among the countries of the free world. One step toward the solution of this problem has already been taken with the establishment of Special Drawing Rights, international reserves which do not depend on a persistent deficit in the balance of payments of the United States or any other country. The purpose in instituting SDR's and related arrangements with respect to reserve creation is, of course, to provide a situation in which all countries can satisfy their demands for reserve increases simultaneously, so that the reserve center need not be forced into persistent deficit through policies adopted by other countries to run net surpluses in their balance-of-payments transactions.

Ideally, the rate of reserve creation should be neither too small nor too great. If it is too small, at least some countries will find their reserve goals frustrated, and their efforts to prevent the inadequacy of their reserves from imparting deflationary pressures to their domestic economies are likely to lead to increasing restrictions on international transactions and a competitive upward pressure on interest rates. If the rate of reserve creation is too great, the excess liquidity will be a vehicle for transmitting inflationary pressures internationally and will make it more difficult for national authorities to control domestic inflation.

In practice, however, it is not possible to find a rate of creating world reserves that is just right for every country. The objective must be a rate which best reflects an international consensus as to the most desirable trend of reserve growth. Moreover, even with such a consensus, problems would still arise if, as suggested earlier, other countries were to formulate balance-of-payments goals that were inconsistent with their aims regarding the composition of international reserves.

Exchange Rates

Because of the possibility that reserve creation and reserve management alone cannot solve the dilemmas just described, interest has recently focused on increased, though limited, flexibility of exchange rates. Changes in official parities have occurred in the past, of course, and have played a role in stabilizing the international monetary system. But the political consequences inherent in exchange-rate decisions have made countries hesitant to undertake such adjustments. As noted earlier, exchange-rate changes by industrial countries in the 1960's resulted in a small net depreciation of these currencies against the dollar, in part perhaps because political inhibitions against exchange-rate changes tend to be stronger in the case of appreciation than in the case of depreciation. To the extent that such an asymmetry exists, its effect is to favor a devaluation against the international standard—the dollar. Opinions about the quantitative significance of this tendency differ, but there is a widespread feeling that modifications which would make exchange-rate changes less politically charged and less likely to lead to speculative disturbances would contribute to the smoother and more effective operation of the existing system.

More frequent and smaller changes in the dollar parities of currencies would reduce the tendency for sizable payments imbalances to build up. This in itself would be an advantage, but an added advantage would arise insofar as the calculation of the appropriate new par became less critical. With smaller and more frequent changes in par value it would be easier to modify those which turned out to be either inadequate or excessive.

Smaller and more frequent changes in parity would not necessarily involve a change in the present IMF rules, but only a change in the practices which member nations have generally followed. A recent report by the Executive Directors of the IMF notes that the Fund is empowered "to concur in members' proposals for prompter and smaller changes in parities, whenever these are necessary to correct a fundamental disequilibrium."

On two recent occasions the difficulty of identifying an appropriate new par value has led countries to move away from the existing exchange-rate parity without immediately choosing a new one. At the end of September 1969 the German Government closed its foreign exchange markets under the pressure of a large capital inflow. When the markets were reopened several days later, no attempt was made to defend the old parity, thus introducing a period of "transitional float." The mark moved upward on the exchanges, and when a new par value was declared toward the end of October it exceeded the previous one by more than 9 percent. A somewhat different case arose at the end of May 1970 when, in the face of a very strong payments position and domestic inflation, the Canadian Government withdrew its defense of the existing par value; it has not yet declared a new one.

There is also the possibility of introducing greater flexibility by some widening of the margin permitted under the present IMF rules for exchange-rate variation around each country's par value. This margin or "band" is now 1 percent each way. Such an increase in the scope for market-induced movements of exchange rates might have several advantages. By increasing the risk of exchange-rate loss and thereby reducing the sensitivity of some types of short-term capital movements to differing degrees of tightness or ease in national money markets, it would make possible greater independence in national monetary policies. It could also be expected to reduce pressure on official reserves by encouraging stabilizing movements of private funds in cases where payments disturbances are regarded as temporary and self-reversing, and by decreasing the potential profitability of speculative flows based on anticipations of a change in parity. Such potential profitability would be reduced not only because the speculators would lose more if they guessed wrong but because the broader scope for exchange movements within the margins might in some cases reduce the need for actual parity changes.

All of the possible modifications just described are at present under study by the IMF in its consideration of whether amendments to its Articles of Agreement are necessary or desirable to encourage the most effective utilization of exchange-rate policies as a tool of international adjustment. The need is to find modifications of law or practice that will alleviate in the best possible way the recurring financial strains in the existing system while still maintaining the essential characteristics of a monetary system under which steady and dramatic advances in world trade and prosperity have been achieved.

ADJUSTMENTS IN INTERNATIONAL TRADE

Improvement in the monetary system has been one of the two major developments in the international economy since World War II. The other is the cooperative effort to dismantle the network of barriers that had obstructed the international exchange of goods and services prior to and during the war. Although many obstacles to trade still exist, gradual tariff reductions have been an important stimulus to the rapid postwar expansion of world trade. A number of international institutions, in particular the General Agreement on Tariffs and Trade (GATT), have been instrumental in reducing the hindrances to freer trade on a multilateral basis. Some problems of adjustment have emerged, however, as international trade has become more important in each country's affairs.

During the 1960's the volume of world trade (excluding that of Communist countries) grew considerably faster than real income in this group of countries, and the relative importance of trade to the American economy has increased as well. For example, the trend rate of growth of real imports of goods and services in the United States during the period 1955–68 was 1.6 times as great as that of real domestic production. In the same period the trend rate of growth of exports in real terms was 1.4 times that of output. Among broad categories of manufacturing industries, sharp increases in penetration by imports were registered in the latter half of the 1960's in apparel, leather goods, electrical machinery, transportation equipment, and other durable goods. The ratio of exports to total output rose significantly in the lumber, electrical machinery, transportation equipment, and primary and fabricated metals industries. Clearly, the growth of U.S. trade has signified not only greater availability of foreign manufactures, but also wider markets for many domestic products.

U.S. TRADE POLICY

The liberal trade policies followed since World War II have not only expanded our exports and imports but have also contributed to a higher standard of living with a richer choice of products both here and abroad. At the same time, these gains require domestic adjustments in certain industries that grow more slowly, or even contract, as a result of trade liberalization. Despite the overall gains, the problems of adjustment and the natural tendency for an industry to resist foreign competition have brought renewed pressures in recent years to reverse trade liberalization. Pressures have also grown because of protectionist actions by some of our trading partners and because the reduction in our merchandise trade surplus has led to a belief that the United States is now benefiting less from trade.

All these pressures converged during 1970 when Congress considered new trade legislation. The trade bill recommended by the President in 1969, and described more fully in the 1970 *Economic Report of the President,* included several measures that represented continued progress in our trade policy. In addition to authority for limited tariff reductions and elimination of the controversial use of the American selling price as a basis for setting certain import duties, the bill proposed new authority to act against countries that employ export subsidies in competition with U.S. exports in third markets. Most important, perhaps, was the bill's proposal to liberalize criteria for providing adjustment assistance to workers and businesses adversely affected by imports.

Certain additional features were subsequently added to the President's proposal. Some of these, including an amendment to allow Domestic International Sales Corporations that would provide tax deferrals to U.S. exporting firms, and the addition of textile quota provisions designed to assist in the conclusion of international agreements on textiles, were supported by the Administration. Other amendments, many of them unacceptable to the Administration, were eventually included in a bill passed by the House of Representatives. The most questionable was a provision to impose increased restrictions on imports of products which met certain quantitative criteria in cases where the Tariff Commission found injury. This and several other amendments threatened to reverse the steady progress that had been achieved in liberalizing our trade policy. The bill opened the prospect of retaliation by other countries against U.S. exports, and it would have weakened the fight against domestic inflation.

U.S. trade policy clearly reached a critical juncture in 1970. Although Congress did not adopt protectionist trade legislation, the pressures for greater import restrictions remain strong at the beginning of 1971. If the broad gains to the economy that have resulted from increasingly open access to markets here and abroad are to be sustained, it is important that the wider public interest be voiced as strongly as the complaints of adversely affected parties. At the same time, better means must be found to meet legitimate problems of adjustment in some industries affected by rapidly increasing imports.

Domestic Adjustments to Changes in Trade Patterns

The burdens of adjustment to foreign competition are too often ignored by those who advocate free trade. Much fixed capital, such as specialized machinery, is not transferable to other industries. Workers will have the difficulty of changing jobs, of moving and starting a new home; some who have acquired skills not needed in other industries may face unemployment or lower incomes.

Import restrictions, however, are neither the only solution to these problems nor in principle the best one. A better approach, taking into consideration the interests of both consumers and producers, is to do more to facilitate the adjustments that injured firms and workers must make. As the President recognized in his original trade bill proposal, adjustment assistance should become available at an earlier point in an industry's struggle to compete with imports. Moreover, it should become available more quickly after the application for aid.

Use of the adjustment assistance provisions of the Trade Expansion Act of 1962, although still limited, expanded notably during 1970. For the first time since the program's inception, the President authorized firms and workers in three industries to apply directly to the Secretaries of Commerce and Labor for assistance. The number of workers and firms actually certified for assistance, including some in other industries that had requested assistance individually from the Tariff Commission, increased greatly during 1970.

There are, of course, costs in administering and financing adjustment assistance programs. These costs, which would be substantial in the case of a large industry such as textiles, are ultimately paid by taxpayers. The aim of such programs, however, is not to provide compensation payments indefinitely to injured firms and employees, but to ease the transfer of labor and other resources to more productive sectors of the economy. For workers, this means retraining and assistance in job hunting. The costs to taxpayers should thus decrease eventually as workers in the injured firms obtain new jobs or reach retirement age. On the other hand, the costs that import quotas create for consumers in the form of higher prices and a narrower choice of goods continue as long as the quota remains in effect.

There may occasionally be sound reasons for reducing the burden of adjustment on import-competing industries by obtaining agreement from foreign exporters to restrict their shipments. This has been done for a number of commodities, including cotton textiles, meat, and steel. The Administration has attempted to negotiate similar restraints for manmade textiles and woolen goods. Such voluntary agreements affect prices in the importing country in the same way that quotas permitting a like volume of imports would do, but their provisions tend to be more flexible than those of legislated quotas.

The main drawback of a quota as compared to a tariff is that unless a tariff is prohibitive it does not inhibit competition as much as a quota, unless the quota is ineffective. This is so because a tariff allows imported goods to enter if, even with the tariff, they are competitively priced. A tariff therefore puts a limit on the amount by which the domestic price can exceed the world price. An effective quota, on the other hand, does not put any limit on the rise in domestic prices. Those who are permitted to import under a quota system are under no obligation to pass on the lower world price to their customers; their right to import gives them a windfall profit. Under a tariff the difference between the world price and the domestic price accrues to the Treasury. In those schemes for quotas or voluntary restraints which do not call for import licenses, the quotas are in effect controlled by the foreign exporter, who is therefore in a position to capture the windfall. In the case of imported beef, for instance, export prices to the United States from the principal supplier are between 10 and 20 percent higher than the export prices to other countries. It is clear therefore that quotas should only be used where no satisfactory alternatives are available.

All these reasons make it important for countries participating in the world trading system not only to reduce tariff barriers but also to work toward eliminating various nontariff barriers to trade. Preliminary efforts to develop a common framework for negotiating reductions in such barriers have begun within GATT, and it is hoped that they will be intensified during 1971.

While much attention has been focused on adjustment problems where labor and capital have been hurt by foreign competition, it is often overlooked that erecting barriers to trade would cause similar problems for firms and workers in exporting industries if other countries reduced their imports from the United States either in retaliation or as a result of the normal response mechanisms in international transactions. It has been estimated that in 1969, 3.8 percent of the private labor force was directly or indirectly dependent upon exports for employment, the same percentage as in 1965 (Table 34). This figure includes not only labor employed directly in producing exports but also labor involved in producing items used in the final export goods. The proportion of agricultural workers whose output found a market abroad has been relatively high for many years. Between 1965 and 1969, however, the proportion of employment accounted for by exports in manufacturing rose and that in agriculture, forestry, and fisheries declined.

Wages in export industries are usually higher than in import-competing industries. For example, a weighted index of wage rates for production workers in manufacturing whose jobs depended on exports in 1966, the latest year for which information is available, was 8 percent higher than the average earnings in jobs which might have been created by import replacement.

TABLE 34.—*Percent of private employment related to U.S. merchandise exports, 1960, 1965, and 1969*

Industry or sector	Export employment as percent of total private employment[1]		
	1960	1965	1969
Total employment	3.9	3.8	3.8
Agriculture, forestry, and fisheries	9.8	10.9	9.4
Mining	9.1	8.4	9.2
Construction	.6	.6	.6
Manufacturing	6.1	6.2	6.9
Services	1.8	1.8	1.9
Government enterprises	2.9	2.8	3.3

[1] Employment covers wage and salary employees, self-employed, and unpaid family workers; Federal, State, and local general government employment and private household employment are excluded.

Source: Department of Labor.

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Import Restrictions and the Domestic Price Level

For a country to benefit from trade liberalization, it is not necessary that its trading partners also have liberal policies, although worldwide trade liberalization would, of course, yield still greater benefits both here and abroad. But the opportunity to obtain some goods at lower cost through exchange for exports rather than through domestic production provides net gains to our consumers and to U.S. industries which use imports as raw materials, whether that opportunity arises from lower-cost production or from subsidized production in other countries.

Import restrictions tend to aggravate inflation by limiting the total supply of goods to the domestic market. When imports are free to expand, some of the excess demand can be diverted from the domestic economy and thus moderate the pressures on the domestic price level. In addition, competitive pressure from imports gives U.S. industries a strong incentive to increase their productivity and cut costs. Such pressure also encourages more competitive pricing, particularly in industries which are highly concentrated.

Nevertheless, experience suggests that progress toward freer trade is more likely to be achieved through reciprocal action than through unilateral moves. The domestic advantages of freer access to imports have usually had to be reinforced by the attraction of better markets for a country's exports. Moreover, a country that imposes fewer restrictions on imports than do its major trading partners makes its industries bear a disproportionate share of the burden of adjustment to changes in the pattern of international trade. The United States has maintained an open market in manmade textiles, for example, while many European countries subject them to quantitative import restrictions.

The benefits of freer trade can therefore be defended most effectively if we not only avoid actions that would unnecessarily deny our consumers access to the lower-cost products of other countries but also keep a careful watch over developments abroad that threaten the achievement of liberal trade policies. The President made this clear in a message to the Congress in December 1970, in which he said:

> The Administration remains committed to the objective of expanding mutually advantageous world trade. The record of the United States demonstrates clearly its willingness to assume its obligations in this field. We must continue to do our part, while at the same time defending vigorously the rights of our traders under international agreements.

REGIONAL TRADING ARRANGEMENTS

One argument cited by proponents of protection against imports has been the rapid expansion of special trading arrangements among groups of countries. Numerous groups of countries in all parts of the world have initiated special trading arrangements. Although its objectives are much broader, the European Economic Community is the largest and most important such trading unit. The principal grounds for concern about such arrangements are that they may unduly discriminate in favor of trade among member countries, and therefore against trade with the United States and other nonmember countries. The General Agreement on Tariffs and Trade has rules governing these matters, but constant review is needed to ensure that the rules are observed and to prevent adverse consequences for third countries.

ENLARGEMENT OF THE EUROPEAN ECONOMIC COMMUNITY (EEC)

The prospective enlargement of the EEC will affect world trading relations substantially. The EEC entered into enlargement negotiations with four other countries in June 1970. If negotiations culminate in the admission of the four applicant countries (Denmark, Ireland, Norway, and the United Kingdom), the combined GNP of the enlarged EEC would be about 60 percent as large as that of the United States, and the total imports of these countries from nonmember countries would be nearly 50 percent larger than U.S. imports. It is anticipated that several other Western European countries would also become associated with the EEC in subsequent negotiations.

The United States has long supported the integration of Western Europe because the broad political gains expected from a strong, united, and outward-looking Europe should exceed whatever economic costs might be incurred. In supporting the enlargement of the EEC for the same reasons, however, the United States has the right to expect that the interests of nonmember countries will be taken fully into account in the process of enlargement and that the policies of the enlarged Community will be responsive to the needs of the world community. With this goal in view, the United States has intensified its consultative arrangements with the EEC.

Enlargement could create significant changes for all U.S. economic relations with Western Europe. Although on balance the effects of the formation of the EEC on industrial trade have so far been favorable, several studies have shown that the EEC's agricultural policies have damaged some major U.S. agricultural exports. The United States is concerned that British entry into the Community at its current high levels of agricultural price supports might lead to further deterioration of U.S. agricultural exports. The solution lies in making the Common Agricultural Policy of an enlarged Community respond better to the needs of both consumers and farmers. Such a change would be to the benefit not only of the member countries but also of efficient outside suppliers. The United States has found over the years that it is better to maintain farm income through direct payments rather than through high price supports.

GENERALIZED TARIFF PREFERENCES FOR LOWER INCOME COUNTRIES

Another set of basically discriminatory trading arrangements are "special preferences" which the EEC countries grant to imports from selected lower income countries and which the United Kingdom and other members of the Commonwealth grant to each other. Frequently, these arrangements also entail "reverse preferences," whereby the less developed nation opens its market to exports from those developed countries which grant it special preferences. Reverse preferences are maintained in most of the EEC's special preference arrangements and in some of the special arrangements between developed and less developed members of the British Commonwealth. There has been a tendency in recent years for such arrangements to spread, thus undermining still further the principle of nondiscrimination on which the international trading system is based and damaging the commercial interests of countries that are not parties to the arrangement.

Recognizing the need to assist the lower income countries in accelerating their economic growth and to avoid the adverse consequences of selective trading arrangements, the President announced in his speech on Latin American policy in October 1969 that he had decided to press for the adoption by all developed countries of a liberal system of generalized tariff preferences for the exports of all lower income countries.

The decision to pursue this course was based on the belief that the best way to assist the lower income countries is for the developed countries to join in a common effort without seeking special trading benefits for themselves. Establishing a nonreciprocal preference system open equally to all lower income countries will have several advantages. It will enable them to increase their exports and their foreign exchange earnings and thus hasten their economic development; it will reduce the present discrimination among lower income countries that arises from special preferences favoring some countries at the expense of others—notably the Latin American countries—with no preferential access to any developed country's market; and, by eliminating reverse preferences, it will allow the lower income countries to buy from the cheapest source of supply.

In the months following the President's announcement the United States engaged in a series of intensive consultations—both bilateral and multilateral—with the prospective preference-granting countries and with the lower income countries in an effort to work out the details of a preference system.

Eighteen developed countries (including the six members of the European Economic Community acting as a unit) have agreed, subject to necessary legislative authorization, to grant generalized tariff preferences for a temporary period, now set at 10 years, and have made specific proposals. Under the U.S. proposal, most manufactures and semimanufactures (excepting only textiles, shoes, and petroleum products) imported from lower income countries, and a selected list of processed and primary agricultural products and raw materials, would be admitted duty free. In order to qualify for generalized preferences, lower income countries must provide adequate assurance that reverse preference arrangements will be eliminated within a reasonable period of time. Proposals by the other major developed countries also call for the elimination of duties on a broad range of products. While the proposals of individual countries differ somewhat in their form, they are designed to achieve similar results. In October 1970 these proposals were accepted by the United Nations Conference on Trade and Development as providing a "mutually acceptable" basis for the establishment of a generalized preference system.

AIDING DEVELOPMENT IN LOWER INCOME COUNTRIES

Stimulation of exports from the lower income countries by means of generalized preferences promises to aid these countries materially; but capital flows, both official and private, must play a major role in the economic development of these nations. While increased trade allows lower income countries to use their existing supply of resources more efficiently, capital flows provide them with additional working resources.

FOREIGN ASSISTANCE

Although the United States still provides more aid than any other developed nation, net official assistance for development has fallen from $3.6 billion, or 0.6 percent of GNP in 1963, to less than $3.2 billion, or 0.3 percent of GNP in 1969. In 1970, there probably was a further slight reduction in the net official flow. However, there are indications that, in line with the President's declared policy, the downward trend in the absolute level of U.S. aid will be reversed. After falling for 3 years, budget authorizations for the portion of gross official flows covered by the Foreign Assistance Act and for other multilateral flows increased slightly in fiscal 1970, and a significant increase has been voted for fiscal 1971.

The fall in the share of our national product devoted to aid has reflected a disillusionment both with the effect of such aid on the growth rates of less developed countries and with the efficiency of our aid institutions. The complexities of the development process were underestimated when the United States first began to assist the less developed world. Aid institutions which were highly successful in implementing the Marshall Plan have lagged in meeting the quite different challenges which lower income countries have recently confronted. On the other hand, there have been some outstanding successes. The economic progress of Israel, South Korea, Taiwan, and several other nations demonstrates that aid can be used efficiently.

The Administration believes that the number of successes can be greatly increased and has assigned high priority to the task of improving the probability of scoring positive gains. In 1969 the President appointed a Task Force on International Development, whose report played an important role in the formulation of his 1970 message on "Foreign Assistance for the Seventies" with its proposal for a fundamental reform of the U.S. effort. According to this proposal, aid would be divided into three components: development assistance, humanitarian assistance, and security assistance. Because each would be administered through a different organizational structure, responsibilities could be more clearly fixed and the success of each program in meeting its specific objectives could be more easily assessed. The President's message recommends that a much higher portion of American aid be channeled through multilateral institutions than at present. This change would allow greater coordination of international assistance and reduce some of the political frictions associated with bilateral aid.

The President also proposed a major reform in our bilateral aid program. He recommended the creation of two new organizations: a U.S. International Development Corporation to manage bilateral lending activities on a businesslike basis, and a U.S. International Development Institute to manage a portion of our technical assistance and to mobilize private scientific expertise and technology to help solve specific problems of lower income countries. The present Agency for International Development would be phased out; the number of U.S. employees working overseas on development projects would be reduced; and greater reliance would be placed on the information gathered by multilateral agencies.

It is important to ensure that each dollar flowing to recipients is used with maximum efficiency. Currently, the usefulness of international aid is limited by the requirement that a large portion of the funds be used to purchase goods from the donor country, even though the necessary items might be cheaper elsewhere. It is estimated that in many countries these "tying" provisions directly reduce the value of aid by at least 20 percent. In addition, tying may force recipients to engage in projects calling for a high import content, although they would otherwise have low priority and although they draw scarce local resources, both administrative and physical, away from more essential activities. In order to eliminate these serious problems, the President's message recommends that donor countries move together to abolish tying restrictions. A joint effort will mitigate any negative effects on the balance of payments of individual donor countries. Most donor countries have agreed to this principle. The United States has already decided to allow the use of development lending for procurement in any of the lower income countries themselves.

Improvements in the form of our aid and in our institutions represent only one approach to the problem. The impact of aid also depends crucially on the policies of the recipient countries. Thus far, some countries' efforts to use aid effectively have been hampered by a lack of administrative talent and technical skills. To meet this problem it is essential to supplement aid for capital formation with technical assistance. The United States has recognized this need, and in recent years technical assistance has been growing more rapidly than capital assistance, even though it still constitutes a smaller portion of our total aid compared to most other donors. One of the most important tasks for the U.S. International Development Institute proposed by the President in his Foreign Aid Message will be to emphasize technical assistance and to provide the research necessary for its most effective use. Even efficient technical assistance will do little to help development, however, if the recipient does not have the will to use it effectively. The effectiveness of the recipient's development efforts must therefore be an important determinant of how aid is distributed.

PRIVATE CAPITAL FLOWS

In the period from 1962 through 1969, net flows of private American capital to the lower income countries were about 40 percent as large as the official flows. Direct investment constituted more than two-thirds of the total private flow, while the rest consisted of private export credits and portfolio investment.

By the end of 1969 the book value of U.S. direct investment in less developed countries totaled $20 billion, of which $7.8 billion was in petroleum and $5.2 billion in manufacturing. Almost $12 billion of the total was invested in Latin America, the rest being almost evenly spread among less developed economies in other parts of the Western Hemisphere, as well as in Africa, the Middle East, and Asia.

Because private capital can confer important benefits, the U.S. Government has adopted a number of policies to encourage direct foreign investment in lower income countries in which it is welcomed. The Overseas Private Investment Corporation was created late in 1969. It will take over and expand the Agency for International Development programs to encourage private investment and will provide financial assistance to private enterprises operating in lower income countries. Its lending policies will follow regular business practices, and in 5 years its formal constitution will be reviewed with the possibility of transferring this agency to the private sector.

To the extent that the programs of the Overseas Private Investment Corporation can reduce the risks associated with investing in the underdeveloped world, those with capital will be more ready to consider a wide range of investment opportunities in the lower income countries. These lower income countries, however, will reap the benefits of this and other policies to stimulate private capital flows only if they create an environment that will attract private foreign investment.

In its program to control capital outflows for direct investment, the U.S. Government has discriminated in favor of investment in the lower income countries. Under the 1968 regulations, the formula setting an upper limit to the flow of direct foreign investment to the lower income countries was much more generous than the formula applying to direct investment in developed countries. In addition, not only can the limits be exceeded in special cases, but a company with unused allocations for direct investment in developed countries or Middle East oil-producing countries could reallocate the funds for use in developing nations. As a result of these policies, restraints on direct foreign investment have had little if any adverse effect on flows to the lower income countries.

While most private capital is moved to lower income countries in search of profits, there has also been a significant flow of aid financed by private foundations and other charitable groups. In 1969, this flow amounted to over $400 million. Private foundations also played a significant role in one of the most dramatic successes among aid programs by contributing to the technological developments culminating in the new varieties of wheat, rice, and other grains which have created the "green revolution." The resulting increase in agricultural productivity greatly heightens the chances of a continual rise in the level of living despite rapidly growing populations. The technological improvement has been so overwhelming, however, that serious adjustment problems are emerging. The benefits do not accrue evenly to the agricultural population, and new job opportunities will have to be created to absorb the labor force released from agriculture. In short, even success can create problems, and this example well illustrates the complexity of the growth process.

RELATIONSHIPS AMONG INTERNATIONAL ECONOMIC POLICIES

The various issues reviewed in this chapter are best considered, not independently, but in terms of the important interrelationships which tie them all together. U.S. trade policy, for example, must be considered in the light of domestic economic conditions as well as of the responsibilities implied by the key role of the dollar in the international monetary system. The relationship between the United States and the European Economic Community is a major consideration in the formulation of both our trade and our balance-of-payments policies. And generalized preferences for the exports of lower income countries, official aid flows, and private investment in these countries all play an important part in the effort to find the most effective contribution which this country, along with other industrialized countries, can make to the economic development of lower income nations.

In the light of these interrelationships, the President has recently moved to assure coordination at the highest level of all aspects of our foreign economic policy and to provide consistency with domestic economic policy and basic foreign policy objectives. Such coordination and overall direction is to be provided by the new Council on International Economic Policy, of which the President will be Chairman, and whose membership will include the Secretaries of State, Treasury, Agriculture, Commerce, and Labor, the Director of the Office of Management and Budget, the Chairman of the Council of Economic Advisers, the Special Representative for Trade Negotiations, the Executive Director of the Domestic Affairs Council, the Assistant to the President for National Security Affairs, and the Ambassador-at-Large. The newly-appointed Assistant to the President for International Economic Affairs will serve as Executive Director. In announcing the formation of this Council, the President pointed out that its purpose is to deal with the international economic policies of the United States as a coherent whole.