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Mr Denny

BALANCE OF PAYMENTS

Three years ago if someone used the term "balance of payments", you would know that he was either an economist specializing in international trade, a banker doing international business, or a central banker such as I am. And the response to use of the term from anyone but one of these would usually be a blank stare and a question, "What's that anyway?" and a conspicuous lack of interest.

Today it is very different. Last Sunday's Minneapolis Tribune had a front page story on the U. S. payments balance figures for the last quarter of 1961. There are lots of speeches and articles on it. The President of the United States refers to the balance of payments quite frequently, and his predecessor called a special news conference on the subject in the late fall of 1960. But even with all this, a lot of people - too many, in fact - neither know much about the balance of payments nor understand that it is very important. I think it is one of the most important economic problems of the day and that it should be of vital interest to all Americans, for every American is affected by the balance of payments and is in position to affect it.

Let's clear away a few technicalities first. The balance of payments problem really is not hard to understand; it's just hard to solve.

Every nation, like an individual, has income and outgo. When it, or its citizens deal with other nations or their citizens, there are payments that flow out and payments that flow in. In any given period, such as a month, a quarter, or a year, the out-payments and the in-payments can be netted to strike a balance. In balance of payments terms, if the balance is negative or a deficit, it is "unfavorable". If it is positive or a surplus, it is "favorable". No nation expects to be in perfect or zero balance at any one time nor all of the time; neither does it expect to, nor can it, run a favorable or unfavorable balance all of the time.

There are a lot of accounts in the balance of payments but I want to group them under four or five headings. The first of these is the trade or merchandise account, the net export or import balance. When we sell goods abroad we receive payments; when we buy abroad we make payments. A favorable trade balance tends to indicate two things - ability to produce more goods than are needed at home and ability to sell them abroad. Obviously competitive costs affect ability to sell abroad or vulnerability to foreign sales either at home or in third markets.

The United States has run a favorable balance on trade account for a long time. It averaged $2.5 billion in the seven years from 1950 through 1956; it was at a high of $6 billion in 1957 because of special circumstances, mainly heavy petroleum sales during the Suez crisis; it was at a low of $1 billion in 1959 when we almost priced outselves out of certain markets and into an unfavorable balance; it was slightly under $5 billion in 1960 and slightly over $5 billion in 1961. In other words, we have done pretty well in competitive foreign trade, but I will have more to say about this later.

Nations also receive and make payments for services and thus there is a service account. For example, payments are made or received via tourists, for shipping and insurance, via returns on investment, via remittances sent or received from abroad. Competitive costs affect this balance also but not as strongly as the trade balance. We do pretty well on service account also. It averages about $1.5 billion in our favor each year and was a bit larger than this in 1961.

Now when we put those two accounts together we get a fairly broad measure of a nation's competitive position in world trade. Given the above figures, it can be seen that we earned net about $6 billion on these accounts in 1960 and about $7 billion in 1961. This, you might say, was our gross profit position.

A third account deals with our military expenditures overseas and our Governmental foreign aid, both loans and grants. Military spending abroad is

just the same as importing; we buy goods and services to support our installations. Why don't we buy these things at home and send them over to the troops? We do, of course, exactly this as far as most military supplies are concerned, but we obviously have to make payments for places we occupy and it makes economic sense to buy some goods on the site rather than pay freight on them. We spend about $3 billion net abroad on overseas military operations.

We spend about that same amount on foreign aid but there is a big difference between these expenditures and military expenditures. Most of our foreign aid dollars, about 80 per cent of them, are used to buy goods and services in the U.S. Thus one reason we have had such a favorable balance on trade account is our foreign aid grants and loans - and I should stress that a lot of the foreign aid is loan rather than grant. For that reason, cutting our foreign aid ~~will~~ would not help our balance of payments problem significantly; it would lead merely to reduced exports from the U. S. and a smaller trade balance.

Taking the military and foreign aid figures together then, we have an adverse balance on this account of about $6 billion. In most years, however, our positive trade and service account balance has been big enough to offset this and still leave us mildly on the plus side. Specifically, in 1960 it left us with $400 million plus and in 1961 with $1.1 billion plus. But in 1959 when we had a bad year in export of goods and services we did not earn enough gross profit from them to pay for more than half our military and aid expense.

The next account is long term capital investment. Whenever American business invests abroad, in a plant or a natural resource, or whenever anyone of us buys a share of stock or a bond of a foreign company, it represents an outpayment of long term funds. We do this, of course, to acquire assets and to get a return, and the return - if it is brought back to the U.S. - shows up in the service account, as I noted earlier. But this long term investment does take funds out of this country and it does affect our current payments balance. In the past decade it has run (net, since there is some investment made in this

country by foreigners) between $1 and $2.5 billion per year. In 1960 it was $1.7 billion, net, in 1961 about $2.3 billion net.

Now I want to group all of these four accounts into one subtotal because that subtotal measures what we call our "basic balance". And here is where we get a shock, for in the past five years our "basic balance" has been in balance only in 1957. Our "basic balance" deficit was $3.5 billion in 1958, $4.4 billion in 1959 (our worst year) $1.9 billion in 1960 and about $1 billion in 1961.

I have just one more account to describe and then we can get to the heart of the balance of payments problem. The last account covers short-term capital movements which reflect mainly financial transactions, loans (nongovernment), short-term investments, transfers of balances, deposit build-ups, and the like. Generally speaking we have run a favorable balance on this account by $100 - $500 million per year. In 1960, however, the balance was unfavorable by almost $2 billion and in 1961 by ~~almost~~ about $1.5 billion.

There are really three reasons for the abrupt change. First and basic is the fact that Western Europe has made great economic advances, that sound fiscal and monetary policies have been followed there, and consequently that a number of European currencies now are strong. Second, is the rate of return available on short-term investment; generally speaking it was higher abroad than in the U. S. in 1960 and 1961. Third, was a strong feeling abroad that the U.S. was not or might not be following sound fiscal and monetary policies, that these might lead to more inflation and that as a consequence the dollar was in danger of devaluation. The heavy movement of short-term capital flows away from the U. S. came in late 1960 and early 1961 and represented in very large measure a confidence crisis and a run ~~of~~ on the dollar. And while the state of confidence has improved a great deal, it is still in a delicate state and needs careful nurturing.

Now here we do come to one of the fairly complicated parts of the balance of payments problem, one which is vital to understand. It is essentially a banking problem and is affected in large measure by confidence. Let me try to explain it to you.

Gold still forms the basic reserve of most currency systems. There is a very simple reason for this; people have confidence in gold and its value stays constant. One ounce of gold is worth $35; our Treasury stands ready to buy gold at that rate and it will convert dollars into gold at that rate for other governments through their central banks. Our government, however, will not convert dollars into gold for private citizens either here or abroad.

When we run an unfavorable balance of payments there are only two ways we can make settlement, either we pay in dollar credits or in gold. When we pay in dollars, in effect we put a kind of mortgage on our gold for these dollar claims if held by central banks can be converted into gold easily, or if held by private holders they can be transferred to central banks and then converted into gold.

During much of the postwar period our settlement took the form mostly of dollar credits but some gold flowed out. On the average, in the seven years from 1950 through 1956 when our payments balance was in deficit by $1.5 billion, settlement was about $1.2 billion in dollar credits and $300 million in gold. Foreigners took some gold because they needed or wanted to build up their basic gold reserves somewhat, and we were glad to have them do so for it built confidence in their currencies. We had a lot of gold and this seven year drain of $2 billion represented less than 10 per cent of our holdings; we held well over half of all the gold in the world outside Russia.

In a very real sense then, foreigners treated the dollar as being "as good as gold". In fact, it was even better than gold for gold earns no return and the dollar balances could be invested to earn income. The dollar thus became what we call a reserve currency. Since it was usable anywhere or

could be converted into gold by central banks it was "as good as gold" for reserve purposes. The presence here of a large scale money market with major loan and investment facilities; the existence of faith in the constant value of the dollar made foreigners not only willing but wanting to keep their reserves in dollars. And aside from holding gold, there was no other large scale currency in which they had confidence. The United States found it both profitable and desirable to be the international banker who provided reserves.

But this whole system is based on confidence. If foreigners believed that the value of the dollar in terms of gold might be changed, they would not hold dollars. Obviously if the price of gold is going to $40, any holder of gold who can will convert dollars into gold at the $35 rate before devaluation simply because he can get more gold for his dollars at that rate.

Furthermore, as other currencies became strong it no longer became necessary to hold earning reserves solely in dollars. The pound, the mark, the lira, and finally the franc became almost "as good as gold" or "as good as dollars". Thus if confidence in the dollar waned, there were other currencies to run to. And in many cases investments denominated in those other currencies were more profitable than those denominated in dollars.

Now this is exactly like a banking operation. You hold bank deposits, some demand for liquidity, some time for return. If you can get better returns on time money elsewhere the tendency is to put it there. And if you lose confidence in your bank you withdraw your funds regardless of the rate of return. In so far as the U. S. is concerned, it can, of course, stop permitting dollars to be converted into gold. But if it did that, it would stop being a world banker and the dollar would cease being a reserve currency. That obviously is not a very good answer to the problem.

Beginning with 1958 we began to lose gold at an alarming rate. In the four years 1958 through 1961 we lost $6 billion. We could afford the loss since

we still have a lot of gold - $17 billion to be precise. But what seemed to be happening was some loss of confidence in the dollar and this was serious. The confidence crisis, as I noted earlier, came in the second half of 1960 and first quarter of 1961. The short term capital outflow from the U. S. ran at better than a $3 billion rate in the last half of 1960 and at better than a $2 billion rate in the first quarter of 1961, in contrast to a normal net inflow to the U.S. of $100 - $500 million, as noted earlier.

Now here we have the banking part of the balance of payments problem. It can be handled by banking means and the means are within our power. Fundamentally we need to maintain confidence in the dollar and we need to keep our short-term rates competitive. There are other technical steps that can be taken to help with this part of the problem such as working out cooperative arrangements with other central banks, making some procedural changes in the International Monetary Fund, and even engaging in foreign currency operations for ourselves. All of these are being done or are in prospect. The real point is that we can do these things, and we can relieve this part of the problem. Short-term capital outflows in the latter part of 1961 were far smaller than in the earlier part. While restoration of confidence was a delicate operation and while our rates are still not completely competitive, we have come a long way.

Finally, I want to return to the other side of the problem - the "basic balance" or the economic part. The distressing thing here is that our problem is worsening rather than improving. Our basic deficit in 1961 was smaller than in 1960 because we had a first half surplus. In the second part of last year, however, the basic deficit was very high, worse than at any time in 1960 and almost as high as in 1958 and 1959. This basic deficit problem is much harder to solve than the banking problem. The steps necessary can be seen but they are very hard to carry out. First we have to stay competitive in foreign trade and even improve our competitive position. This means we must

foster more investment here, improve and enlarge our plant, and make it more productive. It means that we cannot afford wage or price inflation, which incidentally not only affects our competitive position but bears on the confidence factor also. Fundamentally we have to widen the favorable balance between exports and imports of goods and services. This will be hard to achieve; the gap is narrowing rather than widening as our economy goes up and Western Europe's is rising more slowly than it had been.

There is one thing we cannot do successfully to improve our position and that is to raise our trade barriers. On the contrary, we probably will have to give some trade concessions to get some for ourselves. We are much more vulnerable than is Western Europe to a trade barrier conflict.

I said earlier that reduction of our foreign aid program would not help our balance of payments problem because it would be reflected in lessened exports. We can, however, try to "tie" even more of our foreign aid dollars to American purchases and this would help our balance of payments. In similar fashion, while we cannot logically cut down our expenditures abroad for our military installations there, we can try to get countries where these are located to make offsetting purchases here. We have worked out one such deal with the Germans. This will help our basic balance.

Finally, as to long term capital investment abroad, we want to be sure that it produces income which comes back home and we want to foster more investment at home so that it is less attractive to go overseas.

The balance of payments problem is a tough one. We have made some progress toward its solution but not much. It will be with us for some time and probably for the foreseeable future our affairs will be subjected somewhat to the effects of the problem and efforts to correct it.