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TREASURY DEPARTMENT
WASHINGTON

ASSISTANT SECRETARY

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December 11, 1968

MEMORANDUM TO Cabinet Committee on Balance of Payments
Secretary of Defense
Secretary of Commerce
Secretary of Transportation
Under Secretary of State Rostow
Under Secretary of Agriculture Schnittker
Administrator of AID
Special Representative for Trade Negotiations
Director, Bureau of the Budget
Chairman, Council of Economic Advisers
Mr. Edward Fried, White House

Subject: Agenda for Meeting of December 12, 1968, 4:00 p.m., Room 4426, Treasury Department

Attached is a Treasury staff proposed letter to the President from Secretary Fowler, as Committee Chairman, recommending and outlining the 1969 balance of payments program. Basically, this is an expression of the policy outline reviewed at the September meeting. In implementing the policies contained in this letter, some details of the handling of exports under the Federal Reserve guidelines remain to be clarified.

Upon the concurrence of this Committee, it is intended that the letter, following a brief acknowledgment from the President approving the program, will be released to the public next week.

The 1969 Balance of Payments Program and this letter is the only agenda item for the Thursday meeting.

John R. Petty

Attachment

cc: Governor Brimmer
The Honorable E. Goldstein

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THE SECRETARY OF THE TREASURY
WASHINGTON

Dear Mr. President:

Near the end of each year beginning in 1965, your Cabinet Committee on Balance of Payments has submitted a recommended Program to guide and coordinate the many Federal activities relevant to our international balance of payments. This letter report will set forth the recommendations of the Cabinet Committee on Balance of Payments for the 1969 Program. Your approval of this Program should facilitate an effective transition and orderly development of further policies in this important area.

With my colleagues on the Cabinet Committee and the aid of your staff, we have coordinated the execution of the Action Program contained in your Balance of Payments Message to the nation last New Year's Day. A 1968 Progress Report will be separately submitted.

We have also considered together the nature and extent of a program for 1969 if the nation is to build on the progress made in 1968 and achieve a viable and durable equilibrium in our international balance of payments. It is submitted below.

The Cabinet Committee on Balance of Payments has worked with me in preparing the 1969 Program. The following participants join with me in these recommendations:

Secretary of Defense
Secretary of Commerce
Secretary of Transportation
Under Secretary of Agriculture
Under Secretary of State for Political Affairs
Administrator, Agency for International Development
Special Representative for Trade Negotiations
Director, Bureau of the Budget
Chairman, Council of Economic Advisers
Chairman, Federal Reserve System

A few preliminary comments are in order concerning the overall policy framework in which these recommendations are submitted.

Our determination to achieve equilibrium in our international accounts is as vital today as it was on January 1, 1968, the day you announced your Balance of Payments Action Program. The removal of our international payments deficit remains "a national and international responsibility of the highest priority."

The execution to date of the broad and comprehensive Action Program you announced on last New Year's Day has substantially improved our balance of payments situation. A huge deficit in 1967 has been whittled down to near equilibrium in the second and third quarters of this year on the liquidity basis of measure. There is a substantial surplus for the first three quarters on the official settlements basis.

We are pleased that the nation is making substantial progress toward achieving equilibrium in our international balance of payments. But, we cannot be satisfied with the relative composition of its components. Our progress is spotty and some of it may be transitory. It is spotty because two big elements in our current account -- trade and tourism -- are far from satisfactory, and a third -- a reduction in net deficit in government military expenditures in Southeast Asia -- has been difficult to effect up to date because of overriding political and military considerations.

~~Therefore, we must continue our resolve to keep intact those elements of the balance of payments program that are being executed. Equally important, we must press ahead with the implementation next year of the remainder of your Action Program. Portions of that program have not yet been authorized by the Congress or approved by our trading partners where approval is necessary. Other parts have been rendered unfeasible in 1968 by military developments outside the United States.~~

There is reasonable prospect of continuing improvement next year. This assumes that there is no dismantling of the ongoing elements of your Action Program. It also assumes that the initiatives launched in that program to improve our trade surplus and reduce the net deficits in military expenditures abroad and private travel are vigorously pursued. Until these elements of the program are effectively executed, we will not have the durable surplus or the assurance of a long-term equilibrium that will enable us to abandon some of the temporary and less desirable measures we have been forced to employ.

These temporary measures have served us well. They have brought the necessary immediate improvement in our balance of payments and have given renewed confidence in the strength of the United States dollar. These temporary measures, appropriately modified, are needed for some additional period. As the longer term measures instituted last year and in some of the preceding years yield increasingly larger benefits, the restraint achieved by the temporary measures may be phased out.

To complete our task a continued and sustained effort must be pushed forward. This is the quickest and surest route to the strong and viable payments position which will permit us to eliminate those aspects of our program that are not wholly compatible with the free flow of trade and capital movements.

These are the underlying principles on which your Cabinet Committee on Balance of Payments has formulated the 1969 version of the program.

I. <u>A Stable Economy and the Restoration of a Healthy United States Trade Surplus Should be the Primary Objective for 1969</u>.

The keystone of a sound international financial position of the United States and of the dollar is a trade surplus. Without it, the United States cannot do what is natural and desirable for its role in the Free World -- to export capital, to provide its share of the common defense, to give foreign aid, and to have large numbers of its citizens traveling abroad.

Hence, the first order of business in your last New Year's Day Message was for Congress to enact an anti-inflation tax, which, coupled with expenditure controls and appropriate monetary policy, could help stem the inflationary pressures which threatened our economic prosperity, stability and our trade surplus. You also urged labor and management restraints in wage-price decisions and instructed your principal officers in the economic area to work with leaders in business and labor to make effective a voluntary program of wage-price restraint. A similar instruction on preventing our exports from being reduced and our imports increased by crippling work stoppages was prescribed.

Unfortunately, delays in attending to this first order of business in 1968 contributed to a continued instability in the economy and a very substantial decline in our trade surplus. However, the progress that has been made in recent months has laid the foundation for a much better national performance in the area in 1969 and years ahead, _if_ the nation carries through with the program now in progress.

The Revenue and Expenditure Control Act, finally enacted in late June, has locked Federal finances into the appropriate posture through June 30, 1969.

The Congress and the President must decide in the months ahead on fiscal policy for the period beginning July 1, 1969. This policy will require decisions on expenditures and taxes necessary to provide that degree of fiscal restraint which is a fundamental element in an adequate follow-through in the on-going process of disinflation, restoration of our competitive edge, and provision of a healthy trade surplus. This fiscal policy, coupled with appropriate monetary policy by the Federal Reserve Board, will make possible the avoidance of excessive growth with its excess of demand that has contributed to the decline in our trade surplus. It will also restore our competitive edge by arresting inflation and enabling the economy to move back toward reasonable price stability, given accompanying voluntary restraint in wage-price decisions.

The Cabinet Committee on Price Stability, after extended study and consultation with business and labor leaders including, particularly, the President's Labor-Management Advisory Committee, is submitting recommendations with respect to a more lasting and effective effort on the wage-price front.

Although 1968 witnessed the settlement of the work stoppage in copper and the avoidance of a work stoppage in steel, there is an impending threat of a work stoppage on the docks that is pointed at the very throat of our international trade. This work stoppage has been held off since October 1 only by an injunction. It focuses renewed attention on the need for a better method of assuring compatibility between free collective bargaining and the protection of our national interest in maintaining the strength of the dollar.

2. Negotiations Initiated and Pursued in 1968 to Assure Fairness to U.S. Trade in World Markets Should Culminate in 1969 in Cooperative Action Among Our Trading Partners and Appropriate Legislative and Administrative Action.

Action in 1969 to further reduce non-tariff barriers and to achieve appropriate changes in the GATT rules on border tax adjustments must be achieved. International trading rules and practices are established through multilateral consent and negotiated in the multilateral forum of the General Agreements on Tariff and Trade. In early 1968 U.S. representatives inaugurated a determined effort to eliminate non-tariff barriers, negotiate improvements in the trading rules and minimize the disadvantages to our trade which arise from differences in the application of national tax systems to exports and imports.

In the GATT Working Party on Non-Tariff Barriers a catalogue of restrictions has been developed and the Working Party is now turning to the task of removing these restrictions. We must be realistic in our objectives and recognize that they will not all disappear overnight. On the other hand we cannot be satisfied without real progress early next year -- progress which would begin to do away in a substantial manner with these non-tariff barriers. In these negotiations we must bear in mind Section 252 of the Trade Expansion Act of 1962 which points out that the U.S. cannot compensate with trade concessions the removal by others of illegal non-tariff barriers.

The GATT Working Party on Border Taxes has two tasks, both of which must be achieved in the early part of 1969. We have clearly seen the structural disadvantage to the U.S., and to other predominantly direct tax countries, which arises from the border tax adjustment system as presently permitted under the GATT rules. The lack of an overall limitation on border tax adjustments, the proliferation of the practice, and the unequal treatment prejudicial against one tax system as opposed to another are features of the GATT rules which must be improved.

The U.S. has also raised at the GATT Working Party the issue of the provisions in the GATT rules which pertain to the process by which international payments imbalances are adjusted. Under Article XII of the GATT, countries suffering temporary balance of payments difficulties may introduce such short-term trade restricting practices as quotas.

We have seen in the month of November two countries employ other measures which also facilitate the adjustment of their balance of payments position. Through the manipulation of border tax adjustments both France and Germany are endeavoring to influence their trade account in a manner conducive to better overall payments equilibrium. This course of action was chosen as an alternative to a change in parity -- an action which would have a permanent effect on trade. This experience should be examined to consider its lasting implications on the process by which a nation's international payments are brought into balance.

3. The Department of Commerce and AID should Continue On An Intensified Basis the Effort to Expand Commercial Exports in Conjunction With Foreign Assistance to Assure Additionality and Minimize Substitutions.

Our efforts to minimize the balance of payments cost of bilateral economic assistance have been successful in keeping these costs to a minimum. The principles by which this is done are established. The implementation of these principles has now been under way for some time; and the regular, vigilant administration of these methods is what is required and is what we are receiving.

One of the most important byproducts of economic assistance, is the trading benefits arising from the development and growth of viable economies abroad. We trade and prosper together. Our tied bilateral economic assistance has the effect of facilitating the introduction of American goods and services to these foreign markets. In areas far distant from here, where individuals purchase capital goods, sometime once in a lifetime, whether it is a motor or a pump or a drilling gear, through concentrating on the transfer of real resources we automatically introduce the product names of our factories to foreign buyers.

In 1969 and the years that follow, we must concentrate further upon having industry follow up these delivered and working "calling cards." Salesmen must search out additional or follow-on sales, sales of accessories, sales of replacements, sales of the next stage of a company's family of products. Led by industry -- but assisted, if need be, by government -- we must expand upon the export opportunity created by our economic assistance. This should be the subject of a sustained positive program helpful to the U.S. as it will be to those who receive our aid.

The Commerce Department has cooperated closely with AID in seeking ways to maximize U.S. commercial exports through the foreign assistance program. In the area of publicity, Commerce provides information on AID business opportunities through a variety of m-dia such as International Commerce and Quarterly Summary of Future Construction Abroad.

In addition to information available through these publications, Commerce provides information on AID export opportunities and guidance on the procedures for selling under the AID programs directly to American businessmen through personal contacts. The Commerce Department also puts together annual U.S. trade and investment programs for approximately 60 countries of main commercial interest in the world. Specific informational, promotional, and policy activities to be carried out in support of the program objectives are delineated. For countries with AID missions, the AID operations generally constitute an important factor in achieving progress toward the investment program objectives. Additionally, the Department of Commerce through its trade programs, commercial exhibits, and trade missions actively assists the U.S. exporter.

All of these efforts have been helpful to date, and they will have to be reinforced. The recent recommendations of the National Export Expansion Committee provide suggestions of reinforcements. These will have to be considered.

4. <u>Consistent with our Security Commitments, the Nation in 1969 Should Continue to Minimize its Net Military Deficit by Neutralizing these Expenditures through Cooperative Action by our Allies and Reducing Them Whenever Conditions Permit.</u>

We should stand by the principles which we enunciated in the January 1 program:

"We cannot forego our essential commitments abroad, on which America's security and survival depend.

"Nevertheless, we must take every step to reduce their impact on our balance of payments without endangering our security."

As we look at our over-all balance of payments position and prospects, it remains a key concept that the foreign exchange drain from U.S. defense expenditures outside our borders for mutual security is an extraordinary item in the balance of payments. It should be met by special governmental action--it does not result from normal economic developments; nor is it subject to normal economic management through fiscal, monetary and incomes policies.

We need to maintain existing programs and constantly seek new ways to reduce our defense expenditures abroad. The types of actions by the Defense Department to reduce net foreign exchange costs from 1961-1967, as described in Tab B of the Treasury Department Report, January 1968, and in the separate Progress Report for 1968, must be constantly pursued. ~~There is some probability of achieving substantial reductions in the net drain of military expenditures in the Far East during the coming year.~~

We welcome the extensive cooperation from friendly countries in NATO and in other parts of the world during 1968 to minimize our military foreign exchange costs through:

-- purchase in the U.S. of their defense needs, and

-- investments in long-term U.S. securities.

In 1969 we will want to continue this cooperation and conclude new arrangements, with particular emphasis on NATO Europe. In the coming year, we will want to build on past experience in ways which:

-- proceed from the NATO recognition of the principle that the solidarity of the Alliance can be strengthened by cooperation between members to alleviate burdens arising from balance of payments deficits resulting specifically from military expenditures for the collective defense.

-- increase the emphasis on purchases in the U.S. to meet country needs for the improvements NATO has recently called for in country forces, and

-- reduce reliance on investments in long-term U.S. securities as a means for dealing with our foreign exchange costs resulting from defense expenditures outside our borders.

In other parts of the world, we should give particular attention to the Far East. Military expenditures related to Viet Nam and the prospective longer-term security situation in the region may be expected to continue a heavy drain on U. S. foreign exchange. We will be looking to countries in the region to continue and expand their cooperation with us to deal with this problem on a continuing basis. Active negotiations to this end of both a bilateral and multilateral character should be a continuing responsibility of the Secretaries of State, Treasury and Defense.

Of course, the principal opportunity to achieve actual reductions in our gross defense expenditures abroad, without damage to our long-term mutual security interests, are most likely to occur in connection with progress in the negotiations looking to a peaceful settlement of the conflict in Southeast Asia.

Even before our substantial involvement in military operations in Viet Nam in 1965, U.S. military expenditures in the Far East were substantial. The direct foreign exchange costs of these expenditures averaged about $700 million per year before 1965. They have been running approximately $1.5 billion <u>higher</u> in the last year or two.

This heavy direct loss of dollars to and through East Asia must be regarded as unacceptable when the fighting stops.

Therefore, a high priority must be given to the problem of neutralizing to the maximum extent the balance of payments cost of our security forces in East Asia while the fighting continues, and reducing the gross cost when the fighting diminishes or ceases.

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5. <u>The Mandatory and Temporary Foreign Direct Investment Program, as Announced in Modified Form by the Secretary of Commerce on November 15, Should Be Maintained.</u>

The mandatory direct investment control program for 1968 has not interrupted the high, indeed, unprecedented, level of total American investment abroad. It has had the intended effect of reducing capital outflows from this country by increasing the use of funds borrowed overseas for direct investment by U.S. affiliated enterprises.

Our base for future earnings continues to increase and the present balance of payments costs are maintained within tolerable limits. The private sector has for the most part understood this. The best way to keep the program temporary is to press ahead vigorously on all features of the balance of payments front.

There is little disagreement that this program should be temporary and terminated as soon as possible. It is the view of your Cabinet Committee that it is not possible to terminate the program in 1969 without running a grave risk that our progress toward balance of payments equilibrium would be reversed and a heavy deficit become a likely prospect. As earlier stated in the principles governing the formulation of the 1969 program, until the nation has a durable surplus or the assurance of long-term equilibrium, it would be unwise to abandon some of the temporary and less desirable measures that it has been forced to employ.

This has a special relevance to the Foreign Direct Investment Program as the following observations underscore:

First, overseas investments by American business (excluding Canada which is exempt from the direct investment program) are projected to increase again in 1969, with plant and equipment expenditures reaching close to $8 billion -- up from an estimated $7.5 billion this year, and up from $4.6 billion in 1964, the last year before the introduction of the voluntary program.

Second, in order to hold the balance of payments impact of such investment in 1968 to the $2.6 billion targeted by the President last January, it may be necessary for American business to utilize between $2 and $2.5 billion of the proceeds of foreign borrowing in addition to foreign borrowing for day-to-day working capital requirements. To meet the new target for foreign direct investment of $2.9 billion in 1969, we project it may be necessary for business to utilize another $2 to $2.5 billion in foreign borrowing next year.

Third, growing restraint upon capital flows from the United States since the start of the voluntary program in February 1965 has resulted in a substantial, and to some extent abnormal level of foreign debt, as compared to what it might otherwise have been. We don't have any precise way to measure its size, but it surely will exceed $5 billion by the end of this year, perhaps by a considerable amount.

Fourth, during the past four years, in cooperation with the capital programs, many U.S. companies have decreased their overseas liquidities through the reduction of intercompany accounts and the repatriation of earnings, and, as a result, are more active, albeit reluctant, borrowers for working capital purposes.

All of this suggests that termination of capital controls in 1969 could result in a sharp increase in direct investment outflow -- it is difficult to estimate the precise amount, but it could be as much as $3.0 - $4.0 billion. The situation and outlook for 1969 does not permit a risk of that much additional exposure to progress on our balance of payments.

Basically, the 1969 Foreign Direct Investment Program will follow closely the format of this year's program. However, some additional leeway is needed (a) to provide additional flexibility for companies with limited or no overseas investment experience; (b) to make the Regulations more responsive to those companies whose investment quotas are unrealistically low in relation to the return flow of earnings from their direct investments; (c) to assure that the program does not unnecessarily inhibit the growth of intercompany exports of American goods and services to foreign affiliates; and (d) to enable the Office of Foreign Direct Investments to be more responsive to special industry problems and some of the inequities in the Regulations which have become apparent during 1968.

We recognize that just to maintain their existing overseas operations on a sound basis, companies must have the capability to retain abroad a certain percentage of their foreign earnings. Furthermore, retention of a portion of foreign earnings will be necessary to insure an orderly retirement of the growing debt being contracted abroad. We therefore recommended that the target level of direct investment be increased to insure that every company has in 1969 an investment quota of at least 20% of its 1968 earnings from foreign direct investment.

Some adjustment in the target was also necessary to assure that as much direct investment as possible takes the form of exports of goods and services by U.S. companies to their foreign affiliates rather than cash transfers to foreign affiliates.

Further adjustments in the target were needed to make the Program more responsive to hardships arising from the application of the Regulations to special industries such as the international construction and transportation industries, whose operations and accounting procedures do not dovetail with the Regulations; to provide relief for companies whose ability to meet the repatriation requirements of the Regulations is restricted by law or lack of control, and to provide companies with no or limited prior overseas investment experience with a somewhat higher level of permitted direct investment.

Finally, to enable companies to plan ahead and to insure that investment projects with important future balance of payments potential are not discouraged, the Office of Foreign Direct Investments evolved its incremental earnings formula under which additional direct investment in future years is authorized based upon future incremental earnings.

looks as if [illegible] [illegible] want to help future employers

6. <u>The Federal Reserve Voluntary Foreign Credit Restraint Program Should Be Maintained, but Modified to Further Encourage the Promotion and Financing of Exports by the Commercial Banking System.</u>

The Federal Reserve program has required a great deal of U. S. financial institutions and they have responded well. Since 1964, U. S. commercial banks have not increased the volume of U. S. credits to foreign borrowers, even though all other aspects of the foreign banking business have grown substantially. In their international operation, U. S. banks have had to meet the demands of clients for foreign loans within their voluntary ceilings and through the extensive use of resources in foreign branches.

The prospects for 1969 do not permit any basic change in the need for continued restraint on foreign lending of banks and other financial institutions. Nevertheless, as in the case of the foreign direct investment program, it is important that we make adjustments which contribute more to the long-run positive factors in our balance of payments. For the commercial bank program, therefore, we propose adjustments to encourage further the financing of exports.

Since 1964, annual exports from the U. S. have increased by about 32 percent. Financing to support the growth in exports has become available as banks have changed the composition of their portfolios of foreign credits in response to the voluntary program and to a lesser extent, by the use of funds in foreign branches and the expansion of the Exim-bank's direct lending.

In their efforts to encourage manufacturers to stimulate their exports, banks should not be pressed to their guideline limits, less they be inhibited from actively soliciting export credits. The banking industry has, over time, helped many U. S. manufacturers to find new markets for their goods abroad. We must not lose this constructive effort with all its long-run benefits to the balance of payments. With continued balance-of-payments restraints in 1969, we should accentuate those elements which fortify our long-range balance-of-payments position. There is no doubt that export financing is an important part of export promotion, and it is in this area that we are recommending adjustments in the 1969 program.

7. <u>The Interest Equalization Tax which expires July 31, 1969 should be extended with the existing authority to vary the rate from 1-1/2 percent down to zero depending on circumstances.</u>

The size and efficiency of the American capital market necessitated the Interest Equalization Tax in 1963. This tax has served greatly to facilitate the expansion of the European capital market and to develop additional techniques for employing savings around the world in productive investments. Through preserving an exemption for lesser developed countries, the access necessary for development assistance is preserved. In 1967, Congress granted the President certain discretionary authority in order that the purpose of the legislation--which is to limit but not prevent access to the capital market from developed countries--is best served.

In 1969, this legislation will need to be extended. In order that we have available a method for phasing out this tax, the existing authority to vary the rate of the tax from zero to 1-1/2 percent per annum should be retained.

8. <u>A Five-Year Program for Narrowing the Travel Deficit through Promotion of Foreign Travel in the United States by Both Public and Private Action Should be Recommended for Action by Congress in 1969.</u>

As has been pointed out repeatedly to the public and to the appropriate committees of Congress, the trend of the contribution of travel to and from the United States to our balance of payments deficit is such that the United States can not continue to ignore the problem.

It was for this reason that in your New Year's Day Message last January you sought to reduce the 1967 travel deficit in excess of $2 billion by voluntary action. If the Nation is to avoid that tourist deficit from continuing to mount at a pace that would exceed $4 billion by 1975 (as United States disposable income and the portion of it spent on foreign travel increases, and the new airplanes with larger capacities and greater speeds bring lower fares), the Nation must begin to implement <u>now</u> a comprehensive long-term program to rapidly increase foreign travel to this country.

Your special Travel Task Force, formed in 1967, has provided excellent blue prints not only for the immediate measures already taken in 1968 but for the longer term future.

Congress has had before it specific legislation to provide a special fund by which these blue prints can be turned into a viable program. It is important that early in the coming year, the new Congress address itself to a disposition of this proposal.

Under this proposal, the President would be authorized to utilize up to $30 million a year for five years to promote increased foreign travel to the United States.

Although final figures are not yet available, we must anticipate a continued large travel deficit in 1968. It would have been larger but for the many excellent remedial measures recommended by your Special Task Force and carried out voluntarily by the private sector.

The best way to provide regular and adequate financing for the Task Force program is by early congressional action to eliminate the exemption of international flights from the long existing 5% tax on airline tickets and dedicate a proportion of the proceeds to a Special Fund to be used and expended during the fiscal years 1970-74, inclusive, in such amount and under such rules and regulations as the President may prescribe in encouraging foreign travel to and within the United States.

We must not allow an increased tourist deficit to jeopardize progress in other areas of the balance of payments and necessitate the maintenance of temporary restrictive measures on capital flows or handicap the United States in discharging its national security commitments outside the United States.

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The Cabinet Committee on Balance of Payments has reviewed these programs and policies which are so vital to maintain the strength of the United States dollar. We

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recommend their adoption to continue the very real gains achieved from the Action Program you announced on New Year's Day. In the year ahead, these policies will help to preserve these gains and their contribution to a strong free world economy.

Faithfully yours,

Henry H. Fowler

The President

The White House