TALKING PAPER ON

THE U.S. BALANCE OF PAYMENTS PROBLEM

FOR

CHAIRMAN MARTIN'S REMARKS ON THIS SUBJECT

TO

THE CONFERENCE OF GOVERNORS OF THE CENTRAL BANKS

OF THE AMERICAN CONTINENT

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The U.S. Balance-of-Payments Problem

The United States has been wrestling for more than 8 years with a balance-of-payments problem. The problem has proved to be persistent and difficult. But we made further progress in dealing with it last year, and have cut our payments deficit to a rate of roughly $1-1/2 billion a year compared with about $3-1/2 billion in 1960.

Before I report on recent developments, it may be helpful to review very briefly the nature of the problem and the kinds of policies we have adopted to deal with it.

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Nature of the problem

The main symptoms of the U.S. payments problem have been a persistent decline in our reserve assets and a persistent increase in those U.S. liabilities that represent the reserve assets of other countries. In the last 8 years, our reserves have declined by $9-1/2 billion, or nearly 40 per cent, while our liabilities to foreign central banks and governments have increased by nearly $8 billion. Thus, there has been a deterioration in our net reserve position of $17 billion. To be sure, we have added more than that to our long-term assets abroad--direct investments, securities, and loans. But those assets are not readily available to prevent reserve drains. The problem has been to stop this deterioration in the reserve position.

More fundamentally, the United States needs to transfer to other countries the full equivalent in goods and services of the sums that its residents and its Government have been prepared to transfer in

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financial terms. There is no doubt that a large and wealthy country ought to be making substantial private and public transfers to the rest of the world, as we have been doing. But for these flows to be useful in the long run, there must be transfers of real resources, not transfers of gold and liquid claims.

The problem is one of competitiveness in its broadest sense. Somehow we must make it a shade less attractive for U.S. residents to lend and invest abroad and to make purchases abroad, and a shade more attractive for foreigners to make purchases in or invest in the United States. The marginal adjustments needed are very small compared with total U.S. output or total international transactions. But they are crucial, since we cannot afford to draw down our gold stock without limit.

Policy considerations

The choice of appropriate policies for grappling with the payments problem has been conditioned by the special circumstances of the United States and by some general principles that seem to us important. Broadly speaking, we have sought expansive rather than restrictive solutions, and have preferred to work through market adjustments rather than direct controls, to seek gradual rather than abrupt adjustments, and to choose those policies that would improve the payments position with least interference with other national objectives.

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These principles can be illustrated by listing some policy options that we have not chosen:

(1) We have not imposed any form of exchange control on capital flows.

(2) We have not restricted imports of goods and services.

(3) We have not considered devaluation; the key role of the United States and the dollar in world trade and finance would make that disruptive rather than constructive.

(4) We have not cut back our foreign aid programs or military commitments, because those represented important objectives in their own right.

On the positive side:

(1) We have tried to promote exports.

(2) We have changed the policy "mix," using fiscal policy to stimulate domestic investment and reduce unemployment while letting monetary policy exert some restraint on capital outflows.

(3) We have sought--and often received--the cooperation of the major surplus countries in reducing their import barriers, improving their capital markets, and sharing military and foreign aid burdens.

(4) Most importantly, we have been more successful in avoiding inflation than many other countries have been, and we have thereby gradually improved our relative cost-price position.

We have also resorted, on an interim basis, to some policy measures that we do not particularly like, but that seem to us less harmful than any alternatives. These include:

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(1) Tying foreign aid and military disbursements to procurement in the United States;

(2) Application of an Interest Equalization Tax to loans and portfolio investments in developed countries.

(3) Voluntary programs to restrain outflows of capital to developed countries.

All these strands of policy together are intended to achieve a gradual adjustment toward equilibrium in U.S. international transactions. The adjustment has come more slowly than we hoped and expected. But still it has come, although it is by no means yet complete.

Progress during 1965

There was a substantial improvement in the U.S. payments position last year, as a sharp cut in outflows of U.S. private capital more than offset a decline in the current account surplus. The payments deficit on the liquidity basis--measured by changes in U.S. reserves and in liquid liabilities to all foreigners--dropped to $1.3 billion from $2.8 billion the year before.

An alternative measure of the deficit--on the basis of official reserve transactions--declined very little, and was also $1.3 billion. But this second measure had declined significantly the year before, when the liquidity deficit did not change. The main item treated differently in the two calculations is U.S. liabilities to foreign commercial banks. The two measures of the deficit behaved differently chiefly because those liabilities increased very sharply in

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1964 when the sterling crisis led private foreigners to shift funds from sterling into dollars, thus reducing the dollar gains of central banks. Over the two-year interval from 1963 to 1965, there was a clear improvement on both calculations of the deficit.

Total outflows of U.S. private capital were cut from a record $6-1/2 billion in 1964 to $3-1/2 billion in 1965. Outflows of bank credit dropped almost to zero, from more than $2 billion. And U.S. businesses other than banks repatriated most of the liquid funds they had placed abroad during the previous year; this swing from outflow to reflow amounted to more than $1 billion. Both these sharp changes came mainly in response to official requests for voluntary restraint on the extension of credits to foreigners, under the President's program to improve the balance of payments announced in February. But the cut in bank lending was also in part a natural reaction to the earlier record outflow, some of which had been anticipatory; and the restraint program was reinforced by the gradual tightening of domestic credit conditions during the course of the year.

Direct investments by U.S. corporations in their foreign branches and subsidiaries increased sharply from 1964 to 1965, but this flow tapered off during the course of the year. Other U.S. capital outflows, mainly into Canadian securities, changed little.

The large improvement on capital account was partly offset by a decline in the surplus on goods and services. Merchandise imports increased 16 per cent as the domestic economy expanded rapidly and reached very high levels of capacity utilization. Merchandise exports

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increased only 4 per cent as demand faltered early in the year in a few industrial countries and also in a number of nonindustrial countries. There was, as usual, an increase in net receipts of income from foreign investments. But even so, the balance on all goods and services narrowed by $1-1/2 billion.

During the early months of 1966, the over-all payments position has not changed significantly. There have been large reflows of bank credit, as a result of strong domestic credit demands and a firming of monetary policy. On the other hand, there has been a bulge in U.S. purchases of new Canadian securities, the issuance of which had been postponed from the latter part of 1965. Also, there has been some deterioration--temporary, we hope--in the merchandise trade balance.

Assessment of longer trends

Since mid-1965, the payments deficit on either basis of calculation has been running at an annual rate of about $1-1/2 billion. And that figure provides a fair indication of the magnitude of the problem we still face. While a number of special factors have held the deficit down during the past 9 months, notably the voluntary restraint programs, which are intended to be temporary, other special factors have added to the deficit in this period, including sales by the British Treasury of U.S. corporate securities for conversion into liquid assets, a U.K. waiver of scheduled debt service payments, and a bulge in U.S. steel imports associated with anticipation of a possible strike. These two sets of special factors roughly cancel out.

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The present deficit of roughly $1-1/2 billion a year compares with a deficit twice that size in 1960. Clearly the present position is much less uncomfortable than that of 5 years ago. What are the underlying tendencies that have brought this improvement during a period when rapid expansion of the U.S. economy might have been expected to work the other way?

The main one has been the change in relative prices and costs. No precise measurement of this change is possible, but consumer price indexes provide a rough guide. From 1960 to 1965, the U.S. consumer price index increased by only 7 per cent, whereas the indexes of most other leading industrial countries increased by 20 per cent or more. Differential price movements of this kind do not get promptly reflected in export prices, since exporters in the countries with rising cost levels shade their prices to meet the competition. But costs do get reflected ultimately, not only in prices but in changing incentives to seek export markets. Changes of this sort must have been an important reason why the U.S. merchandise trade surplus has trended upward during the early 1960's despite a more rapid rate of growth in the U.S. economy than in most other countries.

There is nothing automatic about these price-cost adjustments, nothing inherent in the system that insures that there will be more inflation in surplus countries than in deficit countries. But so long as other leading countries continue to experience inflationary pressures, avoidance of inflation in the United States does, as a practical matter,

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provide an important avenue of international adjustment. The importance of keeping this avenue open--as we are determined to do--has lent urgency to the current debate in the United States about the appropriate means of curbing inflation.

A second tendency toward adjustment of the U.S. international position comes from the fairly steady increase in U.S. income from foreign investments. Increasing investment income is related to an increasing outflow of capital. But with both flows large, a slight moderation in the long-run upward trend of capital outflows permits investment income receipts to pull ahead. We can hope for that kind of change in trend, particularly vis-a-vis Europe, as European capital markets improve and as the post-convertibility surge of U.S. investment in Europe ultimately tapers off.

It is not tapering off yet, however. And because it is important for the United States to make further progress towards payments equilibrium soon, the voluntary foreign credit restraint programs have been extended into 1966 and guidelines for direct investment in developed countries have been tightened. Corporations are not asked to slow down the expansion of their foreign operations, but under the guidelines more of that expansion will have to be, and is being, financed with funds raised abroad.

Even full compliance with the voluntary programs will by no means insure a further reduction in the U.S. payments deficit this year. Increasing military expenditures abroad will be working in the other

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direction. And the crucial element in the short run, as in the longer run, will be our success in restraining domestic inflationary pressures. At present high levels of capacity operation, excess domestic demand could increase imports very rapidly indeed.

Hence, effective restraint of inflation is the main theme of U.S. economic policy this year from all points of view--external as well as internal, long-run as well as short-run.

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U.S. Balance of Payments, 1960-65
(In billions of dollars)

	1960	1961	1962	1963	1964	1965p
Exports of goods and services 1/	27.2	28.6	30.3	32.4	37.0	39.1
Merchandise, ex. military	19.5	19.9	20.6	22.1	25.3	26.3
Military sales	.3	.4	.7	.7	.8	.8
Investment income receipts	3.4	3.9	4.4	4.7	5.5	6.1
Other services	4.1	4.3	4.6	5.0	5.5	5.9
Imports of goods and services	-23.2	-22.9	-25.1	-26.4	-28.5	-32.0
Merchandise, ex. military	-14.7	-14.5	-16.2	-17.0	-18.6	-21.5
Military expenditures	-3.0	-3.0	-3.1	-2.9	-2.8	-2.8
Investment income payments	-1.0	-.9	-1.1	-1.3	-1.4	-1.6
Other services	-4.4	-4.5	-4.8	-5.2	-5.6	-6.0
Balance on goods and services 1/	4.1	5.6	5.1	5.9	8.6	7.1
Remittances and pensions, net	-.7	-.7	-.7	-.8	-.8	-1.0
U.S. Govt. grants and capital flow, net 2/	-2.8	-2.8	-3.0	-3.6	-3.6	-3.4
Outflows	-3.4	-4.1	-4.3	-4.6	-4.3	-4.3
Repayments	.6	1.3	1.3	1.0	.7	.9
U.S. private capital flow, net	-3.9	-4.2	-3.4	-4.5	-6.5	-3.5
Direct investments	-1.7	-1.6	-1.7	-2.0	-2.4	-3.3
Foreign securities	-.7	-.8	-1.0	-1.1	-.7	-.7
Other reported by banks	-1.2	-1.3	-.5	-1.5	-2.5	.1
Other	-.4	-.6	-.4	.2	-.9	.4
Foreign capital flow, net (I) 3/ (total ex. changes in liquid assets in U.S.)	.6	.6	.6	.7	.7	.2
Foreign capital flow, net (II) 3/ (total ex. changes in U.S. assets of foreign official agencies)	.8	1.7	.9	1.3	2.1	.2
Errors and omissions, net	-1.0	-1.0	-1.2	-.4	-1.2	-.7
Balance on liquidity basis 3/ (including foreign capital I above)	-3.7	-2.4	-2.7	-2.7	-2.8	-1.3
Balance on basis of official reserve transactions 3/ (including foreign capital II above)	-3.4	-1.3	-2.4	-2.1	-1.3	-1.3

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1/ Excludes military transfers under grants.
2/ Excludes military grants.
3/ Includes some revisions not yet published.

Note: Details do not always add to totals because of rounding

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