BALANCE OF PAYMENTS ADJUSTMENT POLICIES

As countries grow at different rates and in different ways, payments imbalances are bound to arise. The adjustment policies of each country will directly affect not only its payments balance but its own internal economic performance and the payments balances of other countries. Therefore, payments adjustment should be pursued in ways compatible with each country's major domestic objectives and with the broad interests of the entire international community.

REPORT ON THE ADJUSTMENT PROCESS

During 1966, important progress was made toward developing a greater international consensus on policies best suited for adjusting payments imbalances. A report by Working Party 3 of the OECD, prepared by representatives of the ten major industrial countries, carefully explored the nature of the adjustment process and pointed to various possibilities for improving it.

The report recommended various ways of strengthening national policy instruments and outlined a set of informal guidelines regarding appropriate adjustment policies. In addition, it suggested a number of steps to improve adjustment procedures through greater international cooperation, including collective reviews of countries' balance of payments aims; the setting up of an "early warning" system for prompter identification and better diagnosis of payments imbalances; and the strengthening of international consultations with respect to the sharing of responsibilities for adjustment. These suggestions stemmed from the report's major conclusions, which included the following:

First, countries need to formulate their balance of payments aims more clearly and base their individual and joint policies on aims that are mutually consistent as well as desirable from the viewpoint of a healthy world economy.

Second, responsibility for adjustment must fall on both surplus and deficit countries.

Third, countries need to have available and make use of a wider range of policy instruments—both general and selective—and to tailor such instruments more finely to the requirements of different circumstances and multiple policy goals. There is particular need in many cases to place greater reliance on fiscal policies, and less on monetary policies, in achieving internal economic balance, because of the important international ramifications of changes in monetary policy.

Fourth, the proper combination of policy instruments depends on the situations encountered and the particular characteristics of the country concerned. No single policy prescription is appropriate in all cases.

Fifth, countries must take continuous account of the impact of their actions on other countries. A special need for international consultation exists in the field of monetary policy to avoid inappropriate levels of interest rates.

U.S. ADJUSTMENT POLICIES

The strategy adopted by the United States to improve its international payments position can be viewed in the light of the adjustment principles outlined by Working Party 3. U.S. policy has been designed to minimize interference with basic domestic and international objectives of this Nation and with the healthy development of the world economy.

Monetary and fiscal policies were used in 1966 to restrain demand in the light of both domestic and balance of payments considerations. The United States has continued to pursue a liberal trade policy. It has maintained its flow of economic assistance to the less developed countries. Direct interference with international transactions has been essentially limited to Government transactions and restraints on the outflow of capital to the developed countries of the world.

Policy on Goods and Services

Resort to controls over private international transactions in goods and services has been avoided as harmful to both the United States and the world economy. The long and steady progress toward trade liberalization could well be reversed by even "temporary" restrictions, which could threaten to become permanent shelters of protection for economic interest groups. Thus, U.S. actions to deal with the balance of payments problem have maintained the trend toward trade liberalization in which the United States has taken strong and consistent leadership since 1934.

On the other hand, vigorous action has been taken to minimize the foreign exchange costs of U.S. Government programs. There is no precedent for the economic and military assistance extended to foreign countries and the military expenditures made abroad by the U.S. Government since World War II. The acceptance of these responsibilities has involved a major balance of payments drain.

U.S. nonmilitary foreign aid programs—which, net of loan repayments, currently amount to $3.6 billion a year—now have only a limited net balance of payments impact. This has been achieved by tying aid so far as feasible to purchases of U.S. goods and services. Although tying is already broadly applied and probably cannot be usefully extended in any major degree, continuing effort is required to assure the effectiveness of the techniques employed.

U.S. offshore military expenditures have been substantial during the entire postwar period, reflecting national security requirements and commitments to allies in an unsettled world. The impact of these expenditures on the U.S. balance of payments was reduced from a 1958 high of $3.4 billion to less than $2.9 billion in 1965; the Vietnam war caused a sharp increase, to $3.6 billion, in 1966 (first three quarters at annual rate). At the same time, deliveries of military equipment sold to foreign countries rose from about $300 million a year in 1960 to about $1.1 billion for the full year 1966.

The foreign exchange costs of the security program, even excluding Vietnam, remain high. The United States is prepared to play its full part in supplying the necessary real resources for the common defense. But it seems reasonable to expect those allied countries whose payments positions benefit from U.S. expenditures for the common defense to adopt measures to neutralize their "windfall" foreign exchange gains—especially when their reserve positions are strong. This could be done in many ways. Specific arrangements could be worked out within the framework of the alliance itself. Such arrangements could relieve strategic planning from balance of payments constraints which, in the extreme, could jeopardize our national security and that of our allies.

Policy on Capital Flows

Over the years, the outflow of U.S. capital has made a major contribution to world economic growth. By providing capital to areas where it is relatively scarce, U.S. foreign investment raises foreign incomes and often leads to a more efficient use of world capital resources. U.S. direct investment has provided a vehicle for the spread of advanced technology and management skills. U.S. foreign investment also has yielded handsome returns to American investors and substantial investment income receipts for the balance of payments.

Despite the advantages of U.S. foreign investment both to the recipient countries and to the United States, it can—like every good thing—be overdone. And it was being overdone in the early 1960's. Just as a person must weigh and balance opportunities for investment that will be highly profitable in the future against his current wants, so must a nation weigh the benefits of future foreign exchange income against current requirements. The costs of adjusting other elements in the balance of payments may be greater than the costs of sacrificing future investment income.

It is often true that U.S. investment abroad generates not only a flow of investment income but also additional U.S. exports. From a balance of payments standpoint, this is an additional dividend. Yet it is also true, in some cases, that U.S. plants abroad supply markets that would otherwise have been supplied from the United States, with a consequent adverse direct effect on U.S. exports.

It is sometimes held that the international flow of capital occurs always and automatically in just the economically "correct" amount, and that any effort to affect this flow through government measures constitutes a subtraction from the economic welfare of the country of origin, the country of receipt, and the entire world community. Such a position cannot be sustained.

While much of the large flow of U.S. capital to the developed countries is no doubt a response to a shortage of real capital there relative to the United States, the flow is also influenced by many other factors. These may include

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cyclical differences in capacity utilization, differences in monetary conditions and financial structure, speculation on exchange rates, tax advantages, and opportunities for tax evasion—none of which necessarily leads to a more rational pattern of international investment.

High prospective returns on investment in a particular country may reflect a particular choice of policies in the recipient country that is quite unrelated to any underlying shortage of capital. If a country chooses to channel the bulk of its private saving into low productivity uses, if it employs a tight monetary policy, if it limits access of its own nationals to its capital market, it will attract foreign capital. Restraint on such capital flows may therefore merely mean that more of the adverse effect of such domestic policies on economic growth will rest—as perhaps it should—on the country that made the policy choice.

Trade restrictions may also lead to a flow of capital that would not otherwise take place. U.S. investment in the EEC has, at least in part, been induced by the desire to get within the tariff walls erected around a large and growing market. If, however, a continued movement toward trade liberalization may be expected, the economic justification for some part of these capital flows is lessened.

One major stimulant for direct investment abroad is undoubtedly the substantial advantage in technology and managerial skills which U.S. firms often possess. The international transfer of these factors may be embodied in a capital outflow independent of the relative scarcity of capital. Action would thus be appropriate, not necessarily to curtail the investment itself, which would interfere with the beneficial transfer of the scarce technology and skills, but to transfer the source of financing to the area receiving the direct investment. This, indeed, is the primary intention and the result of the present voluntary program on direct investment.

Finally, differential monetary conditions among countries can induce capital flows. But monetary policy is an important and useful instrument of domestic stabilization and growth as well as of balance of payments adjustment. During 1960–65, U.S. monetary policy was oriented to serve domestic expansion. In 1966, it contributed to a desirable restraint on internal demand and to an improved balance of payments. In 1967, relaxation of U.S. monetary policy has begun in order to help obtain a better balance of internal demand. Appropriate use of restraints on capital outflows in such forms as the voluntary programs and the IET can usefully supplement monetary policy in promoting domestic and international goals.

In summary, it is clear that balance of payments policy should not exempt capital flows from its compass. It is equally clear that the United States should be a major capital exporter. The U.S. programs have been designed to maintain a reasonable flow of capital, especially to the less developed countries. Given the alternatives and the need to improve its payments position, the United States has restrained the outflow of capital as preferable to cutting essential international commitments, limiting international trade, or restricting domestic—and world—economic growth.

ADJUSTMENT POLICIES OF OTHER DEVELOPED COUNTRIES

Actions by the United States to improve its payments position cannot by themselves assure that the world payments pattern will be either sustainable or desirable from an international point of view. Such a result is only possible through appropriate efforts of both deficit and surplus countries.

In 1966, various other countries pursued policies to reduce payments imbalances. The most dramatic measures were taken by the United Kingdom, following renewed severe speculative attacks on the pound in the summer, which were initially met by drawings on swaps and other short-term international credit facilities cooperatively provided by the financial authorities of the major industrial countries and the Bank for International Settlements. The British increased the bank rate to 7 percent, provided a strong dose of over-all fiscal restraint, adopted selective tax measures to encourage increased productivity, and imposed a temporary freeze on wages and prices. These measures markedly reduced the earlier deficit, and the United Kingdom may soon move into surplus.

In Italy and Japan, resumption of more rapid growth in domestic economic activity, together with policies favorable to increased capital exports, succeeded in reducing payments surpluses as the year progressed. Industrial expansion in France similarly led to a shrinkage in that country's over-all surplus as the trade balance narrowed; however, there continued to be a net capital inflow.

Germany, which had a payments deficit in 1965 for the first time in several years, swung back to a sizable surplus in 1966. Monetary policy was tightened mainly to contain inflation. As a result, domestic investment slowed markedly, and the trade surplus increased sharply. The payments surplus was still expanding at year end. In January 1967, Germany took a welcome step toward monetary ease by lowering the central bank discount rate.

Although somewhat reduced from the preceding year, payments imbalances continued large in 1966. In some countries, corrective policies are clearly needed to prevent imbalances from growing still larger in the current year. Moreover, considerable question remains whether the pattern of adjustment in 1967 will permit a fully satisfactory rate of economic growth in the industrial countries, and an adequate flow of capital to the less developed world.

The United States will be actively pursuing policies to strengthen its payments position in 1967. But reduction of U.S. deficits must have a counterpart in reduced surpluses or increased deficits elsewhere. If the impact of the U.S. payments improvement were to fall largely on the United Kingdom or the less developed countries, the international payments system would suffer rather than benefit. From the viewpoint of a viable international payments pattern, consequently, there is no real alternative: it is the countries with strong underlying payments positions and large reserves which must absorb a major share of the impact of reduced U.S. and U.K. deficits. In particular, a marked reduction is needed in the chronic over-all surplus of the major industrial countries of Continental Europe.

The surplus countries also bear a significant share of the responsibility for assuring that the manner in which adjustment takes place is, to the greatest extent possible, consistent with the broad objectives of the international economic community as a whole.

Most importantly, adjustment policies should not, in the aggregate, prevent a healthy rate of worldwide economic growth compatible with reasonably stable price levels. In the United States, demand policies aiming at a slower rate of growth than that of 1966 are, of course, entirely appropriate on purely domestic grounds. But an even more marked slowdown in demand than is needed for proper domestic balance would entail serious social and economic costs at home and could risk a recession. Given the massive weight of the United States in the world economy, such a policy would risk a slowdown in trade and economic growth on a worldwide basis.

On the other hand, the objectives of international economic expansion and payments adjustment are simultaneously served when surplus countries with lagging internal demand take effective steps to spur the pace of economic activity—as was, for example, true of France, Italy, and Japan during the past year. In 1967, a number of surplus countries will be in a good position to contribute significantly to better international payments equilibrium in this fashion, without running serious risks of engendering inflationary pressures.

Surplus countries also have a special responsibility for fostering relative freedom in international transactions. As the report of Working Party 3 pointed out, it is desirable—wherever possible—that adjustment take place "through the relaxation of controls and restraints over international trade and capital movements by surplus countries, rather than by the imposition of new restraints by deficit countries." In the past year, Italy and Japan generally followed policies that facilitated capital outflows; the recently announced intention of the French Government to liberalize capital controls is also a hopeful development. There is, however, scope for further measures by various surplus countries to liberalize the regulations that govern capital outflows and also to ease restrictions on imports. More liberal import policies would both improve payments balance and counter domestic inflation.

In 1966, there was an escalation of monetary restraint. The sharp tightening of monetary policies in the United States, undertaken largely for domestic reasons, did help significantly to contain the U.S. payments deficit during the year. Monetary action also was a key feature in the program to defend the British pound. But countries in a strong reserve position also placed heavy reliance on restrictive monetary policies to contain domestic demand. The net effect of all these actions, and of the failure of most other countries to take active steps to avoid monetary stringency, was a dramatic upward movement in interest rates on a worldwide basis (Chart 17). Between September 1965 and September 1966, rates on 90-day Eurodollar deposits increased from 4.4 percent to 6.7 percent; yields on long-term international bond issues rose by more than a full percentage point; and there were marked increases in long-term government bond yields in all major industrial countries.

The extent to which the present high worldwide *level* of interest rates aids the process of balance of payments adjustment is doubtful. The substantial benefit to the U.S. balance of payments from the tightening of U.S. monetary conditions stemmed from *differential* monetary conditions here and abroad. The potential magnitude of such effects is reduced when surplus countries simultaneously permit or even encourage their own interest rates to rise.

From the standpoint of world economic growth, it would be preferable if payments adjustment took place at a lower average level of interest rates than has recently prevailed. Precisely what level is appropriate is a matter that deserves continuing international discussion.

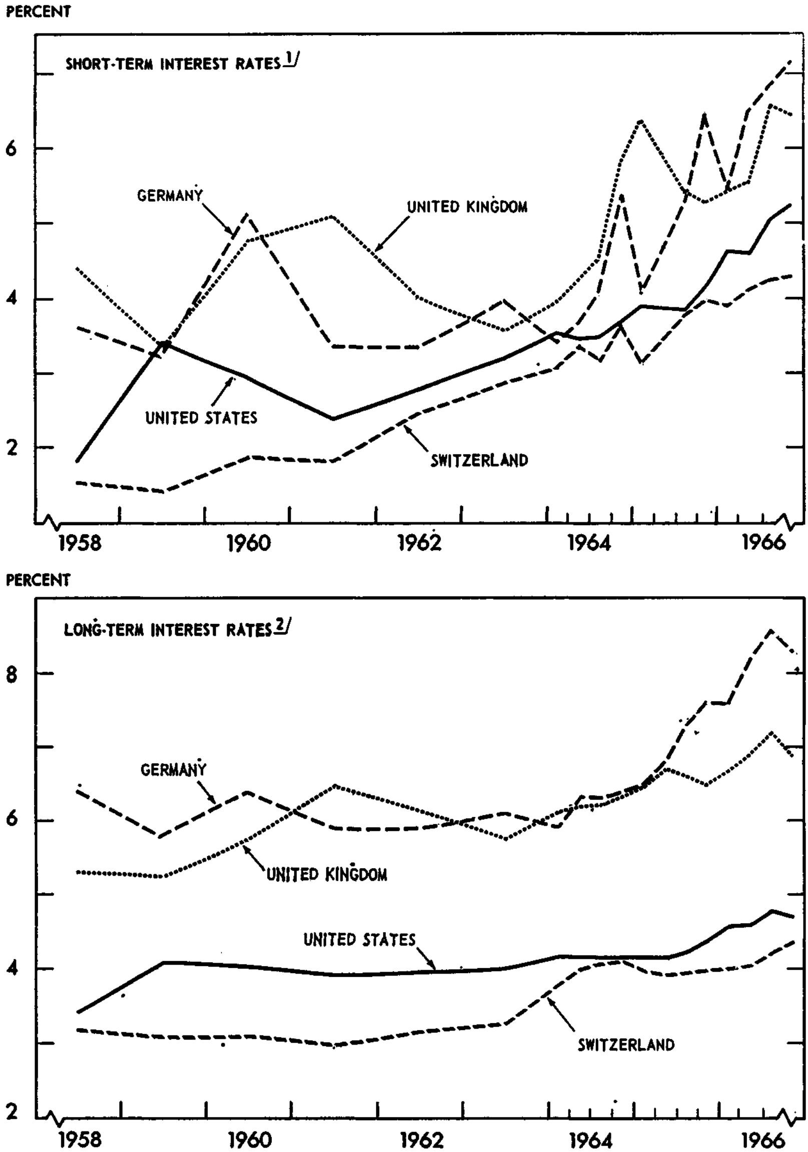
Given the key role of the United States in international financial markets, a general easing in international monetary conditions would be greatly aided by a lessening of monetary tightness in the United States. A move in this direction, already under way, will have major benefits for domestic economic balance. But if credit relaxation were confined to the United States, it would not promote a better balance of payments adjustment either for this country or for the major surplus countries of Europe. Moreover, at least in some important European economies, monetary easing would help to facilitate needed domestic economic growth. It would appear, therefore, that movement toward easier credit conditions by the countries of Western Europe would promote their own and the general welfare. Where necessary for domestic reasons, demand restraint could be maintained by greater reliance on fiscal policy.

If the major surplus countries adjust mainly by permitting their trade surpluses to decline, this can lead to a substantially improved trade surplus for the United States and permit it to maintain and even augment its role as a major capital exporter. Alternatively, if the large surplus countries—and particularly the EEC countries—wish to continue to maintain a substantial surplus on current account, they should assume a larger share of the responsibility for providing financial capital where it is needed.

Some progress in this direction has, in fact, recently been made, partly under the spur of the more restricted access to U.S. capital markets. New international bond issues in Europe during the first three quarters of 1966, for example, were at an annual rate of about $1.4 billion—four times the

Chart 17

Interest Rates in Selected Countries



1/ U.S. AND U.K., 3-MONTH TREASURY BILLS; GERMANY, 3-MONTH INTERBANK LOANS; SWITZERLAND, 3-MONTH BANK DEPOSITS.

2/ U.S., 10-YEAR TAXABLE BONDS; U.K., WAR LOANS; GERMANY, PUBLIC AUTHORITY BONDS; SWITZERLAND, GOVERNMENT BONDS.

NOTE.–DATA PLOTTED ARE ANNUAL THROUGH 1963, QUARTERLY THEREAFTER.

SOURCES: TREASURY DEPARTMENT AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

$360 million level in 1962, the year preceding the introduction of the Interest Equalization Tax. It is highly desirable, however, that the surplus countries take stronger steps to enlarge the capacity of their capital markets and to assure an adequate volume of long-term capital exports (including foreign aid), especially to the less developed countries.

INTERNATIONAL MONETARY REFORM

The avoidance or appropriate correction of large-scale payments imbalances is of key importance in facilitating sound world economic growth and relatively unfettered international trade and payments. But better adjustment alone is not sufficient to attain these objectives.

In the long run, most countries seek some steady increase in their international reserves. With growing world transactions, this has meant that they have generally sought to have surpluses rather than deficits in their balances of payments. Obviously, however, all countries cannot attain such a goal simultaneously. At present, only the flow of new gold into monetary reserves can permit a steady accumulation of reserve assets by some countries without corresponding deficits for others.

This flow of new gold has, for many years, been inadequate. For much of the postwar period, dollars supplied through U.S. deficits served as the major supplement to gold in new reserve creation. For reasons already cited, however, the dollar can no longer be expected to perform this task in the same way; nor can it be assumed that adequate new reserves will accrue in the form of automatic drawing rights at the IMF, as the byproduct of the Fund's normal lending operations. To satisfy desires for rising official monetary reserves over the longer run and to eliminate dependence of the world economy on the vagaries of gold production, deliberate generation of new reserve assets is needed on a cooperative international basis.

In 1966, significant progress was made toward setting up a mechanism for such deliberate reserve creation. Representatives of the major industrial countries known as the Group of Ten agreed that it is prudent to begin the preparation of a contingency plan now. They also agreed that deliberate reserve creation should be tailored to global needs rather than the financing of individual balance of payments deficits; that decisions on the amount of reserves to be created should be made for some years ahead; and that reserve assets should be distributed to all members of the Fund, on the basis of IMF quotas or comparable objective standards. While the negotiations in the Group of Ten, and parallel deliberations by the Executive Directors of the Fund, did not result in complete accord on the precise form and use of new reserve assets, the exploration of technical details produced substantial agreement regarding the nature of alternative "building blocks" that might be incorporated in the final contingency plan.

A major accomplishment in 1966 was the initiation of a second stage of international monetary negotiations late in the year, involving joint dis-