policies, and the tensions among countries resulting from the pursuit of such policies were successfully eased by means of diplomatic efforts.

In working out cooperative approaches to the various global problems governments benefited from discussions regarding a longer-term reform of international economic arrangements. In turn, the experiences of the past year provided a new perspective on plans for reform. Progress was made in each of the three major areas of reform: the international monetary system, the international trading system, and arrangements relating to international investment.

The international monetary system. Discussions on the future of the international monetary system were held in the framework of the Committee of Twenty, which was set up by the countries belonging to the International Monetary Fund (IMF). An indication of the current state of these discussions was provided by the chairman of that committee in a report to the annual meeting of the IMF in Nairobi in September.

The international trading system. Also in September, 105 countries reached agreement in Tokyo on some general objectives and a framework for a major new round of trade negotiations. They pledged to aim simultaneously for an expansion of international trade opportunities and improvements in the rules and procedures for coordinating trade policies. Prior to this meeting the Administration sent to the Congress draft legislation to authorize U.S. participation in a new round of trade negotiations and to improve the legislative provisions dealing with Presidential management of U.S. trade policy.

International investment. Discussions were held on investment questions in the framework of the Organization for Economic Cooperation and Development (OECD). The preliminary conclusions reached on the basis of these discussions point to the desirability of some new procedures and guidelines which would assure an efficient international allocation of new capital.

WHAT HAPPENED IN 1973?

In the area of international economic relations, the year 1973 may be characterized as one of continuing adjustment to past disequilibria as well as to new developments that entered the picture during the year. Early in the year the governments of most major countries abandoned attempts to fix exchange rates at negotiated levels. While central banks continued to intervene to some extent, foreign exchange markets played the major role in determining the exchange rates that would clear the market. This process was marked at times by unusually large fluctuations of market exchange rates. Nevertheless, the market performed its intermediating function well, and neither trade nor long-term capital flows were seriously disrupted at any time during the year.

The developments in the balance of payments accounts of individual countries reflected, in part, the developments in the foreign exchange markets. The appreciation and depreciation of individual currencies, achieved either through formal measures by the authorities or as a result of free movement of exchange rates, continued to influence the flows of international commerce and thus the deficits and surpluses of individual countries. Special developments, such as the shortages of food in certain parts of the world and, later in the year, the emerging world energy crisis, also affected the direction and magnitude of trade and capital flows among countries.

What Happened to Exchange Rates?

Developments during 1973 in the foreign exchange market can be conveniently broken into four periods, coinciding with the 4 quarters of the year. These developments are described in detail below. Briefly, in the first quarter, massive capital flows from the United States to Europe and Japan had two effects: First, foreign central banks added around $10 billion in claims against the United States to their reserves as a result of their efforts to support the value of the dollar in terms of their own currencies. Second, when large-scale market intervention failed to restore stability to foreign exchange markets, fixed exchange rates were abandoned; consequently the dollar fell during the quarter by an average of 10 percent against the EC currencies floating jointly, and 7 percent against the currencies of 14 major industrial countries when each is weighted by that country's bilateral trade with the United States (Table 50). For the computation of the trade-weighted depreciation of the dollar see the supplement to this chapter.

In the second quarter the dollar depreciated against most continental European currencies, but remained in close relationship to the Japanese yen, the Canadian dollar, and a number of other currencies accounting for two-thirds of U.S. trade. The dollar dropped 11 percent against most EC currencies floating jointly, and around 5 percent against the group of 14 currencies. Net claims of foreign central banks on the United States during this period actually decreased by about $0.7 billion.

In the third quarter the decline of the dollar was arrested, and its value remained roughly the same against the group of 14 currencies. In fact there was limited intervention by a number of central banks, including the United States, to prevent the dollar from rising.

TABLE 50.—*Changes in the foreign exchange value of the dollar, U.S. liabilities to officia foreigners and U.S. liabilities to private foreigners, 1973*

Item	Percent change from preceding quarter			
	First quarter	Second quarter	Third quarter	Fourth quarter
Foreign exchange value of the dollar[1]	−6.9	−5.0	1.1	5.5
U.S. liabilities, official foreigners[2]	15.9	−.9	−1.3	(3)
U.S. liabilities, private foreigners[4]	−9.3	10.6	4.5	(3)

[1] Trade-weighted depreciation of the dollar against 14 major currencies; computed by Morgan Guaranty Trust Company.
[2] Liabilities to foreign central banks and governments.
[3] Not available.
[4] External liabilities to other banks and to other foreigners.

Sources: Morgan Guaranty Trust Company and International Monetary Fund.

In the fourth quarter the dollar rose sharply. It rose 12 percent against the German mark and around 5 percent against the group of 14 currencies. Central banks intervened substantially to slow the dollar's rise, and claims by foreign central banks on the United States declined.

The first quarter of 1973: Fixed exchange rates are abandoned. Foreign exchange markets were stable in the beginning of 1973. In most foreign exchange markets the dollar was above the level where central banks were committed to buy dollars to keep its value within the agreed margins. The stability was so fragile, however, that any disturbance had a highly unsettling effect on the market. The first such disturbance was an acceleration of the capital flight from Italy into Switzerland. Confronted with massive outflows, the Italian authorities allowed the lira to float, first for financial transactions and later for all transactions. In Switzerland, the influx of funds from abroad intensified an already high rate of inflation. To gain greater control over its monetary policy, Switzerland decided on January 22 to allow the franc to float. By terminating their purchases of foreign currencies in support of a fixed value of the franc vis-a-vis other currencies, the Swiss monetary authorities were able to avoid further involuntary increases in the Swiss money supply.

The floating of the franc by Switzerland, a country viewed by many as the epitome of financial orthodoxy, strengthened expectations that other exchange rate adjustments were inevitable, particularly for currencies of countries with large payments imbalances such as Japan and Germany. These expectations led to increasingly large speculative purchases of marks and yen for dollars. Such sales reached a peak in the first week of February, forcing the closing of foreign exchange markets on February 10. Extensive consultations among the monetary officials of major countries followed and culminated in a number of coordinated exchange rate adjustments. On February 12 the Administration announced that it would ask Congress to approve a 10 percent devaluation of the dollar in terms of Special Drawing Rights (SDR's). At the same time, the Japanese authorities announced that the Japanese yen would be allowed to float upward. The resulting exchange rate structure was endorsed by the 14 major industrial nations.

The multilateral adjustment of exchange rate patterns in February, including the devaluation of the dollar, did not, however, restore market confidence in the entire pattern of rates—in particular, the rate for the German mark. Large-scale flows of speculative funds out of dollars into marks and some other currencies continued until exchange markets were officially closed on March 2.

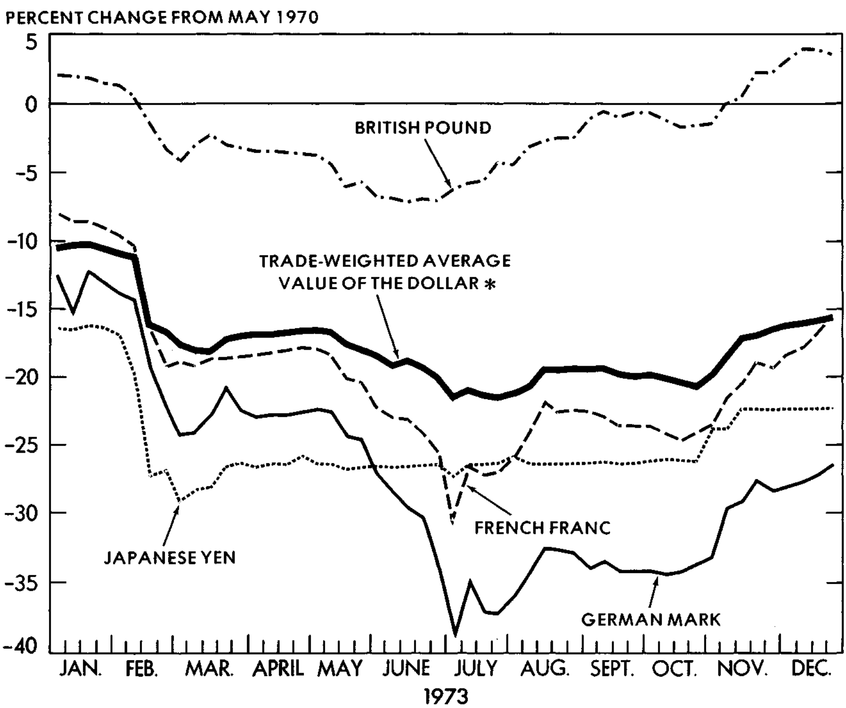
The exchange markets remained officially closed until March 19, although private trading of currencies continued. On March 19, five of the European Community (EC) countries—Belgium, Denmark, France, Germany, and the Netherlands—allowed their currencies to float jointly vis-a-vis the dollar and other currencies. As before, these countries decided to keep the exchange rates between any two of their currencies within 2¼ percent of an agreed relationship. In addition, Norway and Sweden subsequently decided to peg their currencies to the jointly floating EC currencies.

The second quarter of 1973: The dollar drops further. Between the end of March and the end of June the markets were characterized by a substantial depreciation of the dollar against most European currencies. At the same time, the dollar remained relatively unchanged against the currencies of Japan, Canada, and a number of other countries. The dollar declined about 11 percent in terms of most EC currencies floating jointly and 5 percent in terms of the trade-weighted average of 14 currencies. The dollar declined by as much as 15 percent vis-a-vis the German mark, which was revalued by 5½ percent relative to the other EC currencies floating jointly. (Chart 10.)

There were three sources of downward pressure on the dollar in European exchange markets during this period. First, the United States continued to have a deficit vis-a-vis Europe on basic balance transactions—

Chart 10

Change in the Value of the U.S. Dollar Relative to Selected Foreign Currencies



* RELATIVE TO 14 MAJOR CURRENCIES; COMPUTED BY MORGAN GUARANTY TRUST COMPANY.
NOTE: FOR INDIVIDUAL CURRENCIES, FRIDAY CLOSING PRICES WERE USED.
SOURCE: MORGAN GUARANTY TRUST COMPANY.

which include trade, grants and other unilateral transfers, and long-term investment. This meant that the public was supplying more dollars through these transactions in exchange for European currencies than were being purchased with European currencies through these transactions. Second, many non-European countries besides the United States had deficits vis-a-vis Europe in basic transactions. Since most of these countries use the dollar as a reserve currency, they tended to finance their deficits vis-a-vis Europe with dollars. Dollars from non-American sources were thus competing with dollars from the United States in European exchange markets. Third, the dollar is widely held abroad not only by central banks but also by many private individuals, banks, and corporations. With the continuing decline of the dollar during the previous 2 years, many of these private foreign holders wanted to exchange their dollars for foreign currencies.

As long as markets clear, however, there can be no "additional" dollars remaining unsold. Exchange rates will change until enough sellers have been discouraged from selling or enough buyers have been encouraged to buy. Equilibrium in the market was established during this period by private foreigners on balance increasing their dollar holdings. Figures for dollars held by private foreigners in Europe are not available, but the changes in these holdings are reflected in the $2 billion increase of U.S. liquid liabilities to all private foreigners from the end of March to the end of June. Foreign central banks decreased their holdings of dollars over this period by $650 million.

The rapid drop of the dollar significantly below what many considered its longer-term value created widespread uncertainty regarding future exchange market trends; for a short period during the end of June and the beginning of July the spread between buying and selling rates widened, and it became increasingly difficult for traders to obtain forward coverage. Nevertheless foreign exchange markets remained open throughout this period, and normal international trade and investment transactions continued without major disruption. Fears by many that floating exchange rates would disrupt international trade proved to be without foundation.

The third quarter of 1973: The dollar begins to rise. The decline of the dollar relative to European currencies was reversed in the third quarter as an increasing body of opinion in the market held that the dollar had become undervalued, a view that was strengthened by the emergence of a sizable surplus in U.S. trade of goods and services. In this favorable atmosphere, some further impetus to the turn in market opinion came from the announcement on July 18 of U.S. intervention in the foreign exchange market in order to maintain orderly market conditions.

This move discouraged speculation against the dollar by raising the possibility that the U.S. authorities would buy as many dollars (or sell as many foreign currencies) as would be necessary to prevent a further decline. To make large-scale intervention by U.S. authorities in the foreign exchange market a credible possibility, it was announced at the same time that bilateral swap facilities had been increased by $6¼ billion; the amount of foreign currencies that the Federal Reserve could borrow from other central banks thus rose to nearly $18 billion. In fact, intervention by the Federal Reserve amounted to only about $250 million during the last 3 weeks of July. During this period the dollar rose by around 4 percent against the jointly floating European currencies.

The fourth quarter of 1973: The dollar rises further. During the fourth quarter the appreciation of the dollar continued, in part because it was thought that the United States was in a relatively better position than Western European countries and Japan to deal with the cutback of oil production in the Middle East and the simultaneous increase in world oil prices. At the same time, the surpluses in U.S. trade were becoming larger, and figures published for the long-term investment account began to show a surplus. Between September 28 and December 27 the dollar rose by about 11 percent against the jointly floating European currencies. By the end of the year the dollar was thus approximately back to its February post-devaluation level. The dollar was rising so fast, in fact, that some foreign central banks found it increasingly desirable to reduce their controls on capital inflows and to sell off some of the dollars which they had accumulated in the past. Foreign exchange reserves of the Bank of Japan and the Bundesbank declined by $1 billion each during the October to November period as a result of their dollar sales.

Increasingly in the fourth quarter the exchange markets became dominated by the energy crisis and the abrupt and massive additions to import costs of oil. Early in January 1974 both the yen and the European currencies floating jointly depreciated sharply, and in some cases reached levels lower than those prevailing immediately after the multilateral adjustment of February 1973. On January 21, the French franc was allowed to float freely, and immediately declined by 5 percent.

Over the year as a whole the functioning of the exchange market improved as traders gained experience with floating exchange rates. This can be seen, for instance, in the narrowing spread between the buying and selling rates of the major currencies traded and in the diminished day-to-day fluctuations of these currencies. In general, one has to conclude that despite the dramatic decline and the equally dramatic rise of the dollar against the major European currencies, foreign exchange markets functioned remarkably well, and only on a few days was it difficult to carry out foreign exchange transactions.

What Happened to All Those Dollars?

Over the years a large volume of dollars has been accumulated by foreigners, both governments and private individuals. To a large extent these dollars are held because the dollar is the most widely used currency for international transactions, and a stock of dollars was therefore useful for all the reasons that induce people to hold money. Dollars are thus held voluntarily by private banks, corporations, and individuals. They are also held voluntarily by foreign central banks, even though central banks to some extent hold these dollars not because they want to increase their dollar reserves, but because they want to avoid a rise in the value of their currencies relative to the dollar.

Dollars held by foreigners are generally held in the form of dollar balances at commercial banks. However, not all of the dollars held by foreigners are dollars which are liquid liabilities of the United States, that is, dollar balances held in U.S. commercial banks. Some dollars are liabilities of European private banks which have accepted dollar deposits. These are generally known as Eurodollars. European banks can create new dollars by lending dollars to someone who will redeposit them in a Eurodollar bank. As long as the proceeds of new loans are left as deposits in the banking system, the banking system as a whole can continue to create new money in the form of bank deposits.

A number of central banks have participated in the creation of new dollars in the Eurodollar market by depositing their reserves with European commercial banks making Eurodollar loans. By so doing, these central banks not only facilitated the expansion of Eurodollars, but in many cases they ended up by creating new official reserves. Most major central banks, however, have now agreed to refrain from depositing new reserves in the Eurodollar market.

When they are sold in the foreign exchange market, dollars owned by foreigners become indistinguishable from dollars owned by Americans. That is, when they are sold they exert a downward pressure, and when they are purchased they exert an upward pressure on the market value of the dollar. Private American holders of dollars and private foreign holders of dollars, whether these are held in U.S. or in foreign banks, have similar economic motives in selling or buying dollars in the foreign exchange market. For instance, if the dollar is expected to fall relative to foreign currencies, holders of dollars will have an incentive to sell dollars and to buy foreign currencies. If the dollar is expected to rise relative to foreign currencies, holders of foreign currencies have an incentive to buy dollars and to sell their foreign currencies. While the average foreign holder of dollars is likely to be more sensitive to such changes in the foreign exchange value of the dollar than domestic holders of dollars, the experience of the last few years has shown that Americans will exchange large amounts of dollars for foreign currencies when they find it profitable to do so.

There is some reason to believe that during the first half of 1973 expectations of a future fall in the value of the dollar may have induced some dollar holders, both in the United States and abroad, to sell their dollars, thereby depressing the market value. Thus there were occasions when the value of the dollar was declining in the market, even though the United States was experiencing a rapid improvement in its underlying balance of payments. In the second half, expectations of a future rise of the dollar may have reinforced an upward trend by inducing both Americans and foreigners to shift from foreign currencies into dollars.

It is difficult to get a precise estimate of the total amount of dollars held by foreigners, because figures on dollar deposits in foreign banks are not easily available. Recorded liquid dollar liabilities of the United States—dollars held by foreigners which are liquid liabilities of either a U.S. bank or the U.S. Government—amounted to about $83 billion at the end of 1972; of this, $63 billion was held by official institutions, and about $20 billion was held by private banks and other foreigners. In addition the Bank for International Settlements (BIS) has estimated that at the end of 1972 the total liquid dollar liabilities of private banks in the EC, Sweden, and Switzerland amounted to almost $100 billion. If interbank deposits made by these banks are taken out of this figure, and certain other adjustments are made, the BIS finds that the Eurodollar volume was about $70 billion. The total volume of dollars held by foreigners as balances in both American and European banks was thus in the neighborhood of $150 billion. Of this amount perhaps a little more than half was held by official institutions, and the remainder by foreign private banks, corporations, and individuals. In comparison, the domestic supply of dollars in the United States, in the form of currency and demand deposits, was about $250 billion at the end of 1972.

During 1973 the total stock of dollars held abroad increased further. Total liquid dollar liabilities of the United States at the end of September amounted to $92½ billion, of which $72 billion was held by official institutions and $20½ billion by private foreigners. Indications are that the volume of Eurodollars has expanded as well.

What Happened to Trade and Investment?

During the first 3 quarters of 1973 Americans exported $3.0 billion more in goods and services than they imported, a large change from the first 3 quarters of 1972, when imports surpassed exports by $3.7 billion. On a long-term basis, private foreigners invested $1.4 billion more in the United States than Americans invested abroad during the first 3 quarters of the year; during the same period in 1972, U.S. private long-term investment abroad exceeded foreign private long-term investment in the United States by $0.9 billion.

These developments in the balance of payments are consistent with what one might expect from the exchange rate realignments of the past 2 years. The depreciation of the dollar in terms of foreign currencies should lower the price of U.S. goods and services relative to foreign goods and services, thereby stimulating sales abroad and encouraging U.S. residents to purchase goods produced at home rather than abroad. By reducing the relative cost of production in the United States and thus adding to its profitability, the depreciation tended to encourage investment in the United States rather than abroad. Any interpretation of the effect of the depreciation on developments in trade and investment during 1973, however, is complicated by the changing business conditions in the United States and elsewhere, by crop failures abroad, by changes in the demand for and sup-

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ply of oil, and by domestic price control programs, all of which also affected the U.S. balance of payments.

Trade in goods and services. The value of U.S. merchandise exports increased 41 percent from the first 3 quarters of 1972 to the first 3 quarters of 1973, while imports increased 24 percent over the same period. Higher prices resulting from intense inflationary pressures here and abroad during 1973 accounted for much of the increase in the value of U.S. trade. Adjusting for price increases, however, makes the turnabout in U.S. merchandise trade even more apparent. The volume of imports increased only 7 percent during the first 3 quarters of 1973, just over half the growth rate from 1971 to 1972, while the volume of exports increased 24 percent during the first 3 quarters of 1973, more than double the growth rate from 1971 to 1972.

The rapid growth of exports during 1973, following the realignment of exchange rates, is consistent with economic expectations. But factors other than the realignment of exchange rates also affected U.S. exports during 1973.

Shortfalls in foreign crops played a major part in increasing agricultural exports during the first 3 quarters of 1973. Drought in India and Africa, poor weather conditions in the Soviet Union, and the sharp reductions in Peruvian fishmeal production greatly reduced world production of grains and protein feeds in 1972, thus reducing supplies available for 1973. Because the United States was the largest supplier of foodstuffs with relatively open access to foreign buyers, these developments abroad had a particularly strong effect on U.S. agricultural exports. The depreciation of the dollar, however, was also an important factor in expanding agricultural exports by reducing the relative price of American crops. The value of agricultural exports in the first 3 quarters of 1973 equaled $12.7 billion, up 88 percent from the same period in 1972. Although exports of agricultural products accounted for only one-fourth of the value of total exports, 40 percent of the increase in exports during the first 3 quarters of 1973 came from agricultural products. Prices of food exports during the third quarter were nearly 40 percent higher than a year earlier, a change which accounted for a large part of the increase in the value of these exports.

Domestic price control programs also stimulated exports during 1973, at the expense of domestic supplies. As prices of internationally traded goods rose, it became more profitable to sell abroad, where prices remained unconstrained, rather than at home, where prices were controlled.

The increase in U.S. exports, which resulted from food shortages and domestic price control programs, was offset in part by the rapid increase in imports of crude and refined petroleum products. The fact that the demand for oil in recent years has been growing more rapidly than domestic oil production has created a gap which could only be filled by imports. At the same time, the world price of oil increased dramatically during the year. Although the major Arab oil producers embargoed oil shipments to the

United States in October, this did not reduce the value of oil imports during the rest of the year. (For a more complete discussion of these developments see Chapter 4.)

The relatively slow growth of total imports during 1973, despite the rapid increase in imports of crude and refined petroleum products, is the most visible indicator of the impact of exchange rate realignment on U.S. trade. In the later stages of a cyclical expansion, imports should accelerate as domestic producers run low on domestic supplies and rely on foreign suppliers to meet their demands. The fact that the volume of imports did not grow very much faster during 1973 than it did in 1972 suggests that the dollar depreciation had a significant effect on trade.

Developments in U.S. bilateral trade provide some additional clues to the impact of exchange rate realignments. For countries whose currencies have shown a relatively large appreciation in relation to the dollar, one might expect that imports from the United States would grow more rapidly than exports to the United States. This appears to be true, both for Japan and for the EC. Japan, whose currency has risen sharply against the dollar, experienced a 73 percent increase in imports from the United States during the first 3 quarters of 1973, while Japanese exports to the United States increased only 9 percent. The EC, whose currencies also rose sharply in relation to the dollar, increased their imports from the United States by 40 percent, while their exports to the United States increased by 23 percent.

For countries whose currencies changed relatively little in relation to the dollar, the growth rates of exports to and imports from the United States should be more nearly alike. This appears to be true for Canada and the United Kingdom, whose currencies changed relatively little during 1973 in relation to the U.S. dollar. Exports by Canada to the United States and imports from the United States both increased by around 20 percent. Exports by the United Kingdom to the United States and imports from the United States both grew by around 30 percent.

U.S. trade with Communist countries in Europe, including the U.S.S.R., increased dramatically during 1973, not because of exchange rate realignments, but because of a normalization of trade relations combined with poor harvests in the Soviet Union. Exports to the Communist countries in Europe increased to $1.4 billion for the first 3 quarters of 1973, while imports rose to $0.4 billion. Most of the increase in exports was due to larger sales of agricultural products.

Investments. During the first 3 quarters of 1973 private foreigners made more long-term investments in the United States than Americans made abroad. The effective depreciation of the dollar encouraged foreign investment in the United States during the year because it reduced the relative cost of producing internationally traded goods in the United States rather than abroad. The relative cost of producing in the United States declined further as a result of a tendency for wages to rise more rapidly abroad than in the United States; foreign firms thus had a greater incentive to produce in the United States. In view of the fairly large changes in relative labor costs (Table 51), the increase in foreign direct investment from none during the first 3 quarters of 1972 to $1.5 billion during the first 3 quarters of 1973 may seem fairly small. Judging by the number and size of investment plans that have been announced by foreign companies, however, this flow can be expected to increase significantly in the next year.

TABLE 51.—*Relative labor costs in manufacturing, 1968–73*

[1967=100]

Country and year	Hourly compensation in national currency	Output per man-hour	Unit labor cost in national currency	Value of foreign currency relative to the U.S. dollar	Unit labor cost in U.S. dollars[1]	Index of U.S. unit labor cost as percent of index of foreign unit labor cost
United States:						
1968	107.2	104.8	102.3		102.3	
1969	114.0	107.3	106.3		106.3	
1970	122.2	108.0	113.2		113.2	
1971	130.8	115.7	113.0		113.0	
1972	139.0	121.3	114.1		114.1	
1973	150.0	127.5	117.6		117.6	
Germany:						
1968	105.9	107.6	98.5	99.9	98.3	104.0
1969	115.5	113.8	101.5	101.6	103.1	103.1
1970	133.0	116.7	114.0	109.3	124.6	90.9
1971	152.1	122.4	124.3	114.7	142.5	79.3
1972	169.4	131.0	129.4	125.0	161.7	70.6
1973[2]	190.5	140.5	135.5	150.5	204.0	57.6
Japan:						
1968	116.2	112.6	103.2	100.4	103.7	98.6
1969	137.3	130.0	105.8	101.1	106.9	99.4
1970	163.4	146.5	111.5	101.1	112.7	100.4
1971	189.0	151.7	124.6	104.2	129.9	87.0
1972	219.5	167.0	131.5	119.5	157.1	72.6
1973[2]	265.1	198.4	133.7	133.7	178.7	65.8
Canada:						
1968	107.3	107.3	100.0	100.1	100.2	102.1
1969	115.3	113.2	101.9	100.2	102.1	104.1
1970	124.5	115.0	108.2	103.4	111.9	101.2
1971	134.5	121.6	110.6	106.8	118.2	95.6
1972	144.5	126.9	113.8	108.9	124.0	92.0
1973[2]	157.4	133.5	117.9	107.9	127.2	92.5

[1] Indexes in national currency adjusted for changes in prevailing exchange rates.
[2] Based on seasonally adjusted data for first 9 months.

Note.—Data relate to all employees in manufacturing.

Sources: Department of Labor (Bureau of Labor Statistics) and Council of Economic Advisers.

Foreign purchases of U.S. securities other than U.S. Treasury securities also increased, from $2.6 billion during the first 3 quarters of 1972 to $3.4 billion during the first 3 quarters of 1973. Such an increase is also consistent with what one would expect from the large depreciation of the dollar, inasmuch as the depreciation should increase the relative profitability of producing in the United States. Market expectations also exerted a strong influence on the flow of security transactions over the year. Foreign purchases of U.S. securities were quite large in the first quarter, reaching a total of $1.7 billion. During the second quarter, purchases fell to $0.5 billion, but increased again to $1.2 billion in the third quarter.

Direct and portfolio investments abroad by Americans amounted to $3½ billion during the first 3 quarters of 1973, as they had during the first 3 quarters of 1972. There are two possible reasons for the absence of a decline: First, economic conditions were buoyant throughout the world. Second, most of the outflow occurred in the first quarter, before the major exchange rate adjustments of 1973, and was probably motivated by the anticipation of subsequent exchange rate adjustments.

The U.S. Balance of Payments in 1973

In a world characterized by the managed floating of exchange rates, measurement of the overall balance of payments has become less important. In a fixed exchange rate world, one of the major functions of overall measures of the balance of payments was to signal to policy makers when a given exchange rate had become untenable. To the extent that exchange rates are allowed to adjust automatically in response to payments imbalances, it is no longer necessary to communicate the desirability of an exchange rate adjustment to the policy maker. Of course, to the extent that exchange rates remain constrained by official intervention in the foreign exchange market, the balance of payments numbers will continue to indicate when such intervention may need to be relaxed.

The managed floating of exchange rates has changed in particular the analytical meaning of the official reserve transactions balance, which measures the net direction and magnitude of official intervention in the foreign exchange market over a period of time. In other words, it approximately shows the extent to which governments have bought or sold currencies to influence the exchange rate. It also includes government-to-government payments outside the foreign exchange market, but removing these transactions from the foreign exchange market has the same effect as direct intervention. As long as governments kept market exchange rates relatively fixed by buying and selling foreign exchange, the net amount of such official purchases or sales provided an estimate of the net deficit or net surplus of a given currency traded in the market. To the extent that governments no longer attempt to keep market exchange rates from falling below or rising above a fixed level, changes in the net demand or supply of a currency are reflected in a movement of the exchange rate rather than in a net loss or gain of reserves. Since exchange rates were at first fixed and then floating to varying degrees in 1973, changes in market pressures were reflected in part by changes in exchange rates and in part by net changes in international reserves, that is, by the official reserve transactions balance.

As measured by the official reserve transactions balance, the United States had a deficit of $10½ billion in the first quarter, a surplus of $½ billion in the second quarter, and a surplus of $2 billion in the third quarter (Table 52). That is, in the first quarter, governments purchased roughly $10½ billion to keep the dollar higher than it would otherwise have been; in the second quarter, governments more or less allowed the dollar to find its own level in the market; and in the third quarter, governments sold roughly $2 billion, to keep the dollar lower than it would otherwise have been.

TABLE 52.—*U.S. balances on international transactions, 1972–73*

[Billions of dollars, seasonally adjusted]

Type of transaction	First 3 quarters		1972 IV	1973		
	1972	1973		I	II	III
Goods[1]	−5.2	−0.5	−1.7	−1.0	−0.2	0.7
Services	1.4	3.5	.9	1.1	.9	1.4
Military transactions	−2.7	−2.1	−.9	−.8	−.7	−.6
Investment income[2]	5.6	6.7	2.2	2.3	2.1	2.3
Other	−1.5	−1.1	−.5	−.4	−.5	−.3
GOODS AND SERVICES	−3.7	3.0	−.9	.2	.7	2.1
Unilateral transfers, net[3]	−2.9	−2.7	−.9	−.7	−1.0	−.9
CURRENT ACCOUNT	−6.6	.3	−1.8	−.6	−.4	1.2
Long-term capital	−1.7	.7	.2	−.4	−.2	1.3
U.S. Government[4]	−.8	−.6	−.6	−.3	.1	−.4
Direct investment	−2.6	−1.7	−.6	−1.8	−.4	.5
Other private	1.7	3.0	1.4	1.7	.1	1.2
CURRENT ACCOUNT AND LONG-TERM CAPITAL	−8.3	1.0	−1.6	−.9	−.6	2.5
Short-term claims	−1.8	−4.7	−1.2	−3.8	−.6	−.3
Short-term liabilities	2.3	.5	2.6	−1.8	1.1	1.2
Errors and unrecorded transactions, net	−1.6	−4.8	−1.5	−3.9	.4	−1.4
Allocations of SDR	.5		.2			
TOTAL[5]	−8.9	−8.1	−1.5	−10.5	.3	2.1

[1] Excludes transfers under military grants.
[2] Includes direct investment fees and royalties.
[3] Excludes military grants of goods and services.
[4] Excludes official reserve transactions and includes transactions in some short-term U.S. Government assets.
[5] Equals official reserve transactions balance.

Note.—Detail may not add to totals because of rounding.

Sources: Department of Commerce, Bureau of Economic Analysis, and Department of the Treasury.

Another commonly used measure of the U.S. balance of payments is the current account and long-term capital balance, or the "basic" balance, as it is sometimes called. This balance is computed by adding up all the recorded transactions in the current and the long-term capital accounts, including unilateral transfers. It attempts to measure the extent to which the "long-term" or "underlying" demand for foreign exchange has exceeded the "long-term" or "underlying" supply of foreign exchange during a given period. If all such transactions were accurately recorded, this balance would also equal the changes in official reserves and the changes in short-term foreign assets of private banks, corporations, and individuals, net of changes in liabilities. Because some transactions may not be measured correctly, however, or may escape measurement altogether, a difference usually exists between recorded basic transactions above the line and recorded changes in reserves and short-term assets below the line. This difference appears as an errors-and-omissions item in the balance of payments statistics.

Deficits and surpluses in the *basic* balance need not necessarily imply any disequilibrium which requires corrective action by the government. To the extent that changes in net private holdings of short-term foreign assets are voluntary, the existence of a surplus or deficit need not imply that it is either undesirable or unsustainable. When such changes are quite large in any one year, however, there is a strong possibility that the change is a temporary response to unusual circumstances, such as differences in interest rates. In these cases, some governments might be inclined to intervene to moderate the exchange rate fluctuations which could result from large shifts in short-term foreign assets.

The U.S. basic balance was in deficit by $1 billion during the first and $½ billion during the second quarter of 1973, while during the third quarter it was in surplus by about $2½ billion. For the 3 quarters, the U.S. basic balance was in surplus by about $1 billion. In other words, Americans in the first 3 quarters of 1973 earned $1 billion more from current account and long-term capital transactions than they spent on similar transactions.

Table 52 also shows that during the first 3 quarters $5 billion in net foreign currency expenditures were not recorded, while recorded short-term private claims on foreigners increased by $4½ billion. These two items were "financed" by the $1 billion current account surplus; a $½ billion net increase in recorded short-term liabilities to private banks, corporations and individuals; and an $8 billion net increase in U.S. liabilities to foreign official institutions.

The Net Foreign Asset Position

At the end of 1972 the estimated value of American assets abroad was $200 billion, and the value of American liabilities to foreigners was $150 billion. The $50 billion difference between the two is the estimated net American investment position abroad. The net investment position declined by about $20 billion from 1970 to 1972, but data for the first 3 quarters of 1973 suggest that it probably increased last year.

Changes in the U.S. net asset position are brought about in part by surpluses or deficits in the balance on current account, a balance which includes U.S. transactions in goods and services, as well as unilateral transfers (Table 52). The largest changes occurred in the balance on goods and services. When the United States has a deficit in its trade balance as in 1971 and 1972, it imports more than it pays for with exports, thus increasing American liabilities to foreigners. With a trade surplus, as in the first 3 quarters of 1973, the United States acquires imports and an increase in net assets abroad in return for its exports. One would therefore expect an improvement of the U.S. net asset position during 1973.

The U.S. net asset position is also affected by several kinds of transactions and accounting adjustments that do not appear in the balance of payments. When foreign subsidiaries reinvest their earnings, this increases the value of U.S. assets abroad; and when foreign-owned subsidiaries in the United States reinvest their earnings, this increases U.S. liabilities to foreigners. During 1973, U.S. reinvestment of earnings may have exceeded foreign reinvestment by $4 billion or more, thus adding to the U.S. net asset position. Changes in the valuation of outstanding assets and liabilities, which result from changes in market value or changes in exchange rates, also have a small impact on the U.S. net asset position. Because of the small surplus on current account and the large level of net reinvested earnings, the net asset position of the United States must have improved markedly during 1973.

Balance of payments figures indicate, however, that the increase in liabilities to foreigners exceeded the increase in U.S. assets abroad by about $4½ billion for the first 3 quarters of the year. This inconsistency can be partly explained by the net acquisition of unrecorded short-term foreign assets by Americans.

U.S. assets abroad are on the whole less liquid than U.S. liabilities to foreigners. At the end of 1972 about 90 percent of the $200 billion in assets abroad were considered nonliquid. Direct investments amounted to about $95 billion; holdings of long-term foreign securities were about $25 billion. The remaining nonliquid assets include $15 billion in nonliquid short-term assets held by private Americans, $10 billion in private long-term claims by banks and others and $35 billion in Government-owned assets. Most of the U.S. liquid assets are in the form of official monetary reserves. On the other hand, more than half of the $150 billion in liabilities to foreigners are considered liquid; most of these liabilities are in the form of bank deposits, short-term Treasury securities, and negotiable certificates of deposit.

HOW GOVERNMENTS BEHAVED IN THE MONETARY ARENA

During 1973 international monetary arrangements continued to evolve in response to changing needs. A major characteristic of these evolving arrangements is a considerable diversity in practices by different countries. Yet despite this diversity, countries cooperated with each other to a remarkable extent, as they had in 1972, and from their cooperation one could begin to see the development of some conventions to guide countries in their monetary relations. This process has benefited from the discussions taking place in the framework of the Committee of Twenty, a committee associated with the International Monetary Fund.

Exchange Rates and Intervention

Exchange rates became more flexible in 1973, as the governments of most major countries reduced or suspended their commitments to maintain fixed exchange rates, and other governments changed their par values more frequently. While governments have continued to intervene in the foreign exchange market in order to influence the movement of the exchange rate, it can no longer be assumed that they will finance an excess demand or absorb an excess supply of foreign currencies at given exchange rates. The situation can best be described as one of managed floating.

In managing their exchange rates, countries followed widely differing practices, as can be seen in Table 53. Some countries have allowed their currencies to float within a rather wide range, resorting to only limited