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Chapter I

Introduction and Summary: Problems Posed by the Balance-of-Payments Deficit

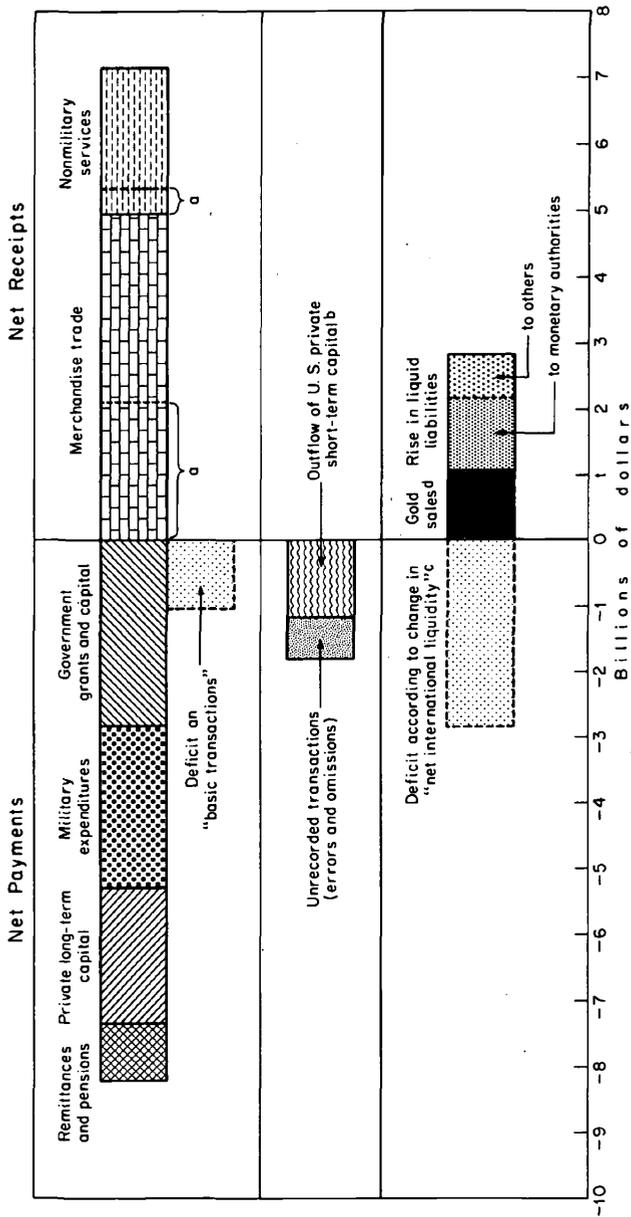
1. *Doubts Regarding Our Competitive Strength*

It is something of a paradox that doubt should arise concerning the competitive strength of a country which, during the two and three-quarters years ended September 1962, had an export surplus averaging \$5 billion on its foreign merchandise trade, or \$7.2 billion including nonmilitary services. It is still a large surplus if one excludes from exports close to \$2.5 billion of goods and services directly paid for by the United States Government, such as farm products supplied as economic aid to other countries under our surplus disposal programs.

Nevertheless, doubt has arisen about our competitive strength and, therewith, about the soundness of our international financial position. The reason is that, even at these high levels, our surplus on goods and nonmilitary services fails to cover our military expenditures abroad, government aid programs, private long-term investments, and transfers of personal remittances and pensions. To finance these items, net of corresponding payments to us, we need at present levels of operations a surplus on goods and nonmilitary services of something like \$8.5 billion each year (Chart 1). The amount required is much greater if, in addition, it must cover outflows of short-term capital of the magnitude experienced in 1960 and 1961.

Any shortfall in the surplus on goods and nonmilitary services in relation to these various expenditures and transfers has to be made up by sales from our gold stock or additions to foreign dollar balances and other liquid claims on the United States. It is, in fact, these latter items—changes in our gold holdings and total liquid liabilities—that

CHART 1
United States Balance of Payments,
Annual Averages for January 1960-September 1962



Problems Posed by the Payments Deficit

NOTES TO CHART 1

^a Financed by government grants and capital.

^b Less changes in foreign commercial credits to the United States.

^c Computed as the sum of U.S. gold sales and rise in U.S. liquid liabilities.

^d Includes also (starting in March 1961) changes in convertible currency holdings of the U.S. monetary authorities.

NOTE: Government grants and capital are net of debt repayments to the U.S. Government, including unscheduled receipts of \$689 million in 1961 and \$547 million in the first nine months of 1962. If these special receipts are excluded, the aggregate of the net payments shown on the left side of the chart, upper section, is increased by some \$450 million to a total of \$8,650 million, and the deficit on "basic transactions" is correspondingly increased to approximately \$1.5 billion (annual averages). Military expenditures are net of military "cash receipts" (see Appendix Tables B-1 and B-2).

are taken by the Commerce Department as representing the change in our "net international liquidity," shown in Chart 1, and as measuring the deficit or surplus in the balance of payments. As will be discussed later, however, the balance on "basic transactions," also shown in the chart, or some other combination of the items may provide a more meaningful measure of the deficit or surplus.

Clearly, then, the adequacy of our competitive strength has to be judged in relation to the size of the burdens to be borne, and corrective adjustments may take the form either of reducing the size of these burdens or of increasing the size of the surplus on goods and nonmilitary services. These two magnitudes are, of course, by no means wholly independent of each other. Looked at very broadly, private foreign investment and the Government's operations abroad add to the ability of other countries to acquire our goods and services. Sometimes the link is very close—for instance, when foreign aid is directly embodied in gifts of food or otherwise tied to procurement in the United States. In such cases a reduction in our expenditures may mean a more or less equivalent reduction in our receipts.¹ In other cases, however, the

¹ Transfers in kind (other than military items supplied as grants-in-aid) are treated in the United States balance of payments as if the funds were first paid over to foreign account (i.e., a "payment") and then used to buy from us the exports in question (i.e., a "receipt"). This treatment has the advantage of covering movements of real resources, and not financial transactions only, but it tends to make the balance-of-payments impact of the foreign aid program, on the one hand, and our export earnings, on the other, appear greater than they actually are. The impact on the balance of payments would not be nil, however, unless the goods supplied under the aid program consisted exclusively of things which the beneficiary country would not otherwise have purchased from the United States.

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connection is remote, as would be true of military expenditures or private investments in countries which are otherwise well supplied with dollars. The problem of strengthening the balance of payments may therefore be thought of as one of increasing receipts or reducing payments in ways which are not offset by their effects on other balance-of-payments items but yield a net reduction in the deficit.

A balance-of-payments deficit is not, in itself, proof of competitive inadequacy. One would need to know more about the causes and prospects. The longer a deficit continues, however, the more it would seem to point to some fundamental difficulty, and 1962 has marked our fifth successive year of substantial deficit. Indeed, some would stress in this regard that the United States has been in deficit ever since 1950 except for brief intervals during the Korean war and again during the Suez crisis.² That rather overstates the duration of our problem. The deficits shown in the balance of payments prior to the Suez crisis were small, on the whole, in relation to our reserves, useful in strengthening those of other countries (Chart 2), and not such as to seem to require urgent collective policies.

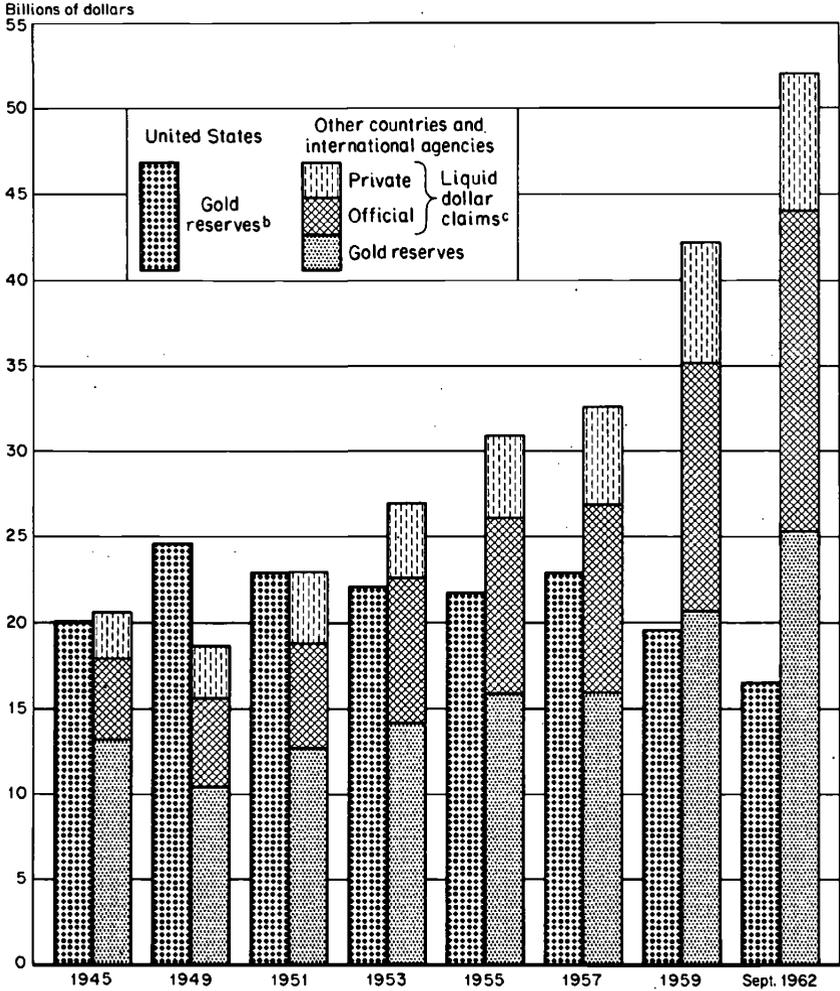
After the Suez interlude, the deficits reappeared in much greater size. On the definition employed by the Commerce Department, they ranged between \$3.5 billion and \$4 billion annually in 1958, 1959 and 1960 and, though declining to \$2.5 billion in 1961 and to an annual rate of \$1.9 billion in the first nine months of 1962, have produced cumulatively unwelcome effects on our net international reserve position.

Out of these protracted deficits arises the fear that, at prevailing rates of exchange, our competitive position is not strong enough to yield a tolerable balance in our international transactions except perhaps at a level of domestic economic activity lower than would be consistent with our other objectives at home and abroad. How much relief a compression of domestic activity affords to the United States balance of payments is, moreover, in doubt. Whatever is gained by reducing imports or releasing resources for export may be offset by adverse repercussions on the buying power of neighboring countries closely dependent on the United States market and by the enhanced attraction, to Americans and others, of investing in Europe and other more rapidly growing areas.

² See Table 1, pp. 12, 13.

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CHART 2
Gold Reserves of the United States and Holdings of Gold and Dollars by Other Countries and International Agencies



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NOTES TO CHART 2

^a Data for end of year or month.

^b Figure for end of September 1962 includes \$450 million of foreign convertible currencies.

^c Includes short-term liabilities to foreigners reported by banks in the United States and also foreign holdings of U.S. Government long-term securities. The latter cannot be broken down between "official" and "private," and are here allocated to the first category on the basis of partial data indicating that the greater part of these securities are so held.

SOURCE: Federal Reserve Board and U.S. Department of Commerce.

2. The New Balance-of-Payments Constraint

The United States thus finds itself exposed to an unfamiliar and awkward constraint. Policies with respect to foreign trade, economic assistance to the less developed countries, military cooperation, and private foreign investment come under closer scrutiny for their effects on the balance of payments. Our effort to attune the commercial policies of the United States and the Common Market seems to be inspired not only by a desire to benefit by freer trade but perhaps even more by a concern lest preferential trading arrangements among other countries add to the stresses in our international payments position.

Questions arise also with regard to the balance-of-payments effects of domestic economic policies. Monetary and fiscal policies aimed at countering recession or at stimulating long-term growth now have to be framed with an eye to their external as well as their internal repercussions. Conflict has already been experienced between domestic objectives and the external stability of the dollar. The dollar itself is no longer immune to speculative attack.

The balance of payments has become, in the words of President Kennedy, "one of the key factors in our national economic life,"³ and strengthening the balance of payments has become a major objective so as to widen the scope for other policy action.

Even if the balance-of-payments deficit were soon to be overcome, the United States could scarcely regain the degree of freedom from external constraint which it had previously known behind the shield of the dollar shortage. For several decades, foreign countries' demands for dollars had usually been greater, frequently far greater, than their current dollar receipts. This disparity did not repose, as many came to

³ Message on Balance of Payments and Gold, February 6, 1961.

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believe, on some unyielding structural disequilibrium causing a permanent dollar shortage. It derived rather from the extraordinary concatenation of misfortunes that befell the world over this period. These included two world wars with their heavy demands for supplies from the United States and a reduction in other countries' export possibilities, followed in each case by urgent relief and reconstruction needs and monetary disturbances abroad. In between came the Great Depression, marked by the shriveling of United States import demand and the drawing down of American investments abroad, and then the flight of European capital to the United States as the Second World War approached.

The dollar thus came to be looked upon as being chronically in short supply. By the end of World War II, it had acquired a status scarcely distinguishable from that of gold and indeed, when United States reserves reached their peak in 1949, was backed by 70 per cent of the world's monetary gold outside the Soviet Union.⁴ Now, with the disappearance of some of the earlier disparities, the shift in the United States balance of payments to large deficits, the consequent fall in its gold stocks and rise in its liquid liabilities, and the increased international mobility of private capital, the United States is concerned not only about its competitive strength as a world trader but also about its problems as a world banker.

3. Some Tentative Findings

From the standpoint of our international objectives, the problem posed by the balance of payments may be regarded as one of increasing our competitive strength or else reducing the demands made upon it. With respect to our domestic objectives, the problem may be viewed as one of achieving greater freedom from external constraint in the pursuit

⁴ The dollar fulfilled, in postwar international finance, the classical textbook functions of money. It was the "unit of account" conveniently specified in many international financial and commercial agreements, even among members of the Communist bloc. It was a universally acceptable "medium of exchange," and working balances of dollars were accordingly needed for international settlements. And, because these advantages were expected to endure, the dollar became a widely used "standard of deferred payments" and was eagerly sought as a "store of value" by central banks, commercial banks, business firms, and individuals.

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of economic stability, long-term growth of output, and higher employment. To the extent that we solve the first problem, we facilitate solutions to the second. And to the extent that we can select and apply domestic policies in ways which strengthen our international position rather than impose new strains, we also facilitate solutions to the first problem.

Some of those who are most skeptical about the first problem or most impatient about the second have tended to doubt that these objectives can be reconciled without abandoning the further objective of maintaining the dollar at its present foreign exchange value. Speculative activity of varying intensity in the foreign exchange and gold markets has reflected the same doubt. A change could take the form of a devaluation to a new fixed gold parity—on the doubtful assumption that other countries would, in fact, be willing to see their currencies and export prices rise in relation to our own. Or, as a number of students of monetary problems would prefer, the dollar might be freed from any fixed ties to gold or other currencies—a panacea to some but Pandora's box to many others. Reasons for doubting that the United States will need to follow either of these courses will be offered in the present essay. Here, by way of a partial summary in advance, it may be suggested that the more pessimistic views entertained with regard to the future of the balance of payments and the dollar may need to be modified for several reasons.

First of all, views on the present position of the United States in the world economy still seem to be permeated by the experience of 1958 and 1959, when the balance of payments abruptly shifted to a deficit of alarming proportions. This shift undoubtedly reflected certain major changes in the conditions of international competition, attributable to developments both at home and abroad, but was greatly accentuated by various circumstances of a more ephemeral nature which, even now, are not always adequately taken into account.

Second, impressions of a fundamental deficiency in our competitive power were enlivened by the new element introduced into our international accounts in 1960 and 1961 with the heavy outflow of liquid capital and by the fact that, on the Commerce Department's method of reckoning, these flows were not as clearly distinguished as they might have been from other more basic factors contributing to the deficit. The informed observer, with time to study the Commerce Department's presentation and analysis, had no difficulty in making this distinction.

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Others, including many most concerned about our international position, were not equally well placed to do so. With the subsidence of these liquid capital outflows in the first half of 1962—largely a reflection of the currency difficulties experienced by Canada—the reverse risk arose that the extent of the basic improvement in the balance of payments would be exaggerated for a time in public opinion. The pendulum swung back once more in the second half of the year with renewed large outflows of liquid funds.

Third, appraisals of the balance of payments sometimes make little allowance for the time element in adjustments to balance-of-payments disturbances. A country's strength in international competition is not to be judged only by its external deficit or surplus, however that may be measured, but also in relation to the nature and degree of the disturbances experienced and to the rate at which they are offset. Adjustments to such major changes as those which have occurred in the world economy during the past decade could not be easy and instantaneous, especially with the downward rigidity of costs and prices characteristic of modern industrial societies. In the light of these considerations it deserves to be stressed that the United States has, in fact, increased its exports of goods and nonmilitary services appreciably faster than its imports, not only since 1959 but also in relation to their respective levels at the beginning of the 1950's. These results are subject to important qualifications, as will be seen, and may be attributable only in part to specific processes of adjustment, whether policy-determined or otherwise, set in motion by the disturbances experienced. They nevertheless seem to point to some significant elements of strength in our competitive position and, in conjunction with the gradual fruition of the various corrective measures which have been taken, suggest that the balance-of-payments problem may be solved without recourse to extreme measures.

The first of the above points, concerning the combination of circumstances which produced the large deficits of 1958 and 1959, will be clarified by the sketch of balance-of-payments developments since the war given in Chapter II. The second, concerning the role of short-term capital movements and the problems which they present for analysis and policy, will be introduced in that chapter and further considered in Chapter IV. The third point—that is, the disturbances experienced in the United States balance of payments, the extent to which they have been offset, and some of the problems and uncer-

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tainties which lie ahead—will be developed in Chapter III and in the first section of Chapter IV.

Against this background, Chapter IV considers the possibilities of improving processes of adjustment in the balance of payments. It suggests that, whatever may be done in this direction, periods of disturbance and strain are to be expected in a rapidly changing world and that time must be allowed for adjustments to be made in an orderly manner. The need is therefore seen of enlarging the resources available to tide over such periods and to prevent strains in confidence such as those which have troubled the last several years. It is further suggested that this need may be especially great for the United States not merely because of its role as the major international reserve center but also because of certain distinctive features of its economy which tend to make external adjustments slower than in other countries more closely integrated into world trade. Because of the special position of the United States in these respects, its problems are not to be confused with the vaguer and less acute questions which have been raised with regard to the adequacy of international liquidity in general. To meet its own problems without, however, reducing international liquidity, the United States may need to aim at achieving not just a balance but a surplus in its international transactions to be settled by the accumulation of foreign convertible currencies rather than by reductions in the gold and dollar assets of other countries.