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Staff and Faculty: The Balance of Payments Problem, The Dollar, and United States Worldwide Responsibilities—Part II

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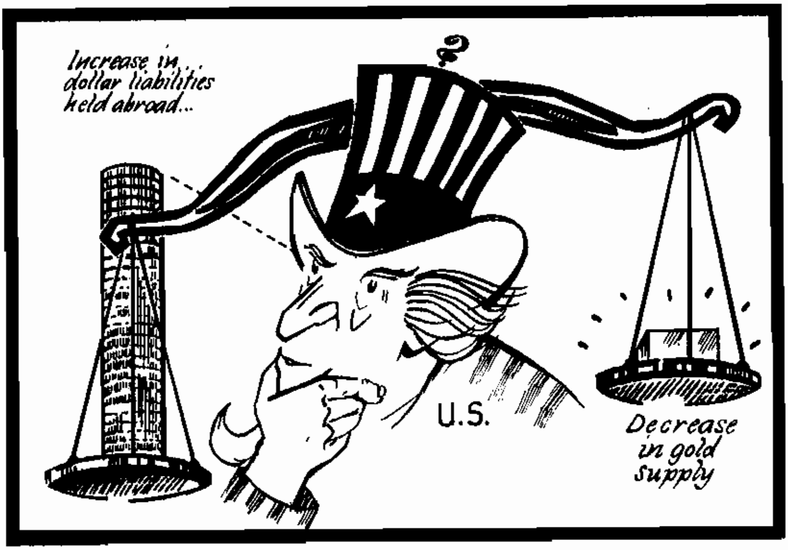

THE BALANCE OF PAYMENTS PROBLEM, THE DOLLAR, AND UNITED STATES WORLDWIDE RESPONSIBILITIES

PART II

by

Professor William A. Dymsza

(The article which follows is the conclusion of a two-part series which commenced in last month's issue. In it, Professor Dymsza analyzes the formulation and pursuit of U.S. balance of payments policies. The reader will find it advantageous to refer to Part I of this series which appeared in the January issue.)

INTRODUCTION

In Part I, after examining the nature of the balance of payments accounting and the meaning of equilibrium and disequilibrium, we analyzed the deficits in the U.S. balance of payments since 1950. We examined three commonly used concepts of the deficit; the liquidity, the official settlements, and the basic transactions concepts. While the Department of Commerce has generally used and preferred the liquidity concept, we concluded that the official settlements concept is superior, as it does not overstate the deficit and has a sounder analytical basis. We also examined major structural and other factors involved in the deficits and emphasized the problem in terms of the responsibilities of the United States as leader of the free world. Finally, after analizing the balance of payments problem in relation to the dollar as an international currency, we concluded that it was urgent to resolve the problem.

In Part II, we shall examine problems in the formulation of balance of payments policies, criteria of such policies, the conflict between balance of payments equilibrium and other objectives, usual ways of achieving equilibrium, measures taken by the U.S. government, including those involving international cooperation, and other possible policies.

THE FORMULATION OF BALANCE OF PAYMENTS POLICIES

Analysis of Factors Involved. Decisions on policies to achieve equilibrium in the balance of payments should be based on a clear analysis of the major factors involved in disequilibrium and the range of policies available, considering possible benefits and costs. While it may be fairly common to attribute the deficits primarily to single factors, such as foreign aid, and to look for simple solutions, our analysis shows that balance of payments analysis is highly complex, and there is no agreement on the basic causes of the deficits. According to our analysis there have been transitory, cyclical, and structural factors involved and rapid change from year to year. A number of structural and other changes in the international economic position of the United States in relation to the rest of the world, some changes in this country's competitive position, and the worldwide military, foreign aid, and other commitments have been involved. Furthermore, other changes--the increased propensity of Americans to consume imported goods and to travel abroad, the growing international investments of U.S. business companies including banks, and the raising of funds by many foreigners in the highly developed U.S. capital market--have contributed to the problem. It is not that the U.S. economy is not vigorous and competitive overall, but it is not sufficiently so to permit this country to pursue the present level of world commitments and its major domestic policies and to have recent trends in imports, foreign investments, and tourist expenditures continue, without experiencing a disequilibrium.

Complexities in Formulating Policies. The determination of appropriate policies to deal with the balance of payments situation is even more complex than analyzing the basic factors involved. The problem has been complicated by different concepts of the deficit and some differences about the seriousness of the problem. But there are more basic considerations involved. The formulation of balance of payments policies, like other policies, involves value judgments and political considerations in broad and narrow terms, as well as economic analysis. Achieving balance of payments equilibrium may conflict with the pursuit of other major foreign policy and national security, commitments this country has assumed as leader of the non-Communist world, and with domestic economic policies, such as maintenance of high and stable levels of employment and economic growth. Many policies that might be effective conflict with basic principles, such as freer trade, freedom of payments, freedom of travel, freedom of investments, and the operation of the market system. Moreover, many policies run into severe opposition by groups affected.

Finally, there is no guarantee of the effectiveness of any policies, because of complex interactions, feedbacks, and repercussions, often not foreseen.[1] Of basic importance, all items in the balance of payments are interrelated. It is not valid to examine individual items in isolation from others. Along the same line it is not valid to examine government expenditures in isolation from commercial transactions because of complex interactions and feedbacks. Analysis of this type may have some usefulness in the formulation of policy, but it can be misguided unless it recognizes various possible interrelationships.

The feedbacks may be shown as follows. Even when foreign aid grants and loans are not tied, a considerable part of them are spent for merchandise and services in this country. Even if the expenditures are not made in the United States by the aid-receiving countries, they may be made via third countries. As another example of a feedback, part of direct investment capital outflows may finance exports of machinery and equipment. Even in other cases where the feedbacks are not as clear or direct as in military expenditures and tourist expenditures, part of the dollars spent overseas may lead to increased purchases of goods and services from the United States, although the exact amounts cannot be ascertained. Indirect feedbacks through third countries are harder to determine. As a result of various feedbacks, a reduction of U.S. military aid, tourist, and other expenditures cannot lead to equivalent improvement in the balance of payments, and the exact savings are difficult to ascertain precisely. Nevertheless, feedbacks of various expenditures do vary and possible feedbacks should be analyzed as a guide to specific measures.

The other repercussions of various balance of payments policies are even more complex in view of various possible reactions by business and financial groups and by foreign governments. Moreover, in the rapidly changing international and domestic environment, many unforeseen developments can take place. U.S. experience during the last few years shows that measures to improve sectors of the balance of payments have been frustrated by changes in other sectors. The improved trade balance in 1964 was offset by an increase in bank loans and direct investments. The attempt to hold down portfolio investments by an interest equalization tax may have contributed to increased bank loans and some increase in direct investments. An attempt to reduce bank loans by "voluntary controls" may have held back financing for merchandise exports. Businessmen and financial institutions can show great ingenuity in adjusting to various policies. Foreign governments can adapt to any policies that hurt their balance of payments position. Thus, as a result of direct and indirect feedbacks, various repercussions, and rapid changes taking place, it is difficult to determine the full impact of specific policies. Still, despite complexities and uncertainties, policies have to be formulated to achieve equilibrium in the balance of payments.

Criteria of Policies. What should be the criteria of balance of payment policies?[2] The first criterion is the effectiveness of specific measures in eliminating or reducing the deficits. While this is a necessary condition, it is not a sufficient basis for evaluation of policies. Second, the policies should be considered in terms of their economic efficiency. Would they interfere with the efficient allocation of economic resources domestically and internationally? Would they significantly impede the efficiency and productivity of the economy? Would they increase barriers to the movement of international trade? Are they consistent with the market system and its economic freedoms? Third, policies should be considered in terms of their possible impact on high and stable levels of employment and economic growth. The general belief is that domestic employment and economic growth should not be sacrificed to attain balance of payments equilibrium. Fourth, and of major importance, the policies have to be considered in terms of the basic U.S. foreign policy, national security, and political commitments in the world. Once again the American Government has been trying to develop balance of payments policies that do not disrupt the military, foreign political, and other worldwide objectives of this country. Finally, policies should be considered from the point of view of their long-run effects as well as their short-run impact. In other words, the economic and political costs of alternative policies, both long-term and short-term, should be evaluated, as well as their possible effectiveness.

An examination of the above criteria shows that it is difficult to formulate balance of payments policies that are effective in achieving equilibrium and that will meet other significant criteria. One of the difficult dilemmas that has to be faced is that the achievement of equilibrium may involve some sacrifice of other objectives and some costs to other policies. In other words, it may be difficult for the United States to achieve balance of payments equilibrium without some sacrifice of other objectives or some relinquishment of basic principles that this country wants to maintain. We turn now to an evaluation of the suitability of policies usually available to deal with a balance of payments problem and then to some measures adopted by the American Government.

USUAL POLICIES TO ESTABLISH EQUILIBRIUM

Usually a country has the following choices to achieve balance of payments equilibrium: (1) take no action and try to let market forces or the automatic adjustment mechanism eventually bring about equilibrium; (2) use a combination of monetary and fiscal policy to achieve deflation; (3) devalue its currency; (4) raise tariffs and impose other restrictions to reduce imports; (5) impose exchange controls to curtail capital movements or possible other payments to foreign countries.

Most of the usual methods of dealing with the balance of payments problem have been excluded because of their clash with major domestic or international policies, their inconsistency with basic principles adhered to by this country, their adverse repercussions, or their possible ineffectiveness. The United States has not been able to follow a course of inaction because of the size and persistence of the deficits and because of the weakness of the so-called adjustment mechanism under the present international monetary system. Furthermore, the expectation that more rapid wage increases and price increases in Western Europe than in the United States would contribute substantially to equilibrium has not been borne out by experience up to this time.[3] The more rapid inflation in Western Europe than in the United States since 1958 has not been reflected in any improvement in this country's share of exports of manufactures, as was expected. Furthermore, the resumption of inflation in this country since the beginning of 1965 has led to some deterioration of the situation.

Deflation and Anti-inflation Policies. The usual classical remedy of deflation to achieve balance of payments equilibrium is unacceptable, because it may increase unemployment and slow down economic growth. The United States like most countries is highly committed to policies to foster high and stable levels of employment and vigorous economic growth--about four per cent a year in meetings of the Organization for Economic Cooperation and Development. From 1958 to 1964 this country had a higher rate of unemployment than was considered tolerable. Furthermore, even disregarding the employment aspects, there are many rigidities in this economy that act to prevent falling prices. With strong unions in major industries, wages are not flexible downwards. Moreover, prices in most manufacturing industries are not highly flexible downwards, because of oligopolistic price setting by a few major dominant campanies and stable price policies pursued.

Nevertheless, while deflation is hardly feasible, a deficit country such as the United States has an obligation to pursue a mix of monetary and fiscal policies to maintain relatively stable prices and have less inflation than surplus countries. In this respect, the United States had a good record from 1958 to the end of 1964, when wholesale prices remained stable and consumer price increases averaged only about one per cent a year. However, with the sharply increased expenditures in Vietnam superimposed on a booming economy, inflation has resumed in this country. During this period the government has primarily relied on monetary policy and has delayed increasing taxes as the inflationary situation justified. Whatever fiscal measures the administration has taken, such as the repeal of the investment tax credit, have come late. As a result wholesale and retail prices have been advancing about three per cent a year. Also, the wage-price guidelines have been breaking down as labor unions have pressed for wage increases in excess of the nation's average increase in productivity, and business companies have been raising prices. The resumption of inflation has contributed to the lag in merchandise exports, the increase in imports, and the narrowing of the trade balance in 1966 from about $6.7 billion in 1964, $4.8 billion in 1965, to an estimated $4 billion or less in 1966. While a tax increase remains a possibility, it may be late in view of a number of weak sectors in the civilian economy and since some damage has already been done to the balance of payments position. The lesson from this experience is that the Administration needs to be vigilant and courageous in pursuing a mix of monetary and fiscal policies to maintain price stability for balance of payments as well as other reasons.

Devaluation of the Dollar. Many economists believe that the solution of balance of payments problem lies in a devaluation of the dollar; that, in effect, would increase the price of gold in terms of dollars.[4] The argument goes that the persistence of the substantial deficits practically every year since 1949, and the larger deficits since 1958 despite many measures taken by the government, show that the dollar is overvalued. Some economists argue that the widespread currency devaluation initiated by the British in 1949 and other devaluations in the early

1950's went too far. Moreover, according to the argument the United States is not able to continue its worldwide military and political commitments and make fundamental adjustments to basic changes in trade, investments, and competitive circumstances and achieve equilibrium in its balance of payments without devaluation. Such an action would encourage an expansion of exports of goods and services by making them cheaper and would curb imports of merchandise and services by making them more expensive, providing foreign countries did not take similar action.

While devaluation has merits on theoretical grounds and is a common way to deal with some types of persistent disequilibrium, it is dubious that the policy would be effective for the United States. It would also impair the dollar as an international currency, and it could have many other adverse repercussions. The American Government has committed itself to maintaining the present fixed price of the dollar at $35 an ounce of gold. A devaluation of a currency is usually appropriate policy when a currency has had considerably more inflation than other countries and finds itself unable to compete in world markets. As we have seen this is not the case of the United States. There is no general overpricing of American goods and services in world markets. The U.S. balance of payments is unique as it results from governmental policies involving military, foreign aid, and other expenditures, as well as rising foreign investments and other changes in commercial transactions. Government military and many other expenditures would not be significantly reduced by devaluation, as the foreign exchange costs are fixed. Rather there might have to be larger domestic federal government expenditures to maintain the same programs overseas. Some other private expenditures, including some interest payments overseas, are also fixed in terms of foreign exchange. Devaluation would also act to encourage an outflow of short-term and long-term capital as well as discourage an inflow of earnings on U.S. investments overseas.

Since the dollar is such a significant currency and the United States is still the largest exporter and importer of goods and services, it is extremely unlikely that foreign countries would stand idle and let the United States increase its balance on merchandise and services. A U.S. devaluation would probably set in motion equivalent currency depreciations by other currencies. It would also set in motion inflationary pressures in this country. In view of the likely devaluations by other countries, the inflationary pressures initiated, and the other aspects mentioned, a devaluation would probably be ineffective in resolving the balance of payments problem.

More serious in some ways, devaluation would probably impair the role of the dollar as an international currency and could disrupt the present international monetary system. In view of the promise of the United States to maintain the present value of dollar at $35 an ounce of gold and to convert on demand dollars held by official institutions into gold at the fixed ratio, foreign central banks and governments now hold about $15 billion in liquid dollar assets. Private holdings of liquid dollars amount to another $11 billion, or a total of $26 billion held by foreigners, excluding international organizations. The possible imminence of a devaluation would lead foreign monetary institutions and private groups to convert liquid dollars into gold. As a result of the inadequacy of American gold stocks, convertibility of dollars into gold would have to be suspended.

A devaluation itself would be a breaking of a commitment made by several U.S. presidents. It would probably lead to a loss of confidence in the dollar as an international currency. It could lead to an international monetary crisis. It would penalize countries that have kept a high proportion of their international reserves in dollars rather than gold, usually at the urging of the United States. It would benefit countries such as France that have been converting a high ratio of their surpluses in gold and also gold producing nations, such as South Africa. It would not lead to a more equitable distribution of international reserves.

Some have suggested that the United States negotiate a devaluation of the dollar in discussions with other countries and the International Monetary Fund. Under such an international arrangement, the profits in raising the price of gold could be used to settle at least part of the liquid dollar liabilities outstanding. Claims that could not be settled could be worked out under longer term repayment arrangements. However, the successful conclusion of such international negotiation would be extremely difficult. The process of consultation in the International Monetary Fund, negotiations with foreign countries, and legislative action in Congress, could very well set off a run on gold. Furthermore, even if such a devaluation could be agreed upon in international negotiations, there would still be all the other problems involved in devaluation, including its likely ineffectiveness.

Import Restrictions and Exchange Controls. Raising tariffs, imposing import quotas or special import levies to reduce imports would go against the efficient utilization of economic resources and would disrupt policies pursued by this country since 1934 to reduce trade barriers in order to expand international trade. These liberal trade policies have been a cornerstone of U.S. foreign economic policy to foster a closer integration of the world economy and contribute to peace. These policies, initiated in the Reciprocal Trade Agreement Act in 1934, are now continued in the Trade Expansion Act of 1962, this country's leading role as a member of GATT (the General Agreement on Tariffs and Trade), and the "Kennedy Round" now in process. Raising trade barriers would mark a fundamental reversal of these policies. Furthermore, it would probably only be effective in the short run, because foreign countries would probably retaliate by raising tariffs and other restrictions against American exports. All this would lead to a movement towards a curtailment of international trade and ultimately adverse economic impact on the United States and other countries.

Exchange controls to reduce capital movement and other overseas payments go against the long-maintained policy of freedom of payments and convertibility. They also involve the Government in bureaucratic administration and direction of payment transactions. They are difficult to enforce without elaborate regulations and surveillance and are incompatible with a free market economy. Furthermore, extensive exchange controls are also incompatible with the dollar's role as an international trade currency. The government has moved in the direction of exchange controls with "voluntary controls" on direct investments and bank loans overseas. Most countries, including Western European countries, consider exchange controls, especially on capital transactions, as legitimate measures to achieve equilibrium, and have used them for this purpose. They are permitted by the International Monetary

Fund when countries are experiencing fundamental disequilibrium. While they have arbitrary aspects, may have many unfavorable repercussions, and should be avoided in a free market system, it is not inconceivable that exchange controls on some types of capital movements, tourist expenditures, or other specific expenditures could be used if other more moderate measures do not succeed. They would probably be effective in forcing equilibrium, although there are considerable costs involved in economic efficiency, and disruption of free market system.

The United States government has taken a number of measures to establish equilibrium in the balance of payments, more than we can discuss in this article. Some of the measures have been to temporarily improve the balance of payments, such as advance repayment of loans, prepayments for military sales, and sales of medium-term inconvertible securities to surplus countries. Other measures have been of minor consequence, such as reducing the amount of duty-free goods that tourists could bring to this country; they can be considered more symbolic rather than substantive. We shall concentrate therefore on the following areas of action: (1) export expansion; (2) foreign aid; (3) military expenditures; (4) tourist expenditures; (5) foreign investments, and (6) cooperative international actions.

EXPORT EXPANSION

Government Programs. From the beginning the government has emphasized export expansion as one of the major ways to improve the balance of payments. First initiated by the Eisenhower Administration and later improved by the Kennedy Administration, the government has had a major interdepartmental National Export Expansion Program. Under the program national and regional export expansion councils, consisting of businessmen active in foreign trade, have been established. The Department of Commerce has substantially expanded and improved its information and other export trade services that are available through its field offices and the national office. These services are designed to encourage companies to get into exporting and also to expand exports. The Department of Commerce has been highly active in arranging trade missions overseas, encouraging participation of American companies in trade fairs, and establishment of trade offices in key countries. The

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Foreign Service has expanded the number of commercial officers and has placed greater emphasis on commercial activities overseas. In the important field of credit, the Export-Import Bank and the Foreign Credit Insurance Association (FCIA) (more recently established by private insurance companies in conjunction with the government) have established wide-ranging export credit insurance and credit guarantees. Other economic programs, especially the investment tax credits (now repealed because of inflationary pressures) and the tax reductions were expected to encourage business investments and make U.S. exports more competitive in world markets. The government has also been trying to get Western European countries and Japan to remove restrictions against American exports. It has also been negotiating for a reduction of tariffs and other barriers to trade under the "Kennedy Round."

Export Expansion and Equilibrium in Balance of Payments. Merchandise exports have expanded since the National Export Expansion Program was initiated, but it would be inappropriate to attribute this improvement to the program. The export expansion program has undoubtedly helped to increase exports, but there is no way of determining to what extent. However, the expansion of exports and the increase in the export balance has not been sufficient to establish equilibrium.

From a survey conducted and from analysis of key factors involved, the author believes that the export expansion program has made a contribution, but more basic economic factors here and abroad are more significant in determining exports. According to a survey made by the author as part of a larger Rutgers Graduate School of Business Administration study, the export program seems to have been more effective in assisting companies already involved in exporting than encouraging additional companies to make a major effort in exporting.[5] In general other factors have been more significant in expanding exports than the government programs. The effort devoted to exporting, the organization for international operations, the overseas channels of distribution, the market research, the adaptation of products for foreign markets, the servicing of products, delivery dates, credit terms, and sales promotion, are especially significant in determining exports of individual companies as well as competitiveness in price. From the national point of view, maintaining price stability, fostering an expanding economy that encourages production at close-to-full capacity, and encouraging domestic business investments to increase productive efficiency, develop new products and improve products are of major importance in expanding exports. However, merchandise exports also depend upon economic activity and economic growth abroad and price and nonprice competitiveness of American goods in relation to foreign products.

Some basic questions can be raised about the role of export expansion in achieving equilibrium, unless further measures are adopted. The expansion of exports during the last few years, as we have seen, has not been sufficient to achieve equilibrium. The government has been trying to expand merchandise exports more rapidly than imports and widen the trade balance. However, as we have seen in Part I, merchandise imports have been rising more rapidly than exports since 1955. Many foreign deficit countries including the United Kingdom and most less developed countries have been trying to expand their exports. American business in many cases has been emphasizing direct investments overseas rather than exporting. Moreover, the recent inflation has encouraged a more rapid rise in imports and has dampened exports. Even without inflation some major factors work against an expansion of exports more rapidly than imports. Usually there are some links between exports and imports; imports rise when exports rise. Foreign countries earn a considerable part of foreign exchange for imports through exports. Many exported products contain imported materials or components. Within the domestic economy, as indicated in Part I, merchandise imports rise in this country in relation to an expansion of the Gross National Product, personal income and industrial production. The increase in imports is especially rapid when the Gross National Product rises by a rate greater than 3½% a year. According to the absorption analysis, an improvement in the merchandise trade balance usually requires some increase in savings and holding down of personal consumption; otherwise as exports rise and Gross National Product increases through the multiplier effect, personal consumption increases and merchandise imports may rise about as rapidly or even more rapidly than exports.[6] This analysis indicates that it is not easy to expand exports considerably more rapidly than imports.

<u>Tax Structures and Exports</u>. The United States tax structure based largely on income and corporation taxes may also work against exports compared to the

tax systems of Western European countries, that are considerably based on turnover and other indirect taxes.[7] The United States like European countries does not levy or refund excise taxes on goods exported and charges such taxes on imported goods that are covered. However, such taxes cover a small number of products. Western European countries, on the other hand, depend very heavily on turnover and value added taxes. These taxes are not levied on goods exported and are imposed on most goods that are imported. In view of this, Europeans may have positive advantages over Americans in exporting to foreign markets. Furthermore, the internal indirect taxes may also make it more difficult for Americans to export to European countries.

Some proposals have been made for the U.S. government to grant export tax concessions such as lower rates of corporation taxes, to encourage exporting. One major difficulty is that these proposals are against GATT rules, which considers such concessions as export subsidies. On the other hand, under GATT rules, countries can rebate indirect taxes on exported products and levy such taxes on imported goods. The effect is to place countries that widely use excise, turnover, and value added taxes, in a more favorable situation than countries like the United States, that primarily imposes income and corporation taxes.

While this issue is highly complex and controversial, the United States government should seriously consider what can be done to place American exports approximately in tax parity with those of Western European countries. The issue is not to give this country's exports an advantage but rather to harmonize tax policies in this country more with those prevailing in Europe. The alternatives seem to be (1) to press for changes in GATT rules or an exception under existing rules or (2) revise the U.S. Tax system to have a major federal value-added tax or other indirect taxes.[8] Neither course of action would be easily accomplished. However, at this time it seems that it would be more promising to seriously negotiate some changes in GATT rule as part of a new foreign trade program after the "Kennedy Round." Furthermore, the United States should strive for further elimination of nontariff barriers, including various quotas that still limit exports to many industrial nations.

FOREIGN AID

Military Assistance. Military assistance has primarily transferred American military equipment and supplies to friendly nations and has led to no direct-dollar costs, except for offshore procurement. The offshore procurement under military assistance programs has been shown under military expenditures and has amounted to about 100 to 150 million dollars a year during the last few years, but it has been rising as a result of the war in Vietnam. However, if the United States has supplied military equipment under the assistance program that friendly countries would have purchased commercially this has had an adverse impact on the balance of payments. While this is unlikely by and large, military assistance grants continued to Western European countries long after the United States first incurred major deficits in its balance of payments in 1958, because of commitments previously made and usual lags in supplying equipment. Thus, military assistance programs did probably have some adverse impact on this country's balance of payments, especially during the early years of the major deficits. But the adverse impact has probably been small during the last few years.

Nonmilitary Foreign Assistance. The impact of economic assistance on the balance of payments is difficult to analyze. In the first place, what is termed foreign aid consists of a number of different programs: (1) loans, grants and technical assistance under the Foreign Assistance Act; (2) disposal of surplus agricultural products under Public Law 480; (3) loans under the Export-Import Bank; (4) contributions to various international lending programs, such as the World Bank, the International Development Association, and the Inter-American Development Bank and (5) some miscellaneous programs. Only about half of foreign aid has been under the Foreign Assistance Acts. However, the loans and grants under the Foreign Assistance Acts have been for a number of different programs, including economic development, military support activities, technical assistance, Alliance for Progress, contingency aid, and contributions to a number of United Nations programs, including the U.N. Expanded Program of Technical Assistance and Special Fund, U.N. assistance to the Congo, U.N. Children's Fund, the World Food Program, and the Indus Basin Development Fund. As we can see in Table I Congress has kept down the amount of funds appropriated under the Foreign Assistance Acts and the total

TABLE I

NONMILITARY FOREIGN AID BY MAJOR PROGRAMS AND BREAKDOWN BY TRANSACTION INVOLVING NO DIRECT DOLLAR PAYMENTS OVERSEAS

1960-1965

(Millions of Dollars)

	Average 1960-1962	1963	1964	1965
Foreign Assistance Acts	1,799	2,158	2,009	2,196
Agricultural Product Disposal Programs	1,377	1,671	1,765	1,475
Export-Import Bank	616	509	338	532
Subscriptions to International and Regional Organizations	149	62	112	
Misc. Programs		151	39	74
Total Foreign Assistance	3,941	4,551	4,263	4,277
Transactions Involving No Direct Dollar Outflow to Foreign Countries	2,812	3,737	3,578	3,569
Estimated Dollar Payments to Foreign Countries	1,119	814	685	708
Per Cent of Transactions Involving No Direct Dollar Payments Overseas as a Per Cent of Total Foreign Aid	71%	82%	84%	83%

Source: Compiled from Lederer, Walther; Pizer, Samuel and Parrish, Evelyn M. "The U.S. Balance of International Payments: First Quarter 1966." *Survey of Current Business*, Vol. 46, No. 6, Tables 1 and 5, pages 24, 25, and 33.

foreign aid has been quite stable at a little over four billion dollars a year from 1961 to 1965.

The major measure to limit the adverse effects of foreign aid on the balance of payments has been to tie most of the assistance to expenditures on goods and services in this country. Tying foreign aid has generated some controversy. It makes foreign aid in many respects less efficient in assisting less developed countries. Aid-receiving countries may be compelled to purchase more costly goods or those that are less satisfactory for their purposes. To some extent it may be equivalent to reducing aid. Still, many other countries, including those having surpluses, have long tied much of their aid.

As a result of tying foreign aid as shown in Table I, about 83 per cent of total U.S. nonmilitary assistance has been directly spent for goods and services in this country in the years 1963 to 1965. The percentage of aid expenditures involving no direct dollar outflows has increased from 71 per cent in the years 1960-1962 to 83 per cent in the years 1963 to 1965. The dollars directly spent overseas have gone down from over a billion dollars a year in the years 1960-1962 to an average of a little over $700 million in the years 1963-1965. Even on this basis the foreign economic assistance has contributed to the deficits the last few years.

Feedbacks and Substitution. However, analysis of the impact of foreign assistance has to consider the feedbacks through third countries and the substitution effects. Some studies have emphasized that tying aid is unnecessary because most of it leads to expenditures for American goods and services because of feedbacks directly or indirectly through third countries.[9] Even some of the foreign aid that is not tied at the present time, especially that through United Nations organization, may be spent indirectly in the United States through feedbacks. On the other hand, substitution means that a country uses foreign aid funds to buy goods that it would normally purchase through commercial channels from the United States and then uses the foreign exchange conserved to purchase goods from other countries. Such substitution from commercial procurement to aid financing, in effect, makes tying aid ineffective and leads to a deterioration of the balance of payments. Considerable substitution would mean that foreign aid has a more adverse impact on the balance of payments than usually maintained by government officials.

The Agency of International Development claims that the feedbacks, especially through third countries, offset the substitution of aid financing for commercial procurement. On the other hand, in a recent study, the International Economic Policy Association after an analysis of the problem reached the conclusion that substitution was greater than the feedback for most foreign aid programs.[10] It especially emphasized that U.S. contributions to international lending organizations, particularly the International Development Association, led to considerable dollar expenditures overseas. However, the analysis of the International Economic Policy Association is not fully convincing, as there is no way of determining the full impact of the foreign aid including that through international organizations. The best that can be said is that the foreign exchange costs of foreign aid probably are greater than indicated by the tying of aid and by the calculation of direct expenditures in this country.

Some Suggestions: Foreign aid to less developed countries has been one of the significant innovations of American foreign policy in the post-war period. It is trying to aid these countries in one of the great undertakings of the last half of the 20th century--their economic development and modernization. It has significant political, economic, and humanitarian consequences for the future of the United States in the world. Still, the balance of payments effects of foreign aid have to receive appropriate consideration, because the future of these and other programs to aid less developed countries would be jeopardized by a continuation of the deficits and an undermining of the dollar.

The way to deal with the foreign aid effects on the balance of payments is not to make sharp reductions, but rather to minimize the adverse effects. Even if the entire foreign aid program were eliminated, it would be doubtful that the United States would experience equilibrium in its balance of payments. Substantial cuts would seriously weaken our foreign policy with less developed countries. At the same time, the United States is not in a position to increase foreign aid until the balance of payments problem is resolved.

The United States could take measures such as the following to limit the foreign exchange costs of foreign aid: (1) try to reduce the substitution of foreign aid procurement for commercial procurement by careful surveillance and study of past import patterns; (2) reduce aid to countries that engage in substitution; (3) try to get international lending agencies to procure more goods in this country when the United States provides funds; (4) try to dispose part of surplus agricultural products for convertible currencies; (5) reduce aid to countries that show that they waste it or do not use it effectively; (6) keep new contributions to international lending organizations to a minimum until the balance of payments problem is resolved; (7) continue efforts to get surplus Western European countries and Japan to increase their foreign aid and provide it on an untied basis.

MILITARY EXPENDITURES OVERSEAS

The Program and Measures to Reduce Expenditures. Military expenditures comprise the following: (1) overseas expenditures by U.S. military, civilians and dependents; (2) payments of wages of foreign nationals; (3) procurement abroad of major equipment, materials, and supplies; (4) payments for construction and contractual services; (5) offshore procurement under military assistance programs; and (6) payments of U.S. share of NATO infrastructure. As shown in Table II military expenditures leveled off at a little under three billion dollars a year from 1960 to 1965. About half of total military expenditures have been made in Western Europe during this period. Part of the military expenditures have been offset by sales of military equipment, especially to West Germany. As we can see in Table II, net military expenditures after military sales have declined from about $2.5 billion in 1960-61 to about $2 billion a year in the 1963 to 1965 period.

The Department of Defense has had a comprehensive program to reduce military expenditures overseas. The program includes: (1) procurement in the United States rather than overseas whenever costs are not more than 50 per cent higher; (2) reduction of employment of foreign nationals at overseas bases; (3) reduction of overseas construction; (4) reduction of offshore procurement under military assistance; and (6) negotiation of offset agreements.

TABLE II

OVERSEAS MILITARY EXPENDITURES
BY MAJOR AREAS FROM 1960-65

(Millions of Dollars)

	Average 1960-1962	1963	1964	1965
Western Europe	-1,591	-1,511	-1,484	-1,456
United Kingdom	-236	-184	-173	-153
Other Countries	-1,355	-1,327	-1,311	-1,303
Canada	-357	-296	-258	172
Latin American Republics	-64	-79	-82	-83
Japan	-382	-362	-312	-323
Other Countries	-674	-687	-697	-846
Total Military Expenditures	-3,068	-2,935	-2,833	-2,880
Less: Military Sales under Offset Agreements	464	657	747	844
Net Military Expenditures	-2,604	-2,278	-2,086	-2,036

Source: Compiled from Lederer, Pizer, and Parrish article on U.S. Balance of Payments, *Survey of Current Business*, June 1966, Tables 1 and 8.

The Bureau of Budget has also carefully scrutinized military expenditures under the "Gold Budget Review." The result of these programs has been basically to prevent military expenditures from rising despite higher costs overseas. However, the offset agreements have reduced net military expenditures. Until recently West Germany has been offsetting the full foreign exchange costs of American troops stationed there. Italy, the United Kingdom, and Canada have been offsetting part of such costs.

More recently, overseas military expenditures have been rising as a result of the increased military effort in Vietnam. There has been increased offshore procurement and other foreign exchange costs incurred from the military effort in Vietnam. Moreover, West Germany has fallen behind in its purchase of military equipment in the United States under the offset agreements, as it has been experiencing budgetary problems and some deterioration in its balance of payments. The West German government is re-studying the offset agreements with the United States and wants to renegotiate them, as it no longer wants to import the amount of the military equipment specified.

Re-evaluation of Military Programs Overseas. The time has come for some very fundamental re-evaluations by the United States concerning military troops in Western Europe in view of changes in NATO, the French withdrawal from the joint command, the moving of NATO headquarters from Paris and basic changes in military technology and mobility. At this time the United States still has about 200,000 troops and 300,000 dependents in Western Europe. Can the United States maintain this level of troops in Western Europe, have a substantial military effort in Vietnam, and perform other worldwide military commitments without contributing to a strain in the balance of payments?

The possible withdrawal of troops from Europe is a highly complex political and military problem, with many ramifications. Some U.S. military and political leaders argue that a reduction of troops in Europe would further weaken NATO. West Germany and other NATO countries have opposed a reduction of U.S. troops. On the other hand, according to some military leaders, mobile forces could be developed under which the United States could maintain its commitments in Europe and considerably reduce its force levels.

These questions certainly involve complex military, technical, and political analysis, but the balance of payments considerations should also be weighted appropriately. Experience shows that long standing military and political policies are not easy to alter, even though many fundamental circumstances do change and will continue to change in the future. Rigidities in thinking should not be allowed to prevent adaptation of policies to rapid changes taking place. In the author's judgment, the present period when the United States is undertaking a study in conjunction with West Germany and the United Kingdom of troop levels, when the West Germans are trying to reduce their commitments under offset agreements, when NATO is undergoing transformation and is moving its headquarters, when important changes seem to be taking place in the Soviet Union and its economy, is an appropriate time for this country to take steps in conjunction with other countries to reduce its military forces in Europe and Japan and also to further renegotiate NATO infrastructure costs. Moreover, while it has proven controversial in the past and not feasible politically, a new attempt could be made to reduce the number of dependents overseas, where troops have to be maintained.

TRAVEL EXPENDITURES

As Americans have traveled more to foreign countries, the gap on tourist expenditures has steadily widened during the last decade. Total travel expenditures by Americans, including fares to foreign carriers, as shown in Table III, have increased from $2.2 billion in 1961 to $3.1 billion in 1965, an average annual increase of about 9 per cent a year. Travel expenditures by foreigners in this country, including fares to American carriers, have also increased--from a little under a billion dollars in 1961 to almost $1.4 billion in 1965. However, the tourist gap, the excess in expenditures by Americans in foreign travel over expenditures by foreigners here, has widened from $1.2 billion a year in 1961 to $1.7 billion in 1965. The tourist gap has widened by about $150 million a year since 1961, except in the years 1963 to 1964, when it remained stable. According to preliminary reports travel expenditures by Americans overseas have continued to rise in 1966.

The U.S. government has been trying to reduce the adverse balance in tourist expenditures by promotion of foreign travel to this country, by a reduction of the amount of duty free goods that American

TABLE III

TRAVEL EXPENDITURES BY AMERICANS OVERSEAS AND BY FOREIGNERS IN THE UNITED STATES

1961-1965

(Millions of Dollars)

	1961	1962	1963	1964	1965
Travel Overseas by U.S. Residents					
Expenditures Abroad	1,735	1,885	2,090	2,201	2,400
Fares to foreign carriers	507	575	615	645	720
Fares to U.S. carriers (for purposes of comparison)	(358)	(415)	(490)	(520)	(610)
Total expenditures to foreign countries	2,242	2,460	2,705	2,846	3,120
U.S. Receipts from foreign visitors in U.S.					
Expenditures by visitors in U.S.	885	878	934	1,095	1,212
Fares to U.S. carriers	110	113	118	150	165
Total receipts by foreign visitors in U.S.	995	991	1,052	1,245	1,377
Balance on travel expenditures	1,247	1,469	1,653	1,601	1,743

Source: Compiled from Miller, Etienne H., "Foreign Travel Payments Continue to Rise in 1965," *Survey of Current Business*, Vol. 46, No. 6, (June 1966), pages 15-17.

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tourists could bring to this country, and by exhorting Americans to travel here rather than abroad. These measures have not been effective in holding down the adverse balance on foreign travel.

The freedom of international travel is considered to be an important right of Americans. International travel also has many educational advantages and can help to increase international understanding, although this can be overestimated.

Some additional measures could be undertaken to increase foreign travel to the United States, although it is unlikely that the gap in expenditures can be closed very much in this way. There could be special lower trans-Atlantic fares from Europe to the United States and more special group rates. More lower price travel packages could be arranged. Furthermore, the American government could promote tourism to this country more effectively. To some extent limited appropriations for travel promotion have held back such programs. Still, because of costs, distances and tastes of foreigners, there are limitations to increased travel to this country.

As long as Americans continue to travel more to foreign countries and increase expenditures rapidly for such travel, it will be difficult to reduce the gap on tourism. Some have proposed taxes or other restrictions on foreign travel by Americans. One proposal is a flat tax, for example $100 or more, on passports. Another proposal is a tax of $10 per day or some other amount on foreign travel. Others have proposed a tax on tourist travel to Western European surplus countries, with exemptions for business and educational travel.

Such a tax or other types of taxes would run into some difficult problems. It would be another restriction that would be inconsistent with general policies long pursued by the United States to expand travel by people as well as movement of goods and capital. Such measures would hurt our airlines and other carriers and would be severely opposed by carriers, travel agents, and many Americans. They would hurt some other deficit countries such as the United Kingdom, and could lead to some counter restrictions by foreign countries. They would be difficult to initiate politically. Furthermore, it would be difficult to distinguish between business, educational and other travel.

Nevertheless, the gap on foreign travel has probably contributed substantially more to the balance deficit during the last few years than foreign economic assistance. Furthermore, the gap has been increasing quite steadily during the last decade. Under these circumstances can we continue to allow complete freedom of international travel, desirable as it is on many grounds? Is it equitable to increase restrictions on direct investments, bank loans, and security sales in this country and leave foreign tourist travel untouched? Under some interpretations of International Monetary Fund rules, restrictions on capital transactions may be preferred to those on current transactions, such as tourist travel. Yet, many Western European countries and Japan still have some restrictions on foreign travel by their citizens.

While recognizing the problems involved and possible adverse repercussions, the author believes that some restrictions on foreign travel by Americans may be one of the necessary measures to achieve equilibrium. He cannot go into specific measures, but generally prefers a tax over other types of restrictions, with some exemptions for genuine business and educational travel.

U.S. PRIVATE FOREIGN INVESTMENTS OVERSEAS

Recent Trends. Private foreign investments and loans have been increasing spectacularly during the last decade. As we can see in Table IV net U.S. investments outflows increased from about $2.7 billion in 1958-1959 to $3.8 billion in 1960-1962 to almost $5 billion in the years 1963 to 1965. The peak in total capital outflows was reached in 1964, when they were about $6.5 billion. Government restrictions undoubtedly held down capital outflows in 1965, although direct overseas investments increased by a billion dollars from 1964 to 1965.

The analysis of long and short-term capital outflows and possible measures to hold them down is highly complex and controversial. Yet, in view of their sharp increase during the last decade and their significance in the balance of payments, the government had to take some measures to hold them down. While we can hardly analyze the many ramifications of U.S. foreign investments overseas in this article, we shall consider the measures taken by the Administration with respect to (1) portfolio investments and bank loans and (2) direct investments.

TABLE IV

U.S. PRIVATE INVESTMENTS OVERSEAS BY MAJOR TYPES

1958-1965

(Millions of Dollars)

	Average 1958-1959	Average 1960-1962	1963	1964	1965
Direct Investments	-1,277	-1,642	-1,976	-2,416	-3,371
Foreign Securities					
New Issues	-790	-718	-1,250	-1,063	-1,206
Redemptions	90	184	195	193	222
Other Transactions	-260	-264	-49	193	226
Net Foreign Securities	-960	-798	-1,104	-677	-758
Bank Loans					
Long-Term	-167	-139	-754	-941	-231
Short-Term	-204	-815	-781	-1,523	325
Net Bank Loans	-371	-954	-1,535	-2,464	94
Other Financial					
Long-Term	-60	-101	163	-343	-91
Short-Term	10	-335	-4	-623	436
Net Other Financial	-50	-436	159	-966	345
Total Net U.S. Investments Abroad	-2,666	-3,830	-4,456	-6,523	-3,690

Source: Compiled from Lederer, Pizer, and Parrish article on U.S. Balance of Payments, *Survey of Current Business*, June 1966, Table 1.

Portfolio Investments and Bank Loans. With the sharp rise in fluctuations of foreign securities in 1961 to 1963, President Kennedy asked for the passage of the Interest Equalization Tax in July 18, 1963. The Interest Equalization Tax was signed into law in September 2, 1964, but it was made retroactive to July 18, 1963. In effect, it increased by approximately one per cent the interest cost to foreigners of obtaining capital in this country through the issue of securities. Securities of less-developed countries were exempted. Bank loans were also exempted initially although there was standby authority to impose the tax on such loans. Nonbank credit was not covered by the law. After the sharp increase in bank loans in 1964 President Johnson extended the application of the tax to bank loans abroad with maturities of one year or more. Furthermore, at the recommendation of the President, the Interest Equalization Tax was extended until the end of 1967. The tax was broadened to cover nonbank credit with maturities over a year.

Some doubts and various criticism have been expressed about the Interest Equalization Tax. When the tax was first proposed to be made retroactive to July 18, 1963, it held down new foreign security issues for about a year. However, foreign security sales resumed in the United States in 1964 and 1965. Part of this may be attributed to the fact that Canada and Japan in part were exempted from its provisions. Furthermore, even with the tax the interest costs of bonds were often less than those in foreign capital markets. In addition, with the tax on securities, there seems to have been a shift to increased bank loans and to some extent direct investment outflows in 1964.

The opposition to the Interest Equalization Tax has been strong by the financial community on the grounds that it interferes with the freedom of investments and market forces. The tax has been considered to some extent as the equivalent of a differential rate of foreign exchange. The financial community has also been concerned by the continuation of the tax for a longer period than originally proposed and by the broadening of its coverage.

It is too early to fully evaluate the Interest Equalization Tax, but it has probably held down portfolio investments and more recently bank and other loans. The exemptions, especially of Canada and other exemptions from the tax (such as securities of the World Bank) made it less effective. In 1965 Canada floated 709 million dollars of new securities in this country, Japan sold about 50 million dollars of securities. During the first half of 1965, Canadian sales of securities in the United States amounted to $646 million. In fact, well over half of new security sales since 1963 have been Canadian. The exemption of Canada was made because of close economic and financial ties, but it has made the tax much less effective.

Bank loans have been held down by the application of the Interest Equalization Tax to loans of a year or longer and by "voluntary restraints" imposed early in 1965. Under the "voluntary restraints," each bank was expected to limit the increase in its foreign loans and investments in 1965 to an amount not more than five per cent above the amount outstanding at the end of 1964. The "voluntary restraints" were administered by the Federal Reserve System through some reporting and review procedures. In December 1965 the voluntary restraints were continued with the ceiling of bank loans gradually raised to 109 per cent in the last quarter of 1966 over the base, December 31, 1964.

With the provisions for some review of overseas bank lending by the Federal Reserve System, the regulations can hardly be considered voluntary. However, in view of the increase in bank short and longer term foreign loans from an average of $954 million in the years 1960 to 1962, to $1.4 billion in 1963 and $2.5 billion in 1964, the government had to take some action to limit these dollar outflows. The present system of restraints has been preferable to exchange controls. However, banks criticize the program for impairing financing of merchandise exports. This matter probably requires further analysis, but the restraints should be administered in such a way as not to limit export financing.

While the restrictions on freedom of portfolio bank investments through the Interest Equalization Tax and "voluntary restraints" are to be regretted, the author believes that these restrictions or others were necessary. Without them the deficits would probably have been larger, and the government may have had to resort to more drastic measures. The feedbacks of portfolio investments in stimulating U.S. exports of goods and services are unclear and may be limited. The Interest Equalization Tax, despite many criticisms of the measure, was a valid way to limit portfolio investments. Furthermore, in order to make it effective, it was appropriate to extend its application to bank and nonbank loans, with maturities over a year. The exemption of Canada has made the tax less effective in holding down portfolio investments. Until balance of payments equilibrium has been achieved under the official settlement concept, there are grounds for continuing the Interest Equalization Tax. If necessary the amount of tax could be increased and the exemption of Canada could be removed. Moreover, for similar reasons, the "voluntary restraints" on overseas bank loans may have to be continued, but every effort should be made to encourage banks to give priority to export financing credit. The alternatives to the present restriction would probably be capital issue controls or other mandatory exchange controls.

INTERNATIONAL COOPERATION BY SURPLUS COUNTRIES

A principle emphasized in some discussions of international bodies is that surplus countries, (as well as deficit countries), have a responsibility for taking action to contribute to equilibrium. The principle sounds good, but surplus countries in recent years have been slow in following through with positive actions. It seems that surplus countries have been more content to have surpluses than achieve equilibrium. Of course, the surpluses have been somewhat less than the U.S. deficits, because of differences in concepts of equilibrium. Having surpluses enables countries to increase holdings of gold and other monetary reserves and provides them with some additional margin of safety. However, it does have costs, as countries forego consumption of imported goods and may experience some inflationary pressures.

The American government has tried to get surplus countries to take a number of positive actions, including the following: (1) eliminate quantitative restrictions on imports; (2) eliminate restrictions on capital outflows and tourism; (3) expand untied foreign aid to less developed countries; (4) share more of the burdens of common defense expenditures; and (5) various types of international monetary cooperation. When the United States had substantial surpluses during the period of the dollar shortage in the post-World War II period, it took many actions to assist countries in disequilibrium, including substantial foreign economic assistance, encouragement of outflow of private capital, unilateral reduction of tariffs to facilitate imports, and substantial military procurement overseas.

The Western European surplus countries have hardly been magnanimous in their actions to eliminate their surpluses or to assist the United States in achievement of equilibrium in its balance of payments. They have increased their foreign aid, but it has been in effect tied to their merchandise exports. They have moved slowly in sharing common military expenditures. Some revisions have been made that have reduced the American share of NATO infrastructure costs. As we have seen West Germany has been offsetting foreign exchange costs of U.S. troops stationed there; Italy and England have been offsetting part of military expenditures; France and other countries have not offset any such costs. Many of the Western European countries still retain various quantitative restrictions on agricultural and other imported goods, that may hurt our exports. Some of the European countries and Japan restrict tourist travel and capital outflows. However, most surplus countries have been repaying their loans to this country ahead of schedule. Otherwise, the most effective cooperation has been in international monetary matters through some coordination of policies among central banks, and swap and other arrangements worked out by the Federal Reserve and International Monetary Fund previously discussed in Part I.

Thus, the reiteration of high-minded principles, about the responsibility of surplus countries has not led to much effective action on the part of these countries to aid for U.S. balance of payments. Rather officials of foreign governments and monetary authorities have sometimes emphasized that the United States should use monetary policy to discourage outflows of foreign capital or to attract funds from overseas and that it should curb outflows of direct investments. Europeans have also sometimes complained that U.S. deficits have contributed to inflation in their countries. Such complaints do not have a sound basis, for as we have indicated surplus countries can pursue many constructive policies to eliminate their surpluses, including reducing tariffs and other restrictions to facilitate imports and increasing untied foreign aid to less-developed countries.

Despite the limited cooperation received from surplus countries, the United States should press even

TABLE V

DIRECT INVESTMENTS OVERSEAS,
INCOME FROM DIRECT INVESTMENTS,

1958-1965

(Millions of Dollars)

	Average 1958-1959	Average 1960-1962	1963	1964	1965
Direct Investments Overseas	-1,277	-1,642	-1,976	-2,416	-3,371
Income received on Direct Investments	2,175	2,724	3,134	3,670	3,961
Fees and Royalties on Direct Investments	297	482	660	756	909
Total Income on Direct Investments	2,472	3,206	3,794	4,426	4,870
Excess of Total Income over Direct Dollar Outflows	1,195	1,564	1,818	2,010	1,499
Merchandise Exports to Affiliates of U.S. Companies Overseas[1]		4,923	5,342	6,290	

[1]Data shown for 1962. Not available for other years and for 1965.

Sources: Compiled from Lederer, Pizer, Parrish article on U.S. Balance of Payments, *Survey of Current Business*, June 1966, *op. cit.*, Table 1, and Pizer, Samuel and Cutler, Frederick, "U.S. Exports to Foreign Affiliates of U.S. Firms," *Survey of Current Business*, Vol. 45, No. 12 (December 1965), Table 1.

harder especially for elimination of restrictions on imports and capital outflows and for a widening of capital markets in those countries.

Direct Investments and Balance of Payments. The analysis of the impact of direct investments overseas on the U.S. balance of payments and of measures to limit any possible short-term adverse effects is even more complex and controversial than in the case of other types of capital.[11] As we can see in Table V, direct investments overseas have been increasing sharply from an annual average of $1.3 billion in 1958-1959 to $1.6 billion in the years 1960-1962 and $2.9 billion in 1964-1965. Still total income on direct investments, including fees and royalties, has exceeded the dollar outflows year by year. This has been true every year from 1945 to 1965. The total cumulative excess of income, including receipts of licensing fees and royalties over dollar outflows has been about 20 billion dollars since 1945. Moreover, as shown in Table V, merchandise exports to affiliates of U.S. companies overseas have been $4.9 billion in 1962, $5.3 billion in 1963, and $6.3 billion in 1964. These exports have averaged almost one-quarter of total U.S. merchandise exports in these years. For these and other reasons, businessmen emphasize that direct investments overseas have contributed positively to an improvement in the balance of payments. But they fail to consider that direct investments overseas may lead to sales from plants in foreign countries that replace exports from this country. According to Department of Commerce statistics sales of foreign affiliates have increased from $18.3 billion in 1957 to $43.4 billion in 1965, an average rate of increase of about 11 per cent a year. On the other hand, exports of manufactures have increased more slowly from $11.1 billion in 1957 to $17.2 billion in 1965, an annual average rate of increase of 5.5 per cent.

Thus, the fact that earnings received on direct investments, including licensing fees and royalties, have exceeded direct investment outflows year by year and that substantial exports are made to affiliates of U.S. companies does not conclusively show that the balance of payments effects of these investments are favorable. Other factors such as sales from overseas production facilities replacing exports from this country to the country in which the investments are made and to third countries should be considered. The excess of earnings transmitted to this country over direct investment outflows may be unfavorable in the short term. As some economists have emphasized, current earnings received on direct investments depend upon past investments made, rather than on current ones. Current capital outflows will yield earnings in the future. There is a lag between the capital outflows, the earnings overseas, and the transfer of earnings to this country. Furthermore, the tendency of business firms is to reinvest about half or so of profit made overseas. On the other hand, the exports generated by direct investments should be considered.

A number of studies have been made of the balance of payments pay-out periods, the time it takes for direct investment outflows to return to the United States in foreign exchange earnings. Some of the early studies by the Department of the Treasury showed payment periods of about 15 years, but these studies ignored some important considerations. A study by Professor Bell showed varying pay-out periods, with around 6-7 years for manufacturing investments in Europe.[12] In a recent article Professor Behrman, placing greater emphasis on export generation by direct investments, calculated that direct investment outlays are returned to the United States by foreign exchange earnings in a little over two years.[13] However, he failed to consider that sales from overseas production facilities may replace some exports from this country. Professor Behrman's calculation seems to be too optimistic, but at the present time the data is not available to make exact calculations.

The determination of the shorter run and longer term effects of direct investments would have to consider a number of positive and negative aspects of these investments.[14] The factors that improve the balance of payments are: (1) exports of machinery, equipment, and services when capital outflows are made; (2) exports of materials and components to foreign affiliates of U.S. companies; (3) exports of U.S. products through foreign affiliates acting as sales offices; (4) indirect exports generated as a result of expansion of income in foreign countries because of investments made there and because of the presence of U.S. affiliates there; and (5) profits, licensing fees, royalties earned overseas and the proportion transmitted to this country. The factors that have a negative effect on the balance of payments are: (1) the dollar outflows for new projects; (2) dollar outflows to maintain or expand investment position overseas; (3) the U.S. exports directly displaced by sales of foreign affiliates; (4) U.S. exports displaced in third countries as a result of exports of foreign affiliates; (5) increased U.S. imports from foreign affiliates. The data is not available on the above factors to fully determine the balance of payments effects of direct investments. But the long-term effects of direct investments seem to be highly favorable to the balance of payments although the shorter term ones may be somewhat adverse, especially when capital outflows are increasing sharply.

Direct investments also reflect the internationalization of American business and the establishment of muli-national corporations with worldwide business. International corporations in their evolution tend to move from exporting, to licensing arrangements to overseas plants and marketing organizations, but they engage in all of these activities simultaneously. Business firms emphasize that they establish plants overseas because it is difficult to export to many countries in view of transportation costs, tariffs, import duties and other restrictions. They also establish plants because of favorable costs and demand conditions. They can in many countries develop market opportunities to the maximum extent through plants and sales organizations in foreign countries rather than through exports. The companies think in terms of longer term opportunities for sales expansion and profits.

Voluntary Restraints. The American government has imposed voluntary restraints on direct investments to hold them down. The first program of voluntary restraints initiated in February 1965 gave major corporations discretion in improving their individual balance of payments through expanding exports, reducing dollar investment outflows, increasing income by transmission of fees, royalties, and income on direct investments, and bringing home short term capital from overseas. Major corporations claim that they complied with the program, but not necessarily by reducing direct investment ouflows, which increased a billion dollars, from $2.4 billion in 1964 to $3.4 billion in 1965. In December 1965, the Administration announced tightened voluntary restraints on direct investments. About 800 major corporations were asked to limit their direct investment outflows to 90 per cent of the amount invested in the three year period 1962 to 1964, considering capital outflows and reinvested earnings of the corporations.

Business companies have generally been highly critical of the voluntary restraints on direct investments. They have claimed that direct investments help the balance of payments far more than they impair it, through the earnings transmitted to this country and the exports generated. They emphasize the voluntary restraints, if continued for several years, will impair their productive capacity and sales organizations, hurt their competitive position overseas, hold down merchandise exports, and also limit earnings that can be made and repatriated to this country. The companies claim that the restraints are not voluntary for they have to make detailed reports to the Department of Commerce. Some companies also complain that voluntary restraints cannot work very long, because some businessmen will not abide by them and will gain advantages over those that comply. Despite the many complaints, according to available evidence business companies are generally complying with the voluntary restraints. In part they prefer the voluntary restraints to exchange controls.

Even though there has been widespread criticism of the voluntary restraints on direct investments, the American government has had to take action to limit these outflows. It could not permit these investments to increase as rapidly as they were increasing from 1961 to 1965 and expect foreign monetary authorities to agree to hold larger liquid dollar balances as international reserves. These voluntary restrictions may have to be continued until equilibrium is established in the balance of payments under the official settlements concept. However, in view of many positive aspects of direct investments in the longer term on the balance of payments and on the world economy, the government should not move to exchange controls on these transactions.

BALANCE OF PAYMENTS EQUILIBRIUM AND OTHER GOVERNMENTAL POLICIES

The American government has been trying to achieve equilibrium without impairing the pursuit of major foreign policy, national security, and international and national economic policies, especially (1) foreign aid to assist in economic development and modernization of less-developed countries; (2) overseas military commitments involving American troops, foreign bases, and military missions; (3) policies to maintain high and stable employment and vigorous economic growth; and (4) the continuation of the dollar as an international currency. It has also been trying to continue liberal trade policies, freedom of investments and freedom of payments.

Balance of payments considerations have placed constraints on these policies and have led to a number of adjustments, but have not been allowed to interfere in a major way with the pursuit of major policies. Along this line, the accelerated military involvement in Vietnam for national security reasons has had an adverse impact on the balance of payments estimated at over a billion dollars a year. We could hardly expect that balance of payments constraints would be allowed to interfere with this country's pursuit of major foreign policy, national security, and domestic economic goals. Moreover, the role of the dollar as an international reserve currency and fixed exchange rates cannot readily be altered without some basic changes in the present international monetary system.

Nevertheless, a fundamental reappraisal of the priority of balance of payments policies may be in order, for the continuation of the persistent deficits could undermine the foundations of our foreign policy, our national security, and the stability and growth of the domestic economy. While many measures have been taken to reinforce the present system, the continuation of deficits could lead to a gold crisis, the breakdown of the present international monetary system, based in part on the dollar as a world currency, and a world economic crisis with significant ramifications on our economy and that of other free world countries. We should emphasize that we are not predicting such a serious crisis, for it might be avoided even with the continuation of the current levels of deficits for many years. But on the other hand, the possibility of such a crisis cannot be excluded. And as the American gold stock declines in relation to dollar assets held by foreigners the probability of a crisis increases.

Under these circumstances balance of payments equilibrium should have at least equal priority with other objectives, and there may have to be some give in other policies. Can we continue the worldwide commitments that we have undertaken since the end of World War II even though we are no longer the economic giant that we were at that time? Have we overextended our foreign policy and military commitments beyond the capacity of this country? Should we not engage in a fundamental re-evaluation to see what commitments, for example, military expenditures in Western Europe, can be reduced? Can we pursue our worldwide commitments indefinitely and at the same time pursue domestic policies to maintain full employment and economic growth and maintain freedom of payments, freedom of travel, freedom to American business to invest worldwide, freedom of access to the American capital and money markets, and liberal trade policies? Already there have been some restraints on direct investments and overseas bank loans through so-called voluntary controls and on access to American capital markets by the interest equalization tax without achieving equilibrium in the balance of payments.

It seems clear that the United States cannot pursue all of its international and domestic policies and maintain all of its international economic freedoms and attain equilibrium in its balance of payments at this time. We can hardly be expected to sacrifice high and stable employment and economic growth for balance of payments equilibrium. Furthermore, the author does not believe that the liberal trade policies long developed under the Reciprocal Trade Agreements Program, the Trade Expansion Act of 1962, and GATT should be forsaken. Any moves to increase tariffs or impose other barriers to trade could only bring temporary improvement in the balance of payments.

The most feasible areas of additional action to improve the balance of payments at this time seems to be positive tax incentives to encourage merchandise exports and to bring our tax system more in harmony with those of Western European countries, more effective anti-inflationary policies, reductions of American troops in Western Europe and Japan, further curtailment of portfolio investments through a steeper interest equalization tax and other measures if necessary, some curtailment of foreign travel by Americans by a tax or other measures, and holding down foreign aid. Ending the hostilities in Vietnam would also help the balance of payments.

At any rate, the American government should move positively and energetically to achieve equilibrium in its balance of payments for an extended period under the official settlements concept. Once it has firmly achieved equilibrium, the United States can press harder for a reform of the international monetary system and gradually expand foreign aid and pursue other enlightened policies to assist less developed countries and achieve greater international cooperation.

FOOTNOTES

1. See Discussion of Salant, Walter S. and others. *U.S. Balance of Payments in 1968*, Washington, D.C.: Brookings Institution, 1963, esp. pages 15-29.

2. For a discussion of criteria and policies see Snider, Delbert A., "The Case for Capital Controls to Relieve the U.S. Balance of Payments," *American Economic Review*, June 1964.

3. The Brookings Institution study by Salant and others, *op. cit.*, emphasized the differences in price increases in Western Europe and the United States as an important factor to contribute to balance of payments equilibrium, using the basic transactions.

4. See Vanek, Jaroslav, "Overevaluation of the Dollar: Causes, Effects, and Remedies," and Houthakker, H.S., "Exchange Rate Adjustment" in *Factors Affecting the United States Balance of Payments* for Subcommittee on International Exchange and Payments, Joint Economic Committee of Congress. Washington, D.C.: Govt. Print. Off., 1962.

5. Dymsza, William A., "Export Expansion--An Evaluation," *International Trade Review*, vol. 39, No. 3 (March 1965), pages 14-15.

6. See Johnson, Harry G., "The International Competitive Position of the United States and Balance of Payments Prospect for 1968," *Review of Economics and Statistics*, vol. XLVI, No. 1 (February 1964), pages 20-24.

7. See Lindholm, Richard W., "Adjusting the Posture of the U.S. Economy to Facilitate Corporate Freedom in International Actions." Paper presented at American Finance Association Meetings, New York City, December 28, 1965.

8. Professor Lindholm advocates the adoption of a major Federal value-added tax. However, this would be a basic change in U.S. tax structure and would be difficult to achieve. *Ibid.*

9. See Salant, Walter S., *op. cit.*, Chapter VI.

10. Danielian, N.R., *The United States Balance of Payments: an Appraisal of U.S. Economic Strategy*, Washington, D.C.: International Economic Policy Association, 1966, pages 91-100.

11. For a detailed analysis of the positive aspects see the International Economic Policy Study, *Ibid.*, esp. Chapters II to VI. However, the study fails to consider some of the possible adverse effects on exports.

12. Bell, Philip W., "Private Capital Movements and the U.S. Balance of Payments Position." *Factors Affecting the United States Balance of Payments*, Joint Economic Committee, *op. cit.*, Part 6.

13. Behrman, Jack, "Foreign Investment Muddle: The Perils of Ad Hoccery," *Columbia Journal of World Business*, vol. 1, No. 1 (Fall 1965), pages 51-61.

14. See analysis and discussion in Polk, Judd and others *U.S. Production Abroad and the Balance of Payments*, New York: National Industrial Conferring Board, 1966, esp. Chapters 6 and 7.

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