

FEDERAL RESERVE BANK OF PHILADELPHIA

A Lower Profile for the U.S. Balance of Payments

By *Janice M. Westerfield**

People reacted with surprise last May when the government accepted an advisory panel's recommendation that it stop publishing summary payments balances. Not long ago, the balance of payments was front-page news. Continuing U.S. payments deficits caught the attention of policymakers at the highest levels, and they responded with programs to combat deficits and maintain the value of the dollar—in a word, to prevent devaluation.

Payments imbalances posed a serious threat to international stability when the U.S. and its trading partners bought and sold one another's currencies at fixed exchange rates. But since 1973, when the fixed-rate system was abandoned, deficit and surplus measures no longer mean what they used to. Many economists believe that the payments restrictions of the fixed-rate era, which were intended to

reduce deficits, may have outlived their usefulness. And now these restrictions are being eased in the belief that relaxed payments policies will foster economic health in an atmosphere of expanded consumer and investor choice.

THE BALANCE OF PAYMENTS AND FIXED EXCHANGE RATES

It's usual to define a nation's balance of payments as a record of the transactions its residents have carried on with foreign residents over a period of time. This record follows the principles of double-entry book-keeping: every credit is balanced by an offsetting debit somewhere on the statement. The credit and debit entries can be grouped into different accounts which bring out distinct features of the payments picture.

A payments balance yardstick often used by policymakers was the balance on current account and long-term capital—the basic balance. This measure was designed to pick out long-term trends in the balance of pay-

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ments by excluding volatile capital flows. The current account portion of this balance records sales of goods and services as well as remittances and government grants. This account reflects all international transactions except capital movements. It's the mirror image of changes in capital flows (excluding errors and omissions). Thus a deficit in the current account is matched by a surplus of roughly the same size in capital accounts.

Payments balances and the financing of deficits were items of central importance to the international economic system that was established after World War II. Policymakers were very much interested in the stability of this system. Balanced international trade and fixed currency exchange rates both were considered important for achieving stability. But there wasn't much give in the system. Imbalances in international payments threatened to change currency exchange rates and vice versa. A nation that imported more goods and services than it exported had to make up the difference with financing or reserves—whose effect may be to make a currency more available and drive down its value against other currencies. Under the fixed-rate system, however, central banks stepped in to hold a currency's value steady if it threatened to move outside agreed-on limits. Where fundamental changes occurred in a nation's economic circumstances, the monetary authorities were able to set a new official value for that nation's currency in terms of other currencies and gold. But it was expected that the United States, with the cooperation of other countries, would maintain the value of the dollar in terms of gold. U.S. policymakers were faced with a choice: either take domestic measures to keep exchange rates and trade balances in order, or face international pressures to redress imbalances. They reacted by developing a combination of domestic economic policies and exchange controls to correct international financial difficulties.

WHY DEFICITS WERE TABOO

International currency exchange is a many-

sided enterprise, and policymakers had many reasons for trying to avoid deficits. Some were economic, others were political; some had to do with the economy of a single nation, others with the economies of several nations.

Deficits Drain Off Reserve Assets. During the late 1950s and 1960s, the U.S. was piling up deficits in its basic balance and other overall balances. Stocks of gold, foreign currencies, and other reserve assets were used to ensure the value of the dollars that were used to cover deficits with trading partners. There was little bodily movement of metals or currency; gold wasn't shipped out of Fort Knox every month. But as time went on and deficits continued, many U.S. dollars—or dollar credits—were accumulated by foreigners. As the foreign dollar holdings grew larger, the willingness to accept still more dollars softened and so the increasing supply of dollars overseas threatened to undercut the value of U.S. currency and upset the fixed-rate system.

The U.S. and its trading partners cooperated to head off sharp movements in currency exchange rates, but they did so at a cost. Foreign central banks bought up excess dollars with their own currencies, and they could present these dollars to the U.S. Treasury for payment in gold. Thus the U.S. lost a lot of its gold to dollar holders in the late 1960s. With no end to balance-of-payments deficits in sight, the threat of a continuing gold loss persuaded the U.S. to suspend its redemption of dollars in 1971. The end of dollar-to-gold convertibility touched off other changes—including the shift from fixed to floating exchange rates—that have altered our outlook on payments deficits.

U.S. Deficits Produce Resentment Abroad... During the Vietnam conflict, the U.S. supplied more and more dollars, overloading currency markets. Other nations had to absorb these dollars to avoid revaluing and, under the fixed-exchange-rate system, they usually bought them up with their own currencies. The West German government, for

example, had to buy up dollars with marks in order to prevent the mark from gaining in value against the dollar. But pumping more marks into circulation swelled the German money supply; and as the money supply expanded, prices shot up. The German government, stuck with dollars it didn't want and with inflation besides, traced many of its difficulties to U.S. policies. And Germany was not the only nation that blamed its high inflation rates of the late 1960s and early 1970s on the U.S.

...and at Home. Many Americans also were unhappy about their country's owing money to foreign creditors, but that's what happens when the payments balance shows a deficit. With deficits piling up year after year, the nation had to borrow continually to finance its spending.

Since the total balance—counting goods and services, capital, and reserve assets—must be zero, dollar outflows in one portion of the statement must be offset by dollar inflows in another. So, for example, if the U.S. has a deficit (net dollar outflow) in the current account, it ordinarily would show a surplus (net dollar inflow) in the capital account, say from foreign purchases of U.S. Treasury securities. And such a net inflow of short-term private capital may mean that the U.S. is borrowing money abroad to tide itself over instead of paying cash on the barrelhead for consumption and investment goods. It's been argued that the U.S. lived beyond its means by running up large international bills this way, especially in the later 1960s, and that neither a nation nor a household can run up a lot of bills without making arrangements to repay its creditors. Without an expansion of national output large enough to liquidate foreign debt as it comes due, a trading country faces the possibility of default and of difficulty in obtaining further credit. Any nation that runs deficits for a prolonged period must gear up to transfer sizable resources to other nations in the future. No wonder international deficit financing goes against the grain of people who don't like to

owe anything to anybody.

Interest Groups Fear Loss of Jobs and Profits. Some groups oppose payments deficits for reasons peculiar to their own situation. Labor unions, for example, use media spots and billboard advertisements to tell the story of U. S. workers knocked out of jobs by foreign imports. Of course, domestic industries may be vulnerable even in times of surplus; it doesn't take a deficit to imperil workers in an industry that faces stiff foreign competition. But labor groups have lobbied consistently in favor of tariffs, quotas, and international agreements to restrict the influx of foreign-made goods. Policymakers have had to reckon with the likelihood that large deficits would galvanize labor into taking further political action and would revive the country's latent but deep-seated protectionism.

Nor is industry all out for free trade. Industry may oppose deficits for much the same reason as labor—fear of competition from abroad. It's believed in many quarters that budding domestic industries have to be helped along until they're able to compete with established foreign producers in world markets. The infant company is supposed to grow up and throw off its protective blanket after a while, but that isn't always the way it works. Many well-established U. S. industries retain powerful lobbies to keep trade controls that were set up when those industries were just getting off the ground. And American industry is not unique in its protectionist tendencies. Foreign producers often lobby to obtain similar protection from their own governments.

The Government Responds. The combination of fixed exchange rates with declining reserve assets, resentment at home and abroad, and pressure from special interest groups led the U. S. to adopt deficit-reducing policies during the 1960s. These policies produced restrictions on long-term foreign investment by American citizens, guidelines for bank lending to foreigners, and ceilings on overseas direct investment—all programs designed to slow capital outflows. In another

program, called Operation Twist, policymakers attempted to encourage economic growth by lowering long-term interest rates while raising short-term rates to attract foreign capital. Other measures subsidized export credits with loans at below-market rates and lowered duty-free allowances for tourists bringing home foreign goods. The government increased its preferences for goods from domestic suppliers. Even defense and foreign aid were affected by the balance of payments. The Armed Services Procurement Regulations required military departments to buy munitions at home under the Buy American program despite the higher cost. And receipt of foreign aid was tied to purchase of American goods. Throughout, the government acted to maintain a fixed exchange rate for the dollar.

These initiatives may have held down the size of succeeding deficits. But since they were in basic conflict with an open trade and payments system, they were not without costs of their own. Capital controls restricted profitable U.S. investment abroad. Higher short-term interest rates raised the cost of domestic borrowing at home. Restrictions on the entry of foreign goods narrowed the range of choices for the U.S. consumer at the same time that export subsidies increased his tax burden. And the Buy American program raised the cost of maintaining a defense establishment which already had come under intense public scrutiny for high spending.

Any measures to reduce deficits would have produced costs somewhere, and under fixed rates policymakers wanted deficits kept small to maintain international economic stability. But now fixed exchange rates are gone, and deficit figures no longer mean what they used to. Yet some of the policies linger on.

EVENTS OUTMODE POLICIES

The system of fixed but adjustable exchange rates came under increasing pressure in the late 1960s and early 1970s. This pressure was reflected in larger movements of

speculative capital, tighter payments restrictions, and more frequent changes in currency values. When dollar-to-gold convertibility was suspended in 1971, many countries let their currencies float against the dollar. Exchange rates were fixed again, temporarily, by the Smithsonian Agreement, but new monetary crises facing the British pound and other currencies hastened the evolution toward floating rates. By spring 1973, all of the leading currencies were floating jointly or independently.

Now the dollar is relatively free to rise or fall in value against other currencies. Capital still moves from country to country, and some countries' balances are in surplus while others are in deficit. But whereas under fixed rates the U.S. would face a loss of reserve assets when the dollar was threatened, under flexible rates the exchange-rate mechanism itself makes the required adjustment by letting the dollar fall in value. Nowadays, governments generally avoid trying to fix exchange rates at predetermined levels as they did prior to 1973.¹ Monetary authorities still intervene in the exchange markets, but mostly to quiet temporary disorders rather than to mask underlying economic conditions. Thus the floating-rate system eliminates some of the undesirable repercussions of a deficit over the long haul and reduces the usefulness of some traditional measures of the balance of payments (see Box).

In fact, floating rates actually tend to correct deficits and to move international payments balances back toward equilibrium. Suppose, for example, that the U.S. were to run a large current account deficit for a year or two and the dollar excess were to reduce

¹Even under floating rates currency values are managed to some extent. The most important departure from the floating-rate system as described in the text is the snake—a joint float adopted by several countries of the European Community. Central banks of the snake countries intervene to keep currency-value fluctuations against one another within narrow limits, but they allow their currencies to float jointly against the dollar and other outside currencies.

BOX

NEW DEVELOPMENTS ALTER MEANING OF PAYMENTS MEASURES

The new international monetary system not only reduces the importance of balance-of-payments measures but also makes the old reporting system obsolete. Until recently, the major focus of U. S. balance-of-payments policy was on the three overall balances—the basic balance, the net liquidity balance, and the official reserve transactions balance. As the international monetary system moved to floating exchange rates, these overall measures came to be misinterpreted by the public. As a result, the President's Advisory Committee on the Presentation of Balance of Payments Statistics suggested that none of these balances be used to measure international transactions of the U. S. and that the words 'deficit' and 'surplus' be avoided as much as possible in press releases.* Some partial balances, such as the merchandise trade and current account balances, will be listed as memorandum items, but the emphasis has shifted from concentrating on one of the overall balances to analyzing information on several classes of international transactions. Capital transactions, for example, now are grouped so that foreign assets in the United States are broken down into transactions with foreign official institutions and transactions with foreign banks or individuals.

Of the three measures that have been discontinued, the official reserve transactions balance was most closely tailored to the fixed-exchange-rate system. This balance includes merchandise trade, services, and remittances, as well as long-term and short-term capital flows. It indicates the surpluses and deficits arising from all these transactions, which are financed by changes in official reserve assets. (Official reserves include gold, Special Drawing Rights, foreign currencies, and borrowings from the International Monetary Fund). In short, this balance was intended to reflect the extent of official intervention required to maintain fixed exchange rates. A deficit, for instance, was interpreted to mean that foreign countries had intervened to support the dollar. As the system of floating rates evolved, the official reserve transactions balance lost much of its meaning. Exchange market pressures on the dollar now are indicated mainly by changes in exchange rates, not by changes in official reserves. And dollar accumulations by foreign official institutions ordinarily are matters of preference rather than obligation—witness the large investment in dollar assets by oil-producing countries.

The net liquidity balance focused on changes in the international liquidity position of the U. S. It included all transactions except liquid private capital flows, liabilities to foreign official agencies, and official reserve assets. Once thought to measure the potential pressure on U. S. primary reserve assets, it was a way of checking that foreign claims did not become so large that the U. S. would be unable to meet them if they were presented for payment. Since the dollar no longer is convertible into gold, this threat is gone. And there are serious statistical problems in the distinction this balance makes of liquid from nonliquid capital transactions.

The balance on current account and long-term capital (basic balance) was intended to capture stable underlying economic trends. It included merchandise trade, services, remittances, and long-term capital flows. This balance also presented statistical difficulties. Long-term capital flows sometimes have effects quite similar to those of short-term flows. But the arbitrary methods of distinguishing these flows made this balance an unsatisfactory indicator of long-term trends.

*"Report of the Advisory Committee on the Presentation of Balance of Payments Statistics," *Statistical Reporter* 76 (1976), pp. 221-238.

the value of U.S. currency. What would happen?

It would take more dollars to buy units of other currencies and commodities priced in other currencies, so the dollar prices of imports would rise and Americans would shift their demand toward domestic goods. At the same time, the foreign currency prices of U.S. goods sold abroad would drop, and foreign consumers would shift their demand toward U.S. goods. After a period of adjustment, the lower dollar value would encourage Americans to buy fewer imports and sell more exports; and both actions would tend to reduce the deficit.

Although floating exchange rates make long periods of payments deficits unlikely, some hefty short-term deficits still may occur. Outside forces, such as sharp rises in foreign commodity prices, could push an importing country into a deficit position for several years. The recent jump in oil prices, for example, played hob with the payments balances of many oil-importing nations. Or deficits could be caused by fundamental internal weaknesses, such as the high domestic inflation rates that are plaguing some nations. Policymakers may well want to take steps that deal with domestic sources of economic weakness. But whether they do or not, the system of flexible exchange rates will lead almost inevitably to currency realignments that tend to reduce deficits and some of their undesirable repercussions.²

²Policymakers in some countries are suggesting that the current system of floating rates has come up short on several counts. They contend that exchange-rate flexibility does not relieve the need to make painful domestic economic adjustments when a country's prices, production, and trade get out of alignment with those of similar countries. They argue that floating rates may have worsened inflation in such countries as Britain and Italy. And they maintain that floating rates may impose costs not only on individual countries but also on the international economic system itself. For a discussion of both sides of this issue see my "Would Fixed Exchange Rates Control Inflation?" *Business Review*, Federal Reserve Bank of Philadelphia, July/August 1976, pp. 3-10.

EASING UP ON RESTRICTIONS

Though old ideas die hard, many observers of international economic developments now think it better not to direct *ad hoc* policies toward correcting a U.S. payments deficit. The basic strategy under floating rates is for the government to pursue monetary and fiscal policies that it expects will lead to a desired rate of economic growth and acceptable inflation, and it lets the payments balance fall where it may.³ Current U.S. domestic economic and payments policies have as a goal the stability of the economic system overall. Beyond that, these policies aim toward allowing market forces to play a major role in determining payments positions and exchange rates. Despite some protectionist provisions in the Trade Act of 1974, the main thrust of U.S. trade policy is directed toward establishing and preserving an open trade and payments system.

The limitations on trade and investment that were imposed in the 1960s do not fit well with current U.S. payments policies. Because of this, most controls on capital flows have been removed. The way is open to move further toward dismantling restrictive policies, but this movement probably will be gradual. The U.S. may not be in a position to alter its procurement practices or cut off subsidized export credits, for example, until other nations agree to do the same. And that may take time. In the interim, having restrictions may serve the useful purpose of providing bargaining leverage with other countries.

In sum, the U.S. still seeks economic stability, not only for itself but for all nations. Under the fixed-rate system, stability required the avoidance of payments deficits; but with floating exchange rates, the relative values of currencies constantly readjust to changing international conditions. Therefore deficit and surplus measures don't mean what they used to mean and so they are being deemphasized. Indeed it would be inconsis-

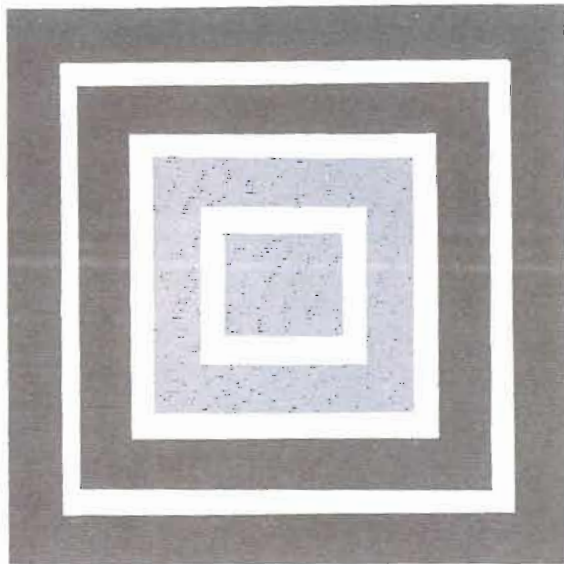
³See F. Lisle Widman, "U.S. Balance of Payments Policy," *Department of the Treasury News*, May 24, 1976.

ent with present developments to tie domestic and foreign economic policy decisions to these figures in the same way as before,

ignoring the flexibility of exchange rates and the complexity of international capital movements.



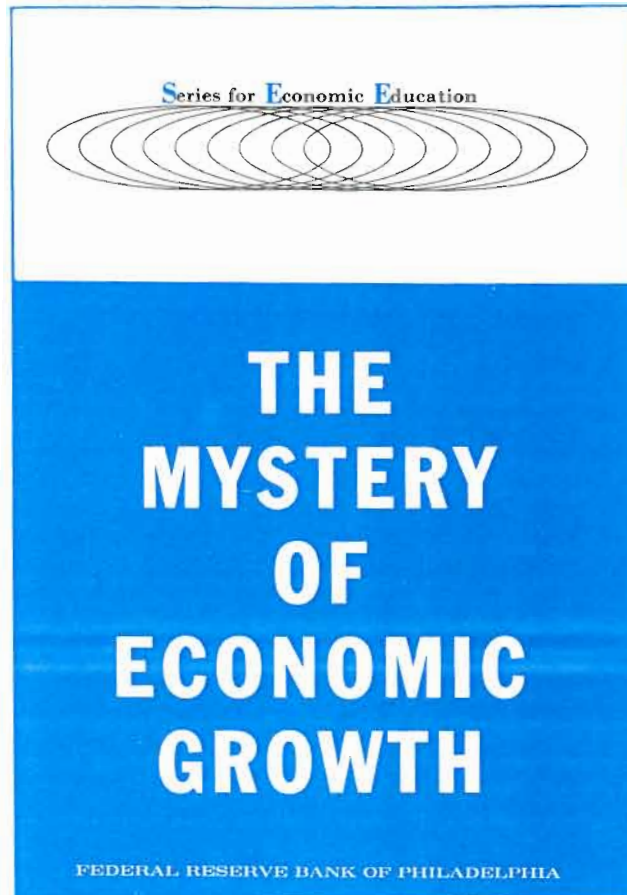
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