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THE DOLLAR PROBLEM: A REAPPRAISAL

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This is the thirty-fifth in the series ESSAYS IN INTERNATIONAL FINANCE *published by the International Finance Section of the Department of Economics in Princeton University.*

The author, Sir Donald MacDougall, is an Official Fellow of Nuffield College, Oxford. He has served in the Prime Minister's Statistical Branch and as Economics Director of the Organization for European Economic Cooperation. He has long been interested in the subject of the present essay, and in 1957 published an authoritative volume on THE WORLD DOLLAR PROBLEM.

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FRITZ MACHLUP, *Director*
International Finance Section

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(This essay was written in the summer of 1960.)

I WELCOME this opportunity to write a reappraisal of the outlook for the U.S. balance of payments. I have been asked to do this in the light of my earlier book on the subject,** but a knowledge of this is unnecessary for an understanding of the present essay. My only misgiving in attempting this task is that recent developments have brought such a spate of discussion in the United States—whereas previously there may well have been more abroad—that it is hard to say much that is new, and easy to be tripped up by the host of experts that now exists.

In *The World Dollar Problem* I concluded that the U.S. balance of payments was more likely to improve than it was to worsen, at least over the following couple of decades, though not necessarily at once. My final conclusion was that "it would seem to be at least as likely as not that the problem [world dollar shortage] will recur, say, a couple of times during the next twenty years" (p. 342), but I shall explain shortly that, according to the trend I considered most likely, this would not yet have happened; on the contrary, the United States would still be running a small deficit in 1960 and the rest of the world would have continued to build up reserves at American expense during the last few years, though on a considerably smaller scale than has in fact occurred.

RECENT DEVELOPMENTS

While the book was going through the press, in the autumn of 1956 and the first half of 1957, the dollar did well (considerably better than I should have expected on the basis of longer-term trends, but I had also expected substantial fluctuations). The U.S. balance of payments, which had been continually in deficit since 1952—though the deficit had been steadily declining—went into substantial surplus. (See Diagram I.)

* I am indebted to Miss Carruthers, Mrs. Dowley and Mrs. Williamson for clerical and statistical assistance, and to many kind people on both sides of the Atlantic who have given their time to discussing these matters with me and to commenting on a draft of this essay. I am particularly grateful for the help given by Mr. Walther Lederer, of the U.S. Department of Commerce.

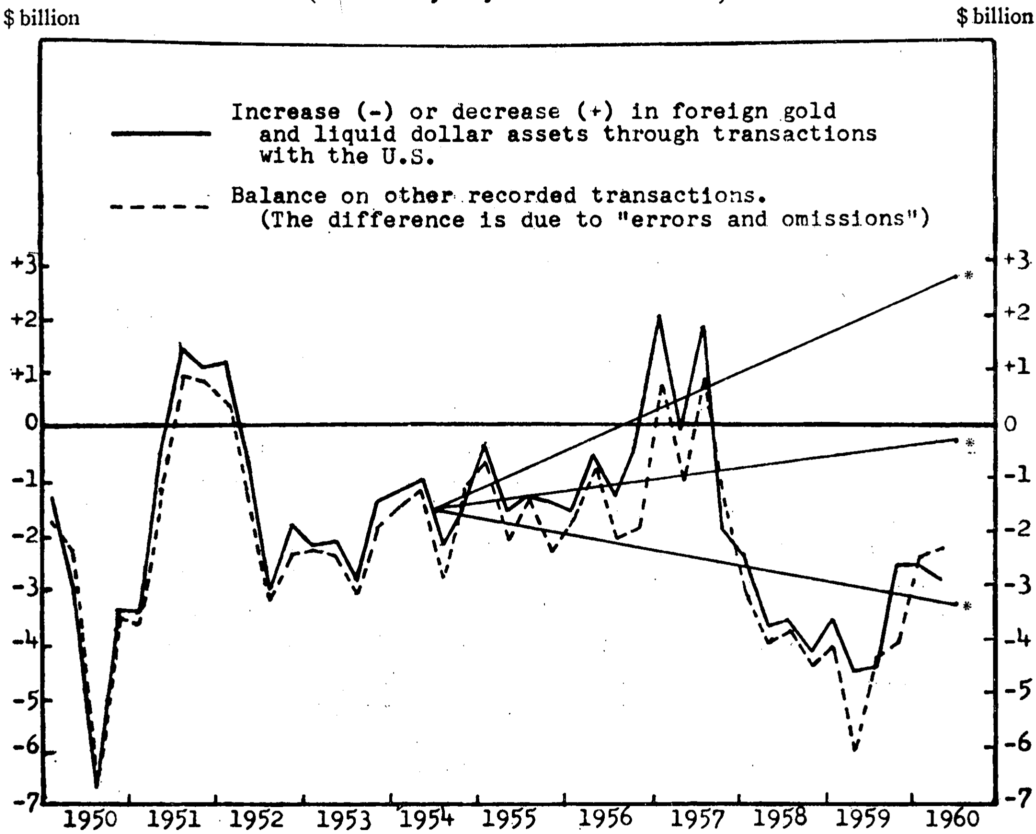
In the tables, the sign .. means not available. Details do not always correspond to totals or differences because of rounding.

** Sir Donald MacDougall, *The World Dollar Problem: A Study in International Economics*, London, 1957.

DIAGRAM I

BALANCE ON U.S. INTERNATIONAL TRANSACTIONS†

(Seasonally adjusted annual rates)



† Excludes subscription to the International Monetary Fund (I.M.F.) in 2nd quarter of 1959.

* Trends from *The World Dollar Problem* (based on 1953-55). See Appendix A for explanation.

During the twelve months to September 1957 the rest of the world lost nearly $1 billion of gold and liquid dollar assets to the United States.

Then, towards the end of 1957, there was an equally dramatic reversal. The U.S. balance swung into deficit again and in 1958, despite a recession in the United States, she lost $3½ billion to the rest of the world, of which no less than $2¼ billion was taken out in gold—the heaviest annual loss in American history. It was this, more than anything else, that started the great debate on the balance of payments.

The deficit grew even larger in 1959, rising to a peak rate of over \$4½ billion per annum, seasonally adjusted, in the second quarter (excluding the U.S. subscription to the International Monetary Fund). The gold loss, however, slowed down markedly. This was partly because higher interest rates in the United States made it considerably more profitable for foreigners to hold income-earning assets rather than gold; partly because the gain of reserves accrued less than in 1958 to monetary authorities that traditionally hold the great bulk of their reserves in gold; partly perhaps because foreign Central Banks and Treasuries exercised restraint to avoid embarrassing the U.S. authorities, though there is no evidence that the latter actually requested them to do so.

Towards the end of 1959 the deficit began to fall once more and in the first half of 1960 was at an annual rate of \$2.7 billion. Moreover, the "errors and omissions" item in the balance of payments was abnormally unfavourable to the United States, probably reflecting the transfer of unrecorded funds abroad to take advantage of higher interest rates—for U.S. rates were falling again and European rates rising. Had errors and omissions been "normal," the deficit would have been at a rate of under \$2 billion per annum.*

The National Foreign Trade Council (N.F.T.C.) expects the recent improvement in the balance of payments to be maintained in the second half of 1960, and in July forecast a deficit for the year of \$2½ billion, *less* any net receipts under the "errors and omissions" item.** If these were at the average rate of recent years the deficit would be under \$2 billion, but it may well, in fact, be very substantially larger. In the first half of the year, "errors and omissions" actually showed net *payments* by the United States, and preliminary indications suggest that there was a large deficit in the third quarter (including a renewed loss of gold at a high rate), associated with a further outflow of capital seeking higher returns abroad, and perhaps with some speculation against the dollar.

As a result of the almost continuous deficit over recent years—and indeed during the past decade—the strength of the U.S. reserve position has declined considerably. From the end of 1953 to the middle of 1960 her gold stock fell by \$2¾ billion (and during the following three

* "Errors and omissions" in the first half of 1960 showed net *payments* by the United States at a rate of \$0.4 billion per annum (seasonally adjusted). In recent years this item has shown net *receipts* averaging about \$0.6 billion per annum. In so far as this difference of \$1.0 billion reflects the transfer of unrecorded liquid dollar assets held by foreigners to foreign Central Banks (where they are recorded), there is no actual loss of dollars by the United States and the true deficit is overstated.

** *Balance of payments outlook—1960 revised*, July 20, 1960. In making this forecast the balance of payments group of the N.F.T.C. had before them provisional figures for the first half year.

months by a further $⅔ billion) while short-term liabilities to foreigners rose by $7¾ billion (Table 1). Liabilities rose roughly from 50 per cent to 100 per cent of the gold stock. (Somewhat different figures would be obtained if one took other definitions of liabilities or included short-term assets other than gold.)

TABLE 1

U.S. GOLD STOCK AND SHORT-TERM LIABILITIES TO FOREIGNERS

($ billion)

	End 1953	*Mid-1960*	*Change*
1. Gold	22.1	19.4	−2.7
2. Liabilities	10.8	18.6	+7.8
2 as % of 1	49%	96%	

Note: Liabilities include foreign-owned government bonds and notes. They exclude liabilities to international institutions.

Sources: I.M.F. *International Financial Statistics* and *Federal Reserve Bulletin.*

Mainly as a result of these changes there was an improvement in the reserve position of other countries but this was heavily concentrated on the advanced nations, especially Germany, Italy, France, other continental Europe and Japan. The underdeveloped countries taken as a whole did not increase their reserves (Table 2).

Has there been an adverse trend?

The fluctuations in the U.S. balance have been striking and make it difficult to establish a trend. A glance at Diagram I shows that very different pictures can be painted by selecting different periods. The change between 1957 and 1958-1959 naturally aroused a great deal of concern, but a comparison of these two periods clearly gives much too alarming a picture of longer-term trends, for the change was from abnormally favourable to abnormally unfavourable conditions.

Exports in 1957 were temporarily boosted by an unusual combination of favourable factors: by an inflationary boom in Europe, Japan, and elsewhere and accompanying shortages of coal, steel, and other materials which had to be met by purchases in the United States; by the Suez crisis which brought large exports of U.S. oil; by bad harvests in Europe in 1956 which boosted wheat exports in the following year; by shipments of cotton well in excess of current needs abroad.

TABLE 2

GOLD AND FOREIGN EXCHANGE HOLDINGS OF MONETARY AND OTHER OFFICIAL AUTHORITIES

($ billion)

	End 1953	*Mid-1960*	*Change*
Germany	2.0	6.0	+4.1
Italy	0.8	2.9	+2.1
France	0.8	2.0	+1.2
Other Continental Europe	6.7	8.5	+1.8
Japan	0.8	1.5	+0.6
Canada	1.8	1.8	—
U.K.	2.5	2.9	+0.4
India	1.9	0.7	−1.2
Rest of sterling area	5.9	6.4	+0.5
Latin America	3.3	3.2	−0.1
Rest of world	3.0	3.4	+0.4
U.S.	22.1	19.4	−2.7
Total	51.6	58.5	+6.9

Notes: 1. Excludes international institutions.
2. The worsening in the reserve position of the United States shown in Table 1 does not equal the increase in reserves of other countries for various reasons. For example, other countries acquired gold from new production as well as from the United States; they hold reserves in sterling as well as in dollars; they have paid gold to the I.M.F.; their reserves do not include private holdings of dollars but these are included in U.S. liabilities.

Source: I.M.F. *International Financial Statistics.*

The reversal of these conditions brought a sharp setback. The Suez Canal was reopened. A slight recession in Europe brought shortages to an end and, as the recovery started considerably later than that from the recession in the United States, American imports began to rise well before her exports. Europe had a good wheat harvest in 1957. Cotton exports were cut back after the heavy accumulation of inventories and, with world prices falling while the U.S. price was maintained, they remained low until the autumn of 1959 in anticipation of a higher government subsidy, which then led to a rapid increase.

There were in addition other transitory factors of an unfavourable nature in 1958-1959. Substantial meat imports were required owing to a temporary decline in domestic supply; they are falling again in

1960. The steel strike of 1959 increased imports and reduced exports. Aircraft exports were low while production was being shifted from propeller to jet planes; they have bounded up in 1960. A rapid rise in car imports was not checked by the American "compacts" until some time in 1959. Foreign long-term investment in the United States dried up temporarily in 1958. U.S. private investment abroad remained high but brought very little extra income until 1960. Military expenditure abroad reached a peak in 1958; it has since been declining.

If there has been an adverse trend in the U.S. balance of payments it was masked by these temporary factors in 1957 and exaggerated in 1958 and 1959. If they could be allowed for, the deficit would show a steadier trend but, as this can hardly be done quantitatively, we have no real choice but to compare some year or years before 1957 and after 1959. The only year after 1959 at present open to us is, of course, 1960, and it will be as well to exclude "errors and omissions" since these have been abnormal. Let us consider whether 1960 can legitimately be compared with the average of the years 1953-1955 (which happens to be the base period I used for illustrative calculations in *The World Dollar Problem*).

It may be argued that this gives too favourable a comparison. First, exports of aircraft and cotton are probably abnormally high in 1960, perhaps by more than half a billion dollars; on the other hand, there are some abnormal items in every year and other exports may be coming along to take their place if these two fall next year. Secondly, there may be more slack in the U.S. economy in 1960 than there was in 1953-1955; unemployment is higher, and so probably is the percentage of unused capacity in industry.* This objection would not, however, apply if we took the recession year of 1954 as our base period. Thirdly, it may be claimed that the European economy was slacker in 1953-1955 than it is in 1960. But this is not easy to substantiate. Unemployment outside Germany and Italy is only a little lower in 1960—at least judging by the first half of the year (see Diagram II, below p. 28). It is admittedly a good deal lower in these two countries but, on the other hand, there are probably fewer shortages in Europe today than there then were.

If, as a first approximation, we do compare 1953-1955 with the N.F.T.C. forecast for 1960, and exclude "errors and omissions," the worsening in the deficit has been about $600 million, or an average of $100 million per annum. (The figure would be lower if we took the

*Unemployment was 5.3 per cent of the civilian labour force in the first eight months of 1960 (seasonally adjusted) compared with 4.3 per cent in 1953-1955. On unused capacity see, for example, the chart on p. 288 of the *Hearings* before the Joint Economic Committee on the January 1960 Economic Report of the President.

first half of 1960 as our terminal period.) If, to meet the first two objections just mentioned, we took 1954 as our base period and allowed for part of the abnormal exports of cotton and aircraft in 1960, the worsening would be around $200 million per annum.*

This appears to be the magnitude of the adverse trend that has to be explained. Some might put it higher, others perhaps lower, but in any case it would be only a fraction of one per cent of the turnover on America's international transactions; adding receipts and payments together this totals some $60,000 million.

A trend of this magnitude falls within the limits I set in *The World Dollar Problem* when assessing possible changes in the U.S. balance of payments. According to my most pessimistic estimates (from the U.S. point of view), the deficit would have increased by about $300 million per annum. This is illustrated in the lower trend line of Diagram I. I thought it most likely, however, that there would be a favourable trend, at least over a much longer period, but also quite a slow one of about $200 million per annum. This is the middle trend line in Diagram I. (The calculation of these trends is explained in Appendix A at the end of this essay.)

The difference between even a small adverse trend and a small favourable one (smallness being measured in relation to the turnover in international transactions) can, however, be very important over a period of years; this is true of any country's balance of payments. Had my favourable trend materialised, the U.S. balance of payments would today be in a much happier state. The reserve position would be stronger, since the cumulative loss of gold and dollars to other countries would have been smaller; and the present rate of deficit would be causing no worry.

But, while the actual position is rightly causing some concern, one wonders whether the *change* that has occurred over the past half dozen years has not sometimes been overexplained. Putting what has happened in another way, we find that, between 1953-1955 and 1960, U.S. receipts from abroad have risen, percentagewise, as much as her payments, both by over two-fifths. The balance has deteriorated only because, in the earlier period, payments exceeded receipts. (See Table 3.) Even allowing for the possibility that conditions are more favourable in 1960 than they were in the earlier period, it seems a little exaggerated, in the circumstances, to talk as if some fundamental unfavourable changes had taken place in the U.S. economy during those years.

* The deficit (excluding errors and omissions) increased by $0.8 billion between 1954 and 1960. If, say, $0.4 billion is added for part of the abnormal exports of cotton and aircraft, one gets a change of $1.2 billion, or $200 million per annum.

TABLE 3

DEFICIT IN U.S. BALANCE OF PAYMENTS 1953-1955 AND 1960

($ billion)

	1953-55 average	1960 Jan.-June annual rate[1]	1960 Year forecast[2]	% increase (1) to (3)
	(1)	(2)	(3)	(4)
Recorded transactions[3]				
U.S. payments	20.5	30.1	29.4	43
U.S. receipts	18.6	27.8	26.9	45
Balance	—1.9	—2.3	—2.5	32
Errors and omissions[4]	0.3	—0.4	..	..
Increase (—) in foreign gold and liquid dollar assets through transactions with the U.S.	—1.6	—2.7	..	..

[1] Seasonally adjusted.
[2] N.F.T.C. forecast made in July 1960.
[3] Excluding gold movements and changes in foreign liquid dollar assets, which are shown in the last line.
[4] Excess of receipts or payments (—) on unrecorded transactions.
Sources: *Survey of Current Business* and *Balance of Payments Statistical Supplement* (U.S. Department of Commerce).

It could in fact be claimed that the United States had done remarkably well during a period when Europe and Japan (partly as a result of earlier aid from the United States) have been recovering rapidly—raising their productivity, reducing their technological lag, ending their shortages and reaping the fruits of export drives and dollar-saving projects started a good many years before—while the United States has stepped up her aid to foreign countries and her military expenditure and private investment abroad (although she has also enjoyed a relaxation of discrimination against her exports). It could even be argued that, once this final recovery of Europe and Japan from the war has been completed, the United States should be able to do well considering the good performance she has put up in recent years; but this would be jumping too easily to optimistic conclusions.

People talk a great deal nowadays about the shortcomings of U.S. business: its slowness to innovate; its lack of interest and poor selling methods in foreign markets; the fact that it makes too elaborate and expensive products; and so on. This is right and proper when searching for ways of improving the balance of payments—the list of complaints is all too familiar to a Britisher—but it is not at all clear that, in these respects, U.S. business has deteriorated over the past five or six years. Any shortcomings may well have been there before.

They did not matter then, however, partly because the U.S. deficit was somewhat smaller than it now is (which in turn may have been partly because Europe and Japan were less well able to compete), but mainly because a substantial U.S. deficit was, until a few years ago, a highly desirable thing. It enabled foreign countries to rebuild their reserves to more adequate levels and could be afforded by the United States in view of her strong reserve position. The process was in fact encouraged by the United States, to her credit, as a matter of deliberate policy: she gave aid to foreign countries, although part of it was clearly being used to swell their reserves, while encouraging imports from them and tolerating discrimination against her exports.

The present deficit is quite a different matter. It is less necessary from a world point of view since, with a few exceptions, the advanced countries at least have rebuilt their reserves to more satisfactory levels. (The underdeveloped countries seem to regard development as more urgent than reserve-building whatever the state of the U.S. balance of payments.) The United States, on the other hand, is now less able to stand a substantial continuing deficit since her reserve position is considerably less strong than it was.

The balance of trade and other transactions

Let us now look at the changes that have taken place in the main broad categories of the U.S. balance of payments. (We shall consider more detailed categories later.) Some figures are given in Table 4. The first striking fact is that, although the balance of payments as a whole deteriorated, the balance of merchandise trade—ordinary exports and imports—actually improved by over \$1 billion between 1953-1955 and 1960. The balance on "civilian" current account, including invisibles other than military expenditure abroad, improved by about \$1½ billion. This improvement was, however, more than offset by increases of over \$1 billion in private investment abroad, of nearly \$1 billion in U.S. Government aid (excluding military aid), and of a much smaller amount in military expenditures abroad (the increase in this item was considerably greater up to 1958 but, as we have seen, it has since declined).

TABLE 4

U.S. BALANCE OF PAYMENTS 1953-1955 AND 1960
SUMMARY

($ billion)

	1953-55 average	1960 Jan.-June annual rate[1]	1960 Year forecast[2]
Current account, excluding military expenditure abroad[3]	+3.5	+4.9	+5.0
Balance on merchandise trade	+2.2	+3.6	+3.4
Balance on invisibles[4]	+1.3	+1.3	+1.6[6]
Other recorded transactions[5]	−5.4	−7.2	−7.5
U.S. private investment abroad (net)	−1.1	−4.9 (both lines)	−2.7[6]
U.S. government loans and grants[3] (net)	−1.9		−2.3
U.S. military expenditure abroad	−2.7	−3.0	−2.9
Foreign long-term investment in the U.S.	+0.3	+0.7	+0.4
Balance on recorded transactions[5]	−1.9	−2.3	−2.5
Errors and omissions	+0.3	−0.4	..
Increase (—) in foreign gold and liquid dollar assets through transactions with the U.S.	−1.6	−2.7	..

[1] Seasonally adjusted.
[2] N.F.T.C. forecast made in July 1960.
[3] Excluding transfers of military aid.
[4] Including remittances and pensions.
[5] Excluding gold movements and changes in foreign liquid dollar assets, which are shown in the last line.
[6] Assuming that government pensions and other miscellaneous transfers are $0.2 billion as in 1959.

Sources: *Survey of Current Business* and *Balance of Payments Statistical Supplement* (U.S. Department of Commerce).

Now it would be wrong to jump to the conclusion that, if these increases had not taken place, the U.S. balance of payments would actually have improved by some $1½ billion. For the various items are interrelated in complex ways. For example, a large part of the aid results, directly or indirectly, in increased exports of goods and services and so improves the current balance, while most private investment leads, sooner or later, to receipts of income, and more immediately to exports of U.S. capital goods, although it may also lead to production abroad that competes with exports and is even imported into the United States.

One cannot, therefore, simply take the figures as they stand as an