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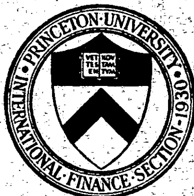

INTERNATIONAL FINANCE SECTION
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THE BALANCE OF PAYMENTS AND THE FOREIGN INVESTMENT POSITION OF THE UNITED STATES

This essay is largely derived from a report I presented in French at a "Colloquium on the Industrial Policy of an Integrated Europe and the Supply of Foreign Capital." The colloquium was held May 23 to 27 in Paris under the auspices of the University Study Center of the European Communities of the Paris Faculty of Law and Economics.

My assignment had been formidable in scope, as indicated by its original title "The Balance of Payments of the United States, the Dollar, and Direct Investments in Europe." This, I felt, was only slightly less inclusive than the title of the treatise by Pico della Mirandola, *Concerning All Things Knowable*, rounded out by ". . . *And a Few Others*"—as Voltaire proposed to add. But even the moderation to three large topics clearly exceeded my capacity to deliver in the allotted time. Thus, I confined myself to dealing with a few more manageable questions: I. The Balance of Payments of the United States, 1950-1964; II. The Balance of Payments of the United States, 1965-1966; III. The United States as a Banker for Europe?; and IV. Conclusion and Forecasts.

In recasting my French report into an English essay I have, of course, made numerous alterations—reformulations, excisions, and insertions. It is very likely, though, that the original form of this paper, as a speech, has remained visible at several places.

The second section reviews current developments of an ephemeral character; they may soon lose actuality. Yet their discussion illustrates the likely consequences of "escapist"—rather than "adjusting"—policies, which are all too likely to be resorted to again and again in the future as they have been in the past.

The third section is an attempt to link the broader problem of the balance of payments of the United States with the problem of American investments in Europe and to relate both to the thesis recently advanced by the DKS-troika—Despres, Kindleberger, and Salant—in an article in *The Economist* (February 5, 1966) emphasizing the role of the United States as financial intermediary for European markets.

I. THE BALANCE OF PAYMENTS OF THE UNITED STATES, 1950-1964

The program of so-called voluntary restraints, introduced at the beginning of last year by the American authorities, has reversed, for a time at least, the long-term trends shown by the U.S. balance of payments over the last fifteen years. Let me explain these trends before venturing a personal appraisal as to the degree of success of the corrective measures adopted in February of last year.

These measures were inspired by a drain of monetary reserves of a magnitude unprecedented in international monetary history: $23 billion in fifteen years. The gross reserves of the United States (gold, foreign currencies, and IMF gold tranche) fell from $26.0 billion at the end of 1949 to $16.7 billion at the end of 1964, while its indebtedness to the IMF and to foreign central banks climbed daringly—but precariously under the gold-exchange standard—from $3.0 billion to $16.4 billion. Such a deterioration of the reserve position could not, obviously, pass unnoticed. It affects, through the dollar—international exchange as well as reserve money—the gold-exchange standard. This system was built, in the aftermath of World War I, on the double base of the pound sterling and the U.S. dollar. It has lately come to rest more and more on the base of the dollar alone, as the checkered history and persistent weakness of the pound has gradually undermined its acceptability as an international-reserve medium and confined it more and more to the area of what was, in happier days, the British Commonwealth.

The mighty dollar itself is now confronting a grave crisis, but one of liquidity rather than solvency. Leaving aside the extraordinary development of national wealth and income of the greatest economic and financial power in the world, and taking into account only the country's international position, we record during this same period of fifteen years a *net* increase of almost $20 billion in the external assets of the United States. The growth of long-term investments abroad ($39 billion in fifteen years) has surpassed by far the erosion of the monetary reserves and other net short-term claims of the United States. (See Table 2.)

The crisis of the dollar, then, is not in the least due to a deterioration of our balance on current account. There is no excess of imports of goods and services over exports. Such an import surplus existed only in one single year, 1959. In that year, for the first time in nearly a century, the United States had a deficit on current account of about $700 million. From the following year on, the United States regained its traditional surplus on current account and carried it in 1964 to the

record figure of $7.7 billion. In spite of a substantial increase in government expenditures for foreign aid and financing of agricultural exports, the balance on current account exceeded these expenditures by more than $4 billion in 1964. The net improvement for these two groups of transactions, taken together, was $4.2 billion as compared with the average for the years 1955-59, and close to $5.2 billion as compared with the average for 1950-54. (See Tables 5 and 7.)

However, net exports of private capital had increased still more: from a $0.3 billion average per year in 1950-54, and $0.9 billion per year in 1955-59, to a $4.5 billion average in 1960-64, and $5.6 billion in 1964. The race between the growing surpluses on current account and the faster growing deficits on capital account was balanced by an equally growing drain of monetary reserves. This drain was $1.3 billion per year in 1950-59, and $2.6 billion per year in 1960-64. (The latter figure includes about $600 million of average yearly official "prepayments" of debts and military contracts, primarily designed to slow down the gold losses of the United States.)

Waking up, somewhat tardily, to the realities of the problem, the United States began in 1963 to experiment with measures intended to plug the huge and still increasing outflow of private capital. If I may use a metaphor, the government did not think it could spur the valiant greyhound of current-account surpluses to overtake the swift rabbit of capital outflows. The measures against the capital outflow were rather gentle in 1963, but became more drastic in 1965. Yet the first action, the announcement of an "interest-equalization tax," apparently had the effect of reducing the net outflow of private capital from $4.5 billion in 1962 to $3.7 billion in 1963.

A closer examination, however, reveals that this "success" was an illusion. The outflow of *American-owned* funds—which are the only ones subject to the Administration's program—increased sharply, by $1 billion in 1963 and $2 billion in 1964, in marked contrast with their slower growth of only $350 million per year, on the average, during the three preceding years. The temporary improvement of the capital account in 1963 came only from the increased inflow of foreign capital ($1.2 billion, instead of a mere $0.2 billion in 1962, particularly on short-term capital account) and the reduced deficit on the "errors and omissions" account ($0.4 billion instead of $1.0 billion). If we include the *fluctuations* of "errors and omissions" in the short-term capital account, we observe $0.4 billion of inflow of foreign short-term funds in 1963, instead of $1.3 billion of outflow in 1962, a total reversal of $1.7 billion. This reversal is due in part to the rise, in 1963, of short-term interest rates in the United States and their decline in England

and Canada. In part, however, the reversal resulted from the temporary discouragement of "bull" speculation on gold and "bear" speculation against the dollar, following massive Russian gold sales in 1963 and the initial agreement of the Group of Ten that international monetary reform should preserve "a structure based, as the present is, on fixed exchange rates and the established price of gold." (*Ministerial Statement*, August 1, 1964.)

This hypothesis fits perfectly with the more general observation on which I wish to conclude this brief analysis of the long-term evolution of the balance of payments of the United States over the fifteen-year period 1950-64. The principal factor of deterioration certainly does not lie in the transactions on current account or for foreign aid, which show persistent and massive improvement during this period (deficits of $1.1 billion per year in 1950-54 and $0.2 billion in 1955-59, but surpluses of $1.8 billion in 1960-64 and $4 billion in 1964). It is, instead, the net outflows of private capital ($0.3 billion in 1950-54, $0.9 billion in 1955-59, $4.5 billion in 1960-64, and $5.6 billion in 1964). Among these outflows of private capital, however, the reversal of *short-term* capital movements (making for a difference of $2.6 billion between the average inflows of 1955-59 and the outflows of 1960-64) surpassed considerably the increase in *long-term* capital outflows ($1 billion).

The fluctuations of relative interest rates in the United States, Europe, and Canada are certainly part of the explanation of the spectacular variations in short-term movements of funds from one year to another ($2.5 billion of *outflows* in 1960, for example, against $1.8 billion of *inflows* in 1959). But they cannot explain the difference in trend, noted above, between the average for 1955-59 and that for 1960-64. This difference, on the other hand, coincides exactly with the onset in 1960 of a persistent uneasiness about the stability of the price of gold and of exchange rates among the principal currencies. There came the "bull" speculation on certain continental currencies (confirmed in part by the revaluation of the German mark and the Dutch florin in March 1961), the doubling of private gold purchases in 1960-64 from their average 1955-59 levels, the further jump of these purchases by 50 per cent in 1965, recurrent waves of speculation against the pound, the conversion by European countries of more than $2 billion of foreign-exchange reserves into gold metal in 1965, etc. An econometric study by Jerome L. Stein (in the *American Economic Review*, March 1965) estimates the impact of such speculative factors on the short-term capital movements in the balance of payments of the United States at $2.5 billion—a figure practically identical with the $2.6 billion cited at the end of the pre-

ceding paragraph. The impact of a one per cent change in relative interest rates he estimates at only $0.9 billion.

I am convinced that the deficits of the United States in 1960-64 were intimately and overwhelmingly related to the obvious crisis of the gold-exchange standard and the inevitable undermining of confidence which it entails in the currency (the pound in former days, and the dollar today) used under the system to supplement the shortage of gold as a medium for reserve accumulation. My prediction of the eventual inevitability of such a crisis seemed particularly venturesome when I first formulated it nine years ago, at a time when the Suez crisis was giving a new lease on life to the diametrically opposite thesis of a structural and permanent "dollar shortage." The emergence of the "dollar glut," however, soon confirmed the fears I had expressed about the future evolution of the gold-exchange standard, though it still leaves one free, of course, to dismiss the reasoning on which they were based.

Yet, how shall we otherwise explain the dramatic and totally abnormal reversal of short-term capital flows, brought on by the 1960 flare-up of gold prices on the London market? Short-term funds find their most *normal* investment outlets in major financial centers, such as London before the First World War and New York after the Second, and the United States indeed *received* $400 million per year of short-term funds during the first half of the decade 1950-59, $1 billion per year during the second half of the same decade, and $1.8 billion in 1959, well after the return of confidence in European currencies. The violent reversal in 1960 (a $2.5 billion outflow instead of a $1.8 billion inflow), and the persistent outflows of short-term funds in the following years are totally aberrant in this respect, particularly as they coincide with a spectacular improvement ($8.4 billion) in the balance on current account.

Mere disappearance of these abnormal outflows of short-term capital would have practically equilibrated the balance of official settlements of the United States in 1964, in spite of the record level of long-term capital outflows, themselves influenced, at least to some extent, by these speculative factors. The return to a more normal situation of net inflows of short-term capital would have left a substantial surplus in our settlement balance. We can estimate at about a half billion dollars per year, and one billion dollars in 1965, the excess of speculative gold purchases during the years 1960-64 over the "normal" (?) or customary level of the previous decade. If any proximate increase of gold prices were to be ruled out by sensible reforms in the international monetary system, such funds would have to seek alternative investment outlets

in a major money market—primarily in New York. This would result in a substantial and durable improvement in our settlements balance. The initial impact of the contemplated agreement would, of course, be much larger, since one should expect considerable, although once-and-for-all, dishoarding from the $7 billion private gold purchases of the last six years alone, to say nothing of the gold accumulated during the years before 1960.

One cannot but deplore, therefore, two of the main trends that have characterized the Group of Ten discussions:

1. Their excessive concentration on the probability of a *future* shortage of international liquidity, and the refusal to discuss explicitly and constructively the far more *immediate* problem of the vulnerability of the present system to massive liquidation in gold metal of the huge foreign-exchange reserves accumulated over many years past.

2. The unanimous agreement of the negotiators—and just about the only operational one reached so far—to subordinate all concrete action on monetary reform to the *prior* elimination of the payments deficits of the United States, deficits the principal cause of which is rooted precisely in the short-run vulnerability and long-run nonviability of the present unreformed gold-exchange standard.

I must refrain, however, from pursuing further a favorite theme of mine, expounded *ad nauseam* in my publications of the last seven years. Let us glance instead at the evolution of the balance of payments of the United States in the course of the last year, and its prospects for the present year.

II. THE BALANCE OF PAYMENTS OF THE UNITED STATES IN 1965 AND 1966

Table 5 summarizes the evolution of the balance of payments of the United States in the course of 1965 in a form comparable to that used for the earlier years. This presentation focuses on the so-called "Bernstein deficit," which is measured by changes in official net reserves. To these changes are added here the amounts of "prepayments" arranged with foreign governments and aimed primarily at reducing gold losses of the United States. It should be noted, however, that dollar balances held by foreign *private banks* (shown in Table 5 as item IIB.1a) may in fact include substantial amounts of foreign official holdings (which should, if full information were available, be included with item IIIB.1b).

(The only definition of the "overall deficit" regularly reported by the *Survey of Current Business* for the whole of the fifteen-year period covered by Table 5 refers to the "liquidity deficit," after official pre-

payments and including the increases in current dollar claims of private foreigners. The so-called "balance on regular types of transactions," identical with the previous one but with the inclusion of prepayments and medium-term "Roosa bonds" below the line, is no longer reported, while the "Bernstein deficit" is not reported for the years before 1963. A comparative digest of these alternative measurements is presented in Table 4.)

Let us note first the deterioration of the combined balance on current account and foreign aid, in striking contrast to its spectacular improvement in 1960-64. The second half of 1965 left a surplus—calculated, as all the other estimates below, at an annual rate—of only $1.8 billion compared with $4 billion in 1964. The escalation of military operations in Viet Nam and the internal economic boom evidently play a vital and growing role here. The surplus of the trade balance, on merchandise account only, dropped from $6.7 billion in 1964 to $5.0 billion in the second half of 1965 and to $4.4 billion for the first quarter of 1966. A further decline to $4.1 billion is already forecast for the year 1966 as a whole.

This deterioration more than offsets the improvement in the capital account, in which the deficit decreased from $5.6 billion in 1964 to an annual rate of $4.1 billion in the second half of 1965. The official-settlements deficit (item IV in Table 4) increased, in consequence, from $1.6 billion in 1964 to an annual rate of $2.3 billion in the second half of 1965, after seasonal adjustment. (This deficit would be $3.1 billion without such adjustment).

The so-called "voluntary" restraints have succeeded in reducing by nearly one half the net exports of *American* funds (an annual rate of $3.4 billion for the second half of 1965 as against $6.5 billion for 1964 as a whole), but the movement of *foreign* funds and "errors and omissions" leaves a deficit of $0.8 billion compared with the surplus of $0.9 billion registered in 1964.

The estimates for the last quarter of 1965 are even more alarming, but they are strongly influenced by the reversal in the movement of private banking funds abroad, and their extrapolation would be hazardous and misleading. The period of six months, retained as a basis for these commentaries, is itself exceedingly brief and would justify similar qualifications. It is unfortunately the longest period now available to appraise the likely results of the present policy, since estimates for the entire year 1965 are distorted by the immediate but ephemeral repercussions of the program of voluntary restraints during the second quarter of 1965 and particularly by the repatriation of $600 million of short-term American funds—$2.4 billion at an annual rate. (See the

official commentaries on the nonrecurrent character of these operations in the *Survey of Current Business* of December 1965, pp. 20-21.)

Provisional estimates for the first quarter of 1966, seasonally adjusted, show an annual rate of more than $1 billion for the Bernstein official-reserves deficit and $2.3 billion for the traditional liquidity deficit, exclusive of prepayments. (See Table 4, items IV.1 and III.1.)

In brief, the voluntary-restraints program has reduced considerably the outflow of American funds, but this reduction is largely offset by the exodus of foreign funds previously accumulated on the American market. Borrowers who find themselves barred from access to the New York market or compelled to repay previous borrowings there are seeking other sources of financing, notably in Europe, and European lenders are withdrawing their funds from New York in order to subscribe to the growing flotations launched on European markets. American firms themselves, anxious to pursue their investment programs abroad, are borrowing in Europe at increasing interest rates the funds which the voluntary-restraints measures prevent them from exporting from the United States. (New foreign bond issues in Europe by American corporations began in 1965 with an estimated $370 million and reached an annual rate of about $1 billion in the first three months of 1966.) To the extent that interest-cost differences remain insufficient to brake investments themselves—and this has certainly been the case up to now, current forecasts suggesting on the contrary a continued expansion for this year at least—interest rates are climbing in Europe and withdrawals of foreign funds from the United States offset, at least in part, the decline in net outflows of American funds.

The present program of voluntary restraints has undoubtedly slowed down the expansion of the global deficit of our balance of payments, but the deficit in the second half of 1965 remains nevertheless larger than that of 1964. Its annual rate ($2.3 billion) is likely to rise again this year, as a result of the deterioration in our current-account balance, of the continuing build-up of military expenditures in Viet Nam, and, last but not least, of speculative movements and gold withdrawals likely to be induced by the comparison between the official prediction of an approximate equilibrium this year, on the one hand, and actual developments on the other—to say nothing of the possible impact of the political differences splitting the Atlantic alliance. These divergences certainly endanger the close monetary and financial cooperation which has saved the world from a tragic repetition, in 1960, of the international monetary collapse of September 1931.

New measures will, therefore, become indispensable in the forthcoming months to redress our balance of payments. I would like to