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VOLUNTARY CONTROLS ON DIRECT INVESTMENT ABROAD AND THE UNITED STATES BALANCE OF PAYMENTS, 1962-1967

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CHAPTER I

INTRODUCTION AND DEFINITION OF THE PROBLEM

The balance of payments of a nation may be defined as a system of accounts of economic transactions in which the accounting entity is a country and the entries refer to transactions between residents and institutions of one country and residents and institutions of the rest of the world.[1] Economic transactions must be used in the broad sense to include all transfers of goods, services, and capital funds. These transfers are of physical goods as well as of ownership of financial and other assets.

Each country's foreign trade and payments are its main economic contact with other nations; a country's balance of payments is dependent not only on its own domestic policies but also on the policies of other countries.

This study will analyze, in general, the balance

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[1]There are exceptions to this rule, such as the treatment of immigrants' belongings and that of gold when transferred from domestic production to the central bank.

of payments problems confronting the United States between the years 1962-67, and, specifically, the effects on the balance of payments of controls on direct investment abroad.

The United States has had deficits almost continuously since the end of World War II. Until 1958, however, the deficits were not of much concern due mainly to the high demand for U.S. dollars in Europe and the rest of the world. In fact, U.S. dollars became an international reserve to most countries; and, thus, despite the large amount of foreign aid given by the United States through the Marshall Plan and other aid projects, even the sum of deficits during this period was low. The United States continued to maintain large gold reserves, and deficits did not greatly affect the country's foreign exchange reserves; they merely added to international liquidity and encouraged more international trade. Since 1958, the annual deficits have increased from year to year, reaching a peak in the years 1962-64. The demand for dollars in many countries was less than the supply, and many European countries accumulated large reserves, part of which they converted to gold. With this situation of countries not wishing to increase their dollar holdings but desiring to exchange these holdings for the decreasing gold reserves of the United States, the nation was faced with a new problem--

the elimination of the deficit in its balance of payments.

The United States, as a key currency country, is interested in achieving and maintaining equilibrium in the international payments balance together with continuing to perform its duties as a key currency nation with a transaction currency. All policies effected to achieve this goal should avoid any restrictions or controls on free movement of goods and capital between nations. However, in persuing this goal, with the appropriate fiscal and monetary policies, the country must aim for domestic stability and growth as well as international trade.

The questions of international trade and the balance of payments are not only matters of flexible and competitive cost and price structure in the production and distribution of goods and services but also are the fulfillment of governmental obligations and political, military, and social aspirations. In spite of a large surplus in the trade balance for many years, the United States had a deficit in the over-all balance because of military and economic foreign aid programs and the outflow of private capital.

The net loss of funds as the result of the deficit is measured in various ways, the two now officially used (which will be explained later) being the "official

settlement" and the "liquidity" measurement. Between 1960 and 1966, the country experienced a deficit of $12.3 billion based on the official settlement measure, and $16.7 billion based on the liquidity concept. Taking the years 1962-66, the amount would be $7.2 billion based on the official method, and $10.4 billion according to the liquidity model. The loss of gold for the period 1960-66 was $7.2 billion, and for the shorter period, 1962-66, only $3.8 billion. In the same period, it should be remembered, holdings of foreign assets by U.S. citizens increased by a much greater amount than did the deficit, including the loss of gold. However, most U.S. assets are direct investments and other long-term claims, whereas foreign claims upon the United States are short term and mainly liquid in form.

There have been many attempts in recent years to blame certain sectors of the economy for the deficit in the balance of payments. One common point of view is that the deficit is due to excessive governmental expenditures abroad in military and economic assistance as well as to U.S. foreign military costs. In some years the expenditure for assistance ran as high as $6.0 billion, but a large part of this assistance was in goods and services and not in outflow of capital. Another view blames the deficit on the private industrial sector where the outflow of capital exceeded $6.0 billion

annually in recent years. But here again the earnings of such investments are growing yearly and are one of the reasons that the United States has a trade surplus. Also, part of the outflow is in the form of exports which improves the nation's position.

As seen, it is difficult to cite one sector as the only source of blame for the deficit. Government expenditures are made, in many cases, to defend national freedom where private industry as well as the rest of the economy benefit from them.

The following statistics illustrate the urgency of the current problem facing the United States. In 1956, total liquid assets held by foreigners were $14.6 billion, and U.S. gold stock was $22.1 billion. By the end of 1966, foreign liquid claims were $27.9 billion, of which $14.7 billion were in official hands and $13.2 billion were in private hands. The U.S. gold reserves declined to only $13.2 billion. The problem of rise in liabilities to foreigners and the decline in the official reserves emphasizes the importance of bringing the balance of payments into equilibrium.

In order to solve the deficit problem, the United States had both short- and long-term policy patterns to follow. The short-term measures included restrictions on duty-free goods permitted to returning tourists, giving tied foreign economic assistance, the Interest

Equalization Tax (IET), and various voluntary programs. These short-term policies were intended to help improve the U.S. position until the time when long-term solutions for the problem could be adopted.

The long-term solution to the balance of payments deficit had to be designed in such a way that it took into account the special role of the U.S. dollar as a key currency and added to free-world security, trade, and development. While achieving approximate balance, all adjustments had to consider the political, military, diplomatic, and economic needs of the country. The U.S. dollar is a reserve currency to many nations and is the keystone of the international monetary system on which all the trade of the free world is based. The outflow of capital from the United States helps many under-developed countries to sustain some rate of growth and in some cases is their only source of foreign exchange.

Taking these factors into consideration, the long-term objectives have been aimed toward reaching a position of equilibrium and building confidence in the dollar as a reserve currency and international monetary unit. To attain this goal, however, the cooperation of business and other developed countries is needed in addition to government action.

Any long-term solution must be based on the following U.S. commitments and responsibilities:

1. The United States must continue to export government capital for bilateral economic assistance, and contributions to multilateral development assistance institutions.

2. The United States must continue defense expenditures abroad for mutual security in the free world.

3. The United States must continue, over time, to export private capital. This is practical; it is sensible; it is necessary. Moreover, the dividends and royalty receipts for past investments must be continued to be brought home--and in increasing amounts--to reward the stockholders and benefit the balance of payments.

4. The United States must continue to discharge its World-wide responsibilities to the international monetary system through its reserve currency and transaction currency roles.[1]

For the fulfillment of these conditions and improvement of the balance of payments without any restrictions on trade or capital movements the United States will have to increase its exports and earn more foreign exchange than it currently earns. By increasing her trade surplus the United States would be able to continue to give aid and export capital and still achieve equilibrium in the balance of payments.

Ways of Measuring Deficit and Surplus

The best means of measuring a deficit or surplus in the balance of payments has been the subject of

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[1]Henry H. Fowler, A World Monetary System for a Greater Society of Nations, Treasury Department News Release, F-847, March 17, 1967, Washington, D.C.

argument during the last few years. The measurement is very important because it is an international indication of the country's economic position and is a base for further economic policy decisions.

In balance of payments accounting debits must equal credits, by definition. But for analytical purposes there are some accounts which may be designated as balancing the account, and by placing them below or above the line a deficit or a surplus may be determined. The measurement of balance of payments deficit or surplus is a matter of analysis and not of accounting.

The United States has additional problems not facing other countries because it is a key currency country and is a banking center for all of the free world.

Since one determines what is a deficit or a surplus only by selected transactions, there is a crucial choice to determine what these transactions should be. The choice must be made in such a way that it has an analytical interpretation to show to what extent there is disequilibrium in the international economic position. The old general approach to the balance of payments divides all accounts into substantive or autonomous and compensatory or balancing accounts. By this method or approach the first grouping is the current account, unilateral transfers, and selected capital movements.

The compensatory accounts are the transactions undertaken to finance the first group, and they usually are placed below the line.

Because of the difficulty of defining autonomous or compensatory transactions during the 1950's, the Commerce Department used the basic balance and overall balance concepts in order to determine deficit or surplus in the balance of payments. The basic balance includes the transactions which respond to long-term economic forces; these transactions are the net of current accounts, transfer payments, and any long-term capital movements. All other transactions, including changes in official holdings, are short-term capital movements and are placed below the line. Many economists objected to this approach on the ground that some nominally short-term capital movements are actually long-term in nature since they may be increases in transactions or working balances, or short maturity loans which will automatically be renewed.

Since the late 1950's, the Department of Commerce has used the "balance on regular type transactions" or "overall balance" to measure surplus or deficit. This means of measurement includes, above the line, the basic balance, U.S. short-term capital movement (net), short-term commercial and brokerage liabilities (net) and errors and ommissions. Many economists, including

the Bernstein Committee, criticized this approach.[1] They charged that the official presentation overstates the payment deficit and that the Commerce Department uses a stricter method than any other nation when it treats any inflow of short-term foreign private capital as a settlement item, which is financing the deficit, rather than an ordinary capital inflow which is reducing the deficit. But outflows of U.S. short-term private capital are treated as regular transactions that increase the deficit. The commerce Department reply was that the United States occupies a special position as the world's key currency country which put upon it more obligations and, hence, the stricter standard.

In 1965, the Department of Commerce started to use a new concept of measurement, the "liquidity balance." This method of measurement includes, above the line, all of the transactions of the "regular type" and adds special governmental transactions. The liquidity balance measures as deficit or surplus all changes in U.S. official reserve assets and liquid liabilities to all foreigners, private and institutional. Official reserves of the United States include official holdings of gold and foreign exchange and the net position of the United

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[1] "Bernstein Committee," The Balance of Payments Statistics of the United States, A Review and Appraisal, The Bureau of the Budget, April 1965, p. 109.

States with the International Monetary Fund which is the "gold tranche" position with the Fund. Liabilities of the United States to foreigners are: all short-term liabilities to private individuals and institutions reported by U.S. banks, plus all foreign holdings of marketable or convertible U.S. Government securities. All other items are above the line. Thus, a deficit in the nation's balance of payments, according to this method of measurement, is any decrease in U.S. official reserve assets plus any increase in liquid liabilities to foreigners.[1]

The Commerce Department's argument for using this method is that the United States has a special role as a key country of the world and that it is the only country which is committed to gold convertibility. Therefore, the United States should keep its payments accounting on a conservative basis: "Hope for the best but be prepared for the worst." This approach assumes that the main purpose of balance of payments accounting is to see the relationship between current liabilities and current assets available to meet them. All foreign holdings are assumed to be potentially redeemable in gold by taking into account the fact that liquid dollar holdings

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[1]Thomas E. Davis, "Measuring a Deficit or Surplus in the U.S. Balance of Payment," Monthly Review (Kansas City Federal Reserve Bank, September-October, 1966), p. 15.

of private foreigners may be easily sold to their central bank which in turn could present them to the U.S. Treasury to be redeemed in gold.

Findings of the Bernstein Committee

The Bernstein Committee gave the major objections to, and criticisms of, the aforementioned Department of Commerce approach. The first objection is that all changes in liabilities to other than monetary authorities represent ordinary capital movement and should be treated as such. Second, it is quite difficult to determine the character of U.S. Government non-marketable, medium-term, convertible securities as to whether they are liquid or non-liquid. Third, in the asymmetrical treatment of short-term private capital flow, according to this treatment, changes in U.S. liquid liabilities to private foreigners are placed below the line, while changes in U.S. private capital claims on other nations are placed above the line. The Department of Commerce justifies the use of this method with the argument that this country has corresponding asymmetries in the real world. The U.S. liquid liabilities are considered to be a potential threat to the U.S. stock of gold, but U.S. private capital claims on other countries are not readily available to U.S. authorities for use in defending the dollar. The United States does not have exchange

controls, and only official reserves are regarded as available to defend the dollar. The Committee's answer to this argument is that a large part of private foreign claims against the United States is really a liability to U.S. residents or banks and is not likely to be withdrawn. An example of this is that when a U.S. bank lends money to a foreigner a part of the sum is required to be placed on deposit at the bank and cannot be withdrawn. A further example is that when a U.S. resident deposits funds in a foreign bank, these funds are not apt to be used in claiming U.S. gold because the funds are liabilities of the bank to this citizen. Thus, not all short-term liquid claims are really potentially dangerous to U.S. gold stock. The Bernstein Committee concluded that the main purpose of measuring the balance of payments surplus or deficit is to indicate the extent of any disequilibrium which may exist in the country's international transactions, and especially to measure the gap between normal supply and demand for foreign exchange which must be filled by the monetary authority if it is to keep the parity of the money. An increase in assets in this country by foreign holders does not necessarily mean a position of disequilibrium and the liquidity concept has no precise meaning.[1]

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[1]"Bernstein Committee," The Balance of Payments Statistics of the United States, A Review and Appraisal, The Bureau of the Budget, April 1965, p. 109.

As an alternative approach the Committee proposed a new concept--the "official settlement"--which it believed to be the most useful measure of deficit and surplus. This approach treats all foreign private claims in the United States, liquid or non-liquid, as ordinary capital inflows. Only the change in U.S. reserves, along with claims of foreign official authorities, would be considered as indicating surplus or deficit. The Committee Report emphasizes that the key to arranging balance of payments presentation is the responsibility of the official authorities to keep their currency stable. In following this responsibility the authorities gain or lose reserve assets and change the size of their liabilities to other countries' monetary authorities. In determining whether a country is in equilibrium, attention must be paid to the changes in its international reserves of gold, convertible currencies, position with the International Monetary Fund, and the liabilities to foreign official authorities. Those liabilities may be liquid or non liquid.

The reason short-term claims should be viewed as capital inflow is that when the United States has short claims on foreigners it counts this as capital outflow; short-term claims against the United States should be treated in the same way and should be counted as capital inflow. The motivations affecting short-term capital flow are the same for private citizens of the United

States as well as for those of other countries. Such treatment of short-term capital flows will eliminate some bias in the direction of enlarging the reported U.S. deficit.

The official settlement approach treats errors and ommissions as unrecorded private capital movements, and they are therefore placed above the line.

The reason for proposing that all changes in U.S. liabilities to foreign official monetary authorities without regard to their maturity or liquidity be classified as settlement items below the line is that these assets are held as part of the international reserve of these countries, and any change of these reserves would affect the balance of payments position.

The main criticism of the official settlement concept is that in most countries private claims of their citizens are closely related to central bank policies. In many of them the commercial banks are owned or controlled by the central bank, and some exchange control exists in most countries. In many cases monetary authorities will encourage commercial banks or private citizens to hold liquid dollar assets rather than exchange them for local currency by agreeing to pay higher interest rates and promising to cash them at a future date at a more favorable exchange rate. Another important argument against using the official settlement is that such an

accounting of the balance of payments deficit may endanger the international position of the U.S. It would postpone very important signals warning of trouble in its transactions with the rest of the world. Short-term liabilities might build up around the world and would not be noticed until after they had been moved to central banks and presented to the United States in exchange for gold.

Four different concepts of measurement have been discussed which can be employed to present deficit or surplus in the balance of payments; yet there is no easy answer as to which is the best method. Each has advantages and disadvantages, depending upon the specific problem it attempts to analyze.

The "basic transaction" approach should be used as a basic starting point for analysis, using the other approaches for special problems. In this paper the figures of all four approaches will be given, with more emphasis on those used by the Department of Commerce.

Any deficit, however measured, does not imply that the United States has a reduction in total foreign net assets. Throughout the years when there have been deficits, total foreign assets plus gold and international reserves of the United States have increased. The change has come mainly in the composition of these assets. Since 1950, total U.S. assets abroad increased many times more

than the decline in gold stock and increased claims by foreigners. During this period, the United States has had deficits for all years except 1957 when it had a small surplus. Total deficits for the years 1950-65, based on the "regular transaction" approach, amounted to $33.3 billion. During this time U.S. long-term assets and credits abroad increased from $28.3 billion to $91.1 billion, and short-term assets increased from $1.8 billion to $13.3 billion. Foreign investment in the United States increased from $8.0 billion to $26.4 billion in long-term assets and from $9.6 billion to $32.5 billion in short-term assets. Even with the decrease in the gold stock and its deficit in the balance of payments, total U.S. international assets and reserves increased by $24.2 billion (Table 1).

During the period 1962-65, the United States continued to increase its assets abroad. This increase was much greater than the increase in the assets of foreigners in the United States. The total increase of U.S. assets abroad during this period was $31.4 billion, or an average increase of $7.9 billion a year. The total increase of foreign assets and investment in the United States was only $12.0 billion, or an average of $3.0 billion per year.

TABLE 1

NET CHANGE IN INTERNATIONAL ASSETS AND RESERVES OF THE UNITED STATES FROM 1950 TO 1965
(million U.S. dollars)

Type of Assets	1950	1965	Change
Liquid			
U.S. gold holdings	22.8	13.8	-9.0
IMF gold tranche position and holdings of convertible currencies	1.4	1.6	+ .2
Short-term claims of the United States, private and government	1.8	13.3	+11.5
Short-term claims of foreigners on the United States	9.6	32.5	-22.9
Net change in gold and short-term claims			-20.2
Non-liquid			
Long-term assets and credit abroad	28.3	91.1	+62.9
Long-term assets and credit by foreigners in the United States	8.0	26.4	-18.4
Net change in long-term assets and credits			+44.5
Total change in liquid and non-liquid international assets of the United States for 1950-1965			+24.2

Source: U.S. Department of Commerce, Survey of Current Business, September 1966, p. 40.

CHAPTER II

THE DEFICIT IN THE UNITED STATES BALANCE OF PAYMENTS, 1962-67

Due to the construction of the balance of payments, no deficit or surplus is possible from the accounting approach, but, as shown in this paper, there must be an analysis in order to measure a deficit or a surplus in the balance of payments. All four concepts of the balance of payments that have been discussed are alike in the sense that all of them show deficits in the balance except in the "official settlement" in 1966. According to the "basic balance" approach, the cumulative deficit for the period 1962-67 is $12.0 billion (Table 2); according to the "balance of regular transaction" approach, it is $17.5 billion; the "official settlement" shows $10.8 billion; and the "liquidity balance" shows $13.9 billion (Table 4). (All four balances are shown in Appendix 1.)

The United States used several methods to finance the deficit during this period. Most important was the sale of gold. Between 1962 and 1967, the United States

TABLE 2

UNITED STATES BALANCE OF PAYMENT, 1962-67, ON "BASIC" TRANSACTION CONCEPT
(million U.S. dollars)

	1962	1963	1964	1965	1966	1967
Export of Goods and Services (excluding transfer under military grants)	30,278	32,339	36,958	38,993	43,039	45,756
Imports of Goods and Services	-25,148	-26,442	-28,468	-32,036	-37,937	40,989
Balance of Goods and Services	5,130	5,897	8,490	6,957	5,102	4,767
Private Capital Account, net	- 2,604	- 4,283	- 4,031	- 4,414	- 1,710	- 4,324
1. U.S. direct investment	(- 1,522)	(- 1,981)	(- 2,421)	(- 3,300)	(- 3,543)	(- 3,020)
2. Other long-term investment (securities)	(- 830)	(- 760)	(- 524)	(- 1,015)	(427)	(- 250)
3. Long-term banks and private claims	(- 252)	(- 542)	(- 1,086)	(- 99)	(1,406)	(- 1,074)
Private Remittance and Government Pensions	- 757	- 867	- 879	- 994	- 1,010	- 1,276
Government Accounts	- 3,449	- 3,460	- 3,664	- 3,612	- 3,609	- 4,369
1. Non-military grants and long-term credit	(- 4,048)	(- 4,104)	(- 4,244)	(- 4,293)	(- 4,415)	(- 5,344)
2. Scheduled repayment of long-term credit	(- 599)	(- 644)	(- 580)	(- 681)	(806)	(975)
Basic Balance	- 1,680	- 1,713	- 84	- 2,063	- 1,227	- 5,202

Sources: U.S. Department of Commerce, Survey of Current Business, June 1966, p. 30 (Years 1962, 1963, 1964); March 1967, pp. 21-23 (Years 1965, 1966); March 1968, pp. 23-25 (Years 1966, 1967).

lost $4.0 billion in gold (Table 3), and during the same period the U.S. IMF gold tranche position[1] declined from $1.69 billion to $0.42 billion at the end of 1967. The rest of the deficit was financed by increases in liabilities to foreigners. Most of the gold purchasing during the last few years was done by one country--France. Other countries which purchased a sizeable amount were Spain, Germany, and Austria.

During the years 1962-1964, the average deficit on the liquidity basis was $2.5 billion; in 1966 it was reduced to $1.3 and $1.4 billion, respectively. During 1962 and 1963 the balance of payments deficit, as measured by the liquidity balance, was about the same. While the deficit in 1963 exceeded that in 1962, $0.5 billion, it mainly reflected a lower level of special receipts from foreign governments. The primary difference between 1962 and 1963 was the composition of financing the deficits. Whereas reduction in the international monetary assets

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[1]IMF Gold Tranche Position: The amount by which a member's quota exceeds the Fund holdings of its currency. Each member of the IMF has a quota in the Fund that is computed in relation to the GNP and foreign trade of the member. The quota is paid 25 percent in gold and 75 percent in the member's currency. (When the foreign reserves of the member are low, it may pay less in gold because it has the choice of paying 10 percent of its reserves or 25 percent of the quota--whichever is smaller.) The amount of gold that the United States deposits with the Fund plus the amount of its currency that other members borrow (if any) are part of the U.S. reserves and are called the gold tranche position.

TABLE 3

UNITED STATES INTERNATIONAL LIQUIDITY POSITION, 1961-1967
(billions of dollars)

International Liquidity	1961	1962	1963	1964	1965	1966	1967
Gold	16.9	16.1	15.6	15.5	14.1	13.2	12.1
Fund Gold Tranche Position	1.7	1.1	1.0	0.8	0.6	0.3	0.4
Foreign Exchange	0.1	0.1	0.2	0.4	0.8	1.3	2.3
TOTAL	18.7	17.3	16.8	16.7	15.4	14.8	14.8

Source: International Monetary Fund, International Financial Statistics, May 1968, Vol. XXII, No. 5.

of the country had accounted for more than three-fourths of the total in 1962 (Table 3), and the increase in liquid liabilities to foreign monetary authorities accounted for the rest, these proportions were approximately reversed in 1963. Compared with the two previous years, the main developments in 1964 were the high balance of trade and services surplus, which reached $8.5 billion, and an unexpectedly large outflow of capital that reached $6.5 billion. Otherwise, the balance of payments remained essentially the same, and the deficit was $2.8 billion as in the previous year. In 1965 and 1966, the deficit measured on this basis declined to $1.3 and $1.4 billion, respectively. This decline came at a time when military expenditures increased because of the war in Viet Nam. The structure of the balance of payments during these two years differed from that of previous years. The surplus on goods and services dropped sharply in 1965 and continued to deteriorate in 1966. Net outflows of private capital declined from the high levels of 1964 to lower levels comparable to the early 1960's.

One of the reasons for the improvement in 1965 and 1966 was the impact of the February 1965 program on commercial bank lending abroad. Claims reported by U.S. banks abroad changed favorably by about $2.5 billion between 1964 and 1965, and there was an additional

improvement of $0.2 billion in 1966. For 1966, the current account balance continued to shrink, and expenditures for the war in Viet Nam continued to rise. However, the tight money situation and higher yield on U.S. securities attracted huge sums of foreign capital. The U.S. banks attracted deposits through their foreign branches for use in the domestic credit market, and long-term foreign investment in the United States increased by $2.0 billion--one of the largest increases since the end of the Second World War. In addition, because of the voluntary program, net outflow of capital to finance direct investment abroad decreased in 1966, and the additional capital needed by U.S. companies was borrowed abroad. Most of the borrowing was in the form of long-term security issues, particularly convertible bonds.

Still another factor operating in 1966 was the high pressure on sterling during the summer, which forced the Bank of England to defend its currency by selling dollars for which U.S. banks abroad were bidding. Since these liquid banking funds continued to be liquid claims against the United States, they did not affect the liquidity balance but improved the official settlement balance.

Despite a balance of payments surplus of $0.2 billion, based on the official settlement, the United

States lost $0.6 billion in gold and had a deterioration in its IMF position, which amounted to an additional $0.3 billion. Foreign exchange holdings of convertible currencies increased that year by $0.5 billion.[1]

The U.S. balance of payments showed appreciable deterioration in 1967. The deficit measured by liquidity balance amounted to $3.6 billion, three times higher than 1966, and, as measured by official settlement, it deteriorated from a surplus of $0.2 billion in 1966 to a deficit of $3.4 billion in 1967. Some unfavorable conditions such as the war in Viet Nam, which existed in 1966 and continued in 1967, and new developments such as the war in the Middle East, Expo '67, and the devaluation of sterling caused the balance of payments deterioration. The slower domestic economic growth helped to improve the balance of trade, but the easing of monetary conditions in the United States caused a reverse in the favorable flows of capital in 1966, making them unfavorable in 1967.

The liquidity measures deficit could have been substantially larger in 1967 if foreign official agencies had not invested over $1.0 billion in non-liquid U.S. Government liabilities and in long-term deposits and certificates of deposits in U.S. banks.

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[1]U.S. Department of Commerce, Survey of Current Business, January 1967, pp. 24-25.

Additional factors in the adverse balance of payments development during that year were the result of a net increase in U.S. Government credit abroad and higher outflows of private capital.

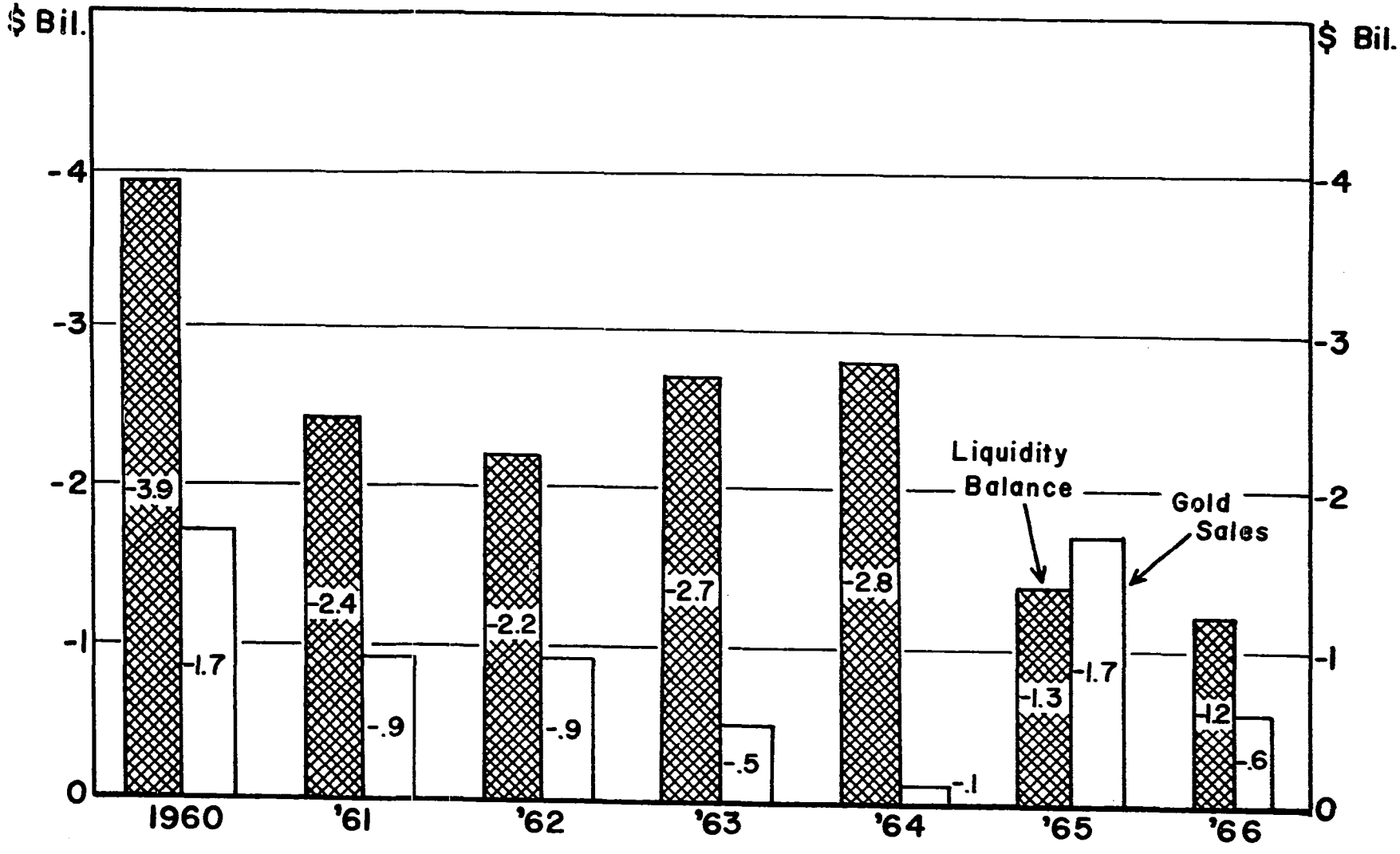
Despite the sharp balance of payments deteriorations, U.S. official holdings of international reserves did not change in 1967 (Table 3). Gold assets declined by about $1.2 billion, but foreign exchange of convertible currencies increased by $1.0 billion, and the Fund gold tranche position improved by $0.1 billion. Therefore, the liquidity deficit for the year was financed through an increase of $3.5 billion in liquid dollar liabilities, of which $2.1 billion was to official agencies.

In order to see how important the claims of foreign countries are to the United States as a key currency center, it is only necessary to use as an example the year 1965. The deficit of both measurements, the liquidity and official balances, was $1.3 billion, but net sales of gold by the United States were $1.7 billion, of which $260 million represented a transfer to the IMF to enlarge its quota. In 1964, the deficit was $2.8 billion on the liquidity basis and $1.5 billion on the official settlement basis, but the sales of gold was only $0.1 billion (Charts A and B).

As mentioned previously, the difference between

CHART A

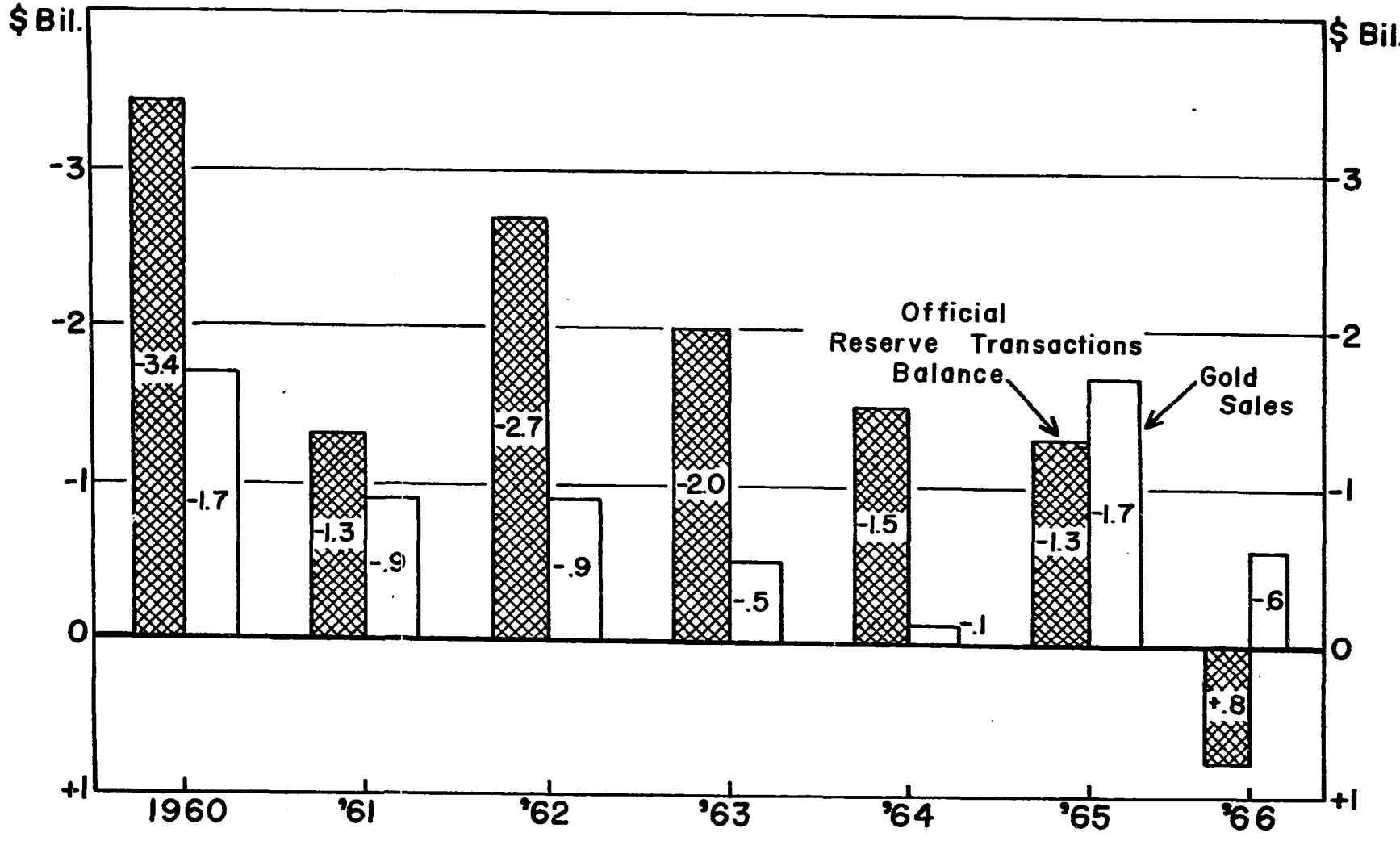
U.S. BALANCE OF PAYMENTS "LIQUIDITY" DEFICIT AND GOLD SALES



Source: Office of the Secretary of the Treasury.

CHART B

U.S. BALANCE OF PAYMENTS ON "OFFICIAL RESERVE TRANSACTIONS BASIS" AND GOLD SALES



Source: Office of the Secretary of the Treasury.

liquidity and official settlement balances is in the various items each one includes, above and below the line. The deficit on the liquidity balance was almost always larger than the official mainly because foreign private liquid capital is a settlement item and appears below the line, as do changes in non-liquid liabilities to foreign monetary authorities. In the official settlement balance the last two items are above the line and are not included as part of the deficit. The reason the outflow of gold in 1965 was larger than the two deficit measurements was that foreign countries cashed all their claims for gold, including the additional amounts of increases in the U.S. convertible currencies and position with the IMF.

It should be remembered that the balance of payments deficit during the late 1940's and the 1950's was necessary in order to provide international liquidity to support free world trade and economic growth. The deficit during that time showed the strength of the economy and helped to increase American assets abroad (Table 1). Since 1958, the amount of deficit has increased sharply while the U.S. stock of gold has declined--a fact that has caused a loss of confidence in the dollar. If a new international liquidity system is not established in the near future, the United States will have to continue operating with a small deficit

each year in order to supply the needed additional international currency for expanding trade.

Balance of Trade

The balance of trade continued to show an excellent record during the period 1962-67. During the 1950's the excess of exports averaged $2.8 billion a year. In the period 1962-67, the surplus averaged $4.7 billion annually. Total exports of merchandise increased from $20.6 billion in 1962 to $30.5 billion in 1967, or an increase of approximately 50 percent. Total imports of merchandise in the same period increased from $16.2 billion to $27.0 billion, or an increase of 68 percent. But the greatest increase of imports came in 1966, because of the unusually large rate of growth in the domestic economy which sharply increased the demand for goods.

Exports of goods and services increased from $30.3 billion in 1962 to $45.8 billion in 1967. Total imports of goods and services increased from $25.1 billion to $40.1 billion, or an increase of 60 percent against a 50 percent increase in exports. In absolute terms, the United States had an increase of $15.5 billion in exports and $15.0 billion in imports; so the trade surplus was larger in 1966 than 1962.

The main reason for the increased surplus in the

services account during this period was the increasing returns of direct investment which rose from $3.1 billion in 1962 to $4.5 billion in 1967, an increase of approximately 50 percent. All other income on the service account is more or less offset by the expenditures on travel (Table 4).

The surplus in the balance of trade rose sharply in the years 1962-64, then dropped to a lower level in the years 1965-67. The drop in surplus was primarily for two reasons: (1) a sharp increase in imports caused by the rapid economic expansion and great pressure on domestic resources; (2) the increase in the cost of the war in Viet Nam. Trade surpluses reached a peak of $8.5 billion in 1964, but declined to $4.8 billion in 1967 (Table 4).

Total merchandise imports as a percent of gross national product between 1962 and 1964 was less than 3 percent, but it rose to 3.2 percent in 1965, 3.5 percent in 1966, and 3.9 percent in 1967. Total imports of merchandise in 1964 was $18.6 billion, and by 1967 the total was $27 billion, an increase of $8.4 billion, or approximately 45 percent. Total exports of merchandise in 1964 was $25.3 billion and in 1967 it rose to $30.5 billion, an increase of $5.1 billion or approximately 20 percent (Table 4). The composition of imports changed in the period 1965-67 due to the rapid economic expansion

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TABLE 4 (continued)

UNITED STATES BALANCE OF PAYMENTS, 1962-67
(billion U.S. dollars)

Type of Transaction	1962	1963	1964	1965	1966	1967
12. Special U.S. Gov. transactions[2]	1.4	0.6	0.3	0.4	0.4	0.4
13. "Over-all liquidity" balance	- 2.2	- 2.7	- 2.8	- 1.3	- 1.4	- 3.6
Plus: Foreign private liquid capital, net	- 0.2	0.7	1.6	0.1	2.4	1.6
Less: Increase in non-liquid liabilities to foreign monetary authorities	0.3	--	0.3	0.1	0.8	1.3
14. Balance on official settlement	- 2.7	- 2.0	- 1.5	- 1.3	0.2	- 3.4
Gold (decrease-)	0.9	0.5	0.1	1.7	0.6	1.2
Convertible currencies (decrease -)	--	- 0.1	- 0.2	- 0.3	- 0.5	- 1.0
IMF gold tranche position (decrease -)	0.6	--	0.3	- 0.1	0.5	- 0.1
Foreign monetary official claims (increase -)	1.2	1.7	1.4	0.1	- 0.8	- 3.5

Sources: Economic Reports of the President, 1965, p. 164; 1966, p. 181; 1968, p. 167. U.S. Department of Commerce, Survey of Current Business, June 1966, March 1967, March 1968, September 1968.

NOTE: Detail will not necessarily add to totals because of rounding.

[1]Excluding transfers under military grants.

[2]Includes non-scheduled repayments of U.S. Gov. loans and change in non-liquid U.S. Gov. liabilities.

in the U.S. While in 1964 only about 3 percent of domestic capital requirement was imported, it increased to 9 percent in 1965, and to over 12 percent in 1966.[1]

Analysis of the U.S. competitive position is a rather difficult task--data are usually ambiguous and incomplete. However, some broad conclusions can be reached, especially when comparisons are made of international trends in labor costs per unit of output. During the period 1960-65, the unit labor cost in manufacturing industries declined slightly, and in the economy as a whole increased very little--less than 0.5 percent (Table 5). In all of the larger European countries labor costs in manufacturing have risen, especially during the years 1962-65 (Table 6). In the United States in 1966, average wage settlements were sharply higher as compared with previous years, and the gain in productivity continued to increase as before. Therefore, the unit labor cost in the private economy rose by 3.6 percent. This trend continued in 1967, with labor unit costs increasing by 4.5 percent in the entire private sector and by 5 percent in manufacturing industries alone. Since mid-1965, the U.S. competitive position has ceased to improve and seems to have been deteriorating since 1967.

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[1]Economic Report of the President, January 1967, p. 181.

TABLE 5

CHANGES IN COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COST IN THE PRIVATE ECONOMY, 1960-1967

	Percentage Change per Year		
	1961 to 1965	1965 to 1966	1966 to 1967
Total private:			
Average hourly compensation	4.4	6.9	6.0
Output per man-hour	3.8	3.1	1.4
Unit labor cost	0.5	3.7	4.5
Private nonfarm			
Average hourly compensation	4.0	6.0	5.8
Output per man-hour	3.5	2.6	0.9
Unit labor cost	0.5	3.4	4.8
Manufacturing			
Average hourly compensation	3.6	4.9	6.1
Output per man-hour	4.6	2.2	0.9
Unit labor cost	-1.0	2.7	5.1

Source: Economic Report of the President, 1968, p. 111.

TABLE 6

UNIT LABOR COST IN MANUFACTURING--UNITED STATES AND MAJOR FOREIGN COMPETITORS [1]
(1961 = 100)

	1962	1963	1964	1965	1966	1967[2]
United States	99	98	98	97	99	104
Canada	99	100	100	95	99	--
France	107	112	118	119	116	--
Germany	107	111	111	117	123	--
Italy	108	118	124	122	118	--
Japan	108	113	111	118	125	--
United Kingdom	104	102	103	109	114	--

Sources: Economic Report of the President, 1968, p. 111.

U.S. Treasury Department, Maintaining the Strength of the United States Dollar in a Strong Free World Economy, Washington, D.C., 1968, p. 65.

1 National Currency basis.

2 For 1967, data available only for the United States, based on 5.1 percent increase in unit labor cost.

Capital Accounts

The outflow of U.S. private capital increased during the period 1962-67, with total capital outflow for this period reaching $27.9 billion. Capital outflow fluctuated from a low of $3.4 billion in 1962, to a high of $6.5 billion in 1964, and down to $5.5 billion in 1967. The larger part of this capital outflow was long-term and direct investment which partially helped to increase U.S. exports. The other part was short-term, liquid capital which was added to the growing private and official holdings of U.S. liquid assets of foreign countries. Some of these funds were exchanged for U.S. gold, but the rest of it continues to be a potential threat for this country's foreign reserves.

Many economists and government officials maintain that the outflow of private capital is really larger than the given figures. These economists add the errors and ommission figures ($3.9 billion for the years 1962-67) to the outflow of private capital. In 1964 alone, this figure reached a peak of $1.2 billion.[1]

To reduce the amount of capital outflow, in July 1963 the Congress imposed an Interest Equalization Tax (IET) on foreign securities sold in the United States

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[1]Frederick L. Deming, The International Monetary Payment System, Department of the Treasury Press Release F-678, October 31, 1966 (Washington, D.C., 1966).

by the developed countries, other than Canada. The main purpose of this tax was to compensate for the interest rate differential between the United States and other countries by increasing the cost to borrowers from other industrialized countries when raising long-term capital in the United States. This tax had the desired effect, and since 1963, most of the foreign securities sold in the United States have been Canadian and those of developing countries. However, direct investment and bank lending abroad increased sharply in 1964 and 1965 but leveled off in 1966 after the voluntary program of restriction had been adopted by government and business (Table 7).

Flows of capital into the United States also fluctuated widely between 1962 and 1967. There was an increase from $1.1 billion in 1962 to $1.9 billion in 1964, then a decline to $0.3 billion in 1965, and a sharp increase to $4.1 billion in 1966 (Table 8). A marked difference exists between the periods 1962-65 and 1966 through 1967. Prior to 1966, inflow of long-term capital was relatively low, and it increased sharply in 1966 and 1967. Partially responsible for the increase were the large foreign purchases of U.S. securities which were sold abroad by American corporations for their domestic subsidiaries for the purpose of financing direct investment in other nations. The other account

TABLE 7

TRANSACTION IN U.S. PRIVATE ASSETS ABROAD
(million U.S. dollars)

	1962	1963	1964	1965	1966	1967
Total U.S. Private Foreign Investment	-3,430	-4,456	-6,523	-3,797	-4,213	-5,504
Direct investment[1]	-1,654	-1,976	-2,416	-3,371	-3,543	-3,020
Foreign securities (net)	- 969	-1,104	- 677	- 760	- 482	-1,266
New issue	-1,076	-1,250	-1,063	-1,208	-1,210	-1,619
Redemption	203	195	193	222	405	469
Other	- 96	- 49	193	226	323	- 116
Claims reported by U.S. banks	- 451	-1,535	-2,464	94	253	- 459
Long-term	- 127	- 754	- 941	- 231	337	285
Short-term	- 324	- 781	-1,523	325	- 84	- 744
Other claims by residents	- 351	159	- 966	340	- 441	- 759
Long-term	- 131	163	- 343	- 88	- 112	- 289
Short-term	- 220	- 4	- 623	428	- 329	- 470

Sources: U.S. Department of Commerce, Survey of Current Business, June 1966, pp. 24-25; March 1966, p. 19; September 1968, p. 31.

1 Excluding reinvestment abroad of funds borrowed abroad.

TABLE 8

TRANSACTION IN FOREIGN ASSETS IN THE UNITED STATES, EXCLUDING U.S. RESERVES LIABILITIES TO FOREIGN OFFICIAL AGENCIES 1

	1962	1963	1964	1965	1966	1967
Foreign Assets in the U.S. Excluding U.S. Reserves Liabilities	1,080	1,315	1,936	309	4,094	3,253
Non-liquid foreign assets (except reserves)	767	696	382	178	1,710	1,802
Direct investment	132	- 5	- 5	57	86	153
U.S. securities other than Treasury issues	134	282	- 84	-357	909	994
Long-term U.S. liabilities reported by banks	5	62	237	203	976	965
Other liabilities reported by U.S. private residents other than banks	-114	- 36	74	178	474	513
U.S. Government liabilities excluding marketable or convertible securities	864	386	463	197	67	451
Less: Non-liquid U.S. liabilities to foreign official agencies	254	- 7	303	100	802	1,274
Liquid foreign assets (except reserves)	313	619	1,554	131	2,384	1,451
Held by:						
Foreign commercial banks	-138	470	1,454	116	2,697	1,265
Other foreign residents	140	385	343	306	212	394
International Organ.	211	- 236	- 243	-291	- 525	- 208

Sources: U.S. Department of Commerce, Survey of Current Business, June 1966, pp. 24, 30; March 1968, pp. 23, 25; September 1968, pp. 31, 33.

1 Minus signs indicate outflows; positive figures represent inflows.

which increased sharply was the long-term U.S. liabilities reported by banks. This development was due to the high interest rate that prevailed in 1966, of which many international organizations took advantage by purchasing time deposit certificates and other time deposits as temporary investments of funds.

The tight monetary condition in the United States in 1966 also was reflected in the movement of U.S. liquid liabilities held by foreigners. This condition resulted in a shift of liquid U.S. assets from foreign official agencies (especially Britain) to foreign commercial banks (mainly foreign branches of U.S. banks) and then transferred for lending in the United States (Table 7).

Government Accounts

Government accounts consist mostly of net military expenditures abroad and foreign aid programs. Foreign aid is divided into two parts: military assistance and economic assistance.

Military expenditures abroad are intended primarily to maintain U.S. military establishments in NATO, Japan, and Southeast Asia. Net expenditures overseas on these military commitments in the years 1962-67 amounted to $14.8 billion (Table 9). Gross military expenditures are higher, but they have been reduced by receipts from

TABLE 9

UNITED STATES MILITARY EXPENDITURES AND RECEIPTS OVERSEAS, ENTERING BALANCE OF PAYMENT ACCOUNTS BY AREA, 1962-1967

	1962	1963	1964	1965	1966	1967
Total Expenditures, net	2.3	2.2	2.1	2.1	2.9	3.1
Expenditure by Areas, gross	3.0	2.9	2.8	2.9	3.7	4.3
Western Europe	1.6	1.5	1.5	1.5	1.5	1.6
Canada	--	0.3	0.3	0.2	0.2	0.2
Japan	0.4	0.4	0.3	0.3	0.4	0.5
Other, Asia and Africa	1.0	0.5	0.5	0.7	1.3	1.8
All other	--	0.2	0.2	0.2	0.3	0.2
Less: Military Sales	0.7	0.7	0.7	0.8	0.8	1.2
Western Europe	0.5	0.5	0.6	0.5	0.6	0.9
Other	0.2	0.2	0.1	0.3	0.2	0.3

Sources: Federal Reserve Bulletin, April 1967, p. 525.

U.S. Department of Commerce, Survey of Current Business, June 1966, pp. 25, 36-38; March 1968, pp. 30-32.

military sales. These expenditures directly affect the U.S. balance of payments because these funds are transferred to residents and governments of foreign countries. The amount of military expenditures during this period exceeded the deficit in the balance of payments on liquidity or official settlement basis.

Military expenditures abroad between 1962 and 1966 would have been much higher if special efforts had not been made by the U.S. Government to purchase large quantities of American goods instead of lower cost foreign goods for military use; also, the NATO allies were persuaded to buy more American-made hardware. However, the war in Viet Nam increased considerably the U.S. purchases of foreign goods and services in Asia. Another factor that lowered the net governmental outflow of capital was the agreement reached with the governments of France, Italy, and Germany to repay, ahead of schedule, loans owed to the United States.

Under the economic foreign aid programs gross government grants and loans amounted to approximately $24.5 billion from 1962 to 1967, including shipments under the Food for Peace Project. All but $2.0 billion of the foreign aid program was tied to purchases of goods in the United States or was for Food for Peace shipments and thus did not affect the balance of payments adversely.

In addition to economic aid, about $9.5 billion was given as military grants. However, these grants were given in the form of goods and services and did not involve any outflow of dollars.

Total U.S. foreign assistance (economic and military) in this period averaged $5.6 billion a year, and of this figure only $0.6 billion involved dollar outflow. An additional sum of $0.5 billion annually went abroad for pensions and other transfers (Table 10).

Overseas military expenditures by the United States were the principal cause of the U.S. Government dollar outflow, with about two-thirds of the total outflow being spent for military commitments around the world. For the period under discussion, these expenditures amounted to $14.5 billion, or $2.4 billion annually.

Total outflow of dollars on government accounts averaged $2.7 billion annually. For the years 1962-65, the sum was $2.4 billion a year; for 1966 and 1967, it was $3.4 billion a year (Table 10).

The annual deficit on the regular transaction basis for the years 1962-67 averaged $2.9 billion. During this period U.S. Government transactions induced an outflow of $2.7 billion annually, or slightly more than 90 percent of the deficit.

TABLE 10

UNITED STATES GOVERNMENT EXPENDITURES ABROAD, 1962-67
(million U.S. dollars)

	1962	1963	1964	1965	1966	1967
I. Military Expenditures, net	2,304	2,279	2,087	2,115	2,906	3,100
A. Military expenditure	2,961	2,936	2,834	2,945	3,735	4,340
B. Military sales contract	- 657	- 657	- 747	- 830	- 829	-1,240
II. Military Grants of Goods and Services	1,539	1,562	1,340	1,628	1,002	905
III. Government Grants, Capital, and other Transfers, net	3,108	3,792	4,039	3,938	4,093	5,157
A. U.S. Government grants	1,919	1,917	1,886	1,800	1,915	1,800
B. Long-term loans	2,007	2,187	2,358	2,493	2,602	3,544
C. Loans in foreign currencies and short-term assets	245	441	19	- 16	265	153
D. Pensions and other transfers	349	414	482	584	582	667
E. Interest payment, net	- 132	- 97	- 3	- 21	- 44	- 26
F. Repayments on credits	-1,280	-1,070	- 703	- 902	-1,227	- 981
Scheduled	(- 599)	(- 644)	(- 580)	(- 681)	(- 799)	(- 975)
Non-scheduled	(- 681)	(- 326)	(- 123)	(- 221)	(- 428)	(- 6)

TABLE 10 (continued)

UNITED STATES GOVERNMENT EXPENDITURES ABROAD, 1962-67
(million U.S. dollars)

	1962	1963	1964	1965	1966	1967
IV. Total Government Expenditures, net (I - II - III)	6,951	7,633	7,466	7,681	8,001	9,164
V. Estimate Transactions Involving No Direct Dollars Outflow from the United States	4,788	5,299	4,918	5,197	4,876	5,366
A. Military grants	1,539	1,562	1,340	1,628	1,002	905
B. Grants and capital	3,249	3,737	3,578	3,569	3,874	4,461
Net Outflow of Dollars on Government Accounts (IV - V)	2,163	2,334	2,548	2,484	3,125	3,798

Sources: U.S. Department of Commerce, Survey of Current Business, June 1966, pp. 28, 29, 33; March 1967, pp. 19, 23; March 1969, pp. 30, 37.

International Monetary Fund, Balance of Payment Yearbook, Vol. A, Washington, D.C. (U.S., pp. 1, 4, 5).

CHAPTER III

ADJUSTMENTS IN THE BALANCE OF PAYMENTS

The classical method of adjusting the balance of payments is to cause a decline in income, costs, wage rates, and prices in the deficit country in relation to the surplus countries. Such a change in relative prices and costs can be brought about by a change in the exchange rate of the currency of the deficit country relative to the currencies of the surplus countries, or by real changes of money income, prices, wages, and costs.

Under the gold standard, these changes came automatically as a result of gold flows between countries. Today, when no countries are on the gold standard, the changes of income, interest rates, prices, and costs are much more difficult. The rigidity of downward movements of wages and prices and the commitment of the different governments to keep their nations at full employment--as nearly as possible--makes the automatic process of adjustment unworkable. When a country has a deficit it can, to some extent, persuing the proper policies, keep its relative price and cost structure down with a

full employment policy.

In today's world, when most countries experience some inflation each year, if a deficit country can keep its costs and prices stable or keep them rising at a lower rate than those of the surplus countries, the deficit country will improve its competitive position and its balance of payments situation. Also the competitive position improves when wages increase less than productivity so that prices remain stable.[1]

Some types of disturbances or disequilibrium require different kinds of adjustment than others. The most dangerous imbalance for a country develops when the "basic balance" is persistently and substantially in deficit. Equilibrium in a basic balance can be definèd as a situation where "total receipts at a given rate of exchange are equal to total payments on the current, unilateral transfer and long-term capital movement accounts."

The persistent structural disequilibrium in the balance usually is caused by real changes in supply or demand conditions affecting the international economic position of the country. Some of the many reasons why

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[1] International Monetary Arrangements: The Problem of Choice, Report on the Deliberation of an International Study Group of 32 Economists, International Finance Section (Princeton, N.J.: Princeton University Press, 1964), p. 25.

a nation finds itself in such a position are: destruction of resources during a war; changes in taste by other countries toward a specific commodity; technological advancement that replaces a major export commodity of a country; or any other change in the comparative advantages of the country. This type of disturbance cannot be financed by limited reserves over a long period and requires a major adjustment which will reallocate resources or change the price and cost structure of the country. The type of adjustment which the country can make will be discussed later in this chapter.

The second type of disturbance may result from an excess of monetary expansion and price increases in one country in relation to other countries. Such a development will bring about two results: (1) demand for imports in the country will increase because they are now relatively cheaper; (2) exports from the country will decrease because they are more expensive.

At present, when all currencies are "pegged," this type of disturbance will persist until the country makes a major adjustment, such as a change in exchange rates (devaluation), or a restraint of monetary expansion. The kind of adjustment that should be made will depend upon the size of the deficit, the reserve position of the country, and its ability to secure international credits.

A third type of disturbance is the "temporary" disturbance, which is caused by unexpected events and which often may be eliminated after a short period. Examples of such events are crop failure in a particular year, minor adjustments in production capacity, outflow of short-term capital because of different interest rates, and cyclical recessions. This type of disequilibrium needs no special adjustment, such as changing relative costs or exchange rates, and could be financed from reserves or short-term loans.[1]

There is a fourth type of disturbance which is somewhat different from the others; it is the easiest to eliminate by economic measures but is difficult to cope with from the political viewpoint.

For the last fifteen years, this type of disturbance has been characteristic of the United States, which has had a large surplus on its current accounts but has sustained a deficit caused by outflow of private long- and short-term capital and government expenditures abroad for military commitments and political objectives.

The weakness in the U.S. balance of payments during the last few years has not been a structural weakness in the trade balance nor in the balance of goods and services. The country had a strong competitive position

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[1] International Monetary Arrangements: The Problem of Choice, pp. 43-44.

with a surplus on the trade accounts, and unit labor cost increases were lower than in most industrial countries. The deficit was caused, as mentioned earlier, mainly because of large defense commitments and military expenditures which, from a strictly economic point of view, were unnecessary but politically were a must. Government foreign assistance programs (economic and military) were largely "tied" and did not adversely affect the balance of payments. Private capital outflows in the long run are necessary and productive; they supply needed capital, technology, and know how to other countries and earn foreign exchange which improves the balance of payments position of the host and investor countries.

Any adjustment requiring restrictions on military expenditures would be politically inadvisable for the near future, and restriction on capital movement is a short-term solution when a long-term solution may be vitally needed. Together with these two factors, any change in income levels or interest rates, may not be in the best interest of the domestic economy or of a full employment and growth policy. Such a disturbance creates the difficult task of combining international economic and political goals.

It is clear that today an automatic adjustment process seldom takes place. Governments must develop

effective policies for restoring any necessary equilibrium in their external balances. Yet, in developing such policies, political or economic obstacles may arise.

Because of political factors, many deficit countries do not take the appropriate measures or take only partial measures to correct imbalances. Policies that are deflationary in nature are always unpopular, and only when there is a national crisis are these measures taken.

Surplus countries, in many cases, do not take appropriate measures to correct any imbalance that creates a surplus. The need for action is not immediately imperative, and they can be more discriminating in their choice of policies. Such countries would prefer that the deficit nations take deflationary actions rather than institute more inflationary courses of action themselves. Their policies tend to be those which are the most tolerable politically. For the deficit nations, regardless of political acceptability, international reserves will one day be depleted (even with new reserves creation), and the needed adjustments eventually will have to be made.

The difficulty faced when economic measures must be taken is that improvement of external balances may work contrary to domestic economic goals. In the case of a country having a deficit in the balance of

payments linked to excessive domestic demand and inflationary pressures, the choice of policy would be relatively easy; a single policy could reduce domestic demand and correct the external deficit. The situation is much more complex in a country which faces unemployment and a lack in demand, together with a deficit, or in a country which has an inflationary pressure with a surplus in the balance of payments. In such cases the goals of the domestic economy have definite priority, and no country is willing to take action that will sacrifice domestic goals. No one argues that such a stand is unreasonable; nevertheless, there is a problem of imbalance in the external accounts, and some adjustment must be made to correct it, however painful it may be.[1]

The report by Working Party No. 3 of the Economic Policy Committee of the Organization for Economic Cooperation and Development concerning the balance of payments adjustment process which was published in August of 1966, recognized the aforementioned problem as well as the difficulties of governments in adopting policies that are consistent on both the international and domestic levels and that at the same time are satisfactory to other governments of the world. The report stated:

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[1]Milton Gilbert, Problems of International Monetary Systems, International Finance Section, No. 53 (Princeton, N.J.: Princeton University Press, 1966), p. 6.

> In concluding its report the Working Party would wish to stress once again the inherent difficulties faced by governments in managing their economies in ways both satisfactory to their own countries and consistent with the aims of their neighbours. These difficulties spring from the imperfections of foresight and of the instruments at governments' disposal and from the complexity of the objectives of modern economic policy.
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> Nevertheless, there is equally clear scope for improving on past performance; and the ways in which the Working Party believes this might be done have been outlined in this report. Continued progress is required on several fronts, in particular: clearer formulation of balance of payments aims; early identification and better diagnosis of payments problems; enlargement and increased selectivity in the instruments of economic policy; more timely action to correct inappropriate demand levels, competitive positions, and capital flows; and a further strengthening of the process of international consultations. More fundamentally, it requires a common will on the part of the co-operating national authorities to give proper weight to the need to maintain or restore equilibrium in the external accounts of their countries. It is the belief of the Working Party that governments, by agreeing to take part in consultation procedures indicated in this report, will be able materially to improve the effectiveness of the balance of payments adjustment process as it applies to their countries.[1]

Different measures of adjustment should be taken when different international monetary systems exist. This study concentrates mainly on the present system where all currency rates are "pegged" in relation to gold and dollars--the international money--and to a lesser extent, the English pound.

A country may adjust its balance of payments

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[1]Working Party No. 3, The Balance of Payments Adjustment Process, Organization for Economic Co-operation and Development, August 1966, p. 29.

disequilibrium in five general ways: (1) changing the interest rates; (2) changing the rate of exchange; (3) change in income levels; (4) changes in the price level; and, (5) combinations of the first four adjustments or parts of them. All of these possibilities are workable in a country where market forces can operate freely and where no excessive government restrictions or controls exist.

Changes in exchange rates are also a question of governmental policy and international agreement. Under the International Monetary Fund agreement the rate of exchange is "pegged" and not allowed to fluctuate more than 1 percent below or above the fixed rate. Any change of consequences must have the approval of the Fund authorities. The new "pegged" rate usually will be established where, it is hoped, the country ultimately will have an external equilibrium that is consistent with domestic goals.

Changes in income and price levels will not come about automatically but will be developed by the government in order to make an adjustment in external equilibrium. The nature of the steps taken depends mainly on the level of employment in the country as well as on its rate of growth. Generally, it is understood that a deficit nation should take deflationary steps in order to import less and to be more competitive in the world market so that

exports will increase. Surplus countries should take expansionary or inflationary steps in order to increase imports and decrease their interest rates so that capital will flow to other countries. Today, a surplus country can have an equilibrium and serve the international community best by encouraging the outflow of capital for investment in underdeveloped nations.

Most adjustment in the balance of payments in this complex world requires some kind of international cooperation. Each country contemplating any change in its course of action should be aware of the effects upon other nations. A surplus country is usually quite slow in taking steps to correct the situation, and in many cases, the steps taken are based only on national interests and domestic goals, without any consideration of the balance of payments.[1]

For the adjustment mechanism to be devised properly, it is first necessary to recognize the kind of disturbance that exists. If it is a temporary situation, no major adjustment is needed; short-term measures should be taken by the government instead. Exchange reserves or international loans may finance the country's external equilibrium for a short period. When disturbanced persists, major adjustments must be taken, such as:

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[1]Max J. Wasserman, Charles W. Hultmun, and Zsoldos Laszlo, International Finance (New York: Simmons-Boardman Publishing Co.), p. 139.

changing cost and price relationships between different goods, reallocation of resources, shifts of supply and demand for goods, or changes in exchange rates.

All types of adjustments should be initiated as quickly as possible after the disturbance occurs, and most should be completed in the shortest possible time. Attention should be given to minimizing the loss of income and employment, and the maintenance of economic growth. During the time that the adjustment takes place an adequate supply of foreign exchange should be available to the country from other countries or international organizations.[2]

The studies made by the Group of 32[2] and Working Party No. 3[3] concerning the process of adjustment in the balance of payments brought up the complex character of present day adjustments. Most of today's governments are first of all committed to full employment, reasonable price stability, equal distribution of income, and acceptable growth rate. The governments of the more developed industrial countries also have international political commitments such as foreign aid, military

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[1] International Monetary Arrangements: The Problem of Choice, p. 102.

[2] International Monetary Arrangements: The Problem of Choice, p. 102.

[3] The Balance of Payments Adjustment Process.

expenditures, and free capital movement. Thus, governments must follow policies which will enable them to achieve most of the aforementioned objectives. The theory that any restrictions on current account transactions are undesirable and should be eliminated is widely accepted. In fact, any restrictions on international commerce should be short-term devices and should be short lived. The process of adjustment by governments in both surplus and deficit nations should be carried out by fiscal and monetary policies that indirectly will influence prices and income; the only influence by government on trade should be through general policies rather than specific restrictions.[1]

All suggestions that have been made by the Council of Economic Advisors[2] and special study groups can be summarized in this way: (1) All countries should clearly spell out their balance of payments aims, trying to adopt policies of mutual benefit to their own countries and to the world economy. (2) The responsibility of adjustment should be shared by both surplus and deficit countries. (3) Countries should use a wide range of policies, both general and specific. They also should place a large emphasis on fiscal policies and a lesser

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[1]Frederic L. Deming, The International Monetary Payment System, p. 11.

[2]Economic Report of the President, 1966, p. 152.

emphasis on monetary policies in order to achieve internal economic balance because direct influence on international transactions is greater when a monetary policy is followed. (4) The proper policy and combination of policies depend on the particular situation of each country, and no one policy can be appropriate for all. (5) All countries should take into account the impact of their policies on other countries. There is a need for consultation between countries when monetary policies are used, especially when changes of interest rates are involved.[1]

Short- and Long-Term Approaches in the United States

Short-term Adjustments

Short-term devices should be used only to control a deficit during a special period of disturbance or to hold out until long-term adjustments have been effected. In the United States it has been recognized that the deficit in the balance of payments is a problem which must be solved and that it can be solved only through effective long-term measures. The solution to the problem requires cooperation of government, private industry, and other nations.

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[1]Economic Report of the President, January 1967, p. 187.

In general, restrictions on trade accounts should be avoided. If such restrictions on trade are imposed, they must be approved by the International Monetary Fund and the General Agreement on Tariffs and Trade (GATT). Where such measures are unavoidable, they should be temporary and used only in specific situations where quick results are essential. At the same time long-range measures to correct the situation should be taken.

Imposing restrictions on the service accounts is a more widely used practice than is imposing restrictions on other accounts. Many nations impose restrictions on traveling abroad or on the amount of earnings which foreign companies can take out of the country. Restrictions on repatriated earnings may be justified more often in underdeveloped countries, but even then such restrictions should be removed as soon as possible.

In principle, it is agreed that a high degree of freedom of capital movement is desirable, but the majority of countries realize that in the event of balance of payment trouble restrictions on capital movement are justified. Such restrictions need not always be direct but may be applied through monetary and fiscal policies. In the United States short-term measures to correct a deficit are concentrated most often on private and government capital accounts.

Emphasis should be made again that the United States is using short-term, temporary measures as holding operations to keep its deficit under control during the period of special commitment in Southeast Asia and during the period required to realize the benefits of its long-term program.[1]

United States Short-term Program

In the early 1960's the U.S. Government initiated a program to eliminate the deficit in the balance of payments. In a message to Congress in 1961, President Kennedy requested and Congress approved: reduction of duty-free allowances, reduction of government expenditures abroad, a study of tax laws to ascertain whether capital outflows were a result of attempt to avoid paying taxes in the United States, and other various measures.

One measure taken by the United States to prevent a higher deficit in the balance of payment during the period under study was the imposition of the Interest Equalization Tax (IET)[2] in mid-1963. This tax came after a sharp increase in the issue of new foreign long-term securities in the United States and the purchase of foreign securities abroad by U.S. citizens.

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[1]Joseph W. Barr, Remarks on International Cooperation, Treasury Department, F-996, April 20, 1965 (Washington, D.C., 1965), p. 4.

[2]A more detailed explanation of the IET can be found on pages 71-72.

There is some explanation for this increase in capital outflow. The U.S. economy usually generates a large volume of savings, sustains low interest rates, and has very efficiently organized capital. In Europe the capital market is small and not very efficient. Besides, the European governments rely more on monetary policies to fight inflation, causing higher interest rates which in turn drive many European companies to borrow more easily and less expensively in the American market. The interest equalization tax increases the interest rate paid by the borrower, but does not add income to the lender. Thus, the tax makes it more expensive to borrow in the United States and more or less equalizes the rate of interest between the United States and Europe.

After the IET had become effective, the sale of foreign new securities in the United States declined, but other kinds of capital outflow increased, especially bank lending. Bank loans increased from $1.5 billion in 1963 to $2.5 billion in 1964. In February 1965, most bank loans for more than one year to borrowers in developed countries were made subject to the IET.

The IET helped to eliminate part of the capital outflow from financial institutions in the United States. However, all banks and financial institutions were asked to observe appropriate "guide-lines" in connection with their foreign operations in order to restrain some of the

short-term loans. This program was to be coordinated by the Federal Reserve System and called for monetary cooperation. The guide-lines suggested that total outstanding loans to foreigners should increase by no more than 5 percent in 1965 over what they had been in 1964. Priority for loans was to be given to export credits and loans to underdeveloped countries. Banks were also requested not to increase their holdings of deposits abroad and to attempt to reduce them. Most of the banks recognized the importance of the program and cooperated to the fullest extent, knowing that the alternative to cooperation might be mandatory controls or even a possible collapse of the international monetary system.

The other short-term measure which caused a great deal of controversy was the voluntary program initiated to reduce direct investment outflow. This voluntary program was executed by a group of American companies and the Department of Commerce. This restraint of investment abroad applied to all developed countries with the exception of Canada. The goals, desirability, and success of the program will be discussed in detail in Chapter 4.

United States Long-term Program

In the long run the equilibrium in the U.S. balance of payments will be influenced by various factors,

such as the increase in productivity, stability of prices, technological progress, and the rate of growth. The same developments in other countries will also affect the U.S. balance of payments. The economy of the United States must have such an advantage in competitive position that its exports and earnings on past investment will be sufficient to finance new investment, payments for military expenditures, military and economic aid, and imports.

As discussed earlier, all the short-term adjustments were aimed at holding the U.S. deficit temporarily in balance until long-range measures could be effected. Any long-term adjustments, of course, cannot yield results quickly. The long-term balance of payments objective of the United States is to reach and sustain the degree of equilibrium necessary to preserve confidence in the stability of the dollar as a transaction and reserve currency.[1]

A long-range program must be based on the continuation of an open and competitive market and on international cooperation. No restrictions should be imposed in the long run which might be damaging to the increase in trade or to the development of other countries. The United States is the leading economic power of the

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[1]Speech by Henry H. Fowler, Secretary of the Treasury, Treasury Department, F-847, March 17, 1967, Washington, D.C., p. 10.

world and has a substantial advantage in technology and management skills. Many of these factors can be transferred to other countries only through the export of capital--both private and governmental. The United States also has an efficient capital market which can supply the capital needs of other nations, especially those that are underdeveloped. However, it must take into account policitical and military necessities which require large expenditures for the defense of the free world. The cooperation of other countries is needed for the success of this program: Since it is a responsibility of the surplus industrial countries to help the United States, they should share in the expenditure for mutual security, growth of underdeveloped countries, and the stability of the current international system.

Specific steps to implement this program have been taken during the last few years, with the main emphasis on increasing exports. Relative prices and cost stability are preconditions, and a better use of economic resources and an increase in productivity are also determining factors. The Commerce Department intensified its promotional efforts by opening special U.S. trade missions in many countries and by furnishing information to American businessmen concerning the supplies needed. The United States takes an active part in commercial trade fairs where large numbers of people are

able to see what this nation can offer them. Special studies are being made on the potential growth of foreign markets and the share of these markets that U.S. exports can gain.

The Export Import Bank simplified its lending and discount procedures and increased the amount of loans and guarantees available to American exporters. AID-financed imports formerly were handled through the funds of the Export Import Bank; but now all the funds are available to private exporters, and AID uses additional funds.

Currently the U.S. Government has under review the relationship between exports and taxes in the United States and abroad. If the conclusion is reached that U.S. exporters are at a disadvantage, appropriate measures should be taken to correct this.

The United States, with its advanced technology and food surpluses, has a large market for agricultural products; new agreements with European countries (such as the Kennedy Round of negotiation to reduce tariffs on a list of various products) will increase agricultural exports. The demand for agricultural produce throughout the world is almost unlimited in relation to this country's capacity to produce, and the United States already is assuming its share of feeding many nations--a role that can be increased by commercial sales.

Other long-term measures include the encouragement of travel to the United States by foreigners. This country has inexpensive facilities to accommodate large groups of tourists during the summer; even university dormitories could be filled with young foreign travelers. A special travel task force is currently working on this problem, and specific recommendations should be forthcoming soon.

The government is trying to encourage foreign nations to develop their own capital markets which in turn could supply their own necessary funds without such great dependence on the capital market of the United States. In the last few years American companies have begun to borrow more and more in the European markets and thus to increase the capacity of that market. The Asian Development Bank is another example of this effort, whereby the industrial countries contributed a large share of the money and the underdeveloped countries of the region contributed part of it.

Increased income from direct investment abroad is a vital part of the long-term program to improve the U.S. balance of payments. The current voluntary program never tries to cut off the outflow of the investment overseas; it only tries to moderate the outflow to developed and oil-producing countries. American companies should seek more profitable investments than in

the past--more earnings should return home. In addition, one must remember that the U.S. military abroad are there to defend all Americans, including private businessmen, and, therefore, that the business community should carry part of this burden.

An effort should be made to sell more long-term securities abroad. The sale of corporate shares and bonds could be a very important export of this country. The United States has the most developed stock exchange and capital market in the world, and it can arrange these transactions. Securities of the U.S. Government are a good, dependable investment which can be used as a part of the foreign exchange reserves of other countries and which, furthermore, will produce income on these reserves.

Some steps have been taken to reduce capital outflow from foreign aid and military expenditures. Other governments have been asked to share part of the burden of military expenditures. Germany, among other nations, agreed to buy military hardware and long-term securities for equal amounts of U.S. military expenditures in Germany. Foreign aid assistance is given by the export of goods and services rather than by the export of capital, and in the future more effort will be made to give assistance by teaching foreigners needed skills by bringing them to this country.

Some economists have suggested that a change in

the international monetary system and an additional creation of reserves may solve our balance of payments problem. The U.S. official view is that a reform in the monetary system will not solve the problem of deficit but that only long-term, effective measures can do this. However, the creation of additional reserves would give this country the time to put such a long-term program into effect. (A more detailed discussion of this subject is persued in the next section.) In relation to this problem, the possible help of a reformed internationnal monetary system to the balance of payment adjustment process brought out two opposing points of view, one from the deficit countries and one from the surplus countries. The one that is characteristic of the deficit nations (mainly the United States and England) is that the balance of payment deficit usually can be corrected only over a long period of time, particularly when the surplus countries do not take any measures to assist them in the adjustment process. The deficit countries say that any measures which interfere with internal domestic goals are a wrong choice of priorities and that any measure which leads to deflation and unemployment cannot be tolerated. These countries are reluctant to use any mandatory controls in trade or capital movements or a change in exchange rate. Thus, it can be seen why the process of adjustment seems to be

a long-time process to them. When the process of adjustment is a long one and deficits continue for some time, there is a definite need for more borrowing facilities and international reserves.

The countries having surpluses in their balance of payments are taking the following view: All of this argument about additional reserves is only an excuse for not promptly taking needed measures. The deficit countries must use more monetary and fiscal policies to put the adjustment process into action and not be overconcerned with domestic priorities. Many of the surplus countries have already an inflationary pressure in their economy and do not want to increase this pressure, especially when the deficit countries do not take the needed corrective measures. They prefer that some of the deficit countries put controls on the outflow of capital (mainly the United States) which may eliminate their deficit. Their conclusion is that international reserve creating facilities should be limited. If these facilities are not limited, the surplus countries will continue to finance the deficit countries, and the latter will never erase their deficits.[1]

The United States, with a gross national product of over $750 billion should easily manage a trade surplus

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[1]Milton Gilbert, Problems of International Monetary Systems, p. 4.

of 8 or 9 billion dollars a year. Consequently, it should be able to fulfill its commitments abroad and to supply the needed capital to underdeveloped countries without a deficit in the balance of payments.

In order to solve the problem the United States must continue to implement its long-range program, which is the only way of reaching an equilibrium in the balance of payments consistent with the goals set.

The Present International Monetary System, Proposed Plans for Its Improvement and Their Possible Effects on the U.S. Balance of Payments

During the past few years there has been growing dissatisfaction with the current international monetary system. Many economists assert the necessary--even urgent--need for reform, and several plans have been submitted by international monetary experts. Some of these proposals are radical, calling for the creation of a completely new system, while others are suggestions on how to improve the present system and add to international liquidity.

The present system is based on the International Monetary Fund which can lend foreign exchange to countries for a short period but does not have the power to create new reserves. The United States and Britain, as key currency countries, add to world reserve supplies by means of increasing their short-term liabilities.

They are willing to increase their liabilities, and the central banks of other countries are willing to hold these reserves within some limits. Gold, as a source of increasing international reserves, has been declining in importance for the last few years. Private demand for hoarding, jewelry manufacture and industrial use increased in the last few years. Gold production was not large enough to supply these needs and official holdings of foreign exchange is replacing gold as international reserves. In 1966, gold holdings of free world governments actually declined by $950 million, and in 1967 they further declined by $1.4 billion. U.S. deficits are not automatically increasing world reserves as had been the case since the end of World War II. In 1966, dollar holdings, as official reserves of other countries, actually decreased by $1.5 billion, when the surplus in the U.S. balance of payments, based on official settlement, was only $0.2 billion. The main reason for this development has been the conversion of dollars into gold by foreign countries, notably France. France, by using her dollars to buy U.S. gold, is decreasing the reserves of the United States but at the same time is not increasing her own reserves, only changing their composition; and so total world reserves decline.

Many economists believe that liquidity is adequate for the present but that a shortage will develop

in the near future, since the supply of new gold available for addition to official reserves is already very small and the United States cannot continue indefinitely running deficits to supply dollars. As international trade volume increases, the need for reserves will be greater than the present system can supply.

The function of international reserves in the present system is to give the countries of the world the means to keep a stable exchange rate with the freedom to pursue their international and domestic economic goals.

International liquidity is needed for more than one reason. The most important and basic need is for a medium of exchange in international trade; if the world is to continue to have multilateral trade in increasing quantity, there must be enough liquidity to make it successful. The need for money in this case is the same as in domestic economy. When production and trade increase, the supply of money must increase to accommodate the increase in the volume of trade. In international trade a type of money acceptable to all is needed, as are gold and dollars at present.

The second purpose of international liquidity has already been mentioned: that governments should hold reserves in order to keep their exchange rates stable and to provide breathing space in the event of

difficulties in the balance of payments. These reserves must be sufficient for a short term while governments take other measures to restore balance of payments equilibrium.

An effective international monetary system must have a built-in mechanism for regular increases in reserves. As the volume of trade increases from year to year the system must supply additional liquidity. In summary, any new or reformed international monetary system will have these objectives:

> Exert corrective discipline upon individual countries that are in sustained deficit or sustained surplus; assume an ample supply of money and credit for the customary transactions among traders and banks throughout the world; provide the credit needed to cushion or avert unduly abrupt corrective changes; and maintain sufficient monetary reserves (including facilities for lending and borrowing them) to meet continuing growth of official requirements as trade and payments expand within and among the countries of the world.[1]

The discussions about reforms in the international monetary system began in 1958, when most European countries returned to convertibility. In the years following World War II, most countries rebuilt their economies and any kind of help given by the United States was welcome. During the 1950's, the dollar was of great strength with a massive backing of gold reserves. Most

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[1]Robert V. Roosa, Monetary Reform for the World Economy (New York: Harper and Rowe, Publishers, 1965), p. 13.

nations were more than willing to accept dollars in order to build up their economies and their reserves, and dollars, therefore, became a type of reserve along with gold. Since 1960, the situation has changed drastically. The United States has run larger deficits than European countries have needed to build their reserves with the result that their excess holdings of dollars have become a threat to the external stability of the dollar. Now it is clear that the dollar cannot continue to be the only increment to world liquidity besides gold and that somehow a new policy must be found. Any such arrangement must add to world liquidity as conditions require, but the purpose of new reserves would not be to solve basic disturbances in the balance of payments of any nation. A prerequisite for the success of a new system is that the United States solve, by other means, its own balance of payments deficit.

A continuation of a deficit in the U.S. balance of payments without any change in policy may bring the present system to a state of collapse. A chain reaction could start, and only strict controls could stop it if the United States continues with deficits. Many private holders of dollars would try to dispose of them, and the U.S. Government would be forced to sell gold in order to keep the exchange rate of the dollar stable. But an increase in the sale of gold would make the ability of

the United States to defend the dollar doubtful, and some governments would try to cash their dollars into gold. Thus, the United States would have two choices. First, to increase the price of gold which would mean the devaluation of the dollar. Such a step would not solve the U.S. deficit problem but would only postpone it for a short period and would result in a loss of confidence in the United States by other countries. The countries that would gain most are the gold-producing countries--Russia and South Africa. Countries that had faith in the United States and held dollars would be the ones to lose. All nations would follow the United States in devaluation with a possible period of world-wide competitive devaluation in which no one would gain. The other choice would be to abandon the gold exchange standard, in which case the present monetary system would collapse. The majority of the countries of the free world realize what the alternatives are unless a new workable arrangement is established soon, and they are cooperating in the search for an improved system.

Various Suggested Plans for Improvement

Because of the numerous suggestions for improving the international monetary system, it is not possible to cover all of them in this paper. Some of these plans have been offered only in order to solve the existing or

potential liquidity shortage; others include proposals for improving the mechanism for adjusting balance of payments disequilibrium. One thing is clear: Any changes in the present system must take into account not only theoretical economic factors but also political implications and their acceptability to most countries through negotiation and compromise.

Basically there are two types of plans which currently are being considered and discussed the most; both of them use the price mechanism and market forces. One is based on the continuation of fixed exchange rates and the gold-exchange standard. The other is the "floating" or "flexible" exchange rate. The pure flexible exchange system, if accepted, would solve the problem of international reserves as well as the problems of disturbances in the balance of payments. There is a third type of plan which combines the first two and is known, among other names, as the "crawling peg" and the "wider band." These last two plans make use of more flexible exchange rates but require the intervention of government in the market and the use of reserves.

Special Drawing Rights (SDR)

The creation of new international reserve assets, the Special Drawing Rights (SDR), was proposed by the staff of the International Monetary Fund and was approved

at its annual meeting in 1967 in Rio de Janeiro. In March 1968, the Stockholm Conference of Finance Ministers and Central Bank Governors of the ten major industrial nations reached an agreement on an amendment to the IMF articles which would make it possible to activate the plan after ratification by sixty-seven member countries which have at least 80 percent of voting power.

In the proposed Special Drawing Rights, international reserves would be created for the first time by a deliberate decision and not by the unpredictable supply of gold and balance of payments deficits of the key currency countries. Currently when nations make use of the facilities of the IMF and borrow convertible currencies, new reserves are being created. However, when these loans are repaid, international reserves are being destroyed. The creation of new international reserves according to the SDR plan would be based on the collective judgement of many countries and the global needs for new reserves.

The creation of SDR's will not solve persistent balance of payments deficits of any country, including the United States, but it will enable nations to utilize a longer period of time in which they could take necessary steps, compatible with their domestic economic policy goals, to improve their balance of payments positions. Furthermore, creation of new reserves by this system

would make it possible for all countries to increase their international reserves without causing other countries to lose part of their reserves.

Allocation of the SDR's would be made only to Fund member countries based in relation to their existing quotas. The decision as to the amount of reserves to be created and in what intervals they would be allocated is left to the IMF with approval of 85 percent of the voting powers. The SDR's could be used unconditionally whenever a country had balance of payments problems or losses of reserves. However, surplus countries with a strong balance of payments position would be obligated, when designated, to accept SDR's in exchange for convertible currencies up to a point where their SDR holdings were equal to the amount of their allocated quota, plus twice that amount. No country could use its Special Drawing Rights to amounts higher than 70 percent averaged over a period of five years. The value of Special Drawing Rights is fixed in terms of gold, and user countries would be required to pay a low interest rate on their drawings. Countries which are drawn upon would earn interest. The International Monetary Fund would maintain and operate the new facility.

The new reserve facility is being created for the purpose of making new liquidity available when needed and only indirectly would help countries with balance of

payments problems. The SDR's are not intended, nor should they be expected, to solve the U.S. balance of payments deficit. On the contrary, this problem is currently the main barrier against activation of the proposed plan. Some major countries have objections to the Special Drawing Rights as long as the U.S. payments deficit persists at the current level. Opponents and proponents of the SDR agree on one fact--that in no way would the new facility solve this deficit problem. Even if $10 billion were to be created in the first five years or $2 billion each year, the U.S. share of it would be somewhat less than $0.5 billion, hardly enough to cover the large deficits of the last few years. Secretary of the Treasury Henry H. Fowler made clear the position of the United States regarding the creation of new reserves and the U.S. balance of payments:

> The idea that the United States looks for reserve creation as a means of solving balance of payments deficits . . . ours or any other country's . . . is false. The obvious fact is that such abuse of the new asset would quickly weaken, and soon destroy, its usefulness as a monetary reserve. It should be abundantly clear to all that we would not seek the means to create reserves only to destroy the usefulness of the new assets. . . . the problem of arriving at a sustainable payments equilibrium position (in the United States balance of payments) now lies chiefly in the transition to long-term from short-term measures for dealing with our foreign exchange balance.[1]

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[1]U.S., Treasury Department, A World Monetary System for a Greater Society of Nations, F-847, March 17, 1967 (Washington, D.C., 1967).

At the Annual Meeting of the International Monetary Fund in September 1969, the participating countries decided to allocate special drawing rights at a value of $9.5 billion over the period 1970-72--$3.5 billion in the first year and $3.0 billion in each of the following years. On January 2, 1970 the new scheme was activated and allocations were made to all of the participating countries that had ratified the agreement.

Flexible Exchange Rates

Economists gradually are accepting the fact that a flexible or floating exchange rate system would be the most appropriate system to lessen the conflict between domestic economic policies and balance of payments objectives. However, such a system involves a different kind of economic cost which most government officials and international traders are not willing to accept. The chief cost would be the discouragement of international trade and investment because of the risk involved when exchange rates are fluctuating and unpredictable. Another important factor, advanced by opponents of a floating exchange rate, is the argument that an inflationary bias is built into such a system, when balance of payments restraints do not exist. Finally, in the post World War II period international trade and investment were advanced rapidly and contributed

to economic growth and prosperity. Thus, the current system, with minor adjustment, is preferable to that of the post World War I period when a flexible exchange rate system existed among the major European countries together with severe price inflation. This situation led to the establishment of the inconvertible paper money standard with exchange controls accompanied by competitive depreciation and commercial warfare. Of course, this policy was useful in preventing losses of foreign reserves, but it did little to correct the basic weaknesses in the balance of payments and it drastically reduced world trade.

Proponents of the flexible exchange rate system, on the other hand, argue that the current monetary system has gone from one crisis to another during the past few years and that most of the advantages of this system are lost due to increased control and trade barriers imposed on movement of goods and capital. Trade barriers, tariffs, quotas and border taxes presently imposed are more of a deterrent to an increase in world trade than is the possible loss which would be the result of risk involved in a fluctuating exchange rate. Moreover, the allocation of resources in the world would be more efficient if all controls were removed and a free exchange rate established.

A flexible exchange rate would enable governments

to carry out their domestic economic policies without sacrificing part of them because of balance of payments difficulties. In a country such as the United States where the foreign trade sector is only about 3 percent of GNP, balance of payments considerations should not carry much weight when the choice of proper domestic policies, compatible with full employment and economic growth, are to be made.

There is no empirical evidence or convincible theoretical argument which can prove that a flexible exchange rate system would reduce or hinder growth in international trade and investments. On the contrary, the additional cost would be small, except during a period of foreign exchange crisis and a large disequilibrium in the balance of payments. However, the possible reduction in tariffs and other imposed controls existing today would reduce the costs of goods. In the case of tariff or trade barriers, the additional costs fall only on the consumer, not on the exporter; the additional costs of exchange rate risk fall on the exporter or importer, and only indirectly on the consumer.[1] Therefore, in the last analysis, the cost to the consumer would be almost the same under either system

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[1]Anthony Lanyi, The Case of Floating Exchange Rates Reconsidered, Essays in International Finance, No. 72, February 1969 (Princeton, N.J.: Princeton University Press, 1969), p. 4.

of exchange rates. From the experiences of some countries in the 1950's, it is quite clear that a system of free exchange rates would not affect to a large extent the flows of goods and capital investments. The extensive investment of capital in Latin America by U.S. companies, especially in Brazil, is only one example. Another is a Canadian experience between 1950 and 1962, when, during that period of flexible exchange rates, the country's international trade doubled and direct investment by foreigners nearly tripled.[1]

In addition to the greater costs because of risk involved, the most important drawback to a flexible exchange system is the speculation in the foreign exchange market that may arise as a result of adopting such a system. The speculation may destabilize the exchange rates in many cases and cause them to fluctuate widely even when the country's balance of payments position is essentially stable. In order to guard against such a possibility, some prominent economists recently have suggested the adoption of a new system which comprises both the current "pegged system" and the "fluctuating system." This is the "wide band" system, or the modification of it--the "crawling peg" system.

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[1]George W. McKenzie, "International Monetary Reform and the 'Crawling Peg,'" Review (Federal Reserve Bank of St. Louis, February 1969), p. 22.

The "Wide Band" System

The need for greater flexibility in exchange rates led to the proposal of the "wide band" system, which would not basically change the present system but would merely increase the fluctuation margin from the current 1 percent to 4 or 5 percent on either side of parity. The central banks of all countries would be required to intervene in the foreign exchange market in case the exchange rates reached the outer limits as is the case today. Wider bands would also divide the cost of adjustment more equally between the deficit and surplus countries. The wider the bands, the greater the risks and disadvantages of freely fluctuating rates, but also the greater the amount of balance of payments adjustment possibilities without affecting the domestic economy. Also it would reduce the amount of reserves needed to be held in order to finance short-term balance of payments disequilibrium. The Sub-committee on International Exchange and Payments of the Joint Economic Committee of the United States Congress[1] and Dr. Fritz Machlup strongly advocate this system.

> My prescription is for a widening of the margin of permissible deviations from par values--the so-called band proposal. Under the present rules of

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[1]U.S., Congress, Next Steps in International Monetary Reform, Report of the Subcommittee on International Exchange and Payments of the Joint Economic Committee, 90th Cong., 2nd sess., 1968.

> the Fund, deviations of exchange rates in the free markets are limited to 1 per cent of parity in each direction. The limitation ought to be changed to permit wider deviations, perhaps 5 per cent up and down. Variations of exchange rates of this order of magnitude would allow the adjustment mechanism to operate on the international flows of goods and services. No government would have to take unpopular action; supply and demand would be allowed to determine exchange rates within the fixed limits; and any variations within these limits would reverse themselves when conditions change.[1]

The main disadvantage of this system is that there is no provision for change if larger exchange rate adjustments are needed. A modified system--the "crawling peg" system--was proposed to eliminate this problem.

"The Crawling Peg" System

Under this system the changes of parity would be made in one of two ways, either discretionary or automatic. In the discretionary method the government would adjust its exchange rate up to a maximum limit of about one-half percent per month. This change could be repeated each month until the desired effects were attained; the timing of such changes would be left to individual governmental discretion. The second plan, the "crawl," would be automatic and not under the control of any government. The daily parity of exchange rate would be the

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[1]Fritz Machlup, The Transfer Gap of the United States, Reprints in International Finance, No. 11, October 1968 (Princeton, N.J.: Princeton University Press, 1968), p. 238.

average of exchange rates over a certain previous period of time.[1] If the trend in the exchange rate of a country were up, so would be the parity rate crawl, and vice versa. This system is really an extention of the "wide band" proposal because "crawling peg" changes would be dependent upon the width of the band, or the different period of calculating the moving average. The "crawling peg" system would also ensure many opponents of a fluctuating exchange rate system that runaway waves of competitive depreciation would not occur. The advantages of such a system are summarized in an article by George W. McKenzie appearing in the Review of the St. Louis Federal Reserve Bank:

> On the other hand, a system of crawling exchange rates renders monetary policy effective without capital controls. In fact, to assure that this is the case, it is necessary to reduce impediments to the free international flow of capital. Equally important is that this system enables long run balance-of-payments adjustments through greater exchange rate flexibility. The increased flexibility does not mean instability, however, for the exchange rate will be free to vary, or "crawl," only within bounds predetermined by the IMF.[2]

The last two systems--"wide band" and "crawling peg" systems--are the two which may be accepted by politicians. These systems, to some extent, contain part of

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[1]George W. McKenzie, "International Monetary Reform and the 'Crawling Peg,'" Review, p. 20.

[2]George W. McKenzie, "International Monetary Reform and the 'Crawling Peg,'" Review, p. 23.

the old "peg" concept together with a freely fluctuating rate within boundaries set by governments through the International Monetary Fund. The two systems would enable more freedom in pursuing domestic economic objectives and in maintaining equilibrium in balance of payments for a longer period. The "crawling peg" system, in contrast to the "wide band" system, would allow for greater change in exchange rates over the long run and would move with the trends of balance of payments developments as a result of change in prices, imports, exports, and capital flows. This system of a "crawling peg" together with the activation of the Special Drawing Rights scheme seems to be the best answer to the balance of payments and liquidity problems existing in today's world.

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[1]George W. McKenzie, "International Monetary Reform and the 'Crawling Peg,'" Review, p. 23.

CHAPTER IV

DIRECT INVESTMENT ABROAD AND THE VOLUNTARY PROGRAM

Various Capital Restriction Plans That Lead to the Voluntary Program

As discussed previously, the United States has sustained balance of payments deficits since the years immediately following the Second World War, but the problem has become severe only during the 1960's. In 1961, when the largest U.S. payment deficit since the war was recorded, the new Kennedy Administration launched its initial attack on the problem. In his message of February 1961,[1] President Kennedy took the following steps to study and correct the situation:

1. Additional funds for the Export-Import Bank to finance exports.
2. Survey to increase farm exports.
3. Negotiation to reduce tariff and other barriers on U.S. exports.
4. Programs to attract more tourists to the

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[1] U.S., Department of the Treasury, Maintaining the Strength of the United States Dollar in Strong Free World Economy, A 1968 Program Report (Washington, D.C.: December 1968), p. 57.

United States.

5. Reduction of duty-free allowances for American tourists, from $500.00 to $100.00.
6. Tax law examination to prevent movement of American capital abroad as a means of tax avoidance.
7. Reduction of government expenditures abroad--military and civilian.
8. Request for change in the Federal Reserve Act to permit payments of higher interest rates to foreign monetary authorities for special securities issued.

Despite the initiation of this program, the deficit in the balance of payments on "regular" transactions came to $3.1 billion in 1961 and $3.6 billion in 1962. The largest increases in the outflow of capital in these years and in the first half of 1963 were in new foreign securities flotations in the United States. They more than doubled between 1961 and 1962, from $0.5 billion to $1.1 billion, and reached an annual rate of $1.9 billion during the first half of 1963. Private short-term capital movement and errors and omissions (considered by many to be short-term capital movement) were also high at that time; they were $2.4 billion in 1962 and $1.8 billion in 1963.

In order to cope with this development, President

Kennedy advanced another program in his message of July 18, 1963.[1] The main feature of the new program was the introduction of the Interest Equalization Tax (IET), which, as originally proposed, raised by the equivalent of 1 per cent per annum the cost to foreign industrial nations of borrowing in the United States. Canada and, to a lesser extent, Japan were exempt from this tax. The reason for imposing the tax was because the high level of interest rates abroad was causing many foreign companies to borrow in the United States. The IET reduced the interest rate differential by increasing the cost of borrowing long-term (one year or more) capital in the United States. The tax exempted direct investment abroad and export credits to underdeveloped nations. The original law was to have expired on December 31, 1965, but was later extended to July 31, 1967, and then to July 31, 1969, with a new provision which gave the President discretion to alter the rates of the tax from zero to an annual rate of 1.5 percent.

Additional provisions of the program included an increase in the amount of aid given to foreign countries which was tied to expenditure in the United States; negotiation with allies for advance payment on military purchases, prepayment of debt by foreigners, and the sale to foreign monetary authorities of medium-term U.S.

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[1] Ibid., p. 56.

securities. In July 1963, the Federal Reserve also took the important step of increasing its discount rate by 0.5 percent in order to cut down short-term capital outflow while maintaining adequate domestic credit.

The limited effects of the IET did not solve the problem of a continued deficit in the balance of payments. The increase in the IET did reduce sharply the flotation of foreign securities in the country in the second half of 1963, but the outflow of capital changed its form to a large increase in long-term bank credit to foreigners, from $100 million in 1962 to over $700 million in 1963, most of which came toward the end of the year.

Notwithstanding all the measures taken in 1963, the deficit on "regular" transactions was $3.3 million and that on "over-all liquidity" balance was $2.7 million. Toward the end of 1963 and at the beginning of 1964, some of the measures taken by the Government seemed to be obtaining results. However, events changed for the worse during the second half of 1964, and even with the record surplus of $8.6 billion in the balance of trade, an unexpected outflow of private capital reached new heights and nullified the current account surplus. Total net outflow of private capital for 1964 was over $6.5 billion as compared to $4.5 billion in 1963 and approximately $3.4 billion in 1962. In the last quarter of 1964 alone, it was $2.0 billion, or an average annual rate of $8 billion.

Long-term investment accounted for $4.2 billion out of $6 billion net outflow in 1964. (Errors and omissions, which are primarily private capital outflow, accounted for an additional $1.1 billion in 1964.)

Most of the increase in private long-term capital outflows during these years was to Japan, Western Europe, and Canada (Table 11). (The major recipient of short-term credit extended to foreigners by U.S. banks during this period was also Japan, who received over one-half of it.) This growth of U.S. private capital outflow is easily explained. One reason was the rapid growth of income in Western Europe, Canada, and Japan and their increased demand for manufactured goods. Other reasons were the development of the European Economic Community (EEC) and the European Free Trade Association (EFTA) whereby internal tariff walls almost disappeared at the same time that external tariffs remained at the same level or higher; wages in these countries were lower than in the United States, and the rate of return on investments was much higher. Many companies invested in developing new sources of raw materials which were less costly than in the United States. Another important factor was the highly developed capital market in the United States and the availability of large funds with lower interest rates than in Europe which caused foreign borrowers to borrow in the United States and American

TABLE 11

NET OUTFLOW OF UNITED STATES PRIVATE LONG-TERM CAPITAL BY AREA, 1961-1967

	1961	1962	1963	1964	1965	1966	1967
U.S. Private Long-term Investment Abroad	2.6	2.9	3.7	4.4	4.5	3.8	4.3
Direct Investment[1]	1.6	1.7	2.0	2.4	3.4	3.5	3.0
(Excluding re-investment abroad of funds borrowed abroad)	(1.6)	(1.7)	(2.0)	(2.4)	(3.4)	(3.1)	(2.8)
Other Long-term	1.0	1.2	1.7	2.0	1.1	0.3	1.3
By Area:							
Western Europe	1.1	1.1	1.7	1.9	1.4	1.5	1.5
Canada	0.6	0.6	0.9	1.1	1.4	1.5	1.3
Latin America	0.3	0.1	0.1	0.5	0.4	0.4	0.6
Other	0.6	1.1	1.0	0.9	1.3	0.4	0.9

Source: U.S., Department of Commerce, Survey of Current Business, June 1966, March 1967, and March 1968.

[1] Excluding undistributed profits of subsidiaries.

capital to move abroad in search of higher returns.

Again, it is important to note that the net addition to U.S. long-term assets abroad increased in 1963 and 1964 more than the entire deficit--"over-all" or "regular type"--in the balance of payments. All other capital outflow, including foreign aid programs, military expenditures abroad, and short-term capital movements, were more than covered by the current account surpluses. Thus, a conclusion may be reached which views the deficit during these years as an exchange of liquidity for long-term external assets.

The February 1965 and Subsequent Voluntary Programs

Description of the Program

The unprecedented expansion of U.S. private capital outflow in the second half of 1964 and in early 1965 raised the deficit to a new level, and in order to achieve a substantial reduction in the U.S. deficit, President Johnson issued a new balance of payments program on February 10, 1965.[1] This program was to be temporary in nature and was mainly to serve the purpose of (1) a psychological effect in order to strengthen the dollar in the exchange market and increase the willingness of

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[1]U.S., Department of the Treasury, Maintaining the Strength of the United States Dollar in Strong Free World Economy, A 1968 Progress Report (Washington, D.C.: December 1968), p. 158.

foreigners to hold it and (2) to "buy time" while other steps were being taken to bring the balance of payments into equilibrium. The United States was interested in reverting to a completely free capital market where capital outflow was allowed and desirable, but in the short run the Government felt that it must take these steps with the clear intention of minimizing any adverse effects on other countries, especially those who were dependent on U.S. capital or who had balance of payments difficulties of their own.

This program was different in one respect from previous government programs in that it was an arrangement of voluntary restraints on all forms of investment and spending abroad by U.S. residents, particularly in the developed nations. Although it was voluntary and depended on the cooperation of business, it established a system of specific quotas for spending and targets for investment. As others before it, this program had special guidelines for banks, non-bank financial institutions, and business enterprises. In addition to the voluntary restraint, it added the application of the IET to bank loans over one year in maturity.

Before engaging in a detailed description, analysis, and evaluation of the voluntary program section concerned with direct investment abroad, it would be worthwhile to describe the other parts of the program.

The Guidelines for Banks[1]

The main objective of the restrictions outlined for U.S. banks by the Federal Reserve Board was to limit bank loans to foreigners to a maximum of 105 percent of the amount outstanding by the end of 1964. Banks which already had exceeded that amount were expected to cut it back to their target as soon as possible. Within the framework of the ceiling, the banks were requested to give priority to the financing of exports, loans to underdeveloped countries, and insofar as possible, special consideration to loans for Japan, England, and Canada. U.S. banks with branches abroad were to include any investment in those branches as part of their lending abroad, Branches of foreign banks in the United States also were requested to cooperate with the main spirit of the program.

The Guidelines for Non-bank Financial Institutions[2]

Non-bank financial institutions include insurance companies, mutual funds, commercial finance companies, investment firms, and charitable organizations. All these institutions with holdings exceeding $500,000 in foreign loans came under the special guidelines. In general, the guidelines were similar to those for the commercial banks but took into account any special

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[1] Ibid., pp. 159-60.

[2] Ibid., p. 160.

peculiarities and differences of these institutions. All liquid funds abroad were to be reduced to the smaller of the amounts which were outstanding at the end of 1963 or 1964. All investments or credits maturing within ten years from the date of acquisition could not expand by more than 5 percent over the amount at the end of 1964. Long-term securities (more than ten years) did not have any special ceilings, but the institutions were expected to follow the same priorities that were set forth for the commercial banks.

The Guidelines for Business Enterprises[1]

The direct investment guidelines were the most important part of the voluntary program. Direct investment outflow reached $2.4 million in 1964 and $1.2 billion in the first quarter of 1965.

With the announcement of the new program it was foreseen that changes in investment plans could not occur overnight. The Secretary of Commerce thus urged U.S. companies to curtail investments insofar as possible as well as to try to raise funds abroad as a means of financing a large share of such investments. The guidelines also called on the business community to increase its contributions to the balance of payments,

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[1]U.S., Department of Commerce, Survey of Current Business, March 1965, p. 23.

with specific requests being made to more than 600 chief executives of large corporations. Initially, the requests were for improvement of contributions to the balance of payments by 15-20 percent. Within the framework of the general guidelines, no specific mandates were made, and the individual companies were to achieve the goal at their own discretion. There was, however, an individual target with respect to repatriation of liquid assets abroad; liquid assets remaining abroad were no more than the amount outstanding at the end of 1963. Some "key" recommendations called for postponement of marginal projects in developed nations; more borrowing abroad to finance investment; expansion of exports; and acceleration of repatriation of income from the developed nations. Corporations were also asked to direct their investments to underdeveloped nations rather than to industrial countries. In order to follow through on the program, the Secretary of Commerce requested all companies to provide reports on the following activities:

1. Exports to all countries.
2. Capital transactions with affiliates and other long-term capital movement in the developed countries.
3. Earnings on direct investment and other activities in the developed countries.
4. The balance of credit from the aforementioned

transactions in 1964 and estimates for 1965.

5. Short-term assets held abroad by the parent company and by the affiliates.

Parts of the program were modified by the end of 1965, and new targest were set for 1966.

The Program in 1965

The results of the February 1965 program were quick and decisive: The Government received favorable, cooperative response from the financial community. An inflow of bank loans, repatriation of money market investment by U.S. enterprises, and other short-term capital inflow brought a balance of payments surplus of $247 million in the second quarter of 1965, compared to the $701 million deficit in the first quarter (over-all liquidity basis). The short-term capital inflow was largely responsible for this improvement since it changed from a net outflow of $2.0 billion in 1964 to a net inflow of $0.9 billion in 1965. These developments caused a reduction in the "over-all liquidity" balance of payments deficit--from $2.8 billion to $1.3 billion in 1965; and based on the "official reserve transaction" the balance of payments deficit declined from $1.5 billion in 1964 to $1.3 billion in 1965.

The direct investment outflow, which represents the most important element of the plan, was the slowest

to respond to the voluntary program. The companies that participated in the program (402 firms in 1965) more than met their goal of 10 percent of increased earnings in net foreign exchange[1] by reaching 12.2 percent (Table 12). However, the private sector's transactions in long-term foreign assets increased its deficit from $4.4 billion to $4.5 billion, and direct investment deficit increased from $-2.435 billion in 1964 to $3.366 billion in 1965 (excluding reinvestment of funds borrowed abroad) (Table 11).

Even with the reduction in the size of the deficit to about one-half the size of the annual average in the last three years of the period, it remained a considerable distance from the aim of payments equilibrium. On November 19, 1965, in a joint press conference with the Secretary of the Treasury and the Governor of the Federal Reserve, the Secretary of Commerce announced a new plan to reorganize the direct investment guidelines without disruptive and expensive consequences and urged intensification of the business community's efforts to improve its contribution to the balance of payments in 1966.

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[1]U.S., Department of Commerce, Office of the Secretary, Press Release, May 11, 1966.

TABLE 12

SUMMARY OF TRANSACTIONS REPORTED BY 402 COMPANIES PARTICIPATING IN THE 1965 VOLUNTARY PROGRAM TO IMPROVE THE BALANCE OF PAYMENTS
(millions of dollars)

	Total*				Canada				All Other*			
			Annual Change				Annual Change				Annual Change	
	1964	1965	Amount	Per-cent	1964	1965	Amount	Per-cent	1964	1965	Amount	Per-cent
A. Exports	11,197	12,065	868	7.8	1,908	2,404	496	26.0	9,289	9,661	372	4.0
B. Earnings on Direct Investments and Current Transactions with Affiliates in Developed Countries	2,195	2,366	171	7.8	765	773	8	1.0	1,430	1,593	163	11.4
C. Earnings on other Investments and Current Transactions with others in Developed Countries	154	172	18	11.7	33	29	(4)	-12.1	121	143	22	18.2

TABLE 12 (cont)

	Total*				Canada				All Other*			
			Annual Change				Annual Change				Annual Change	
	1964	1965	Amount	Per-cent	1964	1965	Amount	Per-cent	1964	1965	Amount	Per-cent
D. Capital Transactions with Affiliates in Developed Countries	(2,383)	(2,447)	(64)	2.7	(540)	(836)	(296)	54.8	(1,843)	(1,611)	232	-12.6
E. Other Capital Transactions in Long-term Assets or Claims on Developed Countries	(3)	369	372	n.a.	13	80	67	515.4	(16)	289	305	n.a.
Balance of Credits (Actual)	11,160	12,525	1,365	12.2	2,179	2,450	271	12.4	8,981	10,075	1,094	12.2

*Except for exports which are to all countries, the data reflect transactions with the following countries only: Australia, Austria, Bahama, Belgium, Bermuda, Denmark, France, Germany, Hong Kong, Ireland, Italy, Japan, Kuwait, Liechtenstein, Luxembroug, Monaco, Netherlands, New Zealand, Norway, Portugal, Republic of South Africa, San Marino, Spain, Sweden, Switzerland, United Kingdom.

n.a. = not applicable

Source: U.S., Department of Commerce, Office of the Secretary, Press Release, May 11, 1966. Replies from 402 of the companies participating in the 1965 Voluntary Program.

The Program in 1966

In general, the program for 1966 placed special emphasis on cutting direct investment abroad and recommended a specific target for each group of corporations and individuals. This program was meant to improve the results of 1965 by encouraging business enterprises to maximize their contributions to the balance of payments by expanding exports, minimizing holdings of liquid assets abroad, financing expansion by borrowing abroad, and maximizing repatriation of income from abroad.

In his letter to the chief executives of companies participating in the program, Secretary of Commerce Connor said:

> In order to make the program more effective, and remain voluntary, I am asking each chief executive:
> - to maximize his company's over-all contributions to the balance of payments in 1966 through a variety of means;
> - to moderate the outflow of funds from the United States for direct investment in developed countries;
> - for the two years 1965 and 1966 combined, to keep the total of such investment within 90 percent of the amount for the three years 1962-64. We will be glad to discuss any special problem that this formula may raise.
> - to provide us with statistics for recent years, and projections for 1966, related to selected foreign transactions, quarterly reports during 1966 are also requested;
> - to give, with each quarterly report, the personal appraisal of the chief executive as to how his company is progressing toward its over-all target for 1966;
> - to name an alternate, familiar with company policy, who could be available for periodic consultation.[1]

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[1]Letter from Secretary of Commerce Connor to Chief Executives, December 8, 1965.

For the purpose of this program direct investment was defined as net outflow of funds from the United States plus the undistributed profits of affiliates abroad. The limit of investment for the two years 1965-66 to 90 percent of the amount for the three years 1962-64 permitted the business community to increase investments abroad with U.S. funds by about 35 percent above the annual average during the base period. The expected result of the modified program was an increase of $1.3 billion in the surplus of total direct investment income over direct outflow in 1966 compared to 1965. The main reason for a three-year base period was to equalize the opportunity for all companies which for some reason had not invested or which had invested large amounts in any particular year; also, by combining 1965 and 1966, greater flexibility was given to companies which had been very cooperative in 1965. The program for 1966 was also expanded to cover additional companies not under the program in 1965.

The U.S. business community continued to cooperate in 1966, and the reduction in outflow of capital for direct investment was substantial, largely due to the financing of such investment by borrowing abroad. Another contributing factor was the large inflow of foreign capital which was without precedent since the end of the Second World War. Net outflow of direct investment, excluding undistributed profits of subsidiaries but

including reinvestment of funds borrowed abroad (because of the balance of payment accounting system these borrowed funds appeared as inflows and outflows), increased to $3.5 billion from $3.4 billion in 1965. However, in 1966 U.S. companies borrowed abroad $445 million as compared to $52 million in 1965.

The over-all contribution made by these companies to the balance of payments rose substantially, from $14.5 billion in 1965 to $16.3 billion in 1966--or an improvement of approximately 12 percent (Table 13). Geographically, the greatest improvement was in direct investment outflow to Western Europe. Nevertheless, even with the improvement in the balance of payments and the accumulation of a small surplus on "official reserve" basis, the over-all liquidity basis deficit continued to be large. In fact, since it was slightly higher than in the year before, the Administration announced in December 1966 the extention of the voluntary program through 1967, especially in view of the continuation of foreign exchange costs as a result of the conflict in Viet Nam.

The Program in 1967

The 1967 program announced by the Secretary of Commerce called for companies to raise their net contribution to the balance of payments by an estimated $2.0 - $2.5 billion as compared to 1966. As before, the over-all

TABLE 13

RESULTS UNDER THE 1966 VOLUNTARY PROGRAM COMPARED WITH PROJECTIONS BY COMPANIES AT THE BEGINNING OF THE YEAR
Data for 612 Companies
(millions of dollars)

	Actual 1965	1966 Projected	1966 Actual	Change from 1965-66 Projected	Change from 1965-66 Actual	Percent Change from 1965-66 Projected	Percent Change from 1965-66 Actual
1. Exports	12,372	13,462	14,032	1,090	1,660	8.8	13.4
2. Direct investment income							
a. Dividends, interest, branch profits	3,085	2,998	3,232	(87)	147	-2.8	4.8
b. Royalties, fees, etc.	695	733	796	38	101	5.5	14.5
Total	3,780	3,731	4,028	(49)	248	-1.3	6.6
3. Other earnings	252	277	277	25	25	9.9	9.9
4. Direct investment capital outflows							
a. Total outflows to affiliates	(2,503)	(2,961)	(2,951)	(458)	(448)	18.3	17.9
b. Financed with funds borrowed abroad[1]	115	548	550	433	435	376.5	378.3
Net outflows from the U.S.	(2,388)	(2,413)	(2,401)	(25)	(13)	1.0	0.5

TABLE 13 (Cont)

	Actual 1965	1966 Projected	1966 Actual	Change from 1965-66 Projected	Change from 1965-66 Actual	Percent Change from 1965-66 Projected	Percent Change from 1965-66 Actual
5. Other Long-term capital transactions	46	(35)	(55)	(81)	(101)	n.a.	n.a.
6. Total transactions	14,062	15,022	15,831	960	1,819	6.8	12.9
Less: Capital outflows to less developed countries	(436)	(572)	(372)	(136)	64	13.2	-14.7
Total transactions in the overall improvement goal	14,498	15,594	16,253	1,096	1,755	7.6	12.1

Source: U.S., Department of Commerce, Office of the Secretary, Press Release.

[1]Use of funds obtained through foreign sales of securities issued by special U.S. incorporated companies or through long-term loans from foreign banks, etc., to all types of U.S. incorporated companies.

n.a. = not applicable.

contribution comprised the exports of these companies (but not imports), repatriation of profits from direct investment, other kinds of earnings, net movement of capital, and other transactions.[1]

The more specific limitations on direct investment capital transfers (capital outflow to affiliated companies and reinvested earnings of those affiliates) to developed countries as well as to some mineral-producing nations were similar to those of 1966. The targets for 1967 were based again on the average of 1962-64 and took into account the combined investment activity of 1966 and 1967.

The limit of investment for the two year period 1966 and 1967 was requested to be 80 percent of the amount for the three years 1962-64; it permitted the business community to increase investment abroad with U.S. funds by about 20 percent above the annual average during the base period. The amount that could be invested in 1967 was determined by subtracting the 1966 amount of investment from the two year total (the 1966 program permitted 90 percent for the same base period).

As a result of the voluntary program and an appeal made in the middle of the year by the Secretary of Commerce, direct investment capital outflow declined.

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[1]U.S., Department of Commerce, Office of the Secretary, Release No. G-66-222, December 13, 1966.

In comparison to previous years, the main decline in the direct investment capital outflow was to Canada and Latin America. Outflows to Europe increased slightly, however, and there was a sharp increase in outflows to Australia, New Zealand, and South Africa, as well as to developing nations in Asia and Africa (especially to oil-producing countries). Also, although the direct investment outflow declined in 1967, total investment abroad remained very high, mainly due to the large amount (approximately $1.5 billion) borrowed abroad by U.S. companies and their affiliates. Other factors, however, also contributed to the increase in long-term capital outflow that resulted in a large deficit in 1967 and occasioned the introduction of the mandatory program in 1968.

The Administration's Justification for the Program

Private capital outflows from the United States have played a most important role in the expansion of world trade since the end of World War II. The United States was a major source of capital supply to the free world, and U.S. direct investment abroad helped spread technological advances and management skills around the world. The returns from these investments were beneficial to the investors and to the U.S. balance of payments. However, in the 1960's the large outflows of private

capital were a major contributing factor to the U.S. balance of payments deficit. During this period the net private international investment position of the United States (mainly non-liquid long-term investment) grew remarkably, but short-term liquid liabilities to foreigners increased substantially and posed a threat to U.S. gold reserves and to the international monetary system.[1]

The average annual private capital outflow during 1960-62 was about $3.5 billion, increasing to $4.5 billion for 1963, and to more than $6.5 billion for 1964. Actually, in the last quarter of 1964 it reached an annual rate of $9 billion. Direct investment capital was to a great extent responsible for the trend: in the late 1950's these outflows averaged about $1.3 billion annually, but rose to $1.7 billion in 1962, to almost $2.0 billion in 1963, and to $2.4 billion in 1964.

The shapp increase in private capital outflows plus a shapr increase in military expenditures abroad (a factor which was recognized by the Government) ultimately led to the introduction of a voluntary restraint system. And, because the authorities understood the nature of investment abroad and the significance to the

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[1]U.S., Department of the Treasury, Maintaining the Strength of the United States Dollar in a Strong Free World Economy, A 1968 Progress Report (Washington, D.C.: December 1968), p. 25.

balance of payments of long-term returns on investment, the decision was to make the program one of voluntary restraint that would moderate the outflow of direct investment capital rather than to impose mandatory controls.

When introducing the voluntary restraing program the Administration emphasized that not only would it be voluntary but also that it would be short term in duration (only until the long-term measures that had been instituted began to be effective). The Secretary of the Treasury said many times that in the given circumstances no other choice was available and that if the program were to continue for a long period its effects on the balance of payments would be harmful rather than helpful. In fact, that the Administration was sensitive to introducint any type of restraint was brought out by Secretary Fowler:

> There is no question that this course, through the voluntary program, requires us to restrict private new or additional business and financial activities which in normal times we would consider highly desirable. There is no question that such new or additional business and financial investment abroad pays excellent dividends to our future balance of payments position.
>
> In fact, more than a third of the balance of payments gains made since 1960 under our first two balance of payments programs reflect increasing returns from such activities. Such returns, however, are realized only in the long run. But ours is a

short-run problem confronting us now--this year. . . .[1]

Thus, it is evident that the Administration recognized the role of long-run direct investment.

During 1964-65, since the earnings from direct investment remitted to the United States were equivalent to about 15 percent of all export receipts, the program clearly emphasized temporary restraints. The program was purely voluntary: There were no mandatory restrictions "but we are confident that most companies will in fact cooperate."[2] Business was not asked to cease all new investment, only to postpone unessential expansion, particularly in Western Europe where net outflows had increased from $725 million in 1961 to $1.2 billion in 1964.[3] The companies were encouraged to finance expansion in Europe with funds raised in the local markets, not in the United States. No restraints were requested on investments in the underdeveloped countries; on the contrary, such investment was encouraged.

The Government did not accept the views expressed

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[1]U.S., Congress, Senate, Balance of Payments - 1965, Hearings, before a subcommittee of the Committee on Banking and Currency, Senate, 89th Cong., 1st sess., May 17, August 3, 5, 17, and 18, 1965, pt. 2, p. 959.

[2]U.S., Department of Commerce, Direct Investment and the Balance of Payments, by Andrew F. Brimmer, Assistant Secretary of Commerce, Press Release, April 20, 1965.

[3]Ibid.

by many businessmen that restrictions on direct investment abroad would not help the balance of payments deficit in the short run. The Government clearly felt that direct capital outflows, especially those going to Europe, contributed to the payments deficit. The returns of such outflows would be gradual with a payback period of 8 to 15 years depending on the particular case, but the problem of the deficit had to be solved immediately.

The period of 8 to 15 years required for direct investment outflow to repay itself in balance of payments terms was based on a model prepared by the Department of the Treasury which was presented in the hearings before the Committee of Finance of the United States Senate.[1] The model measured the impact of direct investment abroad on the balance of payments when all inflows of capital, which are related to a given capital outflow, are taken into consideration. It showed that capital outflows to Canada and Western Europe exceeded inflows and that there had been a cumulative deficit in these regions for many years.

In the spring of 1968 the Treasury Department published another study prepared by professors Gary Hufbauer and Michael Adler; it measured the impact of overseas manufacturing investment on the U.S. balance

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[1]Hearings before the Senate Committee of Finance, 87th Cong., 2nd sess., April 2, 1962, p. 214.

of payments.[1] This study reinforced the conclusion reached in previous studies by the Treasury Department that the full payback period of overseas direct investment in manufacturing in balance of payments terms would take between eight and ten years. (The length of the period depends on given assumptions.)

In arriving at the final results presented in Table 14, Hufbauer and Adler took into consideration a wide range of factors and parameters based on actual data for the years 1962-65. Some factors measured were the following: investment, sales generated, income remissions, future repair parts and equipment, royalties and fees, import effects, and export displacement. The empty spaces in the table are significant and mean that according to the assumptions underlying this model, the direct investment never pays itself back in balance of payments terms.

The cases of Classical and Anticlassical assumptions usually apply to countries where capital is very scarce and where if U.S. companies did not invest, no investment would be made, thus necessitating these countries to continue importing the needed goods. In such cases any investment by U.S. companies would displace

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[1]Michael F. Adler and Gary C. Hufbauer, Overseas Manufacturing Investment and the Balance of Payments, Tax Policy Research Study No. 1 (Washington, D.C.: Department of the Treasury, 1968).

TABLE 14

OVERSEAS MANUFACTURING INVESTMENT AND RECOUPMENT PERIODS

Assumptions	Recoupment Period in Years[1]	Adjusted Recoupment Period in Years[2]
Classical assumptions:[3]		
Canada	-	-
Latin America	-	-
Europe	18.8	7.5
Rest of world	-	22.2
World	-	-
Reversed classical assumptions:[4]		
Canada	10.2	10.2
Latin America	9.8	9.8
Europe	6.5	6.5
Rest of world	-	6.7
World	9.2	8.1
Anticlassical assumptions:[5]		
Canada	-	-
Latin America	-	-
Europe	-	10.8
Rest of World	-	-
World	-	-

Source: Ibid., pp. 67-68, Tables 5-13 and 5-14.

[1] The recoupment period represents the number of years required for a direct investment outflow to produce a cumulative balance of payments surplus equal to itself. These periods are based on "single injection" model.

[2] The effect of exports displacement caused by sales of U.S. subsidiaries abroad were changed slightly causing an adjustment in the recoupment period.

[3] Classical assumptions. Without the foreign investment there would be more U.S. domestic investment and no substitute investment in the host country.

[4] Reversed classical. Without foreign investment by the U.S. company there would be more U.S. domestic investment and some other non-U.S. company will invest in the host country.

[5] Anticlassical. If the U.S. company did not invest in the host country, there would be no substitute investment in either the United States or the host country.

export from the United States and other countries, and the assumption would hold true only until the countries in question could generate needed capital or until some other foreign companies invested.

In the case of the Reversed Classical Assumption the recoupment period is much shorter because it is assumed that if an American company would not invest, a local or another foreign company would; thus the market would be lost for American exports anyway. This assumption applies to a large extent to Europe and other industrial countries where capital is not as scarce as in the developing countries. The column of adjusted recoupment period gives shorter recoupment periods because of changes in the export displacement parameter. In the first column sales of U.S. subsidiaries abroad, to the extent to which exports are displaced, effect only U.S. exports. In the adjusted column sales of U.S. subsidiaries abroad not only displace American exports but also displace exports from other countries and reduce sales of native firms which produce the same kinds of goods.

From all three cases it is possible to conclude that the impact of direct investment abroad on the U.S. balance of payments becomes positive in a shorter period when an American company builds a plant abroad which otherwise would be constructed by a non-U.S. company.

Europe and the industrial countries, therefore, are the places where recoupment periods are the shortest.

The study discussed above received criticism from many quarters, especially from the National Foreign Trade Council, Machinery and Allied Products Institute, and Professor J. N. Behrman. All of them disputed the basic assumptions of the study as well as the data used. Their criticism will be discussed in more detail in a later section of this chapter.

Worthwhile noting is that in the mid-1960's, a similar study was undertaken and published in England--the Reddaway Report.[1] The main conclusion of the report was that it would take between six to ten years before an investing country would recover the balance of payments loss involved in making foreign investment.

Despite the conclusion of the Hufbauer-Adler study, it is argued by most experts on the subject that the payback period of direct investment abroad is between six and eight years.[2] Even Mr. Adler in a later article agreed that the average payback period for the world as a whole is about eight years, with a longer duration for

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[1]William Brian Reddaway, Effects of U.K. Direct Investments Overseas, Final Report (Cambridge, England: Cambridge University Press, 1968).

[2]Walter S. Salant, et al., The United States Balance of Payment in 1968 (Washington, D.C.: The Brookings Institution, 1963).

Canada and the developing countries and a shorter duration for Europe and other industrial nations.[1] In his testimony before the Joint Economic Committee of Congress, the Director of the Office of Foreign Direct Investment of the U.S. Department of Commerce said that the period of paybacks on direct investment is not as long as the Treasury Department suggested. However, it is longer than the period suggested by many leaders of the business community.[2]

The aim of introducing the voluntary program was not to curtail or reduce the level of foreign expansion by U.S. companies abroad but to curb outflows from the United States to finance such expansions. While it is true that these outflows would contribute positively in the U.S. balance of payments position in the long run by the middle 1970's, it was hoped that by then this problem would have been solved. However, the problem of deficit has remained current, and it is not sensible to allow these outflows to contribute to a present deficit in order to realize benefits far in the future.

As an answer to the many leaders of the business

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[1]Michael F. Adler, "The High Cost of Foreign Investment Restraints," Columbia Journal of World Business, Vol. III, No. 3 (May-June 1968), p. 81.

[2]Hearings before the Subcommittee of International Exchange and Payments of the Joint Economic Committee of Congress, 91st Cong., 1st sess., January 1968, p. 198.

community who argued that income from current investment was much larger than the annual capital outflow and therefore that investment abroad should be encouraged as in the past rather than curtailed, Treasury spokesmen said that such a comparison was misleading,[1] the common error being that a comparison is made between two types of flow that actually are unrelated. In reality, the income earnings and other receipts of a given year are generated by investment over a number of past years, and hence are not the result of the outflow of the current or previous year. Also, an important element inevitably excluded, because it could not be readily measured, was the value of sales abroad by foreign subsidiaries which actually displaced U.S. exports.[2]

Views of the Business Community

For many years American direct foreign investment had been regarded by U.S. authorities as highly desirable because it contributed to a better equilibrium in the balance of payments and, even more important, because it contributed U.S. managerial skills and new technology to the countries of the free world. Encouragement to export capital is quite natural for the United States being the

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[1] U.S., Congress, Senate, Revenue Act of 1962, Hearings before the Senate Committee on Finance, 87th Cong., 2nd sess., April 2, 1962, pt. 1, p. 173.

[2] Ibid.

richest country in the world as well as one where huge amounts of savings are generated every year.

When President Johnson announced his voluntary program in February 1965, the leaders of American industry pledged their full cooperation. The program of restraint was accepted with some reservations, but it was hoped that it would be eliminated after a year or two. However, the choice was that if the program were not accepted voluntarily it would have to become mandatory. Despite the imposition of voluntary controls on capital movements, the deficit on the balance of payments continued and amounted to about $1.3 billion for 1965, $1.4 billion for 1966, and $3.6 billion for 1967.

Increasing evidence has shown that short-term arbitrary solutions cannot solve the deficit problem. Many items in the balance of payments are so closely related that curtailing outflows does not necessarily improve the balance. The outflow of capital to subsidiaries abroad usually reduces exports in the short run and curtails the inflow of funds in the form of dividends in the long run. Another short-term effect of the prohibition on capital outflow in the form of investment abroad would be in increase in the interest rate abroad as a result of American companies borrowing there, thus encouraging short-term capital outflow from the United States in order to take advantage of the relative change in interest

rates. Because of the scarcity of capita in Europe and higher interest rates paid by American companies, some foreign investors in the United States sell their securities in order to obtain funds to buy new foreign issues which pay higher interest rates; this to some extent causes a drain on the U.S. balance of payments.

A more basic question is the desirability of capital movement to the location of highest return. The United States for many years was the champion of free enterprise and free movement of resources. A basic economic principle is that if capital is free to seek the highest possible return without any interference, returns to all factors of production will increase because total output will be at a maximum. This is as true of capital flows between countries as it is for flows within a country.[1]

The imposition of controls, even voluntary ones, on a segment of the balance of payments implies that private investment abroad is the main cause of the deficit. Such a view was rejected outright by the business community, which, from all the Department of Commerce publications,[2] considers it very clear that the U.S. payments deficit stems from government expenditure abroad (which

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[1]Kenneth W. Dam and L. B. Krause, Federal Tax Treatment of Foreign Income (Washington, D.C.: The Brookings Institution, 1964).

[2]U.S., Department of Commerce, Survey of Current Business, various issues.

the Government hopes to cover by surpluses generated in the private sector). The validity of this argument is upheld when it is considered that U.S. military expenditures in Europe and the costs of the conflict in Viet Nam are two prime causes of the balance of payments deficit. Therefore, it would benefit the balance of payments if the Government were to curtail such expenditure rather than to impose voluntary controls on direct investment.

Reasons for, and Desirability of, Direct Investment Abroad

In general, direct investment abroad is undertaken because it provides better opportunities for higher profits than alternative means available to investors. Although most companies prefer to produce for export at home because of the greater risks and management difficulties involved in producing abroad, there are many situations in which production abroad is necessary. For example, the extracting industries must invest in the countries where raw materials are found because they need the raw materials for their own production process or because they control or own the distribution and marketing of a given resource. Construction, utilities, trading companies, and other service enterprises are limited in the scope of their activities on foreign sites, and no export substitution can take place of local investment. When an American firm receives a contract to build and operate a dam or a highway,

it must export capital from the United States. The returns can be quite lucrative, but any benefit to the balance of payments would be gradual. Construction of distribution and retail systems for petroleum products in Europe requires large outlays of capital that cannot be replaced by exports from the United States.

Many activities of U.S. companies abroad must be performed at the specific time they are needed or they would either not be performed at all or would be taken over by competitive firms. This was well expressed by a spokesman for the International Telephone and Telegraph Corporation before a Congressional Committee Hearing:[1]

> . . . If foreign subsidiaries sell less abroad as a result of capital outflow restraint, the gap will be filled largely by our foreign competitors, not by U.S. exports. This is quite obvious in the particular case of ITT, because many of our customers are official bodies which will not buy products manufactured outside their countries. But, given the competitiveness of rival enterprises abroad, the case also applies generally. (Hearings, p. 2969)

Additional reasons for investment in foreign countries are the policies of foreign governments, such as: investment incentives, various import duties, quotas, and other barriers which would make it impossible to export from the United States to these nations. However, if U.S. subsidiaries are producing within a country or

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[1]U.S. Congress, Senate, Revenue Act of 1962, Hearing before the Senate Committee on Finance, 87th Cong., 2nd sess., April 24 and 25, pt. 6, p. 2969.

area, such as the EEC and the EFTA, their products can move anywhere within the tariff walls without having to pay duties. Many developing countries with smaller markets are encouraging the establishment of a limited number of industries in various fields and are giving these industries total protection against competition from import. In such cases the choice is to invest or to lose the market; no U.S. export can replace investment in these countries. Other countries introduce exchange controls and special incentives to encourage foreign capital. To forego investment when the opportunity arises often means losing the market permanently.

Among the many economic factors that make investing abroad so enticing is the obvious one of lower production costs, which can result from lower costs of raw materials, labor, power, transportation and insurance, taxation, and proximity to markets, or any combination of these. Taxation incentives and tariff barriers are determining factors in many cases. In some countries production costs are much higher than in the United States, but because of the protective barrier of high tariff and import restrictions, the rate of earnings is much higher.

Market potential and the level of income also are factors that command attention in the investment decision. In some countries the current demand for a given product does not justify an immediate investment, but the

market's potential rate of growth makes it necessary to invest immediately rather than to fill the demand by exporting from the United States because competitive enterprise from other countries might enter the market and thus render it a complete loss to U.S. export.

An additional approach to the problem of U.S. direct investment abroad (with special emphasis on the voluntary restraints) was developed in a special study made by three economists for The National Industrial Conference Board.[1] The main theme of the study is that voluntary capital restraint would be more damaging than beneficial to the balance of payments and that the investing process is quite involved as well as dependent on long-term planning. Basically, the decision to invest abroad is made on the possibility of improving earnings, but three principal factors, which often are in conflict, must be taken into account: the elements of finance, production, and marketing. According to the findings of the study, the marketing strategy was clearly the most important element in the investment decision. Even when businessmen decide to expand or to undertake new ventures, they do so in order to maintain their over-all competitiveness and their earning ability more than for

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[1]Judd Polk, Irene W. Meister, and Lawrence A. Veit, U.S. Production Abroad and the Balance of Payments; A Survey of Corporate Investment Experience (New York: The National Industrial Conference Board, 1966).

the purpose of producing an additional profit line. In contrast to what is generally believed, a declining profit rate may, in many cases, cause a rise in investment rather than a decline or abandonment, especially when it is required to safeguard current market position and long-term plans.

When a private company is required to base its investment decisions on foreign exchange implications and not on business or market conditions, it necessarily must be at the expense of maximizing profits. However, the decision to invest is not based exclusively on foreign exchange considerations; it must also respond to demands for a product in many foreign countries and adapt itself to many institutional, legal, and economic conditions. Such investments may not be foreign exchange earners in the short-run but in the long run will bring back foreign exchange which many times exceeds the original outflow. Continuing investment abroad is measured by the companies as related to their entire position in the market, not just marginal earnings of the new investment. For a petroleum company, for example, it would be useless to continue investing in the developing countries of Asia and Latin America if it could not invest at the same time in Europe in order to build a distribution and retail sales system which would enable the sale of additional products. Moreover, in the event of a demand for

such a distribution system in which the U.S. company were not the supplier, the competitive companies of other nations would take over the existing market and sometimes even the share of the American company.

The study concludes that any growth of business is organic, not incremental. In order to remain competitive and maintain current rates of profit, businesses must expand and keep their share of the market; otherwise the rate of earnings would fall significantly. In contrast to the organic approach takenby private business, the Government approach to investment is basically incremental. This incremental approach sees any investment merely as an addition to existing investment. Therefore, new investments undertaken would generate new profits without any relation to old investments and profits. If companies were to postpone new investments, they would sacrifice only the loss of additional earnings. From such a point of view, the voluntary program to restrain investment abroad would make some sense, provided that the current rate of remitted earnings was no more than 7 or 8 percent. By curtailing additional outflows of capital only this amount would be sacrificed, and about 92-93 percent in foreign exchange would be saved. For the companies the sacrifice would be even less because they can invest the same amount in the United States and their loss would be only the difference between the rate

of profit at home and abroad.

Contrary to the "incremental" approach, the "organic" approach considers all actual or planned investment as necessary to maintain the earning capability of the companies; for, failure to supply new investment when needed would cause not only a loss of additional earnings but would decrease the rate of profit and, in some cases, would cause a loss of total earnings. Many businessmen say, "to stand still is to lose," and then build new facilities. Such expansion usually increases the over-all efficiency of the existing plants. Many of the large firms are multi-national in character, and their decisions to expand are made in response to greater demand, which, for political reasons, cannot be supplied by exports from the United States or elsewhere. Hence, they are forced to invest more abroad in order to keep the market. Under the "organic" concept of investment, added investment or new expansion is treated as it normally is by producers--as being in the nature of improvement of existing structure, and their relationship to earnings is that of the whole investment structure to total earnings.[1]

The foreign investment of the private sector is much greater and more complicated than it appears in the balance of payments accounts. In the 1960's the average

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[1] Ibid., p. 143.

outflow of capital for direct investment was between $2 billion and $3 billion annually, and capital inflow of dividends fluctuated between $3 billion and $5 billion annually. By the end of 1967, total direct investment alone amounted to $59.3 billion, accounting for about $120 billion in annual output. Such magnitude of production, which surpassed the production of most countries in the world, had a great effect on world patterns of production and trade. The larger part of this production, especially in manufacturing, has been in Europe and Canada, and it has influenced the level of output and income in these areas which in turn has effected the demand for U.S. exports. Yet this has not been seen in the balance of payments accounts.

In the last few years, at least for the United States, the main economic tie with other countries has been production abroad--the principle vehicle by which U.S. industry responds to the increasing demands of other countries. Goods continually move between the United States and other nations, but the expanding production stimulated by movement of capital is by far more responsible for higher output and income than the average exchange of goods. The additional contribution of direct investment to the economies of foreign countries is indeed vast. American subsidiaries abroad usually are technologically more advanced, operate more efficiently, and

pay higher wages than the local firms. In addition, they pay royalties and taxes and make a large contribution to the foreign exchange earnings of the host countries and the United States. In many of the developing nations the desire and need to import is limited only by the ability to borrow and earn foreign exchange. Such earnings, therefore, are immediately spent on imports. In the case of most Latin American countries it means additional imports from the United States.

An investment abroad increases production not only by the amount of the investment but is multiplied due to the multiplier effect. Since imports increase as the level of GNP increases, the impact of the investment on additional U.S. exports would be substantial, especially when the marginal propensity to import by the European countries is much higher than that of the United States.[1]

In view of the aforementioned motives and incentives for foreign investment, the business community did not expect the Treasury Department's argument that investment abroad was a cause of the U.S. balance of payments deficit in the short run and long run. On the contrary, the business community as a whole, and particularly

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[1]Rudolf R. Rhomberg and Lorette Boissonmeault, Effects of Income and Price Changes on the United States Balance of Payments, International Monetary Fund Staff Papers, Vol. XI, No. 1 (March 1964).

the 700 or 800 companies which invest abroad, have been the main contributors to a surplus in the current accounts, and their contribution has been far greater than the outflow of capital (Table 15). This view was summarized by a statement made by Mr. Richard C. Fenton, President, Pfizer International, before Congressional hearings on the 'Voluntary Program."

> First, direct investments as a whole and manufacturing direct investments alone both make a substantial and growing contribution to the plus side of the U.S. balance of payments.
>
> Second, manufacturing direct investments in developed countries make a substantial and growing contribution to the plus side of the balance of payments.
>
> Third, direct investments have made a greater contribution to the plus side of the balance of payments than nonmilitary trade unconnected with direct investments.
>
> Fourth, the argument that it is possible to restrict direct investments in the short run because returns are realized only in the long run is not valid. On the contrary, in many cases the payback in balance of payments terms is very short--less than a year.
>
> Fifth, direct investments can contribute more than other factors to the elimination of the deficit in the balance of payments, but only if the President's voluntary program, as described by Secretary of Commerce Connor, is more clearly understood than it is at present time and if direct investments are positively encouraged rather than discouraged.[1]

All five points rely on the main theme that direct investment abroad, particularly in manufacturing,

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[1]U.S., Congress, Senate, Balance of Payments--1965, Hearings before a subcommittee of Banking and Currency, Senate, 89th Cong., 1st sess., pt. 2, May-August 1965.

TABLE 15

CAPITAL OUTFLOW AND INFLOW FROM EXPORTS AND IMPORTS TO THE UNITED STATES BY FOREIGN MANUFACTURING AFFILIATES (1962-64), AS RELATED TO THE U.S. BALANCE OF PAYMENTS
(million of dollars)

	1962	1963	1964	Average 1962-64
Inflow				
Exports of capital equipment	167	123	198	
Exports to affiliates for resale	1,102	1,174	1,403	
Other exports attributed to direct investment	1,723	2,107	2,467	
Royalties and fees	240	371	479	
Dividend income	1,307	1,541	1,852	
Total	4,539	5,316	6,399	5,418
Outflow				
Imports of finished goods from foreign affiliates	1,089	1,126	1,636	
Capital outflow from the United States	712	774	1,034	
Reinvested earnings	561	852	655	
Total	2,362	2,752	3,325	2,813

Source: U.S., Department of Commerce, Survey of Current Business, November 1965, p. 19; December 1965, p. 24; and October 1968, p. 26.

generates large amounts of exports which contribute greatly to the positive side of the balance of payment. Most of the equipment used in new plants abroad is purchased from the United States as are many of the raw materials and semi-manufactured goods. In relation to new expenditures on plants and equipment made by manufacturing subsidiaries abroad, the exact percentage of capital equipment export depends on how the comparison is made. When the comparison is made between exports of capital equipment to subsidiaries abroad and total new expenditures on plant and equipment made from funds obtained from all sources (including funds from the United States, local borrowing, reinvested earnings, depreciation allowances, etc.), the percentage of equipment purchased in the United States is about 30-35 percent. However, if the comparison is made only between exports of such equipment and actual outflow of funds from the United States, it is about 85 percent.[1]

As discussed earlier, it is argued that remittance from direct investment abroad is higher each year

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[1]U.S., Department of Commerce, Survey of Current Business, September 1965, November 1965, and November 1966.

Adler and Hufbauer, Overseas Manufacturing Investment and the Balance of Payment, p. 22.

Jack W. Behrman, Direct Manufacturing Investment, Exports and the Balance of Payments (New York, N.Y.: National Foreign Trade Council, Inc., 1968), p. 11.

than is capital outflow. Hence, foreign investment contributes to the plus side of the balance of payments. In 1967, outflow for direct investment, including reinvested earnings, was $4.6 billion; capital inflow from direct investment, including dividends, reinvested earnings, royalties, and fees, amounted to $7.2 billion, producing a surplus of $2.6 billion. Total outflow of new capital and reinvested earnings for the period 1962-67 was $25.1 billion, compared to an inflow of $36.4 billion during the same period (Table 16). Europe was the only area where outflow exceeded inflow in the years 1962-67. However, part of the earnings which appear in the Department of Commerce publications as coming from oil-producing countries were really profits earned in Europe. When Europe and Canada were taken as one unit, capital inflow equaled capital outflow during that period.

Net inflow of funds related to direct investment abroad resulted in a net surplus of at least $1.5 billion in the payments accounts each year following 1962. The favorable contribution of net capital inflow from direct investment was second only to commercial trade accounts between 1962 and 1965 and was greater than the balance and trade account in the years 1966 and 1967 (Table 17).

Analysis of Arguments for and Against the Program

The fact that in the long run direct investment abroad has a positive impact on the U.S. balance of payments

TABLE 16

FLOWS OF CAPITAL, INCOME, REINVESTED EARNINGS, ROYALTIES, AND FEES, 1962-67
(million of dollars)

	1962	1963	1964	1965	1966	1967
Canada						
Total outflow	685	898	798	1,502	1,682	1,036
Capital outflow	314	365	298	962	1,135	392
Reinvested earnings	371	533	500	540	547	644
Total inflow	961	1,122	1,296	1,428	1,518	1,677
Income	476	455	634	703	756	790
Reinvested earnings	371	533	500	540	547	644
Royalties and fees	114	134	162	185	215	243
Net flows	276	224	498	-74	-164	641
Western Europe						
Total outflow	1,160	1,437	1,796	1,867	2,244	1,708
Capital outflow	868	924	1,388	1,479	1,809	1,442
Reinvested earnings	292	513	408	388	435	266
Total inflow	1,028	1,292	1,372	1,537	1,707	1,588
Income	526	507	659	768	729	849
Reinvested earnings	292	513	408	388	435	266
Royalties and fees	210	272	305	381	443	473
Net flows	-132	-145	-424	-330	-537	-120
Total, all areas						
Total outflow	2,852	3,483	3,759	5,010	5,362	4,598
Capital outflow	1,654	1,976	2,328	3,468	3,623	3,020
Reinvested earnings	1,198	1,507	1,431	1,542	1,739	1,578
Total inflow	4,790	5,296	5,861	6,429	6,814	7,236
Income	3,044	3,129	3,674	3,963	4,045	4,518
Reinvested earnings	1,198	1,507	1,431	1,542	1,739	1,578
Royalties and fees	548	660	756	924	1,030	1,140
Net flows	1,938	1,813	2,102	1,419	1,452	2,638

Source: U.S., Department of Commerce, Survey of Current Business, August 1964, September 1965, 1966, 1967, and October 1968.

TABLE 17

NET BALANCE OF DIRECT INVESTMENT VERSUS NET BALANCE OF COMMERCIAL TRADE ACCOUNT 1962-67[1]
(billion U.S. dollars)

Year	Commercial Foreign Trade Accounts Net Balance	Direct Investment Abroad Accounts Net Balance
1962	2.1	1.9
1963	2.4	1.8
1964	3.9	2.1
1965	2.0	1.4
1966	0.6	1.5
1967	0.3	2.6

Sources: U.S., Department of Commerce, Surveys of Current Business, August 1964, September 1965, 1966, 1967, and October 1968.

[1] Commercial trade excluding such noncommercial exports from the United States as: military grand aid, Public Law 480, AID, and other non-dollar earning shipments.

is accepted by all factions--government officials, business executives, and economists in the academic community. The basic argument between the business community and government officials who formulated and carried out the policy of restraint on direct investment abroad is the length of time it takes for investment to produce a positive effect on the country's balance of payments. Of course, the data used by each group and the way in which the indirect effects of investment abroad are evaluated are determining factors in measuring the length of this period.

To measure the effects of current investment abroad, or even total investment abroad, on the balance of payments is quite complicated because it must be compared to what would happen if the foreign investments were not made. All the data of all exports from, and imports to, the United States which are directly related to the existence of foreign subsidiaries are needed, such as increases in U.S. exports in given years due to: (a) purchases of new capital goods in the United States because of reinvested earnings and new capital outflow from home; (b) purchases of raw materials and intermediate products from the United States by the foreign subsidiaries which would not have been sold by the United States if the subsidiaries had not been in existence; and, (c) the increase in exports (not only to subsidiaries but

also those effected by the subsidiaries' existence) resulting from the introduction of new technology, growth of income, and new contacts and other channels of trade that would not exist otherwise.

From this increase in exports one must deduct the negative effect on the balance of payments in order to see the net effects: (a) imports from the new subsidiaries in addition to the regular imports; and (b) reduction in exports to the countries in which the subsidiaries are located or elsewhere as a result of new production and sales by these subsidiaries. All the above-mentioned factors except the first would have a continuous effect on the balance of payments. Because a plant would require replacement and repair parts, even the first factor could have a lasting effect on total exports.

Having all the data available would be ideal. Partial data given by the Department of Commerce, however, can give a sound foundation for analysis.

The following analysis will discuss and weigh the effects of exports, imports, and capital flows resulting from direct investment abroad on the U.S. balance of payments. Since the voluntary program was concentrated essentially on investment in Europe, Canada, and the more developed economies, this analysis will center mainly on these areas (on Europe and Canada in particular where most of the U.S. deficit was accumulated). Emphasis will

be on manufacturing investment because over 50 percent of the investment in these countries is in manufacturing and because more data are available thereon. However, direct investment in other industries and other areas will also be discussed.

Exports and Imports

After the period of the initial shipment of machinery and equipment, the relationship between exports and direct capital investment abroad is long lasting. It continues through shipments of semi-manufactured goods, raw materials, replacement parts, and finished parts for assembly. In addition, the subsidiaries abroad develop a market for other U.S. exports.

For the years 1962-64, exports by U.S. companies to their affiliates abroad accounted for about 40 percent of their total foreign exports and for an average of 28 percent of total U.S. private exports (Table 18). Data supplied to the Department of Commerce by 708 companies which cooperated in the voluntary program show that about 37 percent of the total exports of these firms in the years 1964-67 was to affiliates abroad and that the aforementioned amount was about 23 percent of the total U.S. private exports abroad (Table 19). The 708 companies exported over 62 percent of total U.S. exports, and it can be estimated that a small percentage of the exports which did not go to affiliates was due to the existence

TABLE 18

EXPORTS TO FOREIGN AFFILIATES OF U.S. COMPANIES, 1962-64
(billion U.S. dollars)

	Exports to Affiliates (1)	Total Exports by Companies with Affiliates (2)	Ratio 1-2 (%) (3)	Total Private Sector Exports (4)	Ratio 1-4 (%) (5)
1962	4.9	12.6	39.0	18.1	27.1
Manufacturing	3.0		23.8		16.6
Other	1.9		15.2		10.5
1963	5.3	13.3	40.0	19.2	27.6
Manufacturing	3.4		25.5		17.7
Other	1.9		14.5		9.9
1964	6.3	15.4	40.9	22.3	28.2
Manufacturing	4.1		27.1		18.4
Other	2.2		13.8		9.8

Source: U.S., Department of Commerce, Survey of Current Business, December 1965, pp. 14, 16; June 1966, pp. 25, 32.

TABLE 19

EXPORTS OF FIRMS COOPERATING IN VOLUNTARY RESTRAINT PROGRAM, 1964-67
(billion U.S. dollars)

	Exports to Affiliates (1)	Total Exports by Companies with Affiliates (2)	Exports to Affiliates as Percentage of Companies' Exports (3)	Total Private Sector Exports (4)	Exports to Affiliates as Percentage of Total Private Exports (5)
1964	4.6	13.3	34.6%	22.3	20.6%
1965	5.3	14.4	36.8%	23.5	22.5%
1966	6.2	16.2	38.3%	26.2	23.6%
1967	6.7	17.7	38.8%	26.9	24.9%

Sources: U.S., Department of Commerce, Survey of Current Business, June 1969, p. 32; March 1967, p. 22; September, 1968, p. 34. Unpublished data reported by 708 companies to the Department of Commerce.

of these foreign subsidiaries.

In addition, U.S. foreign subsidiaries bought goods from companies in the United States other than their parent companies. An estimate by the Department of Commerce indicates that about 20 percent of the materials used by affiliates abroad originated in the United States and that the cost of such materials was approximately at one-half of the value of sales.[1] For 1967, sales of foreign affiliates were estimated at about $120 billion, making the value of materials and semimanufactured goods exported from the United States to these affiliates at about $12 billion. Of course, estimates of exports varied considerably among Europe, Canada, and the developing countries. In 1964 exports to affiliates accounted for about 46 percent of all U.S. exports to Canada, 33 percent to Latin America, and 21 percent to Europe.[2]

The export content of U.S. direct investment is assumed by most studies to be about one-third of capital invested. In a study made by the Department of Commerce concerning 155 American firms investing abroad, it was found that between 25 percent and 30 percent of these firms' direct investment abroad was spent on U.S. capital

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[1]U.S., Department of Commerce, U.S. Business Investment in Foreign Countries (Washington, D.C.: 1965), p. 67.

[2]U.S., Department of Commerce, Survey of Current Business, December 1965, p. 12.

goods.[1] Gary C. Hufbauer and Michael F. Adler suggested in their study that the amount was somewhat lower than one-third.[2] However, their study was concentrated only on manufacturing investment, and the export content in the extractive industries is much higher.[3] The reasons for a higher content of export in extractive industries are mainly two: The ratio of capital goods to total investments in such industries is higher; and, most of the investment is carried out in less developed countries which are not able to supply any capital goods. In some cases the amount of investment abroad is deposited in the subsidiary's name in a New York bank and when purchases of goods are made in the United States they are paid from that account. In other cases the U.S. company invests abroad by shipping capital equipment and other goods to its subsidiary and in return receives shares on other kinds of equity of equal value, in which case the dollars invested never leave the United States.[4]

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[1]U.S., Department of Commerce, U.S. Business Investment in Foreign Countries, p. 67.

[2]Hufbauer and Adler, Overseas Manufacturing Investment and the Balance of Payment, ch. 3.

[3]Rudolf R. Rhomberg, Domestic and Foreign Influences on the United States Balance of Payments, paper presented to the 16th Annual Conference on Economic Outlook, November 14-15, 1968 (Ann Arbor, Michigan).

[4]Emile Benoit, Contribution of Direct Foreign Investment to our Balance of Payments (New York: Columbia University, Graduate School of Business, 1965).

In an unpublished paper, Rudolph R. Rhomberg stated that what impressed him most when examining the U.S. balance of payments accounts for the period 1962-67 was the fact that the current account balance appeared to have adjusted very closely to the variations in the net outflows of capital, having improved somewhat more than the increase in the outflow of funds from 1962-65 and worsened by somewhat more than the reduction in this outflow from 1965-67.[1] This fact implies a very close relation between outflow of capital and the surplus or deficit in the trade account. Curtailment of such outflows necessarily leads to reduction in exports.

It is evident from Table 20 that the ratio of exports from the United States to manufacturing subsidiaries investment abroad is about 26 percent. The ratio of exports going to Canada is substantially higher than to Europe. However, the export data include exports to subsidiaries of goods for resale without further processing, which in most cases would be exported with or without the existence of the subsidiaries. If this type of export were deducted, each dollar of investment abroad would generate considerably less export. In addition, in order to measure the effect of investment abroad on exports, one must deduct the amount imported

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[1]Rhomberg, Domestic and Foreign Influence on the United States Balance of Payments.

TABLE 20

EXPORTS FROM THE UNITED STATES TO, AND IMPORTS TO THE UNITED STATES FROM MANUFACTURING SUBSIDIARIES ABROAD, 1962-64
(By Selected Regions)
(million of dollars)

	1961	1962	1963	1964	Average 1962-64[1]	Ratio to Investment
Canada						
Manufacturing subsidiaries' investment	5,076	5,312	5,761	6,198	5,383	
Gross exports from United States to subsidiaries		1,426	1,615	1,840	1,627	
For processing or assembling		(489)	(606)	(628)	(574)	10.7%
For resale without further manufacturing		(506)	(535)	(659)	(567)	10.5%
Capital equipment for investment use		(41)	(37)	(56)	(45)	0.8%
Exports purchased in the United States directly by foreign affiliates		(376)	(391)	(446)	(404)	7.5%
Exports sold by affiliates on commission		(14)	(45)	(50)	(36)	0.7%
Ratio of gross exports to investment						30.2%
Less imports to the United States from subsidiaries		829	844	1,227	966	
Net export		595	771	613	661	
Ratio of net exports to investment						12.3%

TABLE 20 (Cont)

	1961	1962	1963	1964	Average 1962-64[1]	Ratio to Investment
Europe						
Manufacturing subsidiaries investment	4,255	4,883	5,634	6,587	4,924	
Gross Exports from United States to subsidiaries		721	811	1,029	854	
For processing or assembling		(239)	(326)	(428)	(331)	6.7%
For resale without further manufacturing		(331)	(355)	(408)	(364)	7.4%
Capital equipment for investment use		(54)	(37)	(54)	(48)	1.0%
Exports purchased in the United States directly by foreign affiliates		(38)	(41)	(71)	(50)	1.0%
Exports sold by affiliates on commission		(58)	(52)	(69)	(60)	1.2%
Ratio of gross exports to investment						17.3%
Less imports to the United States from subsidiaries		135	121	208	155	
Net Export		586	690	821	699	
Ratio of net export to investment						14.2%

TABLE 20 (Concluded)

	1961	1962	1963	1964	Average 1962-64[1]	Ratio to Investment
All areas						
Manufacturing subsidiaries investment	11,997	13,250	14,937	16,935	13,395	
Gross exports from United States to subsidiaries		2,992	3,404	4,068	3,488	
For processing or assembling		(1,082)	(1,370)	(1,589)	(1,347)	10.0%
Ror resale without further manufacturing		(1,102)	(1,174)	(1,403)	(1,226)	9.2%
Capital equipment for investment use		(167)	(123)	(198)	(163)	1.2%
Exports purchased in the United States directly by foreign affiliates		(463)	(492)	(602)	(519)	3.9%
Exports sold by affiliates on commission		(177)	(245)	(275)	(232)	1.7%
Ratio of gross exports to investment						26.0%
Less imports to the United States from subsidiaries		1,089	1,126	1,636	1,284	
Net export		1,903	2,278	2,432	2,204	
Ratio of net exports to investment						16.5%

Source: U.S., Department of Commerce, Survey of Current Business, December 1965, p. 14; November 1965, p. 19; and October 1968, p. 26.

[1] Average of investment is 1961-64.

by U.S. companies from their subsidiaries abroad. As seen in Table 20, when this amount was deducted the average dollar invested in manufacturing abroad generated only 16.5 percent of export. After examining the content of imports and discussing it with company executives, however, it is clear that a high proportion of goods purchased from subsidiaries are raw materials or other resources which do not exist in the United States or which are in limited supply. Therefore, the imports of such goods would take place whether subsidiaries existed or not. The ratio of exports to the investment discussed above is concerned only with actual exports and imports and does not include other exports which are indirect and which may result from the subsidiaries' activities abroad. Nor does this include displaced exports from the United States to the countries where the subsidiaries are located or to third countries.

It is recognized that production of subsidiaries abroad and their sales to third countries in some cases have displaced exports from the United States, but no conclusive evidence as to the extent of this effect can be shown. Furthermore, subsidiaries operating in foreign countries must have an interest in the economic development and needs of those countries. Some governments attract foreign industry and give it a protected market on the condition that the products produced should be an

import substitution or should be exported to other countries in order to help the balance of payments of the host country. In hearings before the Committee on Finance of the United States Senate, representatives of the Department of the Treasury argued that if only slightly more than three percent of the sales by foreign subsidiaries of goods they produced abroad displaced U.S. exports, the "net export"[1] factor of investment abroad would be eliminated.[2]

Sales of American manufacturing subsidiaries abroad average $32.3 billion annually between 1962 and 1964, and rose by approximately 17.4 percent annually (Table 21). Of these sales, 14.1 percent was exported to third countries with an additional 3.9 percent going to the United States. The average annual exports to third countries by subsidiaries in Europe and Canada amounted to 16.2 percent (footnote to Table 21) of their total production. For justification of the aforementioned argument of the Treasury Department concerning exports, at least 10.7 percent of all manufacturing subsidiaries' sales abroad ($3.5 billion), or 76 percent

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[1]"Net export" factor in this context means all the increase in export as the result of investment abroad.

[2]U.S., Congress, Senate, Statement of Secretary of the Treasury Douglas Dillon at the Hearings before the Senate Committee on Finance on the Revenue Act of 1962, 87th Cong., 2nd sess., April 2, 1962, p. 174.

TABLE 21

SALES OF U.S. MANUFACTURING SUBSIDIARIES ABROAD
(million of dollars)

	1962	1963	1964	Average 1962-64	Ratio to Total Sales[1]
Canada					
Sales of subsidiaries	9,196	10,163	11,450	10,270	
Local sales	(7,478)	(8,350)	(9,347)	(8,392)	81.8%
Exported to the United States	(829)	(844)	(1,227)	(966)	9.4%
Exported to other countries	(889)	(969)	(876)	(912)	8.8%
Europe					
Sales of subsidiaries	12,020	14,015	16,500	14,178	
Local sales	(9,374)	(10,782)	(12,711)	(10,956)	77.3%
Exported to the United States	(135)	(121)	(208)	(155)	1.1%
Exported to other countries	(2,511)	(3,112)	(3,581)	(3,068)	21.6%
All areas					
Sales of subsidiaries	27,923	31,769	37,270	32,321	
Local sales	(23,009)	(26,000)	(30,585)	(26,531)	82.0%
Exported to the United States	(1,089)	(1,126)	(1,636)	(1,284)	3.9%
Exported to other countries	(3,825)	(4,643)	(5,049)	(4,560)	14.1%

Source: U.S., Department of Commerce, Survey of Current Business, November 1965, p. 19

[1] Total sales of subsidiares in Europe and Canada are $24,448 million.
Weighted proportion of it: Europe 58.0 per cent
Canada 42.0 per cent

Local sales: Europe - 77.3 p.c. x 58.0 = 48.34
Canada - 81.8 p.c. x 42.0 = 34.36
82.70 p.c.

Exported to the United States:
Europe - 1.1 p.c. x 58.0 = 0.6
Canada - 9.4 p.c. x 42.0 = 3.9
4.5 p.c.

Exported to other countries:

Europe - 21.6 p.c.	x	58.0	= 12.5
Canada - 8.8 p.c.	x	42.0	= 3.7
			16.2 p.c.

of subsidiaries' sales to third countries, would have to displace exports from the United States in order to eliminate the "net export" factor gains from investment abroad ($3.5 billion as presented in Table 20). However, if only 3 percent of subsidiaries' sales abroad displaces export from the U.S., it amounts to less than $1 billion which is about 29 percent of "net exports" factor gains from investment abroad.

The Treasury's argument is acceptable only to a limited extent since it misjudges the reasons for the increased sales of subsidiaries abroad and especially to third countries. In Europe it is true that large amounts of production by American affiliates are sold in third countries, but this was an original reason for establishing American companies in Europe--to escape the high tariff walls imposed on goods outside the European economic community. Because of the restrictions and high tariffs, it is questionable that American exported goods could otherwise be sold in this market. If the demand for a product exists and the tariff walls are high enough, some local businessman inevitably will enter the market and produce despite higher costs. The choice open to the United States has been for an American company to set up an affiliate factory abroad, export some capital equipment from the United States, and remit back part of the earnings, or to lose the market completely. It is

unlikely that over 75 percent of the goods produced abroad and sold in third countries replace American exports. American investment in England is a significant part of the investment in Europe, and the ratio of exports to total sales for American subsidiaries in England is no higher than that of British firms in similar industries.[1]

Hufbauer and Adler concluded in their study[2] that in the economically advanced countries the displacement export effect from American investment abroad would be minimal because someone else undoubtedly would invest there if a U.S. company did not. However, in less developed countries, because capital is scarce, it would take many years before other capital made the investment; therefore, export displacement from the United States would be significant. The authors also maintained that having subsidiaries abroad is not necessary to stimulate exports, especially associated exports.[3] They gave the examples of Germany, Italy, and Japan, which have increased

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[1]Kenneth W. Dam and Lawrence B. Krause, Federal Tax Treatment of Foreign Income (Washington, D.C.: The Banking Institute, 1964), p. 74.

[2]Hufbauer and Adler, Overseas Manufacturing Investment and the Balance of Payments.

[3]Associated exports are products that an affiliate abroad is not producing but is acting as an agent for the parent company in order to exploit and sell products produced in the United States.

their exports many times in the post-war period without the help of overseas subsidiaries. However, this fact does not constitute a standard: U.S. trade surpluses during the same period, until 1968, were greater. If Germany, Italy, and Japan had subsidiaries abroad, they could export even more than they do.

From the discussion in this section it is evident that U.S. companies with affiliates abroad use this channel to export about 38 percent of their total exports and that this amount is about 25 percent of total private exports. When imports from subsidiaries are taken into account the net share of export declines to about 20 percent. However, a large part of these imports are raw materials which do not exist or which are in limited supply in the United States, and such imports would take place whether subsidiaries existed or not.

It is clear that some displacement of exports from the United States occurs as the result of subsidiary activities abroad. However, the extent of this effect is difficult to measure or to prove. In the case of Europe the choice available to American companies was to increase production and displace some American exports or to lose the market completely. The high tariff walls imposed on goods coming from outside the European Economic Community made it necessary to invest locally in order to keep a share of the growing market.

Capital Flows; Earnings, Dividends, Royalties and Fees; Reinvested Earnings, and Capital Outflow

Direct foreign investment outflows and inflows resulted in a net surplus each year from 1962 through 1967. Income repatriated to the United States increased by 50 percent during this period (Table 22). Unquestionably, direct investment abroad earned more for the United States during that time than the amounts of direct investment outflows, even when royalties and fees were not included.

From Table 23 (where capital outflow and earnings repatriated to the United States are broken into regions and industries) it becomes clear that capital inflows do not always exceed capital outflows. Capital outflow to Europe was greater than capital inflow from Europe each year since 1961. Furthermore, investment in Europe increased by 110 percent between 1961 and 1967, and at the same time earnings rose by only 35 percent. In Canada the rate of increase in earnings only slightly exceeded that of investment. One of the reasons that the Government requested the voluntary restraints was because of the large outflows to Europe and the more developed countries.

Companies cooperating with the Government in the voluntary restraing program have been asked to curtail their outflow of funds principally to Europe and a few other industrial countries, but they can continue to

TABLE 22

DIRECT FOREIGN INVESTMENT OUTFLOWS AND INFLOWS, 1962-67
(billion U.S. dollars)

Year	Capital Outflow (1)	Reinvested Earnings (2)	Total Outflow 1+2 (3)	Repatriated Earnings (4)	Reinvested Earnings (5)	Royalties and Fees (6)	Total Inflow 4+5+6 (7)	Net Balance 7-3 (8)
1962	1.7	1.2	2.9	3.0	1.2	0.6	4.8	1.9
1963	2.0	1.5	3.5	3.1	1.5	0.7	5.3	1.8
1964	2.3	1.4	3.7	3.7	1.4	0.8	5.9	2.2
1965	3.5	1.5	5.0	4.0	1.5	0.9	6.4	1.4
1966	3.6	1.7	5.3	4.0	1.7	1.0	6.7	1.4
1967	3.0	1.6	4.6	4.5	1.6	1.1	7.2	2.6

Source: Table 16.

TABLE 23

SELECTED DATA ON DIRECT INVESTMENT ABROAD, EARNINGS, INCOME, CAPITAL OUTFLOW, ROYALTIES AND FEES, AND REINVESTED EARNINGS, BY MAJOR AREAS
(million of dollars)

	1961			1962		
	Total	Manufac-turing	Other	Total	Manufac-turing	Other
Canada						
Outstanding direct investment	11,602	5,076	6,526	12,133	5,312	6,821
Outflows				685	251	434
Capital outflow				314	12	302
Reinvested earnings				371	239	132
Inflows[1]				949	526	423
Total earnings				825	460	365
Repatriated earnings				476	221	255
Royalties and Fees				102	66	36
Europe						
Outstanding direct investment	7,742	4,255	3,478	8,930	4,883	4,047
Outflows				1,160	615	545
Capital outflow				868	453	415
Reinvested earnings				292	162	130
Inflows[1]				979	602	277
Total earnings				844	496	348
Repatriated earnings				526	334	192
Royalties and Fees				161	106	55
All areas						
Outstanding direct investment	34,667	11,997	22,670	37,226	13,250	23,976
Outflows				2852	1,273	1,597
Capital outflow				1,654	712	942
Reinvested earnings				1,198	561	637
Inflows[1]				4,790	1,547	3,243
Total earnings				4,235	1,307	2,928
Repatriated earnings				3,044	746	2,298
Royalties and fees				548	240	308

[1] Inflows includes Repatriated earnings, Reinvested earnings, Royalties and fees.

TABLE 23 (Cont)

	1963			1964		
	Total	Manufac-turing	Other	Total	Manufac-turing	Other
Canada						
Outstanding direct investment	13,044	5,761	7,283	13,855	6,198	7,657
Outflows	898	458	437	796	429	367
Capital outflow	365	120	245	298	140	158
Reinvested earnings	533	338	192	498	289	209
Inflows[1]	1,122	626	493	1,294	683	611
Total earnings	948	525	423	1,106	585	541
Repatriated earnings	455	192	263	634	296	365
Royalties and fees	134	96	38	162	125	37
Europe						
Outstanding direct investment	10,304	5,634	4,670	12,129	6,587	5,542
Outflows	1,437	696	741	1,748	946	802
Capital outflow	924	395	529	1,338	619	719
Reinvested earnings	513	301	212	410	327	83
Inflows[1]	1,292	792	500	1,374	990	384
Total earnings	996	627	396	1,115	782	333
Repatriated earnings	507	305	202	659	427	232
Royalties and fees	272	186	86	305	236	69
All areas						
Outstanding direct investment	40,686	14,937	25,749	44,430	16,935	27,495
Outflows	3,483	1,626	1,857	3,759	1,948	1,811
Capital outflow	1,976	774	1,202	2,328	1,034	1,294
Reinvested earnings	1,507	852	655	1,431	914	517
Inflows[1]	5,296	1,879	3,417	5,861	2,286	3,575
Total earnings	4,587	1,541	3,046	5,071	1,852	3,219
Repatriated earnings	3,129	656	2,473	3,674	893	2,781
Royalties and fees	660	371	289	756	479	277

TABLE 23 (Cont)

	1965			1966		
	Total	Manufac-turing	Other	Total	Manufac-turing	Other
Canada						
Outstanding direct investment	15,318	6,872	8,446	16,999	7,675	9,324
Outflows	1,502	678	824	1,664	823	851
Capital outflow	962	395	567	1,135	549	586
Reinvested earnings	540	283	257	539	274	265
Inflows[1]	1,428	742	686	1,510	793	717
Total earnings	1,209	606	603	1,237	628	609
Repatriated earnings	703	315	388	756	354	402
Royalties and fees	185	144	41	215	165	50
Europe						
Outstanding direct investment	13,985	7,606	6,379	16,209	8,876	7,333
Outflows	1,860	1,054	806	2,243	1,262	981
Capital outflow	1,479	760	719	1,809	896	913
Reinvested earnings	381	294	87	434	366	68
Inflows[1]	1,530	1,112	418	1,606	1,182	424
Total earnings	1,176	859	317	1,161	860	301
Repatriated earnings	768	532	236	729	489	240
Royalties and fees	381	286	95	443	327	116
All areas						
Outstanding direct investment	49,424	19,339	30,085	54,711	22,058	32,653
Outflows	4,993	2,417	2,576	5,339	2,707	2,632
Capital outflow	3,468	1,525	1,943	3,623	1,732	1,891
Reinvested earnings	1,525	892	633	1,716	975	741
Inflows[1]	6,412	2,564	3,848	6,791	2,743	4,048
Total earnings	5,460	2,022	3,438	5,702	2,104	3,598
Repatriated earnings	3,963	1,094	2,869	4,045	1,116	2,929
Royalties and fees	924	578	346	1,030	652	378

TABLE 23 (Cont)

	1967		
	Total	Manufac-turing	Other
Canada			
Outstanding direct investment	18,069	8,083	9,986
Outflows	1,036	369	667
Capital outflow	392	25	367
Reinvested earnings	644	344	300
Inflows[1]	1,677	826	851
Total earnings	1,327	613	714
Repatriated earnings	790	296	494
Royalties and fees	243	186	57
Europe			
Outstanding direct investment	17,882	9,781	8,101
Outflows	1,708	921	787
Capital outflow	1,442	670	772
Reinvested earnings	266	251	15
Inflows[1]	1,588	1,062	526
Total earnings	1,139	847	292
Repatriated earnings	849	561	288
Royalties and fees	473	250	223
All areas			
Outstanding direct investment	59,267	24,124	35,143
Outflows	4,598	2,053	2,545
Capital outflow	3,020	1,211	1,809
Reinvested earnings	1,578	842	736
Inflows[1]	7,236	2,768	4,468
Total earnings	6,017	2,051	3,966
Repatriated earnings	4,518	1,193	3,325
Royalties and fees	1,140	733	407

Source: U.S., Department of Commerce, Survey of Current Business, 1963, 1964, 1965, 1966, and 1967.

invest in the developing countries. (Most of this investment is with funds from the United States.) Businessmen complain, with some justification, that it is improper to differentiate between the developed and the developing countries as there is a large amount of interplay between them. Reported earned income in the developing countries is, in many cases, from sales in the developed countries. Oil and raw materials are extracted in Latin America and the Middle East but are sold in Europe where the profits are made. It is the resale in Europe from which most of the profit actually is derived. However, because of tax considerations, a company may find it convenient to make use of its intra-company accounts, and the profit appears as income derived in one of the developing countries and not in Europe.

The fastest growing markets for U.S. companies are in the developed rather than the underdeveloped countries since only the more economically advanced countries have the level of income necessary to buy the goods produced by American companies. The underdeveloped nations do not have the foreign exchange to enable profit remittance; furthermore, in many cases, they have exchange controls which make it impossible for the profits to be taken out.[55]

Government officials and economists accept the

fact that inflows of repatriated earnings and royalties and fees are greater in any given year than are capital outflows for direct investment. However, their main argument is that the two types of flows being compared have little relationship to one another. The inflows of dividends and some of the royalties and fees result from investment over many years prior to a current period. To measure the impact of investment abroad on the balance of payments in a current period or in the future, one must relate these inflows to a given capital outflow currently undertaken. Of course, this point of view disregards the "organic approach" to investment abroad discussed in an earlier section of this chapter.

There is no question that total inflows as a result of direct investment abroad substantially exceed total outflows or that the surplus of these outflows in recent years is larger than those of the trade account. However, government officials are justified in pointing out that a comparison which is misleading is made between two types of flows. Curtailment of direct investment outflow would adversely effect only an increment of investment a number of years hence. The main question to be answered is how many years it would take before curtailment of capital outflow would have an adverse effect on the U.S. balance of payments.

Direct Investment Recoupment Periods as Related to the Balance of Payments

In this section various approaches will be examined in order to ascertain the length of time needed for direct investment abroad to repay itself in balance of payment terms, when such different but related factors as outflows of capital, earnings, reinvested earnings, dividends, generated exports, and generated imports are taken into consideration.

One of the approaches that has caused considerable controversy is the model approach which was developed by Professor P. W. Bell. In his testimony before the Joint Economic Committee[1] in 1962, Professor Bell tried to calculate the number of years required for cumulative dividends to equal an initial amount of capital outflow. His approach has been used in many cases by government officials when called upon to justify, on economic grounds, the voluntary restraint program on direct investment abroad.

In 1968 the Treasury Department sponsored and published the independent study made by Professors Adler and Hufbauer,[2] in which it was concluded that when all trade effects are taken into account and when it is

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[1] P. W. Bell, Private Capital Movement and the U.S. Balance of Payments, cited in testimony before Joint Economic Committee, U.S. Congress, 87th Cong., 2nd sess.

[2] Adler and Hufbauer, Overseas Manufacturing Investment and the Balance of Payments.

assumed that the U.S. direct foreign investment is defensive (if American companies do not invest, others will), the following average payback periods will result: Canada, 10.2 years; Latin America, 9.7 years; Europe, 6.5 years; rest of world, 6.6 years; world total, 8.1 years. In cases where it is assumed that investment abroad is not defensive, the period of payback, in balance of payments terms, would be between eight and an infinite number of years.

Although the Adler-Hufbauer study was not intended to be the basis for policy making, its conclusions have supported direct capital outflow restraint, and it has been used by the Treasury Department to bolster its case.

The assumptions and conclusions of the Adler-Hufbauer study have received sharp criticism from many business organizations. The study assumed that all additions to investment abroad are incremental and that all restrictions on capital outflow would offset only the marginal investment and not the total earning capacity of the companies operating abroad. This assumption is not accepted by many business leaders who advance the "organic" assumption that all additional investment is necessary in order to support the current level of total investment. Other assumptions were that the level of demand for a given product was fixed and could be supplied

only by U.S. exports or by local production--not by both, and that all investments abroad are for facilities to manufacture products which are substitutes for U.S. exports. There are investments for the production of such products, but there are also investments in products that are never exported from the United States. A significant weakness of the model was pointed out by Dr. Jack N. Behrman, former Assistant Secretary of Commerce, in his study evaluating the validity and accuracy of the model:

> The study (model) also miscalculates the return to investment arising from remission of earnings by including earnings retained abroad in the outstanding investment but not including it in the return to U.S. payments. The retained earnings did not actually flow out of the United States through international payment because they did not come in. They have to be included in both the numerator and denominator, or in neither, to obtain a balance of payments ratio of returns and outflows.[1]

Another basic flaw in the model is the treatment of net capital expenditure abroad. The authors related earnings repatriated and other inflows to total investment abroad. However, in order to measure the impact on the balance of payments they should have related it only to capital outflows and should not have treated funds borrowed abroad as capital outflow. If capital inflows were related only to funds that came out of the United

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[1]Jack N. Behrman, Direct Manufacturing Investment, Exports and the Balance of Payments (New York, N.Y.: National Foreign Trade Council, 1968), p. 2.

States, the repayment period, in balance of payments terms, would be shortened considerably.

In the following part of this section three models will be presented in an attempt to measure the recoupment period of direct investment abroad. The first model (Table 26) will utilize the approach developed by Professor Bell[1] (and used by Adler and Hufbauer in their study) in which an attempt was made to calculate the recoupment period of total investment and manufacturing investment abroad based on the actual data in the periods 1962-64 and 1965-67 by relying only on the value of direct investment, the earnings of such investment, and the share remitted to the United States. This approach disregards any effects of increasing or displacing exports from the United States or of increasing imports to the United States.

Table 27 shows a calculation of the actual dividends, royalties, fees, and net exports in manufacturing for the years 1961-67 as directly related to total capital outflow and reinvestment for this period. The model in Table 29 is constructed in such a way as to show the effects on the balance of payments when an annual outflow of $840 million is invested in manufacturing in Europe and Canada. The direct investment accumulates

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[1]Bell, Private Capital Movement and the U.S. Balance of Payments Position.

each year by an additional $840 million of capital outflow plus the reinvested earnings. The figure of $840 million was chosen because it was the actual average of capital outflow from the United States to Canada and Europe for investment in manufacturing during 1961-67.

All data about capital outflow, reinvested earnings, and other outflows were taken from the Survey of Current Business for the years 1960-67, and were compared with all capital inflows that were generated because of the investments during the same period.

The models omit many important factors which may have a great impact on the balance of payments but which cannot be measured. Recoupment periods of investment abroad as measured by the following models could be changed significantly if effects such as export displacements, additional export, and the like were taken into consideration.

Tables 23, 24 and 25 given the book value, in U.S. dollars, of total direct investment abroad and earnings and remittances to the United States from these investments, with a breakdown for manufacturing. It will be observed that total direct investment in manufacturing in Europe increased by over 130 percent between 1961 and 1967, while earnings rose by only about 60 percent; for Canada, investment increased by 60 percent and earnings by 70 percent (Table 24). Furthermore, the

TABLE 24

ANNUAL EARNINGS, ANNUAL INCOME, AND CUMULATIVE DIRECT INVESTMENT IN MANUFACTURING
(million of dollars)

	1961	1962	1963	1964	1965	1966	1967
Canada							
Earnings	360	460	525	565	606	628	613
Income	213	221	192	269	315	354	296
Direct Investment	5,076	5,312	5,761	6,198	6,872	7,675	8,038
Latin America							
Earnings	172	173	171	243	289	342	264
Income	75	71	70	98	123	147	195
Direct Investment	1,707	1,944	2,213	2,507	2,945	3,317	3,572
Europe							
Earnings	530	496	627	782	859	860	847
Income	326	334	305	427	532	489	561
Direct Investment	4,253	4,883	5,634	6,587	7,606	8,876	9,781
Other Areas							
Earnings	141	178	218	262	268	274	328
Income	108	120	89	99	124	126	141
Direct Investment	949	1,111	1,329	1,643	1,916	2,190	2,688
World, total							
Earnings	1,203	1,307	1,541	1,852	2,022	2,104	2,051
Income	722	746	656	893	1,094	1,116	1,193
Direct Investment	11,997	13,250	14,937	16,935	19,339	22,058	24,124

Source: U.S., Department of Commerce, Survey of Current Business, October 1968, p. 26.

TABLE 25

ANNUAL EARNINGS[1], ANNUAL INCOME[2], AND DIRECT CUMULATIVE INVESTMENTS[3] ABROAD, BY MAJOR AREAS
(million of dollars)

	1961[4]	1962	1963	1964	1965	1966	1967
Canada							
Earnings	--	825	948	1,106	1,209	1,237	1,327
Income	--	476	455	634	703	756	790
Direct Investment	11,602	12,133	13,044	13,855	15,318	16,999	--
Latin America							
Earnings	--	1,179	1,125	1,244	1,320	1,452	1,403
Income	--	891	956	1,011	995	1,113	1,190
Direct Investment	9,189	9,474	9,891	10,204	10,836	11,448	--
Europe							
Earnings	--	844	996	1,115	1,176	1,161	1,139
Income	--	526	507	659	678	729	849
Direct Investment	7,742	8,930	10,304	12,129	13,985	16,209	--
Other areas							
Earnings	--	1,387	1,518	1,606	1,755	1,852	2,149
Income	--	1,151	1,211	1,370	1,497	1,447	1,689
Direct Investment	6,134	6,689	7,411	8,242	9,285	10,055	--
World, total							
Earnings	--	4,235	4,587	5,071	5,460	5,702	6,017
Income	--	3,044	3,129	3,674	3,963	4,045	4,518
Direct Investment	34,667	37,226	40,686	44,430	49,424	54,711	--

Source: U.S., Department of Commerce, Survey of Current Business, October 1968, p. 26.

[1] Earnings is the sum of the U.S. share in the net earnings of subsidiaries and branch profit.

[2] Income is the sum of dividends, interest, branch profits remitted to the United States.

[3] Direct investment is the book value of U.S. equity and debt ownership of foreign subsidiaries, in which more than 25 percent of the share capital is owned by American interests.

[4] The table relates earnings to total investment with one year lag.

TABLE 26

REMISSION PARAMETERS FOR MANUFACTURING AND TOTAL INVESTMENT

	r^1	a^2	$(1-a)r^3$	ar^4	Recoupment Period in Years[5]
		Manufacturing 1962-64			
Canada	0.096	0.440	0.054	0.042	16.2
Latin America	0.100	0.408	0.059	0.041	16.4
Europe	0.130	0.559	0.059	0.071	11.1
Other areas	0.197	0.493	0.104	0.093	8.1
World total	0.117	0.488	0.060	0.057	12.8
		1965-67			
Canada	0.089	0.523	0.042	0.047	16.0
Latin America	0.102	0.520	0.049	0.053	14.2
Europe	0.112	0.616	0.043	0.069	12.1
Other areas	0.151	0.448	0.084	0.067	10.5
World total	0.106	0.551	0.048	0.058	13.4
		Total Direct Investment, 1962-64			
Canada	0.078	0.548	0.035	0.043	17.8
Latin America	0.124	0.806	0.024	0.100	9.8
Europe	0.110	0.573	0.047	0.063	12.7
Other areas	0.223	0.827	0.039	0.184	5.8
World total	0.125	0.709	0.037	0.088	10.4
		1965-67			
Canada	0.082	0.596	0.033	0.049	16.4
Latin America	0.129	0.790	0.027	0.102	9.6
Europe	0.082	0.649	0.029	0.053	15.9
Other areas	0.209	0.805	0.041	0.168	6.2
World total	0.116	0.729	0.031	0.085	10.9

Sources: Derived from data presented in Tables 23, 24, and 25.

1 "r" is the after-tax rate of return on investment.

2 "a" is the remission to the United States as a percentage of total after-tax earnings.

3 "(1-a)r" is retained earnings as a proportion of direct investment

4 "ar" is remitted earnings as a proportion of direct investment.

5 equation: $1 = z + zx + zx^2 + zx^3 \ldots + zx^n$
$z = ar$, $x = = (1 + (1-a)r)$
where n is the recoupment period in years.

amount of investment in Europe between 1961 and 1966 was larger than the combined investment in Canada and Latin America. The share of investment in Europe grew from 22 percent of total in 1961 to 30 percent of total in 1966. However, income return of this investment grew only from 17 percent to 19 percent of total income (Table 25).

For the model in Table 26, which was calculated from Tables 23, 24, and 25, various parameters were calculated for the two periods 1962-64 and 1965-67 for manufacturing and total investment. As discussed earlier, the main aim was to find the length of time which was required for cumulative remission to pay back an original investment. Reinvested earnings are also taken into consideration. A lag of one year for return earnings was assumed because of the time required to build a plant which would function properly (the formula for the calculation is given in the footnote to Table 26).

The rate of return on investment (r) has been declining for manufacturing investment since the early 1950's. In the Adler-Hufbauer study[1] the average rate of return for U.S. manufacturing investment throughout the world was 15.9 percent for the period 1950-53, 13.3 percent for 1954-57, and 11.8 percent for 1958-61.

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[1] Adler and Hufbauer, Overseas Manufacturing Investment and the Balance of Payments.

The "r" used in Table 26 was 11.7 percent for the period 1962-64 and 10.6 percent for 1965-67. For American manufacturing investment in Europe the rate of return declined from 18.1 percent in the period 1950-53 to 16.0 percent during 1958-61, to 13 percent for 1962-64, and to 11.2 percent for 1965-67. The principal effect of such a decline on the balance of payments is that it would take longer to recoup an original outflow of capital.

The recoupment period for investment in manufacturing abroad has widened since 1950: It was an average of 10.1 years for the period 1950-53, 12.8 years for 1962-64, and 13.4 years for 1965-67. In Canada it rose from 10.1 years for the period 1950-53 to 16.2 years during 1962-64 and declined slightly, to 16 years, for 1965-67, mainly because of the larger proportion of earnings returned to the United States in this period (one of the requirements of the voluntary program). The recoupment period in Europe also has increased since the 1950's. From 1958-61 it took 9.8 years for original investment to return to the United States in the form of dividends, but for 1965-67 it increased to 12.1 years.[1] Despite a higher proportion of earnings remitted to the

[1]Recoupment periods prior to 1962 are cited from Adler and Hufbauer, Overseas Manufacturing Investment and the Balance of Payments.

United States in the last-mentioned period, the longer period for recoupment resulted mainly because of the decline in the rate of earnings.

Recoupment duration for total direct investment abroad is about two and one-half years shorter than it is solely for manufacturing investment. The reason for the shorter payback period, in balance of payment terms, is that the rate of return and the rate of repatriation are higher for total direct investment.

The model in Table 27 was constructed in such a way that it would measure the effect of direct manufacturing investment in Canada and Europe on the balance of payments. This model takes into consideration exports, remitted income, reinvested earnings, and royalties and fees when related to total new investment (capital outflow from the United States and reinvested earnings) during the period and not to accumulated investment from previous years. Cumulative direct investment in Europe and Canada for 1961-67 was $6.1 billion, of which $0.7 billion was reinvested earnings computed from the actual rate of reinvestment for this period. Actual dividends, royalties, fees and net exports for the six years also were computed and are directly related to total outflow and reinvestment. Compared to the $5.4 billion outflow for this period, cumulative net inflow was $3.1 billion, and the cumulative deficit amounted to $2.3 billion in

TABLE 27

ESTIMATED EFFECT ON THE BALANCE OF PAYMENTS OF NEW CAPITAL OUTFLOW TO MANUFACTURING SUBSIDIARIES IN CANADA AND WESTERN EUROPE, 1961-67[1]
(million of dollars)

Year	Annual Capital Outflow (1)	Computed Reinvested Earnings (2)	Cumulative Increment to Outstanding Investment (3)	Computed Dividends (4)	Computed Royalties Fees and Net Exports (5)	Total Inflows (6)	Cumulative Capital Outflows (7)	Cumulative Inflows (8)	Balance (9)
1961	350		350				350		
1962	467	18	835	22	58	80	817	80	-737
1963	515	42	1,392	53	137	190	1,332	170	-1,062
1964	759	69	2,220	89	231	320	2,091	590	-1,501
1965	1,155	111	3,486	142	368	510	3,246	1,100	-1,146
1966	1,445	174	5,105	223	579	802	4,691	1,902	-2,789
1967	695	255	6,055	328	847	1,175	5,386	3,077	-2,309

Source: Derived from data presented in Tables 16, 23-26.

[1] The table makes use of actual data on capital outflow and the parameter values for manufacturing subsidiaries on rate of return on investment, proportion of earnings distributed and reinvested, rate of payments of fees and royalties per dollar of investment and value of net export to subsidiaries computed in Tables 22 and 26. In aggregating the data, the parameter values are weighted in accordance with the value of new capital outflow in manufacturing going to each region over the period 1961-67. The weights are 75 per cent for Europe and 25 per cent for Canada.

(continued)

Footnote to Table 27 (concluded)

The relevant parameter values used are computed as follows:

Column 1 taken from Table 23.

Capital outflow weighted: Europe 75%
Canada 25%

Earnings averages:	1961-67	Europe 12.1%	12.1% x 75 =	9.1
		Canada 9.2%	9.2% x 25 =	2.3
				11.4%

Proportion of earnings remitted (as of total earnings):

Europe 58.5%	58.5% x 75 =	43.9	
Canada 48.2%	48.2% x 25 =	12.1	
		56.0%	

Rate of return on investment which is remitted as dividend: 6.4%
Rate of return on investment which is reinvested: 5.0%

These two figures are multiplied by the cumulative increment to outstanding investment of the previous year to obtain the figures in columns 2 and 4.

Rate of return on Royalties and fees (taken from Tables 16 and 23):

Europe 3.7%	3.7% x 75 =	2.8
Canada 2.1%	2.1% x 25 =	0.1
		2.9%

Net Export (Table 20)	Europe 14.2%	14.2% x 75 =	10.6
	Canada 12.3%	12.3% x 25 =	3.1
			13.7%

The sum of these two rates is multiplied by the previous year's outstanding investment (Column 3) to yield the data in column 5.

1967 after a decline from $2.8 billion the previous year. The decline in 1967 can be attributed, to an extent, to the voluntary program. (It is clear from the model in Table 27 that if capital outflow continues at the same rate as in the middle 1960's the cumulative return will "catch up" only after several years.) However, in the sixth year, total capital inflows already exceeded capital outflows by a considerable amount. These inflows continued to grow at an accelerated rate.

The model in Table 27 relates dividends, net exports, and royalties and fees only to the capital outflow of the given period. However, the additional investment in manufacturing also included other sources of capital. In order to take into consideration inflows which resulted from total investment in manufacturing, a model was constructed on similar lines in Table 28. From this model it is evident that the annual inflow of capital resulting from investment abroad made during the period 1961-68 exceeded substantially the annual outflow in the sixth year. Cumulative inflows exceeded cumulative outflow in the eighth year.

Another method of examining the effect of investment on the balance of payments is the model used in Table 29. The model was constructed to show how many years it would take for investment to repay itself in balance of payments terms when direct investment outflow

TABLE 28

ESTIMATED EFFECT ON THE BALANCE OF PAYMENT OF OUTFLOWS AND INFLOWS RESULTING FROM MANUFACTURING INVESTMENTS IN CANADA AND WESTERN EUROPE, 1961-67[1]
(million of dollars)

Year	Outstanding Direct Investment (1)	Increase during the Year (2)	Cumulative Increment to Outstanding Investment (3)	Annual Capital Outflow[2] [3] (4)	Computed Dividends (5)
1960	8,631				
1961	9,331	700	700	350	
1962	10,195	864	1,564	467	45
1963	11,395	1,200	2,764	515	100
1964	12,785	1,390	4,154	759	177
1965	14,478	1,693	5,847	1,155	266
1966	16,551	2,073	7,920	1,445	374
1967	17,864	1,313	9,233	695	507
1968	19,324	1,460	10,693	561	591

Source: U.S., Department of Commerce, Survey of Current Business, October, 1969, p. 30; Derived from data presented in Tables 16, 23-27.

[1] The table makes use of actual data on capital outflow and the parameter values for manufacturing subsidiaries on rate of return on investment, proportioned of earnings distributed and reinvested, rate of repayments of fees and royalties per dollar of investment and value of net export to subsidiaries computed in Tables 26 and 27. In aggregating the data, the parameter values are weighted in accordance with the value of new capital outflow in manufacturing going to each region over the period of 1961-68. The weights are 75 percent for Europe and 25 percent for Canada.

[2] Reinvested earnings were eliminated from outflows and inflows.

[3] Capital outflow for the years 1965-68 includes funds borrowed abroad, but because no breakdown is available the total outflow is given.

TABLE 28 (Cont)

Year	Computed Royalties Fees and Net Exports (6)	Total Inflow 2 (7)	Cumulative Capital Outflows (8)	Cumulative Inflows (9)	Balance (10)
1960					
1961			350		-350
1962	116	161	817	161	-656
1963	260	361	1,332	522	-810
1964	459	636	2,091	1,158	-933
1965	690	956	3,246	2,114	-1,132
1966	971	1,345	4,691	3,459	-1,232
1967	1,315	1,822	5,386	5,281	-105
1968	1,533	2,124	5,947	7,405	1,458

TABLE 29

ESTIMATED EFFECT OF A FLOW OF $840 DIRECT INVESTMENT IN MANUFACTURING IN EUROPE AND CANADA ON THE BALANCE OF PAYMENTS
(million of dollars)

Year	New Direct Investment (1)	Cumulative Direct Investment End of Year (2)	Net Export Stimulus (3)	Royalties and Fees (4)	Remitted Earnings (5)	Balance of Payments: Annual Net Effect (6)	Balance of Payments: Cumulative Effect (7)
1	840	840	--	--	--	-840	-840
2	840	1,722	115	24	53	-648	-1,488
3	840	2,648	237	50	110	-443	-1,931
4	840	3,620	363	77	169	-231	-2,162
5	840	4,621	496	105	232	-7	-2,169
6	840	5,692	633	134	296	223	-1,939
7	840	6,817	778	165	364	467	-1,472
8	840	7,997	937	198	436	731	-741
9	840	9,237	1,096	235	512	1,003	262
10	840	10,539	1,266	268	589	1,383	1,645
11	840	11,900	1,444	306	674	1,584	3,229
12	840	13,341	1,631	345	761	1,897	5,126

Source: Tables 22-27.

Notes: Column 2: Computed by adding retained earnings (5 percent of cumulative investment in preceding year) to total investment in the preceding year and the new outflow of investment.
Column 3: 13.7 percent of cumulative investment in the preceding year.
Column 4: 2.9 percent of cumulative investment in the preceding year.
Column 5: 6.4 percent of cumulative investment in the preceding year.
Column 6: Column3 plus 4 plus 5 minus column 1.

accumulates each year by an additional $840 million plus the amount of reinvested earnings. All the parameters were derived from Tables 22 through 27. (The main difference between this model and the one presented in Table 27 is the assumption that capital outflow would continue at the same level as the 1962-67 average and how it would affect the balance of payments in the future.)

In the first year there was only capital outflow, and the effect on the balance of payments was completely negative. It remained negative until the end of the fifth year, even when all new exports, royalties and fees, and remitted earnings of such investments were considered. The cumulative impact on the balance of payments remained negative until the end of the eighth year. The explanation for this is that the European countries and Canada accumulate liquid dollar claims against the United States until the end of the fifth year. After five years the annual inflow exceeds the annual outflow, and by the end of the ninth year the cumulative impact on the U.S. balance of payments becomes positive. Thereafter, returns continue at an increasing rate. The main conclusion which may be drawn from this model is that the effects of direct investment in manufacturing on the balance of payments are negative in the short run and, at an increasing rate, are positive in the long run.

Besides the problem of measuring indirect effects of investment abroad, the models shown in Tables 27 and 29 also present an additional difficulty--that capital inflows are computed as parameters of the part of direct investment abroad which consists only of capital outflow and reinvested earnings but the earnings returned to the United States which are related to investment of funds borrowed outside of the U.S. are completely disregarded.

Another method of measuring the impact of direct investment abroad on the balance of payments would be to relate inflow of repatriated earnings and reinvested earnings which resulted from an increase in total investment abroad to capital outflows from the United States. The book value of direct investment abroad increased by $24.6 billion between the beginning of 1962 and the end of 1967, but only slightly less than two-thirds of it was as a result of capital outflow from the United States (Table 32). Furthermore, an increasing part of the capital outflow from the United States includes funds borrowed abroad, but in the balance of payments accounts they appear as foreign assets in the United States and as capital outflow.

> With the advent of the Voluntary Program in 1965, the United States incorporated companies with affiliates operating abroad began borrowing funds in foreign capital markets and using the proceeds of such borrowings to finance investment in their

> affiliates. Initially, borrowing abroad by the U.S. company is a balance of payments inflow, and the liability to the foreign lender is reflected as a foreign asset in the United States. When foreign-borrowed funds are transferred to a foreign affiliate, they are included in direct investment capital outflows, i.e., are reported with funds sent directly from the United States.[1]

Taking into consideration reinvested earnings, as inflow and outflow, and the funds borrowed abroad, it is evident that actual capital outflow from the United States for investment abroad is only about 65 percent of the increase in value of total investment. When these adjustments were incorporated into the model presented in Table 26, all recoupment periods were cut by approximately one-third. The recoupment period of U.S. manufacturing investment in Europe was eight years, and for the world as a whole it was about 8.3 years. For total investment abroad the recoupment period in Europe was 9.5 years and for the world as a whole, about 7.5 years.

The models in Tables 30 and 31 are constructed in such a way as to measure the resultant effect on the balance of payments from manufacturing investment in Canada and Europe, taking into account most of the indirect effects which were omitted from all previous models. The models take into consideration not only the increase in direct investment resulting from U.S.

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[1]Emil L. Nelson and Frederick Cutler, "The International Investment Position of the United States in 1967," Survey of Current Business (Washington, D.C.: Department of Commerce, October 1968), p. 22.

U.S. capital outflow, but also the actual amounts of reinvested earnings and borrowing abroad used in direct investment during the period 1962-67. In addition, two estimates have been made of the amount of capital goods exported from the U.S. to subsidiaries abroad as the result of the additional investment and the amount by which U.S. exports have been displaced by the sales of subsidiaries in the producing, or third countries. There are many difficulties inherent in an attempt to build a model which takes into account direct and indirect effects of direct investment abroad on the balance of payments. The available data published by the Department of Commerce lack much of the information needed to measure the direct effects and do not include the figures needed to measure the indirect effects. Data on borrowing abroad used for direct investment have been available only since 1965, and only for total investment in all industries. Therefore, an estimate has been made of the amount of borrowing used for manufacturing investment in Europe and Canada. There is no way to measure empirically the amount of export displaced as the result of direct investment abroad, but it is agreed that such displacement occurs, at least in the short-run. However, most businessmen will argue this point using the justification that investment in Europe is the result of export displacement. The high tariff wall imposed by

the Common Market and other regional agreements have made it necessary for American companies to invest in these countries in order to keep part of the growing markets. Nevertheless, two estimates have been made in an attempt to measure such displacement; one is that it amounts to 3 percent of subsidiaries sales; and the other is for 6 percent of such sales. One more estimate had to be made in order to measure the amount of initial capital goods exported from the U.S. when an American company invests in a plant abroad. As discussed earlier (page 143) the amount most often agreed upon by economists, businessmen and government officials is about 30-35 percent of the increase in investment. However, the amount for investment in manufacturing, especially in Europe, is lower. In the following tables two estimates have been made; one is 20 percent of the increase in investment and the second is for 6 percent of the increase in expenditures on plant and equipment.[1] Six percent of the increase in expenditures has been chosen because it is the figure computed by a Treasury Department

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[1]The annual increase in U.S. direct investment abroad is the net change in the value of investment from one year to the previous one. However, there is a certain amount of depreciation each year which is reinvested. Expenditures on plant and equipment include the direct investment capital outflow from the U.S., reinvested earnings, borrowing abroad used for direct investment, and the corporation's internally generated overseas depreciation reserves.

sponsored study.[1] Another indirect effect on the balance of payments is the amount borrowed abroad by U.S. corporations to be used for direct investment. Such borrowing may tend to reduce purchases of other U.S. securities, such as stocks, Government bonds, etc. There is no possible way to measure such activity nor would the amount involved be significant enough to change the result of the models presented in Tables 30 and 31.

The average annual increase in direct investment abroad was $1422 million during the period 1962-67. To finance this investment U.S. companies used $742 million capital outflow from the U.S., $578 million of reinvested earnings and $109 million in borrowing abroad. When considering all related direct and indirect effects on the balance of payments the recoupment periods in relation to outflow of capital from the U.S. is between 3.4 and 5.4 years (Table 30). The two year spread in the recoupment period is due to the two different estimates made on capital goods exports and export displacement, the lower limit being when capital goods export is the higher and exports displacement is low, and the upper limit being when they are reversed.

In Table 31 an attempt was made to measure the cumulative effects of the factors presented in the data

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[1]Adler and Hufbauer, Overseas Manufacturing Investment and the Balance of Payments.

TABLE 30

ESTIMATED EFFECT ON THE BALANCE OF PAYMENTS OF OUTFLOWS AND INFLOWS
(CONSIDERING REINVESTED EARNINGS AS OUTFLOWS AND INFLOWS)
RESULTING FROM MANUFACTURING INVESTMENT IN
CANADA AND EUROPE, 1962-67
(millions of dollars)

Year	Annual Increase in Investment	Annual Capital Outflow		Borrowing Abroad Used in Direct Investment	Capital Goods Exports Resulting From New Direct Investment		Net Outflow	
		Outflow From the U.S.	Reinvested Earnings					
	(1)	(2)	(3)	(4)	(5)		(6)	
					A	B	A	B
1962	864	465	400	--	90	172	774	692
1963	1200	515	639	46	99	240	1055	914
1964	1390	579	616	195	126	268	1069	927
1965	1693	1100	577	40	168	338	1485	1315
1966	2073	1200	640	233	204	414	1636	1426
1967	1313	575	595	143	198	262	972	908
Annual Average for period	1422	742	578	109	147	282	1165	1028

Year	Induced Exports	Induced Imports	Displaced Exports		Total Income Return	Royalties and Fees	Net Inflow	
	(7)	(8)	(9)		(10)	(11)	(12)	
			A	B			A	B
1962	170	59	64	128	99	25	171	117
1963	235	85	73	146	137	35	249	176
1964	272	95	84	168	158	40	291	207
1965	332	115	90	180	193	48	368	278
1966	406	141	99	198	236	60	462	363
1967	257	89	107	214	150	38	249	142
Annual Average for Period	279	97	86	172	162	41	299	214

Sources: Table 30

Column 1: Table 23.
Column 2: Table 23.
Column 3: Table 23.
Column 4: U.S. Department of Commerce, Survey of Current Business, September 1968, pp. 22-44, and estimate.

Notes:

Column 5: A. Computed as 6 percent of the expenditures on plant and equipment each year.
B. Computed as 20 percent of increase in new investment each year.

Column 6: A. Columns 2 plus 3 minus 5A.
B. Columns 2 plus 3 minus 5B.

Column 7: 19.5 percent of investment during year. (Computed from Table 20)

Exports (not including capital export)

Europe	16.3%	16.3% x 75 =	12.2
Canada	29.4%	29.4% x 25 =	7.3
			19.5%

Column 8: 6.8 percent of investment during year. (Computed from Table 20)

Imports

Europe	3.1%	3.1% x 75 =	2.3
Canada	17.9%	17.9% x 25 =	4.5
			6.8%

Column 9: A. 3 percent of subsidiaries sales during year.
B. 6 percent of subsidiaries sales during year.

Column 10: 11.4 percent of investment during year includes 6.4 percent of repatriated earnings and 5 percent of reinvested earnings. (Parameter computed in Table 27)

Column 11: 2.9 percent of investment during year. (Parameter computed in Table 27)

Column 12: A. Columns 7 plus 10 plus 11 minus 8 minus 9A.
B. Columns 7 plus 10 plus 11 minus 8 minus 9B.

Recoupment period in years. (Net outflow divided by net inflow)

A. $\frac{1,028}{299} = 3.4$

B. $\frac{1,028}{214} = 4.8$

C. $\frac{1,165}{299} = 3.9$

D. $\frac{1,165}{214} = 5.4$

TABLE 31

ESTIMATED EFFECT ON THE BALANCE OF PAYMENTS OF A FLOW OF $1313 DIRECT INVESTMENT IN MANUFACTURING IN EUROPE AND CANADA[1]
(millions of dollars)

Year	Annual Increase in Direct Investment	Cumulative Direct Investment at End of Year	Borrowing Abroad Used for Direct Investment	Cumulative Borrowing Abroad	Annual Increase in Investment From U.S. Outflows	Cumulative Outflow From the U.S.	Induced Imports
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1	1,422	1,422	109	109	1,313	1,313	--
2	1,422	2,844	109	218	1,313	2,626	97
3	1,422	4,266	109	327	1,313	3,939	194
4	1,422	5,688	109	436	1,313	5,252	291
5	1,422	7,110	109	545	1,313	6,565	398
6	1,422	8,532	109	654	1,313	7,878	495
7	1,422	9,954	109	763	1,313	9,191	592

Year	Estimated Displaced Exports (8)		Estimated Capital Goods Exports Resulted From New Investment (9)		Induced Exports (10)	Income Investment (11)	Royalties and Fees (12)
	A	B	A	B			
1	--	--	147	282	--	--	--
2	86	172	294	564	279	162	41
3	172	344	441	846	558	324	82
4	258	516	588	1,128	837	486	123
5	344	688	735	1,410	1,116	648	164
6	430	860	882	1,692	1,395	810	205
7	516	1,032	1,029	1,974	1,674	972	245

Source: Table 30.

Notes: [1]See footnote to Table 30, all data and computed parameters are the same as in Table 30. However, the data presented in this table is the annual average for the period.

(Notes continued)

TABLE 31 (Cont)

Year	Annual Net Effect[2] (13)				Cumulative Net Effect (14)			
	A (A-A)	B (A-B)	C (B-A)	D (B-B)	A (A-A)	B (A-B)	C (B-A)	D (B-B)
1	-1,166	-1,031	-1,166	-1,031	-1,166	-1,031	1,166	-1,031
2	- 720	- 450	- 806	- 536	-1,886	-1,481	-1,972	-1,567
3	- 274	131	- 446	- 41	-2,160	-1,350	-2,418	-1,608
4	172	709	- 86	451	-1,988	- 641	-2,504	-1,157
5	608	1,288	264	939	-1,380	579	-2,240	- 218
6	1,054	1,864	624	1,434	- 326	2,443	-1,616	1,216
7	1,501	2,346	985	1,830	1,115	4,789	- 631	3,046

Notes: continuation - Table 31

[2]Column 13:

A. Columns 4 plus 7 plus 8A minus 9A minus 10 minus 11 minus 12.

B. Columns 4 plus 7 plus 8A minus 9B minus 10 minus 11 minus 12.

C. Columns 4 plus 7 plus 8B minus 9A minus 10 minus 11 minus 12.

D. Columns 4 plus 7 plus 8B minus 9B minus 10 minus 11 minus 12.

in Table 30. During the first year the only factor to offset part of the capital outflow was the exported goods resulting from new investment; all other effects started the second year. The recoupment period in this table in one extreme (14B) is the middle of the fifty year when cumulative flows become positive. In the other extreme (14C) the recoupment period would not be until the middle of the eighth year. In the other two cases the recoupment period would be about 6.5 years.

From the discussion and the models contained in this section it is possible to estimate that the recoupment period for investment abroad in balance of payments terms is between 5 and 7 years. When only outflow of capital from the United States and reinvested earnings are compared to the inflow of repatriated earnings the period of recoupment is between 8 and 10 years. However, when other direct effects of investment abroad such as exports, imports, and royalties and fees are taken into consideration the recoupment period is shortened substantially--to approximately seven years. Furthermore, when indirect effects of investment abroad are also taken into consideration, the recoupment period is further shortened to 5 to 6 years. It should be remembered that these figures are based essentially on data for manufacturing in the developed countries. Nevertheless, in at least two examples the recoupment period was related

to total investment in all areas, making the recoupment period appear to be slightly shorter. Of course, one can find examples of specific industries in specific areas where the recoupment period is either longer or shorter.

There are additional factors which cannot be quantified or measured and which in the aforementioned models prolonged the recoupment period, but their adverse effects on the balance of payments would exist or even be greater if no direct investment abroad were made. Investment in public utilities and trade do not replace any exports from the United States; on the contrary, such investment encourages export of capital goods in the case of utilities and develops new markets in the case of trade. However, the voluntary program asked for restraint on all investments without giving special consideration to these industries. Furthermore, curtailing investment in distributive and utility industries abroad can cause not only the loss of additional exports but possibly can lose existing markets for exports as well.

Investment in raw materials all over the world is necessary in order to supply the domestic economy with this vital requirement. The importation of raw materials would continue whether or not American companies invested abroad in the extractive industries. However,

even though the importation of raw materials would continue if American companies did not invest or if they curtailed investment to a large degree, the United States would forego part of the exports to build plants as well as the income generated by such investment.

All of the models presented are based on the incremental approach (discussed on pp. 98-100), to the extent that the organic (rather than the incremental) concept is correct, the net inflow of Tables 27-31 would be increased by the amount of annual earnings on past investment which would have been lost had the current new investment not been made. This would reduce the time it takes for the cumulative flows to become positive.

Foreign Borrowing and Direct Investment

The voluntary program of capital restraing was aimed at reducing the adverse impact of foreign direct investment on the U.S. balance of payments, not to curtail or reduce foreign investment. Actually it was designed to shift the financing of investment abroad. The restraints on capital outflows were limited mainly to Europe and a few developed countries where liquid liabilities were accumulating as the result of the balance of payments deficits.

The book value of direct investment at the end

of 1967 was $59.3 billion--70 percent more than the amount at the beginning of 1962 (Table 32). Over 40 percent of this total was investment in manufacturing, which was the fastest growing area of investment and which accounted for almost 50 percent of the total growth in direct investment abroad.

Although the restraints on capital outflows were aimed primarily at the developed countries, expenditures on foreign plants and equipment increased greatly between 1964 and 1967; and this occurred mostly in the developed countries. In addition, American companies expanded through the acquisition of existing foreign companies, with the price paid for such acquisitions averaging $0.5 billion per year during those three years. Total annual expenditures on plants and equipment increased from $6.2 billion in 1964 to $9.2 billion in 1967 (Table 33). However, at the same time foreign direct investment outflow from the United States declined from $3.5 billion in 1965 to $3 billion in 1967 (Table 11). This was made possible because U.S. companies turned increasingly to foreign financial markets to finance thier investment. During the years 1965-67, about $1.2 billion in long-term funds was borrowed abroad for direct investment by the U.S. companies which participated in the voluntary program. In addition, approximately $2 billion also was borrowed by affiliates of the participating

TABLE 32

BOOK VALUE OF DIRECT INVESTMENT ABROAD, 1962-67
AND CAPITAL OUTFLOW
(million of dollars)

	All Areas	Canada	Europe
Book value			
Beginning of 1962	34,667	11,179	7,742
End of 1967	59,267	18,069	17,882
Change 1962-67	24,600	6,890	10,140
Capital outflow	16,069	3,456	7,929
Retained earnings and other	8,531	3,434	2,211

Source: U.S., Department of Commerce, Survey of Current Business, October, 1968, p. 26.

TABLE 33

PLANT AND EQUIPMENT EXPENDITURES BY FOREIGN AFFILIATES OF U.S. CORPORATION BY AREA 1964-67

	1964	1965	1966	1967
All areas, total	6.2	7.4	8.6	9.2
Manufacturing	3.0	3.9	4.6	4.5
Other	3.2	3.5	4.0	4.7
Canada	1.6	1.8	2.4	2.2
Manufacturing	0.8	0.9	1.2	1.0
Other	0.8	0.9	1.2	1.2
Europe	2.2	2.6	3.3	3.6
Manufacturing	1.3	1.9	2.2	2.3
Other	0.9	0.7	1.1	1.3
Other areas	2.4	3.0	3.0	3.4
Manufacturing	0.9	1.1	1.2	1.2
Other	1.5	1.9	1.8	2.2

Source: U.S., Department of Commerce, Survey of Current Business, March 1969, p. 14; October 1967, p. 17.

companies. Other additional funds were derived from the rising depreciation of the foreign affiliates. U.S. capital outflow financed only 40 percent of the total expenditures on plants and equipment.[1] Thus, borrowing abroad was the main reason that the U.S. companies which participated in the voluntary program were below the target ceilings (although the ceilings were gradually lowered).

With respect to encouraging companies to borrow abroad in order to reduce outflows from the United States, the voluntary program was quite successful, and its impact on the balance of payments in the short run was positive. However, the economic cost to the companies involved in the program, the long-run impact on the balance of payments, and the effect of the borrowing on foreign capital markets remain to be seen.

During the years 1965-68, interest rates in Europe were higher than those in the United States--a fact that increased the cost of operating in Eruope. Furthermore, many European investors who held U.S. Government or private securities sold them in the United States and bought new securities in Europe in order to

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[1]Statement of Charles E. Fiero, Director of the Office of Foreign Direct Investment, U.S. Department of Commerce, concerning a Review of Balance of Payment Policies at the Hearings before the Subcommittee on International Exchange and Payments, Joint Economic Committee, 91st Cong., 1st sess., January 1969, p. 142.

benefit from the higher interest rates; to the amount that such substitution took place, it is an offset to the gain of borrowing abroad. The accelerated growth of American firms which borrowed in Europe caused a further increase in interest rates, making it more expensive for the local businessman to borrow for their own needs. The increasing interest rates made it almost impossible for the developing countries to borrow in Europe or in the United States.

The most important point is that substituting borrowed money for direct outflow does not save foreign exchange in the long run; furthermore, the favorable impact on the balance of payments of borrowing abroad is only short term. Companies that borrow abroad must pay interest which would reduce direct investment income inflow to the United States by the end of the first year. Repayment of the indebtedness on maturity would increase capital outflow in the future. It has been assumed by the Government that the current temporary gains in the balance of payments would provide more time for working out fundamental improvements in the payments balance and that in the future it would be strong enough to repay the additional burdens. However, for each additional year that the voluntary restraints (or later mandatory controls) have been in existence, the debt to foreigners has increased, and it grows more difficult

to eliminate those restraints because of a fear of large outflows to pay the outstanding debt.

Alternative Possibilities to Voluntary or Direct Controls

Devaluation of the Dollar

Devaluation of the dollar or increasing the price of gold has been discussed in the 1960's as one possible solution to the world liquidity problem and the U.S. payments deficit. The reason given for such a move in order to improve the U.S. payments position has been that other countries would not necessarily follow the full amount of devaluation; thus, the competitive position of the United States would be improved.

A higher rate of inflation in the United States (compared to that in Europe during the period 1965-68), decline in balance of trade surpluses, increase in U.S. short-term liabilities, and lower gold reserves were the main reasons given in favor of devaluation. Under the Articles of Agreement of the International Monetary Fund the United States may devalue unilaterally up to 10 percent; however, such a move probably would be ineffective since other countries would follow suit, and the problem of would liquidity would not be solved for more than a few years. Any larger increase in the price of gold (devaluation) would be contrary to the U.S. international

agreement and surely would lead other countries to devalue their currencies--an event which would benefit mainly the gold-producing countries of Russia and South Africa. In addition, such action would almost certainly rule out the dollar as a key currency in future international arrangements. The countries which trusted in the United States and kept a large portion of their reserves in the form of dollars would be the main losers, and countries and individuals who hoarded gold in anticipation of a rise in price would be the main beneficiaries. More important is the fact that such action would only postpone the crisis for a few years because the supply of gold is not flexible and does not meet the increase in demand for liquidity as world trade increases. Thus, it would only increase gold speculation in expectation of a repeated action in the future.

Devaluation usually is carried out when a country's balance of trade is in disequilibrium. However, the U.S. deficit problem stems basically from the transfer and capital accounts, not from the current account. In 1964 and 1965 when the U.S. surplus on the merchandise account was very high (the highest since 1947), the deficit in the balance of payments was more than $2.5 billion each year. In 1968 the U.S. merchandise trade balance shrank to the lowest point since World War II, but the balance of payments, measured in the "liquidity" basis

or the "official reserve transaction," showed a surplus. The elimination of the trade surplus was caused by a surge of imports resulting from a rapid increase in private and governmental demands due to the war in Vietnam. Therefore, even if devaluation were possible, because of the large demand at home and strong pressures on existing resources, it is not a certainty that devaluation would solve the payments deficit problem.

For the U.S. balance of payments to gain from devaluation, the prices of exports in U.S. dollars would have to remain stable in relation to those of other countries and exports would have to increase by at least the same percentage as the devaluation. Concurrently, imports would have to decline because of the higher prices (in U.S. dollars) of imported goods. However, since the middle of 1965, the U.S. economy has operated at relatively full capacity, and devaluation during this period would only have added to inflationary pressure on the economy.

The effect of devaluation on American companies operating in the United States and abroad would be mixed, favorable, and unfavorable. However, unfavorable effects would outweigh the favorable effects. If the United States were the only nation to devalue (which would be unlikely), the cost of investment abroad would rise at least proportionately to the percentage of devaluation. A given amount of export from the U.S. by companies with

foreign affiliates would earn less in foreign exchange, and the prices in U.S. dollars for imported raw materials (which is the majority of the exports of the foreign affiliates) would increase. The favorable effect would be that exports from the United States would be more competitive, and earnings of these companies, from their investment abroad, would be exchanged for more dollars. In the case that other countries were to follow the example of the United States and competitive devaluation developed, no country (except the major gold producers) would gain, and it is likely that most countries would impose restrictions on trade and investment. In such an event, the effect of devaluation would be very unfavorable for American companies with investment abroad or for that matter to all American companies with international trade relations.

Settling the War in Vietnam

As a result of the continuing build-up of military expenditures in Vietnam and declining surpluses in the balance of trade (for which the war has been partially responsible) the deficit in the balance of payments continued to grow despite the restrictions of the voluntary program on capital outflows during the years 1965-67. The surpluses in the balance of trade were not large enough to cover the continuation of reduced foreign aid,

military expenditures in Europe, lower outflows of capital, travel, and most important, the increasing foreign exchange costs of the war in Vietnam.

The Department of Defense estimates that defense expenditures entering the balance of payments accounts as a result of the war in Vietnam have averaged about $1.5 billion annually for the major Asian countries since the beginning of 1965 (Table 34).

TABLE 34

U.S. DEFENSE EXPENDITURES ENTERING THE INTERNATIONAL BALANCE OF PAYMENTS BY MAJOR AREAS, FISCAL YEARS 1964-68 (billion of dollars)

Fiscal Year	Western Europe	Major Asian Countries	Canada	Others	Worldwide
1964	1.5	0.7	0.3	0.4	2.9
1965	1.4	0.8	0.2	0.4	2.8
1966	1.5	1.3	0.2	0.4	3.4
1967	1.6	1.9	0.2	0.5	4.2
1968	1.6	2.1	0.3	0.5	4.5

Source: Statement of Hon. Robert C. Moot, Assistant Secretary of Defense, at the Hearings before the Subcommittee on International Exchange and Payment, Joint Economic Committee, 91st Cong., 1st sess., January 1969, p. 108.

The aforementioned $1.5 billion figure includes estimated expenditures made outside Vietnam but related to the conflict

there; however, it does not include indirect foreign exchange costs such as increased imports in order to supply the increasing need for military goods.

In a study prepared by economists, Leonard Dudley and Peter Passel, it was concluded that the real foreign exchange cost of the war has been between $3.6 and $4 billion annually since the beginning of 1965.[1] In the Hearings before the Subcommittee on International Exchange and Payments in January of 1969, Mr. Passel agreed, more or less, with the direct costs given by the Department of Defense, but he argued that if the secondary and indirect effects were taken into consideration, the impact on the balance of payments would have been much higher.

Two important effects which should be taken into consideration are the following:

1. Greater purchases of foreign goods to be used as inputs in U.S. defense production.
2. Deterioration in the U.S. net exports, due to both war stimulated inflation and to supply bottlenecks in those sectors of production most affected by the increased

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[1]Leonard Dudley and Peter Passel, "The War in Viet-Nam and the U.S. Balance of Payments," The Review of Economics and Statistics, November 1968 (Cambridge, Massachusetts: Harvard University Press, 1968).

spending.[1]

The large increase in imports since 1964 is partially due to higher imports of raw materials and intermediate goods by private industry for use in the production of military supplies. It is quite difficult to calculate the share of imports for military purposes that go to aid the war in Vietnam, but in the study discussed, the estimate (based on input-output relationship) was about $1.1 billion annually (Table 35). Other indirect factors are the diversion of some production from export to military use, inflationary pressures, and manpower shortages which caused price increases and deterioration in price competitiveness of U.S. exports. The impact of these factors is estimated to be about $1.3 billion annually (Table 35).

TABLE 35

TOTAL CURRENT ACCOUNT IMPACT OF THE WAR IN VIETNAM, 1965-67
(billion U.S. dollars)

Component of Deficit	Alternative Estimate	Best Estimate
Direct foreign expenditures	1.6	1.6
War material import content	0.6	1.1
Indirect impact on trade position	1.4	1.3
Total	3.6	4.0

Source: Statement of Peter Passel, Hearings before the Subcommittee on International Exchange and Payments, Joint Economic Committee, 91st Cong., 1st sess., January 1969, p. 114.

[1]U.S. Congress, A Review of Balance of Payment Policies, Hearings before the Subcommittee on International Exchange and Payments, Joint Economic Committee, 91st Cong., 1st sess., January 1969, p. 110.

From the foregoing analysis one can conclude that the decline in the U.S. balance of trade surplus is, to a large extent, a result of the war in Vietnam. It affects the balance from two directions: Increase in imports and decline in exports from the amounts they could be if the war were not in progress.

The Department of Defense disputes the accuracy of the figures and the basic assumptions presented, maintaining that there is no way to estimate the indirect cost of the war. However, whether or not the estimates of indirect foreign exchange costs of the war are accurate, all exports, including those of the Defense Department, agree that they exist and that the total impact of the war on the balance of payments is higher than the direct cost of $1.5 billion. There are some offsetting inflows of foreign exchange which occur as the result of defense expenditures and the existence of the "feedback" effect. In some cases they may run as high as 40 percent of total expenditures. Assistant Secretary of Defense, Robert C. Moot, agrees that the direct and indirect foreign exchange cost of the war is between $2 billion and $3 billion annually.[1]

Even if the lower figure of about $2.5 billion is the adverse impact on the balance of payments, it is still

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[1] Ibid., p. 127.

higher than the average balance of payments deficit since 1964. However, settling the war in Vietnam would not automatically solve the payments problem of the United States: the adjustment would take several years and would be gradual. The initial impact of the voluntary program on the balance of payments was positive and helped to keep the deficits smaller than they would have been otherwise. In addition, the United States had a persistent deficit on its international accounts long before the added foreign exchange cost of the war in Vietnam. Nevertheless, the end of this conflict would be the largest single contribution to improving the balance of payments position, and it could be to such a magnitude that voluntary or mandatory controls of direct investment abroad would no longer be necessary.

Monetary and Fiscal Policies

Economic and social costs are always involved when using monetary and fiscal policies, thus raising the problem of determining to what extent they should be used. When such measures can be used harmoniously for domestic and balance of payments economic goals, no problem arises, but when the steps that must be taken are not compatible with all goals, the domestic priorities of economic growth and full employment must come first.

The monetary and fiscal actions that can be taken

in the United States are limited and are not flexible because of the institutional arrangements. Until policy makers recognize a problem and decide what measures to take, long periods of time elapse. They then must convince the Congress (as in the case of imposing the surcharge tax) that such measures are necessary; often, if the measures are finally imposed it is too late for them to be effective. Monetary policies which are easier to apply also depend on many factors which create a real problem for the Federal Reserve. First, there is a lag between the time the action is taken and its effect on the economy. Therefore, all action must be dependent on the right forecast of economic development and, in addition, should be coordinated with fiscal actions. Otherwise the effects of monetary actions on the economy may be somewhat harmful--as was the case in 1968 when the erroneous official forecast of economic developments, based partially on exaggerated estimates of the impact of the fiscal program (tax surcharge and budget restraint), lead to an excessive rate of credit expansion, inflationary pressure, and indirectly to deterioration in the balance of trade. Second, the control of the Federal Reserve on the credit flow is partially limited. About 35 percent of total credit flow in the United States is through nonfinancial institutions such as insurance companies and pension funds which are not under the control of the

Federal Reserve. Therefore, any policy decision must take into account the fact that the credit flow cannot be controlled. And last, most of the monetary actions taken would affect the economy on the aggregate, but there are some sectors, such as construction, which would be affected most at times when it was intended that they should be affected the least.

From the above discussion it is clear that using fiscal and monetary policies for domestic goals is quite limited and difficult. It would be unwise for a nation such as the United States, where foreign trade is only about 3 percent of gross national product, to pursue for balance of payments purposes monetary and fiscal policies which are not in line with domestic needs and goals. In 1964 and 1965 the country's balance of payments was in deficit and the voluntary program was introduced. During most of this period the rate of unemployment was high (around 5 percent), prices were relatively stable, and there was unused productive capacity. With such conditions, to follow a policy of monetary and fiscal restraints would have been disastrous for the domestic economy even though it may have been desirable for balance of payments purposes. For the period since mid-1965, the unemployment rate declined, prices advanced more rapidly, and pressure on resources became considerable. The source for these developments was the Government's

stimulative budget due to the soaring military expenditures resulting from the war in Vietnam. During this period the appropriate fiscal and monetary policies for domestic and external purposes coincided, but because of the indecisiveness of Congress to act promptly and the fear of the Federal Reserve of "over-kill" actions, the policies applied were late and were not strong enough. The effects of these combined policies lead to inflationary pressures in the economy and a rapid deterioration in the merchandise trade balance.

For the U.S. Government to pursue monetary and fiscal policies merely for balance of payments purposes as an alternative to voluntary controls is unthinkable. There would be times as in 1966-68 when these policies could serve both the balance of payments and domestic economic goals, but at other times when these goals are not compatible, to sacrifice the goals of the domestic economy for the problematic 3 percent in external trade would be rather foolish. For the U.S. companies that invest abroad such a policy would be more harmful than the voluntary controls. For most of the companies investment abroad is only a share of domestic investment, and a deflated economy at home would create more hardship and loss of earnings than the additional costs and difficulties resulting from the voluntary program. Besides, a restrained monetary policy at home would cause an increase

in domestic and foreign interest rates which would mean higher costs of borrowing and production.

Monetary and fiscal policies and their proper combination in order to attain economic domestic goals will continue in the future. However, with the current international monetary system of fixed exchange rates and full convertibility, the problem of whether or not to employ monetary and fiscal policies because of the balance of payment problems would depend on the relative importance which U.S. authorities give to the balance of payments in comparison with domestic economic problems.

Changing the International Monetary System

The current system of fixed exchange rates, in existence since 1945, has contributed greatly to the increase in international trade, travel, and capital flows. This system worked well in the past and served a useful purpose, but the continuation of U.S. and British balance of payments deficits and repeated international monetary crises in the past few years suggests that some fundamental adjustments are necessary. The combination of fixed exchange rates, free convertibility, and imperfect harmonization of the national economic policies of the member countries cannot work well.[1]

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[1]George Hlam, Toward Limited Exchange-Rate Flexibility, Essays in International Finance, No. 73, March 1969 (Princeton, New Jersey: Princeton University Press, 1969).

As the number of voluntary and mandatory controls on trade and capital movements increase, the advantages of fixed exchange rates in encouraging such movements are lost, and the need for a change in the existing system becomes apparent.

The problem of a gradual increase in the supply of international liquidity, as needs arise, has been solved by activation of the SDR's; but in order to eliminate the growing number of trade and capital movement controls and to bring the balance of payments of the different countries into equilibrium a reformed international monetary system is needed.

The way in which the various suggested new or revised monetary systems would work and the pros and cons of such systems were discussed in Chapter III.

The system which may be accepted by most international economists, bankers, government officials, and others is the limited flexible exchange system. Most U.S. economic professors as well as the Joint Economic Committee of the Congress favor a "wider band" plan in which the margins around par value would be greater than the existing margins.[1]

The Economist of London also reached the conclusion

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[1]Fritz Machlup, The Transfer Gap of the United States, Reprints in International Finance, No. II, October 1968 (Princeton, N.J.: Princeton University Press, 1968), p. 238.

that the only solution to balance of payments crises of nations would be the adoption of a flexible exchange system or at least a limited flexible system such as the "wider band" or "crawling peg." The Economist attributes most of England's domestic economic troubles to the current fixed exchange system and advocates a more flexible system which would put greater harmony between domestic and balance of payments policies.

> Britain is one of several countries which have constantly had to try to check their expansion at precisely the wrong economic moments, because of balances of payments worries which the fixed exchange rate system has ruled can be tackled only by attempts at internal squeeze. Often such internal squeezes have not worked, and have left the economy still bloated with overdemand and still in balance of payments deficit. . . . The proper international financial framework would be one which permitted all countries to make their own choice about the degree of utilization of internal resources they wished to aim for solely by reference to other internal factors. . . . But, if an entirely sensible system is regarded as politically impossible, by all means let the world turn to one of the second best systems . . . such as the devices for so-called "crawling pegs" or "wider margins."[1]

The United States should have used more fiscal and monetary actions in the past few years in order to

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U.S., Congress, Next Steps in International Monetary Reform, Report of the Subcommittee on International Exchange and Payments, Joint Economic Committee, 90th Cong., 2nd sess., 1968, p. 7.

A. F. W. Plumptre, Flexible Parities, the Case for Smoother Exchange Rate Adjustment, paper presented to Economic Seminar in Washington, D.C., November 13, 1968.

[1]The Economist, March 15, 1969, p. 20.

stop the increasing rate of inflation and deterioration in the competitiveness of American exports. However, because of the institutional set-up of the country and the need for congressional approval for many such actions, these measures came too late and were not strong enough. In addition, the business community, the strength of labor unions, and social unrest prevented the Government from applying many necessary policy measures. Under a system of more flexible exchange rates such domestic considerations would not have as much effect on the balance of payments position, and the Government would be able to act more freely to achieve its domestic goals.

Of course, a more flexible exchange rate system such as "wider band" or "crawling peg" would not solve the inflation problem of any one country, but neither can the current system.

None of the balance of payment policy actions taken by the U.S. Government under the current fixed rate system between 1965 and 1968 worked well (the voluntary restraint program was successful in the sense that all ceilings were observed and capital outflow was kept at a lower level than it would have been with the program, but the balance of payment deficit was not eliminated). The size of the deficit increased each year, occasioning the introduction of more and more voluntary and mandatory controls. The primary aim of the governmental

policy was to increase the surplus in the balance of trade; however, the position of this surplus deteriorated each year until recently when it almost vanished. The war in Vietnam and congressional reluctance to approve fiscal measures are partly to blame, but these factors were foreseeable when this policy was formulated. For the United States to continue its domestic social programs, to continue engagement in the war in Vietnam, and to stop inflation would be impossible. However, adopting a new system of limited flexible exchange rates would help to relieve the additional pressures exerted by the adverse balance of payments position.

The effect of a more flexible international monetary system on American companies investing abroad as compared with the existing voluntary or mandatory controls would be quite favorable. The added costs involved because of the risk factor due to the fluctuating and less predictable exchange rate would be offset by a partial removal of trade barriers, tariffs, and border taxes which are currently imposed because of balance of payments considerations.

The need to invest abroad because of current trade barriers would not be so great, and exports from the United States by these companies would keep their share of the foreign market. The allocation of funds to be invested abroad would be dependent upon market

forces and not on an arbitrary decision of government bureaucrats which is based on an arbitrary past year and which is usually discriminatory against new companies that intend to invest abroad, regardless of the profitability of the new investment.

The introduction of wider band or sliding parities would enable the Government to eliminate all controls imposed on direct investment outflows and movement of goods, and plans such as voluntary restrictions would not be necessary.

In order to devise a new and more flexible international monetary system which would not be a radical change from the current system, the following plan is recommended. The new system would continue to have a par value with wider bands, and freely fluctuating rates would be within the limits of the bands. The Federal Reserve and the Central Bank would be required to enter the market when the exchange rates reached the outer limits. Such a system would still require the holding of foreign reserves, but to a lesser amount. In order to provide international liquidity when needed, the SDR's were activated. In a case when a nation's balance of payments position continued to deteriorate through a prolonged period, it would be allowed to devalue on a larger scale and to establish a new par value as is done today under the Articles of Agreement

of the International Monetary Fund. Such a system would enable the United States to dispose of its increasing number of controls--voluntary and mandatory--(if this system had existed during the mid-1960's, these controls would not have been necessary), and the balance of payments would be in equilibrium.

CHAPTER V

CONCLUSIONS AND SUGGESTIONS

Conclusions

The position of U.S. authorities which maintains that restraints on capital outflow can to a large extent solve the problem of deficit in the balance of payments was challenged by the conclusion of the fourth chapter. The average recoupment period in balance of payment terms was an estimated five to seven years, with the returns on investment abroad greatly exceeding the original flow after that length of time. A sudden curtailment of investment outflow for two or three years would partially improve the nation's balance of payment position for a short time; however, any longer period of adherence to a policy of capital restraint would hurt the balance of payments permanently and to a much greater extent than it temporarily had helped. The policies of voluntary and mandatory restraint are now in their sixth year and the initial effect from 1965 has already begun to have an adverse impact on the balance of payments. (Even according to estimates of the Treasury Department

if this policy is to continue for another 2-3 years they would adversely effect the balance of payments.

The policy of the voluntary restraing program, which was supposed to have been temporary, became long term and finally became mandatory. From the program's inception the business community did not accept it as voluntary as there was always the implied threat of mandatory control in the event that its guidelines were not cooperated with fully. And, as anticipated, even with full cooperation the voluntary restraint became mandatory. In fact, it has become clear that the longer the policy remains in duration, the more difficult will be its elimination, partially because of the balance of payments adjustments which already have taken place under the controls.

Although government officials pointed to the Hufbauer-Adler study to justify the direct investment capital outflow restraints, one of those authors reassessed his position concluding that the short-term effects of controls on capital outflow are uncertain and that the long-term effects most likely are harmful.

> For the use of investment controls to be justified, the short-term costs of control must be smaller than the benefits and, in addition, there should be no harmful long-range effects. Deeper analysis indicates that the short-term effects of the recently enacted mandatory controls are uncertain; they may be politically helpful or economically harmful. There is less ambiguity about the long-term effects.

> In the long run the mandatory controls seem likely to do more harm than good to the U.S. balance of payments.[1]

The reasons for the introduction of the "voluntary restraint program" and later the program of "mandatory control" were chiefly politically motivated. Government expenditures abroad (other than foreign aid) and tourist expenditures in foreign countries have been by far more responsible for the balance of payment deficit than investment abroad has been. However, the restraints on direct capital outflow are less sensitive in the political sense.

The requirements that companies repatriate most of their earnings and the encouragement of U.S. companies to borrow abroad cannot go unchallenged indefinitely. American companies abroad, after all, are subject to the laws of the host countries, and those countries may resent a unilateral American regulation. Some European governments already are considering the implementation of an Interest Equalization Tax similar to that which has been in effect in the United States for the last seven years.

A more basic economic objection to any voluntary or mandatory program is the fact that allocation of funds

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[1]Michael F. Adler, "The High Cost of Foreign Investment Restraints," Columbia Journal of World Business, Vol. III, No. 3, May-June 1968, p. 74.

to be invested abroad is dependent on arbitrary decisions made by government bureaucrats based on an arbitrary past year and not on the free market forces. The program discriminated against new companies which were planning to invest abroad but which had not done so in the past. The profitability of a company and its contribution to the balance of payments was not a factor in deciding which companies could invest abroad or in deciding on the size of sums that would be allowed for foreign investment. The quota based on past investment abroad by necessity gave to some companies advantages which were not given to their competitors.

As stated previously, when the "voluntary program" of controls on direct investment abroad was introduced by the President on February 10, 1965, it was intended to be temporary in nature mainly for the purpose of "buying time" while other steps could be effected to equalize the balance of payments. The program was designed to moderate--not to halt--the outflow of U.S. capital and to shift to foreign sources for a portion of direct investment financing.

Business leaders were congratulated many times for their cooperation with the Department of Commerce guidelines. The participating companies as a group succeeded in holding their capital outflow below the targeted ceilings, with their total contributions to the

balance of payments exceeding projections or expectations.[1]

Depreciation reserves and borrowing by foreign affiliates theretofore had been an important part of financing new investment abroad, but because of the voluntary restraints those sources of financing increased considerably. In addition, U.S. companies borrowed directly from abroad large amounts of funds which were accounted for as part of direct investment outflows from the United States. Total capital expenditure for plant and equipment by affiliates of U.S. companies was $7.4 billion in 1965, $8.6 billion in 1966, and $9.2 billion in 1967; but outflows of new funds from the United States for direct investment declined from $3.5 billion in 1965 to $3.0 billion in 1967 (including funds borrowed abroad and actually used abroad to finance direct investment--excluding funds borrowed abroad net outflows would be $3.3 billion in 1965, $.29 billion in 1966, and $2.6 billion in 1967).[2] Inflow of funds to the United States resulting from direct investment abroad increased from $4.9 billion in 1965 to $5.7 billion in 1967. Despite this excellent performance by the business community,

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[1]U.S., Department of Commerce, Office of the Secretary, Press Release of April 1967, G-67-91, Washington, D.C.

[2]U.S., Department of Commerce, Survey of Current Business, March 1968, p. 22.

which was repeatedly acknowledged by government officials, balance of payment deficits continued, and more severe mandatory controls thus were introduced in 1968.

After examining the balance of payments data for 1965-68, it is obvious that a main cause of the vanishing trade surplus and the deficit was the war in Vietnam. The impact of the war on the balance of payments was twofold; the direct foreign exchange costs which resulted from the war and such indirect costs as government budget deficits, skilled manpower shortages, and increased demand which caused inflationary pressures and deterioration in price competitiveness of U.S. exports.

Although the performance of the business community under the voluntary restraint program was outstanding, the program never achieved its basic goal of eliminating the balance of payments deficit. Investment by U.S. companies abroad continued to grow; the outflow of capital from the United States declined; and the companies financed an increasing portion of their investment abroad from sources other than capital outflow. Nevertheless, the program as a whole cannot be regarded as a success, but rather as a failure. The controls were promised to be temporary but were extended repeatedly with additional restricted conditions which finally became mandatory. The persistent balance of payments

deficit continued, and the program never achieved its promised results. The success of a temporary program is measured by its early termination. However, if such a program becomes self-perpetuated and the problem which it was intended to solve becomes even more aggravated, the program must be considered as unsuccessful and a solution must be found elsewhere.

The program was not based on sound economic theory or sound empirical economic data. All the accounts of the balance of payments are interrelated, and it is therefore impossible to take action on one item without affecting the others. Curtailment of capital outflows would have an immediate effect on exports of capital goods and a future effect on exports of replacement parts, and raw materials. In addition, it would reduce the inflow of income in later years. Borrowing abroad has only an initial short-term positive effect on the balance of payments; interest rates, usually higher than in the United States must be paid regularly, and the debt must be paid back upon maturity. Therefore, indebtedness abroad does not improve the nation's payments position: It only postpones the necessary solutions for a short time and makes it more difficult to cope with the problem when the time does come.

Suggestions

The policies of voluntary capital restraint on direct investment abroad which have been pursued by the U.S. Government since the beginning of 1965 have not solved the problem of deficit in the country's balance of payments. The deficit not only has not disappeared, but the size of it has increased. Therefore, the restrictions imposed on direct investment abroad should be eliminated gradually, and a different solution to the deficit problem should be found. A gradual phaseout of restrictions is needed in order to avoid a massive outflow of U.S. funds to repay foreign debts or to finance previously postponed investment plans. During the duration of the continued restrictions, the nature of the controls should be changed to a special investment tax. Such a tax should be imposed on a graduate scale with the rate varying inversely to the over-all positive contribution of each company to the balance of payments in a ratio to the size of its foreign operations.

In the short run the most significant step that can be taken and one which would contribute most to the reduction in the size of the balance of payments deficit is the termination of the war in Viet Nam. The effects on the balance of payments would be twofold: reduction in direct foreign costs resulting from the war and reduction in such indirect effects as inflationary

pressures at home and deterioration in the competitive position of U.S. exports abroad.

In the long run a more flexible international monetary system as suggested in the fourth chapter would enable the government to pursue economic policies which would achieve domestic goals as well as equilibrium in the international payments balance. Pursuit of prudent monetary and fiscal policies would have to be continued in order to prevent deficits in the balance of payments in the coming years. However, balance of payments considerations would not have as much weight as they do today when a choice of domestic policies must be made compatible with full employment and economic growth.

APPENDIX I

The Concepts of "Balance"

I. "Basic Transactinn" Balance

Goods and services
United States Government grants and loans
Private long term capital, United States and foreign
Direct investment
Other (except foreign holdings of United States Government bonds and notes)
Remittance and pensions

Balance on "Basic" transactions

settled by:
Special Government transactions
United States private short term capital (net)
United States private short term commercial and brokerage liabilities, net.
United States liquid liabilities, including United States Government non-marketable, convertible securities
Errors and omissions
United States monetary reserves; gold, convertible currencies and International Monetary Fund position.

II. Balance on "Regular Type Transactions," and "Liquidity" Concept

Balance on "Basic" transaction (I)
United States private short term capital
United States private commercial and brokerage liabilities, net
Errors and omissions

Balance on Regular type transactions

settled by:
Special government transactions
Balance on all transactions other than changes in United States reserve assets and in liquid liabilities

settled by:
United States liquid liabilities including United States Government non-marketable, medium term, convertible securities
United States monetary reserves assets (gold, convertible currencies, and IMF position)

III. "Official Settlement" Concept

Balance on Regular type transactions (II)
United States liquid liabilities to:
Foreign commercial banks
International non-monetary institutions
Private non-bank foreigners
Advances on United States military exports
United States Government non-marketable, non-convertible securities

Balance settled by "Official Transactions"

settled by:
Advanced repayment of United States Government loans
Liabilities to official foreign monetary institutions
Changes in United States monetary reserves (gold, convertible currencies, IMF position)

Sources: Report of the Review Committee for Balance of Payments Statistics, The Balance of Payment Statistics of the United States, The Bureau of the Budget, Washington, D.C., 1965, pp. 104, 105, 107, 110.

Howard S. Piquet, The United States Balance of Payments and International Monetary Reserves, American Enterprise Institute, Washington, D.C., 1966, pp. 45, 46, 48.

APPENDIX II

1967 DEVELOPMENTS IN THE BALANCE OF PAYMENTS AND THE PRESIDENT'S NEW PROGRAM

In his statement on January 1, 1968, President Johnson said:

> The time is now come for decisive action designed to bring our balance of payments to- or close to-equilibrium in the year ahead. The need for action is a national and international responsibility of the highest priority.[1]

The President issued an executive order which transformed the previously voluntary Direct Investment Program into a mandatory one.[2] The new program was expected to yield payments improvements totaling approximately $3 billion in 1968. The new Mandatory Program was established not because of an uncooperative business community: On the contrary, the cooperation with the Department of Commerce in the Voluntary Program was excellent. However, the increase in the balance of payments deficit in 1967 needed further improvement which

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[1]U.S., Department of the Treasury, Maintaining the strength of the United States Dollar in a Strong Free World Economy (Washington, D.C.: 1968), p. xi.

[2]Executive Order 11387.

could be achieved only by such a new program.

Developments in 1967

In 1967 the U.S. balance of payments deficit increased to over $3.6 billion, more than twice as much as in the two previous years. Also, the gold loss in 1967 reached almost $1.2 billion, of which $900 million occurred during the month of December.

On the basis of "official reserves" transactions, the deficit for 1967 showed erratic movement due to swap arrangements between the United States and foreign governments and to large movements of funds from foreign commercial banks into central banks and back into commercial banks. In 1966, because of the extremely tight credit conditions in the United States, the country enjoyed an inflow of liquid funds from foreign banks--an occurrence that produced a surplus of $0.2 billion on the "official reserves" account. In 1967 the credit conditions eased in the United States, and foreign banks reduced their foreign assets in this country by substantial amounts. This reduction had the effects of return flows of dollars into foreign official holdings and a sharp deterioration in the "official reserves" balance. By the end of 1967 the deficit on this basis was running at an annualrate of $2.9 billion.

One of the most disappointing aspects of the balance

of payments for 1967 was the performance in the trade accounts. The trade surplus increased only slightly from its depressed level of 1966. In the first quarter of 1967, the surplus rose to $4.1 billion on adjusted annual rate in comparison to $2.4 billion in the last quarter of 1966. In the second quarter of 1967, it advanced even further to $4.6 billion. However, it declined somewhat in the third quarter and very sharply in the last quarter of 1967. The main factor contributing to the increase in surplus in the beginning of 1967 was that imports leveled off because of slacking demand in the domestic economy in the first half of the year, but it began to rise sharply toward the end of the year. Exports also leveled off due to the decline in economic activity in Western Europe. For 1967 as a whole the improvement in the trade surplus which had been expected by the United States in the beginning of the year never did materialize. Domestic economic situations such as the large increase in expenditures for Vietnam, large government deficit, increase in wages and costs, and inflationary pressures were the main factors that aggravated the problem.

In the first three quarters of 1967 the net outflow of U.S. private capital was running at an annual rate of $5.1 billion--much higher than in 1966 or any other year since the War except in 1964 when it reached

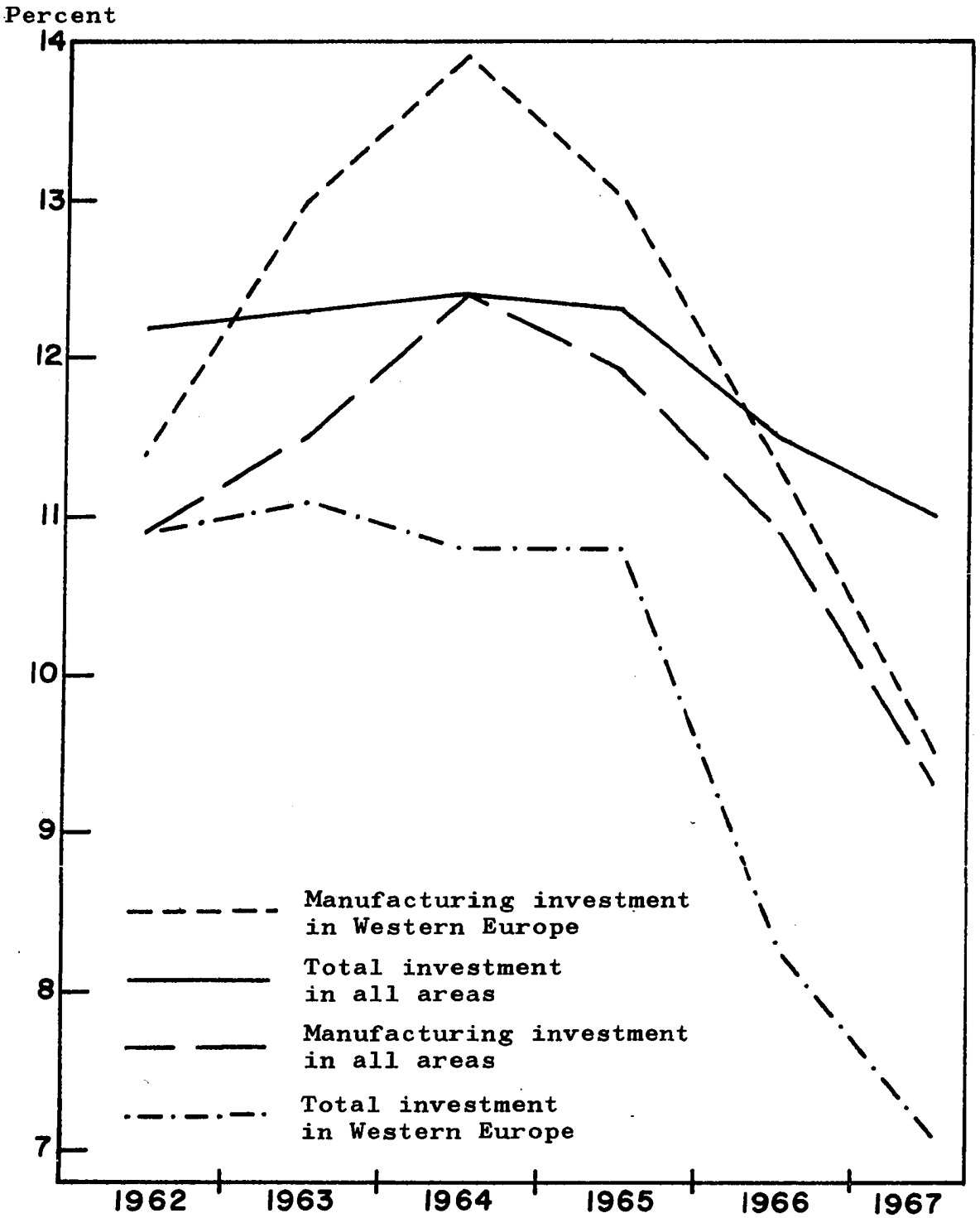
a peak of $6.5 billion. The large outflow of portfolio investment in 1967 was due to a sharp increase in new issues of foreign securities in the United States, mainly an issue of nearly $250 million in bonds sold by the World Bank and an issue of special bonds for about $90 million sold by the State of Israel.

Net outflow of capital funds for direct investment declined from the rates in 1965 and 1966. On an annual rate, the outflow for direct investment reached $3.2 billion, of which $0.4 billion had been financed abroad; thus, the net outflow was around $2.7 billion in comparison to $3.1 billion in 1966 and $3.4 billion in 1965.

The decline in direct investment outflow abroad was partly a result of the cooperation of the business community with the Voluntary Program, but there are some reasons to believe that this was not the only factor in reducing direct investment abroad. Other reasons are because the outflow in 1964 and 1965 was exceptionally high and because the rate of return on U.S. direct investment has been slowing down and appears to have diminished considerably in recent years (Chart 1). The slowdown in economic activity in Europe for the last two years has also been an important factor in reducing the rate of U.S. investment and decline in profits. A very important fact (especially in 1967) is that the voluntary

CHART 1

U.S. RETURNS ON INVESTMENT ABROAD



Source: Department of Commerce, Survey of Current Business, October 1969, p. 30.

program was instrumental in inducing U.S. companies to borrow more foreign funds in order to expand their activities in Europe and other developed nations.

The decline in direct investment outflow in 1967 came mainly as a result of reduction of investments in Canada and Latin America. The outflow to Europe rose slightly, but the largest increase came in New Zealand, Australia, South Africa, and the oil-producing countries in the Middle East and Africa.

The President's New Program

The nations that have benefited the most from the U.S. deficit are the West European countries which run a surplus comparable to or somewhat larger than the U.S. deficit. The United States has sought to formulate a program that would eliminate its deficit, especially the deficit with Europe. A most important task for the United States was to select the measures that would be most effective in reaching the balance of payments objectives and which at the same time would allow an expansion of world trade and domestic economic growth in the United States. In his policy statement of January 1, 1968, announcing the new program, the President kept these objectives in mind, and the new program was built on the foundations of the voluntary program which it replaced.

The new program deals with several accounts in

the balance of payments, but its principal emphasis is on cutting the flow of direct investment abroad through the employment of mandatory controls. The authority for such controls was given to the President by the Trading with the Enemy Act of 1917. Other parts of the program are the following: additional restraints on banks and other financial institutions lending abroad, restricted travel abroad, reduced government expenditures abroad, and some measures to increase exports.

An ideal situation would be for the United States to solve its problem through a gradual long-term approach without interference to domestic growth and the free movement of goods, capital, and people between countries. With a Gross National Product of over $800 billion and foreign assets of over $110 billion which earn about $6.0 billion annually, the United States possesses the resources and strength to carry out such an approach. In the long run the nation is strong. The short-term situation, however, requires immediate corrective action in order to give the long-term measures time to work toward equilibrium. In the short run the new program of immediate action called for specific quantitative targets which would reduce the deficit by $3.0 billion in 1968. Of this amount, direct investment cuts would account for $1.0 billion, Federal Reserve programs for $500 million, reduction in net government

expenditures abroad for $500 million, restraint on travel abroad for $500 million, and the steps relating to non-tariff barriers for $500 million. Together with these targets some money was appropriated for promotion of U.S. exports and the encouragement of foreign investment and travel in the United States.

The Federal Reserve program which became effective on January 1, 1968, put a ceiling on foreign credit of 103 percent of the amount outstanding at the end of 1964, and the banks were asked not to renew maturing term loans to the developed European countries. Also, the banks were requested to give credit only for financing export or loans to underdeveloped countries. The other governmental programs were aimed at reduction of expenditures abroad by curtailing travel to countries outside the Western Hemisphere and by cutting government expenditures required to maintain troups in Europe and reducing the personnel in other agencies abroad. The measures affecting private travel abroad have not been adopted, but other plans have been put into effect. In order to implement this program the President urged Congress to enact the proposed income tax surcharge and stressed the need for an effective voluntary program of wage-price restraint.

The Direct Investment Program

> The program provides three basic limitations on direct investors: (1) annual limits are placed on their new direct investment - capital outflow plus reinvested earnings - in foreign subsidiaries on branches; (2) a minimum share of total earnings from their direct investment must be repatriated - generally equal to the same percentage that they repatriated during 1964-66; and (3) their short term financial assets held abroad must be reduced to the average level of 1965-66 and held at or below that level.[1]

The mandatory program covers all countries, which are divided into three groups with different ceilings for each group. The ceilings were set in such a way that they would achieve the policy objectives of the United States.

The first group (Schedule A countries[2]) includes all of the developing countries where direct investment, including reinvested earnings, may not exceed 110 percent of the 1965-66 average invested by any investor. The ceiling of 110 percent was set to maintain the investment at about the level of 1967.

The second group (Schedule B countries[3]) includes developed countries which were judged by the United States to be in need of high-level capital inflow in order to

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[1]Economic Report of the President, 1968, p. 173.

[2]Schedule A countries: Latin America, Far East less Japan, Africa less Libya and Republic of South Africa, Other Western Hemisphere.

[3]Schedule B countries: Australia, Japan, Libya, oil-producing nations of the Middle East, and the United Kingdom.

continue their economic growth and financial stability and for which there was no source other than the United States to supply them with necessary capital. For these countries, direct investment, including reinvested earnings, could not exceed 65 percent of the average of 1965-66.

For the third group of countries (Schedule C countries[1]), principally Continental Europe, a moratorium was imposed on any new capital outflow from the United States, but reinvestment of earnings in these countries was authorized at the same percentage of the average earnings which they have reinvested in the years 1964-66. However, the maximum allowable reinvestment of earnings could not exceed 35 percent of the investor's average base period of direct investment.

For all three groups, direct investors must have repatriated at least the same percentage of earnings as the average repatriated in 1964-66 plus any excess of total earnings over the amount which could have been invested under the authorized ceiling. All short-term assets other than direct investment, above the average of 1965-66, must have been brought home. The regulation applied to all "direct investors" who directly or indirectly owned, who have voting power in, or who received

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[1]Schedule C countries: Common Market, Other Europe less United Kingdom, Republic of South Africa.

income of more than 10 percent from a company abroad. This did not apply to investment of less than $100,000 in any year. The program was to be administered by the Department of Commerce, with final authority in the hands of the Secretary of Commerce.

Based on direct investment statistics some preliminary calculations have shown that the net direct investment and reinvestment earnings in 1965 and 1966 averaged about $900 million in Schedule "A" countries, $2.1 billion in Schedule "B" countries, and $1.2 billion in Schedule "C" countries. The new program implied that the maximum net capital outflow for direct investment plus reinvested earnings in 1968 would amount to about $1.0 billion for the less-developed nations, approximately $1.4 billion in the second group, and $0.3 billion in the developed countries of Western Europe--or a total of approximately $2.7 billion in comparison to $4.2 billion in 1966. U.S. investors would be able to continue borrowing abroad to finance additional needed investment.

With the formulation of the new program it was emphasized that the controls would not be static but would be adapted to new developments as they arose. One change occurred in March of 1968 when ceilings of capital outflow to Canada were changed and more capital was allowed to move there.

As expected, most of the business community was

opposed to the new mandatory program, claiming, and rightly so, that all companies had cooperated with the Department of Commerce in carrying out the voluntary program. All during the 1960's, direct investment income exceeded by far the amount of funds that went into direct investment. In 1967 direct investment income, not including royalties and fees, exceeded investment outflow by about $2.0 billion, and the cause of the balance of payments deficit was due primarily to the weakening of the trade surplus, the deficit in the Government budget, and a rise in U.S. Government outlay abroad because of Vietnam.[1] The argument continues that the program would reduce exports and, more importantly, that it would reduce the future earning potential of the United States abroad. A large part of direct investment is for new sources of raw materials which cannot be extracted in the United States or for which the cost of doing so would be prohibitive. Of course, all business leaders realize that something must be done in order to reduce the deficit. They are willing to accept controls only as a short-term, "Last resort" measure which they feel should be accompanied by a more effective monetary and fiscal policy in the domestic economy.

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[1]First National City Bank Letter of February 1968, p. 21.

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