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The US Balance of Payments Problem

by Professor Walter P. Egle, Cincinnati

In the domestic as well as foreign discussion of the persistent American external deficit, the aspect of its size has played a dominant role. This is understandable, despite the fact that annual deficits ranging up to 3.5 billion dollars may seem small if held against the background of the vast dimensions of the American economy. The crucial point, of course, is that the deficits are not small in relation to the nation's external transactions and especially not from the standpoint of the dollar's role as a key currency.

Moreover, the size and duration of external deficits are not the only criteria that should be applied in evaluating the degree of severity of imbalances in external accounts. The American case furnishes a valid example as to why, in addition to quantitative considerations, qualitative ones should be employed.

The Postwar History

The term qualitative, in the context of this analysis, refers to the source and location of the deficit in the overall account. It involves the argument that, depending on where the imbalance occurs, the degree of concern over it varies. Thus deficits of the same size may have to be diagnosed differently from the degree of urgency of adjustment measures. In one case the need for the exercise of discipline may be strong, whereas in another the element of urgency is not—or at least much less—present. The criterion used for such distinction is whether the deficit arises from weakness or strength of the nation's position in international economic relations. The meaning of weakness or strength will be illustrated by the example of the postwar history of the American balance of payments situation. The entire period can be divided into three parts, each of which characterised by a different source of the protracted deficits.

In the first subperiod (from 1949 to 1957) the deficit producing transactions occurred in the government sector. They resulted from deliberate aid programs aiming at the restoration of war-torn economies, development of retarded nations, and especially also at the removal of the maldistribution of international reserves. These deficits—pertaining to the era of the so-called international "dollar shortage"—would surely defy a diagnosis in terms of alarm over the conditions of the American economy at that time.

As this writer has stated elsewhere¹ any attempt to fight these deficits—in the face of these deliberate objectives of American foreign policy—would have deserved to be called a case of misconceived balance of payments discipline. Admittedly, this is the strongest and clearest case that can be made in favour of applying qualitative criteria.

The second subperiod (from 1958 to the last quarter of 1967) was characterised by a dramatic revival of American private interest in foreign investment, making net capital exports the main "offender" of the overall payments' account. But by no stretch of the imagination can this development be called a sign of weakness. The major portion of the outflow consisted of "direct" investment on the part of American parent companies seeking to establish foreign branches and subsidiaries. Behind such investment stood such elements as financial affluence, managerial aggressiveness (often resented abroad), tax advantages, and possibly the desire to circumvent foreign protectionism against the parent companies' products. Neither does the "portfolio" portion of the outflow indicate weakness. The initiative behind such transactions came usually from the party of the foreign borrowers who availed themselves of the opportunity to secure funds more cheaply and smoothly than they could have elsewhere. In fact, it is fair to say that as a source of loanable funds the dollar was "undervalued" rather than "overvalued", speaking in terms of the cost of loans (interest rates, administrative expense).

Declining Surplus in Trade Account

Had trade account continued to yield high surpluses, there would have been nothing wrong. Happy the nation, such as presently West Germany, which can afford to compensate for a high surplus in trade account with resort to net capital exports, rather than complying with pressure on the part of its international rivals to stage a second appreciation of the Mark on the foreign exchanges. There are long-range balance of payments rewards in such deficits, as well as accommodation of capital needs in countries deficient of domestic ability to meet them (whereas compliance with the afore-mentioned pres-

¹ "The Problem of Balance of Payments Discipline: In General and in Regard to the United States". *Weltwirtschaftliches Archiv*, Band 99, 1967, Heft 1, pp. 1-9.

sure might merely encourage the rivals to shun necessary adjustment in their external accounts).

Alas, as the following chart shows for crucial years of this period, the United States is not in such an enviable position. Its surplus in trade and service account deteriorated substantially and furnished less and less of an offset for the deficits in capital account. The decline refers primarily to trade account, since in the remainder of "current" accounts (transportation, travel, military expenditures, investment income receipts) credits and debits, taken as a whole, have more nearly offset each other. Thus in 1967 the surplus in trade account was down roughly \$ 1.3 billion from what it had been in 1964 (the comparable figures for the deficits were \$ 4.8 billion in 1964, and \$ 3.5 billion in 1967). This latter development is really the alarming feature because it reflects unfavourably on the international competitive strength of American enterprise.

A More Constructive Adjustment Policy

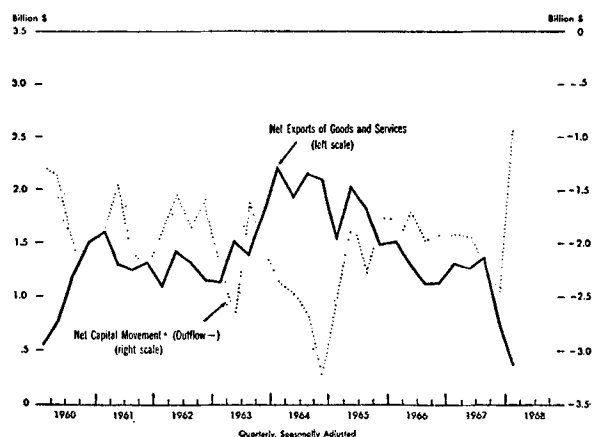
The third subperiod began in the latter half of 1967. To treat it as the beginning of a new episode in American balance of payments experience may appear to be premature. But the fact remains that events of substantial importance have occurred recently. One is that in the last few months trade account has suffered an accelerated deterioration to the point of showing actual monthly deficits, namely \$ 32 million in May, and \$ 87 million in June, 1968.² But the really striking feature is that toward the end of 1967, as the chart shows, a drastic change occurred in regard to net capital outflow, in terms of a sharp reduction. This has been the result of governmental interference, first on the basis of extracting "voluntary" restraints, and later of compulsory measures, for direct investment and bank loans, and the well-known "equalisation tax" on portfolio investment. As a result the overall deficit, measured on the "settlements" basis, was down to \$ 600 million in the first quarter of 1968, from \$ 1.740 billion in the last quarter of 1967.³

This quantitative success should not blind us to the fact that the method of adjustment fails to come to the core of the problem. The choice of method followed political expediency aside from promising quicker results than could have been achieved with attempts to improve the trade balance. Whatever private resistances the control of capital exports have met, they are not comparable to those mobilised in the Congress against the Administration's plan to fight the deterioration in trade account with anti-inflationary measures. After many months of futile pressure by Washington's Administration on the Congress—joined by the Federal Reserve authorities—the plan to use fiscal restraints has now finally received grudging legislative authorisation. It had be-

come clear that tight money policy was not sufficient to achieve the task despite considerable efforts which demonstrated, among other things, its highly discriminatory effects.

The sadly delayed resort to budgetary restraints (a combination of tax increases and expenditure cuts) indicates two important facts. First, it indicates that the persistent deterioration of trade account is traced to a rate of inflation which since the middle of the sixties has been in excess of that experienced in most of the foreign industrial rivals. Secondly—and this point is in line with the tenor of this analysis—the final readiness of the legislators to attack the payments' problem with such distinctly unpopular measures suggests that not merely the dimensions of the external imbalance, but also the qualitative nature of the deficits, has gained recognition in Congress. No longer can one justly speak of adjustment policies which attack the problem merely from angles which are questionable from long-range considerations and fail to attack the true source of the malady. The earlier temptation to seek solutions along the lines of political expediency, and to exploit chances of quick success at the price of postponing overdue reform in vital areas, is no longer at work. It is true, of course, that the legislator's readiness to resort to a more constructive adjustment policy has been aided by widespread domestic and foreign reaction to the losses of gold and the fear of a dollar devaluation. Unfortunately, it is also true that the combination of fiscal and monetary restraints is bound to have a greater depressing effect on employment and output than on prices, but when this happens it will at least be the "income effect" of shrinking total demand on imports that will improve the trade balance. Those who are of the opinion that this effect is more important than the "price effect" will derive comfort from the action that has been taken since the middle of this year.

Balances on Goods and Services and on Capital Transactions



* Exclude nonscheduled repayments of Government credits and long-term liabilities of U.S. banks. U.S. Department of Commerce, Office of Business Economics.

Source: "The US Balance of Payments: First Quarter 1968", Survey of Current Business, June 1968, p. 20.

² "Trade Deficit Deepened in June: Data Disturbing", The Wall Street Journal, July 30, 1968, p. 2.

³ Loc. Cit., p. 18.