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Problems of the U.S. Balance of International Payments

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Problems of the U.S. Balance of International Payments [1]

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The continuing deficit in the U.S. balance of payments threatens recovery and growth at home, and beyond that prosperity in the entire free world, since it creates uncertainties about the future of the dollar as an international reserve currency.

Diagnosis and therapy of our deficit must be concerned with the three major components of our international balance: (1) current payments, public and private; (2) flows of short-term capital, public and private; and (3) movements of long-term capital, public and private.

Wage-push theory

To some of us this task may seem gratuitous. Every economist knows the reason and at least one of the two alternative cures for our imbalance: labor unions are raising wages faster than productivity and thus creating a vicious wage-price spiral, the famous wage-push inflation.

Ex-Austrians and post-Keynesians, econometricians and institutionalists, all agree on the wage-push diagnosis. They are not quite as unanimous as to therapy, however. Some of them want, as they put it, to break the power of the "labor monopolies"; others prefer to institute wage and possibly also price controls.

Unfortunately, like so many things every economist knows, this diagnosis is wrong. First, a continuing wage-price spiral would increasingly impair the competitive position of our industries and thus steadily diminish exports and enlarge imports. But at least for the last four years -- ever since our balance-of-payments surplus caused the dollar-shortage scare of 1957 -- our exports have not been declining in relation to output, even after deducting those exports that are financed by public or private capital flows; and our imports have not been rising in relation to national income.

Second, for the last four years we have not had any price inflation (as measured by the level of wholesale prices) of either the cost-push or the demand-pull variety.

Third, those price increases which have occurred in recent years generally cannot be blamed on an increase in wages of union labor. In this country, the only well-organized labor group in manufacturing industries is that of production workers. Payrolls of these workers have risen less fast than output ever since the early fifties, when the productivity of American labor was so much greater than that of our competitors that (as every economist knew) a permanent dollar shortage appeared inevitable. Total labor costs per unit of output also have been declining since 1957.

[1] Paper presented at a seminar meeting of the staff of the Board of Governors on November 21, 1961.

The diagnosis that blames U.S. labor for our international difficulties is thus contrary to fact, and the therapies based on that diagnosis must accordingly be rejected.

Obviously, this does not mean that wage and price stability are unimportant; or that the danger of a wage-push inflation has never existed in the past or has been permanently banished for the future. Neither does it mean that more cautious wage and price policies might not in the long run improve our balance of payments together with the pace of our domestic growth. It only means that we have to look for other diagnoses and other therapies if we want to understand and correct our present imbalance.

Foreign-surplus theory

Among those who have escaped the error of the wage-push theory, some have fallen into that of the foreign-surplus theory. It is indeed true by definition that the United States cannot have a deficit unless the rest of the world has a surplus; and it is true that the recent U.S. deficit has been accompanied by a surplus of some Continental European countries, of which Germany is the most important. Furthermore, it is true that it would not help the cause of international financial stability to eliminate the U.S. deficit by shifting it to another deficit country, such as the United Kingdom. Any desirable therapy would also have to eliminate or reduce the surplus of Continental Europe.

Obviously, the task of eliminating our deficit would be facilitated if the surplus countries themselves took measures to reduce their surplus. Needless to say, the United States should try to convince surplus countries to increase their contributions to military expenditures and foreign aid; to eliminate or reduce discrimination against U.S. goods and services and especially restrictions on agricultural imports; to adjust exchange ratios if they prove unrealistic; and to adopt interest-rate and reserve policies that minimize destabilizing capital movements. Perhaps, if the surplus countries did everything to keep their own house in order, very little would remain for us to do.

It does not follow, however, that our strategy should concentrate on the policies to be followed by other countries; or that if the others did not act in accordance with the needs of international stability, we should have to resort to contractive measures that would endanger domestic economic or international political goals of U.S. policy. If this were our only choice, the outlook would be dismal indeed. For we must realize that few if any foreign countries are likely to change their policies for our sake, even if such a change is also in their own long-run interest.

I believe therefore that little can be gained by stressing the duties of the surplus countries, and that we should instead concentrate on constructive policies of our own. It so happens that the policies I regard as most promising also seem likely to reduce the surplus of Continental Europe. While this is a coincidence, we must be grateful for small favors.

Current-account balance

It is easier to criticize the diagnoses and therapies that are wrong than to establish those that are right.

As to the public part of the current account sector of our international payments, everybody agrees (and this time I do not dissent) that our military expenditures abroad should be kept as low as compatible with the overriding needs of national defense. I understand that experts on the subject believe that, in one form or another, net savings of about $600 million a year would be practicable; and I shall assume in the following discussion that this improvement will be achieved as soon as possible.

It is less simple to deal with the private part of the current account sector. Needless to say, an expansion in our exports of goods and services sufficient to wipe out our deficit would be the best of all possible solutions. Unfortunately, most attempts to improve our trade balance either have such bad side effects as to make them inapplicable in practice, or they are likely to work only in the long run.

In the first category are such remedies as devaluation of the dollar (either by increasing the dollar price of gold or by permitting dollar exchange rates to fluctuate freely); protectionist policies (in their most radical version, the imposition of direct trade or exchange controls); or deflationary fiscal or monetary policies, designed to reduce rather than stabilize incomes and price levels.

The second category unfortunately includes all the policies that we are trying to apply at present. Our policies are designed to promote exports, particularly by means of government credits, guaranties, and insurance; and to keep wage increases within the bounds of increases in productivity, and thus, with the aid of anti-inflationary fiscal and monetary measures, to preserve price stability, while waiting for our competitors to fall into the abyss of inflation.

These policies should indeed be continued, and they might well be supplemented by attempts at curbing, through appropriate fiscal measures, other factors that tend to push up costs and prices. In particular, it should be within our power to find methods of taxation that bear more heavily on profits gained by Veblenian behavior (price increases or excessive margins) and less heavily on those gained by Schumpeterian behavior (improvement in products or productivity, accompanied by lower prices). We could not, however, expect any of these actions significantly to enhance the competitive position of our exporters in the short run.

Short-term capital

Turning from current accounts to the flow of short-term funds, it seems clear that movements of foreign public funds do not directly affect our balance of payments. A switch of foreign central bank reserves from dollars into gold, for instance, does not increase our deficit, as we are accustomed to measuring it by considering changes in our short-term liabilities to foreigners as well as those in our official holdings of gold and convertible foreign currencies. A decline in our gold stock exactly offset by a decline in our short-term dollar liabilities to foreigners thus leaves our balance of payments unchanged.

Indirectly, to be sure, such changes may exert a strong influence: any significant reduction in our gold stock may aggravate uncertainties about the future of the dollar and thus have serious economic repercussions. For this reason, cooperation of central banks, designed to avoid (among other disturbing actions) large or sudden conversions of reserve currencies into gold, would be extremely useful. We must not believe, however, that such cooperation could in itself cure the deficit in our international payments.

The same reasoning applies to movements of private short-term funds. For historical reasons, dating back to the time when the United States was the only country with a "hard" international currency, we usually disregard, in the calculation of our balance of payments, changes in our liquid claims on foreigners (apart from changes in our -- relatively small -- official holdings of foreign convertible currencies). I think that this practice is outdated. If we treat our claims on foreigners statistically in the same way as our liabilities to foreigners, it becomes clear that short-term capital flows, resulting in variations in our short-term liabilities exactly offset by corresponding variations in our liquid claims, have as little statistical influence on our balance of payments as conversions of foreign official reserves from dollars into gold.

Obviously, the economic meaning of the effects of short-term capital flows on our international position does not depend on the method we use for calculating our balance of payments. Actually, the main economic role of these flows is to serve as indicators of market attitudes. For this reason, it is inadvisable to tamper with them, except in special circumstances of excessive speculation or irrational panic. It is particularly inadvisable to try to influence these flows by means that might adversely affect our domestic economy, such as attempts at increasing short-term interest rates over and above a level deemed appropriate from the point of view of domestic policies.

Manipulations of interest rates may not be very effective in any case as recent experience suggests that large movements of private short-term funds are usually due more to changes in market confidence -- which can hardly be altered by modest variations in interest rates -- than to the interest differentials themselves. Also, funds that are highly sensitive to yield differentials may be as much in search of capital gains as of higher current returns. An increase in interest rates reduces the prices of outstanding securities and thus may repel instead of attracting funds looking for capital gains.

Moreover, for reasons to be explained presently, a rapid expansion of our economy is more important for equilibrium in our international payments than the behavior of short-term funds; any remedy that might interfere with recovery and growth in our domestic economy would probably lead to a deterioration rather than to an improvement in our international position.

Finally, in view of the very large size of our short-term liabilities to foreigners, an increase in short-term interest rates is likely to burden our current account by a sum that would offset a good deal of the expected improvement in the capital account.

This reasoning leaves the sector of public and private long-term capital as the main object of therapy.

Public long-term capital

Our outflow of public long-term capital, represented by foreign aid, is probably the most controversial item in our balance of payments.

Nevertheless, a cut in our foreign aid program would be questionable therapy, not only because many experts believe that such action would run the risk of adverse international political repercussions, but primarily because such a cut would contribute relatively little to the improvement in our balance of payments. As long as the U.S. suffers from serious unemployment of labor and capital, additional exports of goods and services generated by our foreign aid program generally are a negligible burden on both our domestic economy and our balance of payments. Only that part of our aid which is not represented by U.S. exports is really burdensome -- in sharp contrast to the incidence of foreign aid in the situation of full employment that exists in most other industrial countries.

The best way to reduce the impact of foreign aid on our balance of payments is therefore to tighten the "tying" of our aid to exports of U.S. goods and services. Such tying is not inconsistent with liberal trade policies, nor does it unduly burden aid recipients.

The policy is consistent with free trade because it does not impinge upon the freedom of our customers to buy goods and services wherever they find them most economical. If they want to buy goods and services that are cheaper in other countries, they are free to do so provided that they can get these other countries to finance their own exports. It is not unfair restraint of trade for the United States to cease to subsidize, by grants or soft loans, exports from other countries.

Moreover, by tying its aid, the United States is enabled to extend much more assistance than it could otherwise do. Both because of this effect and because it stimulates grants of aid by other industrial countries, "tying" of aid increases rather than decreases the amount of real goods and services available to undeveloped countries.

It has been estimated that about $800 million of our aid still is spent on goods and services of other industrial countries. If we cut that spending in half, we could thus expect to improve our balance of payments by $400 million.

Since this reasoning applies only to a situation in which a deficit coexists with domestic unemployment, tying should be discontinued as soon as either of these two conditions is no longer fulfilled.

Private long-term capital

In contrast to public capital, our outflow of private long-term capital goes mainly to other industrialized countries.

It would be inappropriate to interfere with that part of the outflow that goes to Canada or to undeveloped countries. Canada's economy is so inter-twined with our own that the two countries should almost be regarded as one economic unit. As to undeveloped countries, their interest in receiving private U.S. capital assistance is greater than the interest of the United States in a reduction of its deficit. Moreover, a very large part of our capital outflow to undeveloped countries is reflected in exports of U.S. goods and services, and thus does not burden our balance of payments.

It is different with the outflow of funds to other developed countries, such as the United Kingdom, continental western Europe, and Japan. It has been estimated that only a small part of that outflow generates exports of goods and services. These capital movements therefore represent, for the moment, a direct burden on our balance of payments -- again in sharp contrast to the incidence of capital exports from countries with full employment.

As long as present circumstances prevail, it is essential to reduce our net capital outflow to foreign developed countries outside the Western Hemisphere. Obviously, the best method would be to improve our economic prospects so as to make investment in the United States more attractive than investment abroad, to domestic as well as foreign capital. This is the basic reason for avoiding all measures (such as raising interest rates in relation to the marginal efficiency of capital) that would endanger the long-run prospects of our domestic economy for the sake of short-term advantages for our balance of payments.

Once the international financial community realizes that prospects of sustainable rapid growth, justifying expectations of high yields and capital gains on equities and direct investments, are as good in the United States as in other developed countries, no special efforts will be needed to combat an excessive outflow of investment funds. Policies designed to speed domestic growth -- like those designed to improve our international competitive position -- would work too slowly, however, to bring the necessary relief to our balance of payments at this critical moment.

In the meantime, we shall be obliged to find other ways that make it less attractive for new capital to be exported and more attractive for the yield of existing capital to be repatriated.

The Administration has tried to achieve this purpose by proposing to tighten taxation of income from U.S. investments abroad. It may be necessary to go further in this respect, and at the same time to combine the stick of tax disadvantages with the carrot of tax advantages for the return of funds from abroad. For instance, it would be possible to put a tax on any increase in U.S. investment in foreign developed countries, including direct investments as well as portfolio holdings, while giving preferred tax treatment to the repatriation of profits as well as of capital on existing (not also on future) investments.

Such measures would not violate general principles of liberal international economic policies, nor would they harm the U.S. economy in the long run.

First, capital movements are basically different from current transactions. This has been recognized in the IMF Agreement, which requires liberalization only of current and not of capital transactions; and it follows from an analysis of the advantages of free trade.

Free trade benefits all participants because it maximizes consumer satisfaction in all participating countries. Restrictions of investment may interfere with the maximization of profits, but not necessarily with that of total income. On the contrary, in a country suffering from large unemployment and insufficient growth, outflows of capital tend to reduce domestic investment, and thus interfere with the maximization of employment, productivity, and economic expansion in general. At the same time, capital that flows into a country with full employment re-enforces inflationary tendencies and may therefore hamper rather than promote the optimum allocation of resources in that country, too.

Second, at least some reasons for international capital movements have little if anything to do with optimum allocation of resources under assumptions of a free competitive economy. Continental Europe is attractive to U.S. capital not only because of the rapid expansion of the European economy, but also because of discriminatory protection afforded by the Common Market treaties; because of less severe tax laws and practices; because of greater toleration of monopolistic practices; and because of the reluctance of European Governments to impose burdens on their economies comparable to those borne by the United States in the common interest of the free world, from rearmament and foreign aid to embargoes on trade with our common enemies. It would be both rational and fair for the United States to use fiscal penalties and inducements to offset such artificial benefits, which are unrelated to any comparative advantage due to differences in natural resources, capital, or labor.

Continental European countries usually are, by the way, anything but happy about the massive inflow of U.S. capital. Thus, there is no danger that a U.S. tax program of the kind here proposed would interfere with unity and friendship among the developed countries of the free world. For the same reason, there would be little danger of retaliation, quite apart from the fact that (again in sharp contrast to trade transactions) the inflow of foreign long-term capital into the U.S. is very much smaller than the outflow of U.S. capital.

More serious is the objection that such a program might endanger our balance of payments of tomorrow, by reducing future yields of foreign investment. In my judgment, however, its advantages both for our balance of payments of today and incidentally for the level of our domestic investment would more than offset any possible future impact.

Moreover, these tax provisions should be made as flexible as the provisions about tying foreign aid. The rationale for our proposals would vanish as soon as the unusual combination of a balance-of-payments deficit with domestic unemployment disappears, and the Administration should therefore be empowered to suspend the tax provisions whenever that combination is dissolved. 1/

I expect that the resulting improvement in our balance of payments, both through a reduction in the capital outflow and the increase in profit repatriation, would reach at least $600 million annually, a sum equal to only 35 per cent of the 1960 increase in U.S. long-term capital investment in Western Europe alone.

Summary and conclusions

To sum up: measures designed to improve our current account (apart from the reduction in military expenditures, which is a political rather than economic problem), while highly important in the long run, will not give the necessary immediate relief to our balance of payments. Measures designed to moderate or offset outflows of volatile capital, while highly important for psychological reasons, would be ineffectual unless accompanied by a correction of our basic deficit. We must, therefore, curtail outflows of long-term capital. This may be done in the public sector by tightening tying of aid to exports of our goods and services, and in the private sector by cutting down portfolio and direct investments in foreign developed countries. This last proposal is quantitatively the most important but at the same time politically the most difficult part of the program as it threatens the interests of powerful pressure groups.

The total improvement in our balance of payments resulting from the reduction in our military expenditures abroad, the increased tying of our foreign aid, and the reduction in our private long-term capital outflow would reach at least $1.6 billion annually. This sum would be not quite sufficient to equilibrate our basic balance of payments in the average of a cyclical period, but it would give us breathing space until our long-term therapies begin to show results.

There would be a basic surplus of $1-2 billion in cyclically favorable years, and a deficit of $2-3 billion in unfavorable years. The resulting average annual deficit of perhaps $500 million would be bearable for quite some time. It would raise foreign dollar holdings by not much more than the additional amounts foreigners would presumably want to hold in view of the needs of an expanding world economy; and even a gold loss of that magnitude would probably not create alarm.

Putting our basic balance in order would, in my opinion, automatically solve the problem of short-term capital movements. These movements would again vary from one direction to another over the cycle,

1/ I owe this suggestion to my colleague, Robert L. Sammons.

instead showing a one-way bias. We would then no longer be tempted to renounce cyclically appropriate monetary and fiscal policies for the sake of satisfying the prejudices of foreign holders of short-term claims.

The proposed remedies would also help rather than hinder restoration of high employment and more rapid growth at home. As soon as our economy reaches again a satisfactory level of domestic employment and growth, any remaining problem of international balance would be much easier to solve.

The orthodox means of restrictive fiscal and monetary policies might then again become applicable, as they are today in the United Kingdom, without threatening to interfere with our domestic objectives.

At that time, we might therefore be glad to abandon unorthodox measures. Meanwhile, however, we must brave the charge of heresy, unless we prefer to risk either domestic stagnation or a breakdown of the dollar exchange standard, or both, with all their consequences for the political as well as the economic coherence of the free world.