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BALANCE OF PAYMENTS AIMS AND STRUCTURES IN THE 1970'S

by

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Balance of Payments Aims and Structures in the 1970's*[1/]

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August 15, 1971 marks a crucial turning point in international financial history. With the suspension of the convertibility of the U.S. dollar into gold or other reserve assets and the de facto adoption of a regime of managed floats for many currencies, the way the international financial system had been functioning since the Bretton Woods conference in the mid-'Forties came to an end. Up to that date, the operation of the Bretton Woods system hinged upon the central role of the U.S. dollar. Other nations pegged the exchange value of their currencies to the dollar and tied this value to gold on the basis of the readiness of the U.S. Treasury to convert officially-held dollar balances into gold at fixed rates. Because of this, the dollar had come to be the hub of the system. Within given rules, other currencies were freely able to vary their exchange value vis-à-vis the dollar. The dollar rate, however, was viewed as the fixed point in the multilateral exchange rate structure and, thus, considered not to be variable at the initiative of the U.S. authorities.

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The views expressed in this paper are those of the author and do not necessarily represent those of the Board of Governors or its staff.

1/ I am grateful to my colleagues, and in particular to Geza Feketekuty, for patient comment.

There was nothing in the rules laid down at Bretton Woods that stipulated this asymmetrical treatment of the dollar. The explanation why the dollar came to play this central role in the monetary system is found in the post-war economic reality that the United States was the strongest economy for almost two decades after the end of World War II. By the same token, the restoration and then the expansion of industrial capacity in Western Europe and Japan has meant a diminished relative economic importance for the United States in more recent years. That is, the United States gradually moved from a dominant position in the international economy towards one of "primus inter pares" among the major industrial powers. The international monetary authorities, however, were slow to recognize the implications of this process. As a result, they did not make needed changes in the way the international monetary arrangements were operated.

It is true that, as a practical matter, the role of the dollar had been changing well before August 15, 1971. Thus, the dollar had not been fully convertible into reserve assets for several years prior to that date. Moreover, as strains on the international payments system grew during the second half of the 1960's, other countries began to make more active use of exchange rate policy than in the past in order to achieve external as well as domestic policy goals. But these changes were generally made under crisis conditions and were insufficient to bring about substantial progress toward better payments equilibrium.

Thus, there was no question at the time of the Smithsonian Agreement in December 1971, that a multilateral realignment of exchange rates aimed at eliminating the existing external payments disequilibria was long overdue. It was also clear, however, that the realignment -- though necessary -- was not a sufficient step towards assuring that the world economy could operate smoothly in future.

What other steps were needed? Clearly, the rules under which the international economic system had operated had not been sufficient to prevent the build-up of large and disruptive disequilibria. When the Bretton Woods system was designed, the memories of the Nineteen Thirties had predominated. Exchange rate policy during the 'Thirties had been used actively, but it had been used with two aims in mind that were not necessarily conducive to restoring equilibrium: first, simply to prevent losses of reserves in the belief that such losses were inherently undesirable; and second, to achieve domestic policy goals, in particular the restoration of full employment. This use of exchange rate policy led to competitive devaluations -- a prime example of so-called beggar-thy-neighbor policies -- and international isolationism.

The fixed rate principle of the Bretton Woods system sought to prevent these mistakes of the 'Thirties. And in this way it served well. In the post-war world, countries pursued demand management goals by using fiscal and monetary policies, reserving exchange rate policy to affect their external payments situation. However, with the rapid growth

of the flow of goods, services and capital across national borders which this system helped to foster, new problems started to come to the fore. The growing interdependence of the national economies accelerated the speed with which effects of differential domestic policies and differing economic structures were felt elsewhere. And the system was not sufficiently flexible in that it provided the opportunity for -- but did not ensure -- prompt adjustment of international flows to these national differences.

The task of formulating ways and means to prevent the build-up of large disruptive disequilibria in the future has been assigned to an ad hoc Committee of the Board of Governors of the International Monetary Fund on Reform of the International Monetary System and Related Issues, the so-called Committee of Twenty. The talks now going on in that Committee aim at achieving a system that will be responsive to the changing needs of the international community. In fact, the Committee is specifically charged to see that "reform should meet the present and future needs of the world economy."2/ However, in order to devise a system that will be shaped to take care not only of current, but also of coming problems, it is necessary to be aware of how economic relations among countries may be changing.

If anything is to be learned from experience, it is that simple extrapolation of the past into the future may lead to grave misconceptions.

2/ International Monetary Fund, Annual Report, 1972, Washington, D.C., 1972.

This is clearly evident as one looks at the sharp differences between the post-war decades. Thus, the late 'Forties and the early 'Fifties were characterized by supply constraints. This meant that markets, and particularly markets for manufactured goods, were dominated by those who had the capacity to supply, i.e., producers in Great Britain and in the United States. In the late 1950's and 1960's, as war-damaged capacities were rebuilt and restrictions on the flows of transactions across national borders were relaxed, sellers' markets were gradually transformed into buyers' markets and market competition increased sharply. This was particularly true for trade among industrial countries, especially after the growth of this trade was further stimulated by the formation of the European Economic Community (EEC) (See Table 1).

Questions regarding the 'Seventies

As the international community embarks upon the design of new trading and payments rules for the next decade, the following questions will become particularly relevant: In what respect should one expect payments trends in the 'Seventies to differ basically from those that characterized the 'Fifties and the 'Sixties? How will such differences affect the balance-of-payments aims and policies of different countries? Do the answers to these questions apply equally to the United States and to other countries, or are U.S. payments trends likely to be subject to a unique set of influences?

Table 1. Structure of World Trade
1960-1972
(Percentages)

Origin ↓ / Destination →	Industrial Areas	Developing Areas	Eastern Trading Area	Total World[1/]
Industrial Areas				
1960	42.5	16.3	2.3	63.8
1965	46.9	13.7	2.5	65.9
1970	51.5	12.8	2.6	69.2
1971	51.7	12.9	2.6	69.4
1972	52.6	12.1	2.8	69.3
Developing Areas				
1960	15.0	4.9	1.0	21.4
1965	13.6	4.1	1.3	19.5
1970	12.8	3.6	1.0	17.8
1971	12.9	3.7	0.9	17.9
1972	12.9	3.8	0.8	17.9
Eastern Trading Area				
1960	2.2	1.0	8.5	11.7
1965	2.5	1.7	7.4	11.7
1970	2.5	1.6	6.4	10.5
1971	2.5	1.5	6.3	10.3
1972	2.4	1.5	6.3	10.3
Total World[1/]				
1960	61.9	22.8	11.8	100.0
1965	65.2	20.0	11.4	100.0
1970	68.5	18.5	10.1	100.0
1971	68.9	18.6	9.9	100.0
1972	69.8	17.9	10.1	100.0

1/ Including Australia, New Zealand and South Africa, which are not shown separately.

Note: Percentage distributions are based on dollar values of f.o.b. exports.

Source: General Agreement on Tariffs and Trade, International Trade, 1972, Geneva, 1973.

Questions regarding possible structural changes in external payments flows during the coming decade principally relate to (1) the trading relationships between the industrial countries and the rest of the world; (2) the worldwide trading relationships among multinational firms; and (3) the freedom with which goods, services and capital can flow across national borders.

Trade relationships between industrial and non-industrial countries

It has become customary to define the industrial countries as those included in the Organization for Economic Cooperation and Development (OECD), with the rest of the world constituting the non-industrial countries. This definition is somewhat misleading, however, since the rest of the world is becoming more and more differentiated in terms of the structure of output of individual countries. Although it would be hard to discern an embryo industrial giant similar to Japan among the non-OECD countries at this time, the capacity of a growing number of these countries to supply manufactured goods is rising fast. The share of manufacturing output in total domestic product has grown rapidly in many of these countries. Perhaps the most notable examples are Mexico, Chile, Peru, Korea, Taiwan, Hong Kong, Iran and Zaire, to name a few (see Table 2). Clearly, industrialization and export-led growth of industry is a spreading pattern in a growing number of countries of the non-OECD world.

Table 2: Share of Manufacturing Output in Gross Domestic Product at Factor Cost
(In Per Cent)

	Mexico	Chile	Peru	Iran	Zaire	Hong Kong	Korea	Taiwan
1950	23	17	15	25[a/]	5	12	8[b/]	14[c/]
1968	30[d/]	28[e/]	20	32[e/]	20	38	21[e/]	20[e/]

a/ 1960; b/ 1953; c/ 1951; d/ 1967; e/ 1969.

Source: United Nationa, Handbook of International Trade and Development Statistics, New York, 1972.

As shown in Table 3, imports of manufactured goods by industrial countries have risen rapidly, both in total value and as a per cent of apparent internal consumption. It appears that developing countries have not only been able to expand their capacity to export manufactured goods in line with the rapid rise in overall consumption of industrial countries, but have also increased their share in that consumption slightly. Although this share is still very small, there is little question that it will continue to expand and perhaps, in the absence of trade restrictions, expand very rapidly. In addition, the ability of these countries to meet increasing export demand also indicates an increasing capacity to satisfy internal demand for these products.

As the table shows, the recent increase in the share of non-OECD countries in domestic consumption of industrial countries was largely concentrated in the United States and Japan. For the United States, for example, the share of total imports of consumer goods

Table 3: Imports as Per Cent of Apparent Consumption
(in current prices)

	U.S.			EEC			U.K.			Japan			Total		
	59-60	67-68	69-70	59-60	67-68	69-70	59-60	67-68	69-70	59-60	67-68	69-70	59-60	67-68	69-70
Manufactures															
Value of apparent consumption ($bn)	275.8	446.6	496.4	107.9	210.6	271.8	42.6	65.5	75.0	25.1	85.1	116.1	451.4	807.9	959.3
Imports as % of consumption	3.3	4.6	5.4	7.6	7.8	8.9	16.8	18.7	18.9	6.0	5.6	5.9	5.7	6.7	7.5
From developing countries	0.7	0.9	1.1	1.5	1.4	1.5	3.6	2.7	2.8	1.2	1.2	1.4	1.2	1.2	1.4
Primary Products															
Value of apparent consumption ($bn)	57.9	73.3	81.0	32.5	49.0	58.8	11.7	13.7	14.5	10.6	24.8	27.9	112.8	160.7	182.1
Imports as % of consumption	9.2	8.8	8.9	27.7	29.9	29.8	41.8	42.9	42.3	23.8	30.4	36.2	19.3	21.5	22.5
From developing countries	6.6	5.3	5.2	16.4	18.8	18.7	21.4	20.3	21.1	12.9	15.6	18.6	11.6	12.3	12.9
Total															
Value of apparent consumption ($bn)	333.6	519.9	577.4	140.4	259.7	330.5	54.4	79.2	89.6	35.7	109.9	144.0	564.2	968.6	1,141.4
Imports as % of consumption	4.3	5.2	5.8	12.2	12.0	12.6	22.2	22.8	22.6	11.3	11.2	11.7	8.4	9.1	9.9
From developing countries	1.8	1.6	1.7	4.9	4.6	4.6	7.5	5.8	5.8	4.7	4.4	4.7	3.3	3.1	3.2

Note: EEC data exclude intra-EEC trade. Totals may not add because of rounding.
Source: United Nations, Handbook of International Trade and Development Statistics, New York, 1972.

(other than automobiles) that is supplied by non-industrial countries has risen from 17% in 1965 to 29-1/2% in 1972. Over the same period their share in U.S. imports of non-durable consumer goods rose from 29-1/2% to 48% and for durable consumer goods from 7-1/4% to 17-3/4%.

The United States and Japan account for the fastest growth of foreign investment activity in a number of the developing countries, particularly in countries in the Pacific area. But there are indications that various European countries, especially Germany, are now stepping up private foreign investment expenditures. Among the factors contributing to this development are increasing labor costs and shortages of skilled labor in these countries; the growth in special trading arrangements between the EEC countries and a number of developing nations; and the changing cost relationships stemming from the recent exchange rate adjustments. Thus, it can be expected that more and more of the manufacture of relatively low-skill, labor intensive goods will spread to various developing countries. Moreover, unless restrictive trade policies are employed that check this, it is likely that the industrial countries as a whole will become increasingly dependent on imports of such goods.

The growth in earnings from exports of light manufactures and the lessened dependence of non-OECD countries on imports of such goods are likely to be accompanied by an increase in demand for capital goods imports as well as by an expansion in overall import demand as per capita

incomes rise. In addition, increasing foreign investment in these countries will lead to rising remittances of earnings to the industrial countries. While the growing industrialization of a number of the non-OECD countries is thus likely to produce a significant shift in individual components of trade and payments flows between them and OECD countries, net flows may be affected to a much lesser extent.

The shift in trade in manufactured goods is likely to be a fairly gradual and long-run process. A more rapid and, in terms of total values, more important shift will be produced by what appears to be a growing import need of the industrial countries for certain primary products. The most widely discussed and the most important example of this need is petroleum. The growth in OECD countries' demand for energy sources appears to be outpacing new discoveries within that area, including the large natural gas deposits in the North Sea. In addition, demand for oil supplies outside the industrial countries' area has grown, and is projected to continue to grow rapidly. While long-range projections necessarily must be very tentative -- and to a certain extent are based upon extrapolation of the present -- even the lower range forecasts foresee a growing flow of payments to the oil-producing countries. The Oil Committee of the OECD estimated in mid-1973 that the volume of import demand for oil in the OECD area is likely to about double between 1970 and 1980 (see Table 4). This would imply, at 1970 prices, an import bill of some $37-$40 billion dollars by 1980 and

Table 4: Imports of Oil

	Millions of tons			as per cent of each area's total demand for oil	
	1970	1980	% change 1970-1980	1970	1980
North America	165	478	190	22	40
OECD Europe	597	934	56	96	84
Japan	190	464	144	100	100
TOTAL OECD	952	1,876	97	60	65

Source: Oil, the Present Situation and Future Prospects, Oil Committee, Organization for Economic Cooperation and Development, Paris, 1973, p. 90.

probably of about two-and-a-half times that amount at current prices. Net receipts of the oil producing countries would be considerably less because of remittances of oil company and tanker earnings to OECD countries. However, they still would be very large compared with current levels.

It seems that recent events have brought the future a greal deal nearer than the OECD projections of even this recent date could have foreseen. It now appears that in 1974, the oil import bill for all OECD countries combined -- under the assumption that normal flows of oil from Arab countries are restored sometime during the first half of the year -- could run to about $40 billion. However, the production cutbacks by the Arab countries and the large price increases for crude oil themselves probably are altering the longer-range outlook materially. Governments

have been led to change their policies towards initiation and acceleration of programs leading to greater degrees of self-sufficiency in the energy field and both, exploration for energy sources and shifts towards oil alternatives are being stimulated. Consequently, oil import requirements by 1980 may look quite different from those projected now. Nevertheless, whether or not programs aimed at greater self-sufficiency are successful, oil producing countries outside the OECD area are likely to receive very large earning flows from exports for at least a large part of the decade.

Although a number of the oil producing countries can be expected to respend all or most of their rising foreign exchange earnings, the ability of some of these countries to increase imports is very low. These latter countries, moreover, are among the main potential producers of large quantities of oil over a long period. They may, at least initially, be expected to add some part of additional earnings to their reserves. They are also likely to search intensively for investment outlets for these funds -- as a number of them are, indeed, already in the process of doing. Consequently, the structure of payments between the OECD countries and the rest of the world could be materially altered. The traditional current account surpluses of the OECD countries may well diminish significantly and their net capital flows to the rest of the world may be reduced.

To some extent the oil situation, while clearly of special importance, may only be representative of what is likely to occur in

the case of other primary products. It is true that in contrast to the oil producing countries, increased imports from the non-oil primary commodity producers should generally be expected to be matched by increased exports to these areas, though only with some time lag. Still, for the industrial world as a whole, such increases in trade would clearly also imply a structural shift away from growing current account surpluses with the rest of the world.

Trading Relationships, of Multinational Firms

The developments discussed in the preceding section are likely to be intensified by trends in the investment and trading patterns of multinational firms. In the 'Sixties, the dynamics of international transactions were dominated by expanding trade among industrial nations. These trends, moreover, were also reflected in and, to some extent, shaped by the investment decisions of multinational firms. Thus, the largest growth in direct investment flows in the 'Sixties occurred among industrial nations. But, as suggested above (p. 8) the 1970's may be characterized by a great expansion of trade flows between the industrial countries and the rest of the world. A major role in this shift in trend, furthermore, will be played by the activities of multinational firms.

In the past decade, productive foreign investment has tended to be located in, or near, the markets it was intended to serve. For example, sales of U.S. subsidiaries to the local market constitute 70 per cent of their total sales. This pattern of investment reflected a

reaction to various types of trade barriers and an awareness of differences in local market practices and tastes; and it was also influenced by differences in wage rates and other costs of production. More recently, the latter factors have begun to predominate in some investment flows. Hence, foreign investment patterns are beginning to shift towards production designed to serve export markets. This is particularly true for various investments by U.S. and Japanese firms, but European foreign investment for this purpose has also been increasing.

The recent changes in exchange rate relationships, in part, tend to reinforce this process. The change in relative cost relationships that has resulted from the exchange rate changes has made it more profitable for Japan and European countries to produce in foreign low-cost areas in order to supply both other foreign and their own domestic markets. But, because the change in relative cost relationships also makes it more profitable to produce in the United States, this trend may to some extent be offset as both foreign and U.S. producers increase their investments in the United States in order to supply the local market.

The growth of investment by multinational firms in manufacturing activities in the lesser developed countries is likely to be further stimulated by a growing trend towards initial processing of raw materials in the country of origin. This reflects in part a desire of the material-rich countries to share in the profits related to utilization of their

natural resources and in part a tendency for industrial countries to export some high polluting industrial activities. These trends, coupled with further growth of investment in the industrial areas stimulated by the enlargement of the Common Market, indicate that trade of multinational firms will continue to be an increasingly important element in overall trade.

For the United States at least, this trend was already apparent during the 'Sixties. According to estimates made by the U.S. Department of Commerce, about one half of U.S. exports in 1970 involved, in one way or another, subsidiaries of multinational firms.3/ Perhaps more important, about 20 per cent of U.S. exports in 1970 appears to have stemmed from transactions of multinational firms with their own affiliates. The corresponding import share was 15 per cent and mainly involved imports of industrial materials. In the manufacturing area, imports were largely concentrated in the automotive sector, partly reflecting the Canadian automobile agreement.

It is reasonable to believe that international trade among entities of the same multinational firm will continue to be a very dynamic factor in the 'Seventies, and it should be noted that these developments are not confined to the United States. In fact, multinational firms resident in industrial countries other than the United States are likely to expand their worldwide activities more rapidly than U.S. based companies during the current decade.

3/ Betty L. Barker, "U.S. Foreign Trade Associated with U.S. Multinational Companies," Survey of Current Business, U.S. Department of Commerce, Washington, D.C., December, 1972.

The growing ability of a given company to supply particular markets from different locations may speed the responses of trade flows to changes in market conditions and cost structures. Multinational firms, by their nature, are better placed than purely domestic firms to accumulate market information and, in combination with efficient channels of communication and considerable flexibility of supply possibilities, to act quickly upon such information. Consequently, the growing activities of multinational firms are likely to accelerate the pace of balance-of-payments shifts in response to changes in economic activity.

At the same time, balance-of-payments adjustment to structural changes, and notably to exchange rate changes, may on balance well be retarded because of the existence of multinational firms. Quick adjustment requires that domestic producers take full advantage of changes in their competitive position vis-à-vis foreign producers. In other words, the domestic producer should aim to cut as much as possible into the sales of the foreign producer. However, if the foreign producer is part of a multinational complex, it may, at least in the short-run, be more profitable for him not to reduce his subsidiaries' sales to the full extent possible. Such a course, moreover, may not solely be based on economic grounds. There often are also strong political reasons, connected with labor relations and relations with foreign governments, that may tend to slow the adjustment process.

In all cases, however -- whether they involve slow or fast adjustment -- the responses to changes in cost differentials will first be reflected in profits and second in either earning flows or capital requirements. This leads to a further intermeshing of the various accounts in the external payments structures of individual countries and intensifies the need for a much better understanding of the relationships among the various accounts and their responses to changes in market conditions. For a misunderstanding of these interrelationships can lead to an erroneous view of both the balance-of-payments adjustment process and of countries' balance-of-payments aims.

Balance of Payments Aims

Overall equilibrium in payments balances, it is often argued, does not necessarily require a specific notion about what the structure of individual countries' external balances should look like. This may well be true from an accounting point of view: as long as official settlements balances tend more or less towards zero, balance-of-payments aims would be met, at least from the limited point of view of equilibrium in international reserve positions. Nevertheless, whether countries do or do not say so explicitly, there are certain payments flows which they consider matters of national priority, or which for economic or political reasons cannot easily be changed. Consequently, external payments goals generally presume a particular longer-run relationship between at least the current and the capital accounts, if not between items within

those accounts. Rightly or wrongly, countries will attempt to pursue policies aimed at achieving these goals.

Discussions within Working Party 3 (WP-3) of the Economic Policy Committee of the OECD, a body concerned with international policy consultation on the balance-of-payments adjustment process, have centered upon the question of national balance-of-payments aims and their mutual compatibility. A major element in these discussions has been the assumption that the industrial countries as a whole are justified in aiming at a substantial current surplus vis-á-vis the rest of the world. Such surpluses are said to be required because of the need to provide real resources to the less developed countries that are financed by both aid and private capital.

In recent years, the current account surplus of the industrial countries vis-á-vis the rest of the world has run at about $11 billion annually, equal to about 1/2 of one percent of the combined GNP of the OECD area (see Table 5). But the oil-producing countries have run a small current account surplus -- of about $1/2 billion -- with the industrial countries.[4/] If the oil producers in the years to come were to run a substantial current account surplus with the industrial countries amounting to approximately 1/2 of one percent of the GNP of

4/ For purposes of Table 5, the oil producing countries are Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, The Netherlands Antilles, Nigeria, Saudi Arabia, Trinidad and Tobago, and Venezuela. This is the definition used by the International Monetary Fund in compiling its statistics.

Table 5. World Payments Balances
1969-1971 Average
($ billions)

	Industrial Countries	of which United States	Other Industrial Countries	Primary Producers	of which More Developed	Less Developed	Less Developed excl. oil Producers
Trade	10.2	a/	10.3	-5.3	-5.4	a/	-6.0
Services and private transfers	0.6	0.8	-0.2	-5.2	2.8	-8.0	-2.4
Current account	10.8	0.7	10.1	-10.5	-2.5	-8.0	-8.4
Capital Account 1/	-9.8	-13.5	3.7	14.5	4.0	10.5	9.5
Allocation of SDRs	1.4	0.5	0.9	0.7	0.2	0.5	0.4
Overall Balance 1/	2.4	-12.3	14.7	4.7	1.6	3.0	1.5

1/ Capital account includes Government transfers and constitutes the difference between the overall balance less SDR allocations and the current balance. Capital outflows for industrial countries are estimated to be understated by $5.0 billion annually because of placements of official reserves in the Euro-$ market. This adjustment still leaves a statistical discrepancy of +$2 billion for the world balance.

a/ less than $40 million.

Source: International Monetary Fund, Annual Report 1972, Washington, D.C., 1972.

the industrial countries -- that is, of perhaps $20-$30 billion by 1980 depending upon price assumptions and based on the GNP projections to 1980 submitted to the OECD in 1969-70 -- this would fully offset the current surplus the OECD area might be running with the non-oil producers.

These developments suggest that the rationale for the maintenance of relatively large current account surpluses by the industrial countries needs to be re-examined. The shift in trading relationships between the OECD area and the rest of the world discussed in the preceding section may by itself tend to diminish some of the need for continued growth in the transfer of real resources from the industrial to the less developed countries. This does not mean that poverty levels in the developing countries are such that the need for substantial aid flows no longer remains pressing. Most of these flows, however, are not without cost and the debt service ratios for a growing number of the poorer countries already tends to be excessively high. In addition, the absorptive capacity of these countries for financial capital is limited by their development potential.

If the industrial countries were to continue to formulate their balance-of-payments aims in the same GNP percentage terms as they have hitherto -- and as the Japanese government, for example, has continued to do in its official projections to 1977 -- the less developed nations, excluding oil producers, would need to be able to absorb about $40 billion or more in financial flows by 1977. Around $20 billion directly from the industrial countries and perhaps another $20 billion to offset the current account surpluses the oil producing countries would be running with the OECD area. These magnitudes show that under the circumstances assumed, the balance-of-payments aims of the industrial countries would clearly not be realistic. Pursuit of such aims would thus lead to considerable adjustment problems.

Thus, although there is a continuing need for the industrial countries to transfer real resources to the rest of the world, this need is not likely to grow as fast as the stated balance-of-payments aims of the industrial countries indicate. Consequently, it will be necessary for OECD countries, individually and as a whole, to rethink their balance-of-payments aims and policies. An integral part of such an exercise would be the problem of how resources from the oil countries might be transmitted to other non-OECD countries. If the oil producers were not to invest directly in non-OECD countries but should find investment in the industrial areas more profitable, this might imply that industrial countries would need to subsidize such a transfer of resources.

A partial, and probably small, offset to what appears to be a tendency towards a lesser dependence by the rest of the world upon direct capital flows from the OECD countries, may result from the growing economic relationships between the OECD countries and the non-market economies of Eastern Europe, Russia and China. Trade of the OECD area with these countries is still not very large -- it constituted only 3-1/2 percent of total OECD trade (exports plus imports) in 1972 -- but it has been growing very fast. Between 1968 and 1972 trade flows between the two areas have about doubled. While some part of this increase resulted from the crop failures in the Soviet Union in 1972, a large part seems to represent a more basic trend. Since 1967, in fact, trade of Russia and Eastern Europe with OECD countries has been by far the most dynamic element in the overall trade of the Eastern trading area. A large part of this trade is financed by export credits, giving rise to increasing capital flows to these countries as the value of trade grows.

Effects on the United States

What do the changes in payments trends discussed above imply for the ability of the United States to achieve equilibrium in its overall payments position in a reasonable period of time?

Although the United States has not generally aimed at a particular structure in its payments balance, it was readily apparent that elimination of the disequilibrium which had been built up during the 'Sixties required a large shift in the trade balance. In fact, the U.S. representatives at

the Smithsonian Conference estimated that achievement of a reasonable equilibrium position in the U.S. payments balance required a shift of about $10 billion[5/] in the trade balance. They then estimated that in 1972 the U.S. deficit on current account, under conditions of reasonably full employment in the United States and abroad, would amount to $4 billion in the absence of exchange rate or other policy changes; government and private capital flows abroad were figured to run at an underlying annual rate of $6 billion. Reasonable equilibrium in the U.S. payments position, therefore, required a current account surplus of at least $6 billion, implying a swing in the current account balance of $10 billion.

Government analysts arrived at the conclusion that almost all the adjustment would have to come in the trade balance. It is true that a number of observers had postulated that service receipts -- particularly investment income from abroad -- would over time rise sufficiently to allow a sizable current account surplus, even with a zero trade balance. But whatever the arguments pro and con this view, the interest costs of cumulating official liabilities with rapidly increasing deficits cut substantially into net income from abroad. Hence, this postulate became largely academic.

The realignment of exchange rates from 1971 onward has resulted in an effective devaluation of the U.S. dollar against all other currencies

5/ The figure of $13 billion that was widely quoted as the needed shift in the U.S. current account included a $1 billion offset to a persistent outflow on "errors and omissions" and a $2 billion "safety margin."

of over 15 percent. This is a very substantial change, particularly since the change against some of the main surplus countries, notably Japan and Germany, has been much greater, i.e., about 27% and 30% respectively, as of early September 1973. This has probably created the potential to bring about the desired swing in the U.S. trade position over the next three years or so. Whether this development will actually result in lasting payments equilibrium depends largely upon cost and price trends here and abroad as well as on the extent to which individual countries may adopt policies to resist the required shifts in resources.

In the debate on what was needed to achieve equilibrium in the U.S. payments positions, various doubts have been expressed regarding the efficacy of exchange rate changes as an adjustment mechanism. These doubts, however, rest largely upon a short-run view of the reaction of consumers to relative price changes. In the long run, adjustment that is not achieved by the reaction of purchases to price changes is likely to be achieved by the reaction of producers to changes in profits. A market situation where there is no discernible reaction to changes either in prices or in profits would imply a degree of compartmentalization that would make markets totally unresponsive to any policy instrument, be it for domestic or for external purposes.

If the exchange rate changes effected over the past two years are, indeed, sufficient to bring the U.S. payments balance back into equilibrium around the middle of the decade, how are the structural changes envisaged for the decade likely to affect this process?

It is clear that the increasing dependence of industrial countries upon imports of certain primary products is going to affect the United States more strongly than it will others. This is so because the United States has in the past been much more self-sufficient for a number of these commodities than have other countries (see Table 4 for oil). It is also probably true, however, that the United States will provide greater possibilities for the investment needs of the non-OECD reserve accumulators than will other countries. In addition, the shift in the growth of market demand for goods produced by non-OECD countries may give U.S. producers a competitive advantage. This may occur both as a result of the recent exchange rate changes and because of the commodity and geographic composition of this demand.

Conclusion

A number of the questions raised about structural trends in international transactions show that the 1970's may, indeed, turn out to differ from the 1960's in a number of important respects.

First, the trading relationships between the OECD and the non-OECD countries may be in the process of fundamental change. It appears clear that the oil-producing countries will run growing current surpluses with the OECD countries and that various other primary producing countries may reduce their current account deficits with the industrial countries. In addition, a number of the more advanced "less-developed" countries may become more self-sufficient in supplying their own needs for certain kinds

of manufactured goods. They may also attract private investment funds from the industrial countries in greater measure than hitherto. The latter developments could lead to some dimunition of the needs for certain kinds of imports on the part of these countries. On the other hand, the more rapid pace of industrialization is likely to increase the demand of these countries for capital goods. Consequently, while there may be little net change in their overall current balance account positions vis-á-vis the industrial area, a rather significant shift may be registered in the structure of that balance. The extent to which this will occur will depend largely upon the willingness of the industrial countries to allow further import penetration in their markets for essentially light manufactures.

Second, the current account surpluses or reduced deficits of the primary producers will tend to diminish the need for rising net capital outflows from the industrial countries. In the case of the oil producers, there will be increased capital flows to the industrial countries. This means that the industrial countries will need to review their balance of payments goals which have generally been expressed in terms of substantial and growing current account surpluses.

To the extent that countries agree that these goals should be modified, they are likely to err on the side of attempting to hold on to greater than necessary surpluses. This is partly so because countries have traditionally erred on this side, but also because there may be little

created -- means that such a system cannot meet a fair test for some time to come. It also means that national policies need to be shaped to meet the current adjustment problems as well as those that will arise from the structural trends now in the process of evolving.

It is often said that responsiveness to these problems implies that national macro-economic policies must be progressively harmonized across countries. Yet it is not at all clear that the solution, realistically or logically, should be sought in this direction. What is clear, is that as national economies become progressively intertwined, national policies need to take explicit account of policy actions and considerations elsewhere. The main need would be strengthening of those international rules and procedures that are designed to ensure a speedy response to economic realities. A major step forward would be a realistic assessment of the implications of national goals for particular structures of payments balances, for the continued pursuit of such goals might imply future needs for adjustment.