U. S. Balance of Payments in 1968*

NINETEEN SIXTY-EIGHT was a year of interesting developments with respect to the balance of payments. The virtual elimination of the United States trade surplus was associated with a strong improvement in the overall balance of payments, and the rapid domestic inflation manifested in a 4 per cent decline in the purchasing power of the dollar has coincided with a revival in foreign confidence in the dollar and the United States economy in general. These seemingly paradoxical events will be considered in this article.

Shifts in Components of Balance of Payments

The overall balance of payments has improved and there has been a sharp change in its components in the first three quarters of 1968, compared with 1967 (see table). The trade surplus, a traditionally strong component of the United States balance of payments accounts, declined from $3.5 billion in 1967 to an $0.8 billion annual rate in the first three quarters of 1968. The capital account, generally an area of weakness in the balance of payments, showed an improvement from a deficit of $2.8 billion to a surplus of about $1.4 billion in the first half of 1968. The Government sector (excluding military purchases and sales) also showed a strong improvement. However, this was due almost entirely to a unique and non-recurring transfer between the Canadian and the United States Governments of $500 million in May, 1968.¹

The net effect of the weakness in the trade account and the strength in the capital and Government accounts was an improvement in the overall balance of payments. On the liquidity basis, the $3.6 billion deficit in 1967 became a $1.1 billion annual rate of deficit in the first three quarters of 1968, while on the Official Settlements basis the $3.4 billion deficit in 1967 became a $1.8 billion annual net surplus in the first three quarters of 1968. These sharp changes in the trade balance and in the private capital account can be attributed partially to developments within the United States and partially to developments abroad.

Domestic Factors

Trade Account — During 1968 the United States economy has been characterized by rapid growth in real income with virtually full employment and an acceleration in prices. These domestic factors contributed to rapid growth in imports and therefore to a decline in the trade balance. Larger real incomes resulted in an increase in foreign as well as domestic purchases, with foreign purchases accelerated partially because domestic labor resources were fully employed. In addition, domestic prices increased relative to foreign prices, and more favorable prices of foreign products induced a substitution of foreign goods for domestic goods by United States firms and households. Consequently, while real income increased 6 per cent between the third quarter of 1967 and the third quarter of 1968, and prices increased 4 per cent, imports increased by a phenomenal 37 per cent.² The trend rate of import growth from 1960 to 1967 was 9.1 per cent.

Capital Account — The major factor contributing to the improvement in the balance of payments in 1968 was the shift in private capital flows from an outflow to an inflow. One possible explanation for this switch

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¹This article will consider only the U.S. balance of payments. A forthcoming article will consider other international economic topics.

²There were also some special factors which tended to accelerate imports during the four quarters ending September 1968. The strike in the United States copper industry, forced domestic consumers to purchase foreign copper rather than domestic copper, and the anticipated strike in the steel industry encouraged domestic consumers to establish foreign sources of supply in case their domestic source of supply was severed.
was the President's expanded Foreign Credit Restraint Program (F.C.R.) announced on January 1, 1968. This program, as eventually implemented, restricted the outflow of corporate and banking capital.

Two earlier Administration attempts to improve the balance of payments by restricting capital flows, the Interest Equalization Tax (I.E.T.) originally proposed in July 1963, and the first Voluntary Foreign Credit Restraint Program (V.F.C.R.) announced in February 1965, have not had discernibly beneficial effects on the balance of payments in the long run. Following announcement of the 1963 I.E.T. program, the overall balance of payments improved for about six months and then deteriorated as those capital items not subject to the I.E.T. (largely bank loans) increased rapidly. By the second half of 1964 the overall balance of payments had returned to its weak position of the previous year.

The V.F.C.R. Program inaugurated in February 1965 was also followed by a balance-of-payments improvement for about six months. However, with the escalation of the Vietnam War and shrinkage in the trade surplus, this improvement was not sustained. By the second half of 1967 the deficit was as large as it had been prior to February 1965. Yet, the V.F.C.R. actions in 1965 seemed to have a longer and more beneficial effect on the capital account than the I.E.T. With respect to the four quarters just before and just after February 1965, short-term capital went from $—2.0 billion to $0.6 billion, and long-term capital from $—4.3 billion to $—2.7 billion. This was probably because these Administrative actions coincided with a rise in United States interest rates relative to those of foreign countries, especially Japan. This tightening in domestic financial markets made it easier for banks and corporations to comply with the program without being in serious conflict with their profit objectives.

The Foreign Credit Restraint Program now in effect appears to be more effective than earlier programs because the forces of the market, specifically, high interest rates, have complemented it. Inflation in the United States implies not only that the prices of commodities and services are rising, but that the price of financial assets is rising if, as is the case in 1968, inflationary expectations are strong. If the general price level is expected to rise, purchasers of financial assets will demand a higher nominal return on the expectation that continued inflation will ease the burden of interest payments in the future.

A rise in domestic interest rates has the short-term effect of making United States financial assets more attractive than foreign financial assets. Consequently, United States funds which would otherwise have gone abroad in 1968 stayed at home, and foreign funds which would otherwise have been invested abroad were attracted to the United States. In addition, United States corporations making direct investments abroad have had more of an interest rate incentive to finance these investments in foreign rather than in United States financial markets. United States corporate borrowing in Europe was $1,057 million in the first half of 1968, compared with just $440 million in all of 1967 when United States Corporate Aaa bond yields rose to 6.2 per cent from 5.5 per cent.

Consequently, the net private capital outflow of $2.8 billion in 1967 became a net private capital inflow of about $1.4 billion in the first half of 1968, measured on a liquidity basis. This major reversal in the capital account substantially exceeded the guide-
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major factor in this occurrence.

Capital inflows associated with high interest rates

and domestic inflation may only be temporary. If the

inflation and high interest rates continue for an ex-

extended period, individuals may become fearful that

the decline in the domestic value of the dollar will

force a devaluation in the international value of the

currency. Such expectations could lead to a specula-
tive capital outflow. As is obvious from recent British

experience, no matter how high domestic interest

rates are, expectations of a devaluation can cause a

large capital outflow.

The present healthy glow in the United States

balance of payments may therefore be a sign of in-

flation fever associated with the boom phase of the

business cycle rather than recovery in the balance of

payments. If and when the present rapid inflationary
pace is slowed, the short-term effects on the capital

account may be adverse. Containing inflation will

cause market interest rates to decline, reducing the

short-term incentive to invest in the United States

financial assets, and causing a decline or reversal in

the recent capital inflow. However, this would

probably cause only a temporary weakness in the

balance of payments.

Foreign Factors

While the primary factors in recent balance-of-
payments developments can be ascribed to domestic

conditions, developments abroad also played an im-

portant role. The higher rate of economic growth in

Europe in 1968 relative to 1967 has encouraged

United States exports to grow at a rate of 18.2 per

cent in the first three quarters of 1968, more than
double the trend rate of 7.0 per cent between 1960

and 1966. The rapid growth in United States exports

largely to Europe helped prevent the decline in the

United States trade balance from being much worse.

The continued uncertainties with respect to the

British balance of payments, and speculation against

the French franc after the May 1968 crisis, have

resulted in capital outflows from those countries. The

outflow of funds from England and France was

largely deposited in the Euro-dollar market where

branches of United States commercial banks aggres-
sively bid for them. When these funds are transferred
to the head office in the United States, they are

recorded as a capital inflow on the Official Settle-
ments measure of the balance of payments. (See

pages 18 and 19 for an explanation of the various

balance of payments measures).

If United States commercial banks had not been

aggressively bidding for Euro-dollar funds, those

selling francs and sterling probably would have pur-

chased more deutsche marks than they actually did.
The demand by United States banks kept the Euro-
dollar rates high and rising so that the decline in

official holdings of dollars by the French and British

was not matched by an equal increase in official

dollar holdings by central banks of other countries in

the first three quarters of 1968. It is still too early to
tell what effects will result in the fourth quarter of

1968 from the massive currency speculation in

November 1968.

Conclusion

The virtual elimination of the United States trade

surplus has been associated with a strong improve-

ment in the overall balance of payments in 1968, due
to the initially favorable effects inflation and high

interest rates have on the capital account. The rise

in interest rates will continue to attract foreign funds

into the United States until such time as the continu-
ing inflation and declining purchasing power of the
dollar lead to speculation of devaluation of the dollar.
The United States is presently in the position where

inflation has encouraged the capital inflow, but has

not created strong expectations of devaluation.

The improved international position of the dollar,
in spite of what for the United States is a heavy

inflationary period, can only be partially explained

by Administrative actions and rising interest rates.

Perhaps an equally important reason is political rather

than economic. Recent events in Europe may have

convinced some people that the underlying political

stability of the United States, in spite of well-

publicized riots and disorders, may be greater than

that of Europe. This attitude has undoubtedly in-

fluenced some Europeans to invest their funds in the

United States.

5It is difficult to say whether the improvement in the United

States capital account was due to the problems faced by

France and England, which caused a decline in their hold-
ings of dollars, or to high interest rates in the United

States, which made it attractive for United States banks to

borrow in the Euro-dollar market. If it had not been for the

incentive of United States banks to borrow, the decline in

official dollar balances of France and England probably would

have been matched by an increase in official dollar balances

of other countries. That is, the speculators would have moved

their funds not into the Euro-dollar market, but into some

other European currency.

There was a substantial speculation in deutsche marks in

September and in late November, 1968, but the German cen-
tral bank made it profitable for the German commercial banks
to reinvest balances in the Euro-dollar market which came

from selling deutsche marks to speculators.

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