

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.

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

¹The Canadian government purchased \$500 million of special nonmarketable, medium-term U.S. Government securities under the U.S.-Canadian reserve agreement. In substance, the United States agreed to exempt Canada from the Interest Equalization Tax, and Canada agreed not to increase its international reserves above a certain limit.

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.

U. S. Balance of Payments
(Billions of Dollars)

| | 1967 | 1968 First Three Quarters At Annual Rate |
|----------------------------------|-------|---|
| I. CURRENT ACCOUNT | 4.8 | 2.0 |
| (Trade Balance) | (3.5) | (0.8) |
| Exports | 30.5 | 33.6 |
| Imports | 27.0 | 32.8 |
| II. CAPITAL ACCOUNT ¹ | - 2.8 | + 1.4* |
| Long-term | - 2.0 | + 1.7* |
| Short-term | - 0.8 | + 0.3* |
| III. GOVERNMENT ACCOUNT | - 4.2 | - 3.4 ^e |
| IV. BALANCE OF PAYMENTS MEASURES | | |
| Liquidity Balance ² | - 3.6 | - 1.1 |
| Official Settlements Balance | - 3.4 | + 1.8 |

*First half 1968.

^e—estimated.

¹Liquidity basis.

²Balance of payments is not a sum of components because errors and omissions and private transfers are not included.

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

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.³

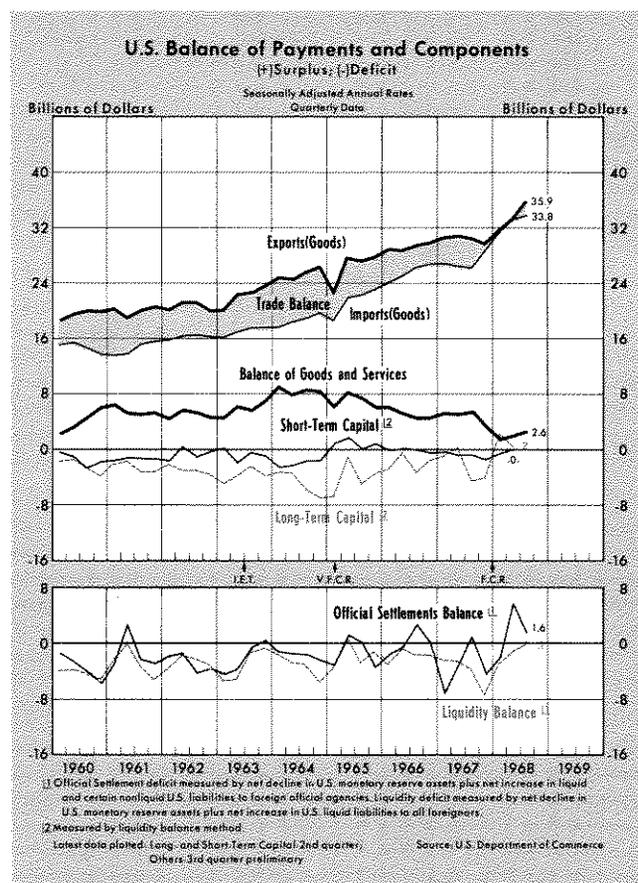
Following announcement of the 1963 I.E.T. program, the overall balance of payments improved for about six months and then deteriorated as those capital items not subject to the I.E.T. (largely bank loans) increased rapidly. By the second half of 1964 the overall balance of payments had returned to its 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 assets⁴ 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

³For a detailed explanation of these programs, see the December 1966 issue of this *Review*, p. 21.

⁴The price of a financial asset is most appropriately measured by its market yield rather than by its market price. This is because the yield represents the cost of issuing and the benefits of purchasing financial assets. The relation between market price (P) and market yield (r) is as follows: $P = (1/r)$.



so that their real rate of return will not decline, and the suppliers of financial assets will be willing to pay 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 \$1,087 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-

lines specified in the January 1, 1968 program. The rise in United States interest rates was probably a 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 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 speculative 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 inflation 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 important 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 16.2 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 aggressively 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 Settlements 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 purchased 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 1968.⁵ 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 improvement 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 continuing 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 influenced 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 holdings 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 central 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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