Perspective on the United States External Position Since World War II*

During the past generation, the international economic position of the United States has been transformed. In the years immediately following World War II, this country was perceived as the world's most powerful nation—the center country, the stabilizer of the international economy. In this role, its initial function was to provide leadership and vital resources for the postwar recovery. Thereafter, its task was to maintain a strong but noninflationary domestic economy as well as open goods and capital markets. If international imbalances occurred, it was the task of *other* countries to adjust. During the seventies, and particularly after the breakdown of Bretton Woods, this perception of the United States as the center country faded. It is still acknowledged as the world's largest economy and still seeks most of the same economic objectives as before. However, it no longer dominates the world economy and must, like other countries, participate in the international adjustment process. This greatly complicates the function of stabilization which—if it is to be performed at all—must be shared among a group of major countries, of which the United States is only one.

This shift in the position of the United States has been closely associated with a corresponding change in the international role of the dollar. For twenty-five years after the war, the stability of the American currency was widely regarded as essential to world prosperity. For most countries, an increase in official claims on the United States was viewed as a sign of success in economic policy. The dollar's stability in terms of gold was almost unquestioned. It was the *nth* currency in terms of which other currencies would adjust.

In practice, the setting of the exchange rate of the dollar by foreign countries involved two distinct but related asymmetries. One involved a devaluation bias against the American currency. Many nations devalued their currencies against the dollar, but countries whose currencies were strong normally preferred to accumulate dollars—sometimes in large amounts—rather than risk the deterioration in competitive strength that was expected to result from appreciation. The other side of the coin was another asymmetry, seen by some as giving the United States an "exorbitant privilege" and by others as weakening external discipline on its economic policy. When foreign currencies weakened, the countries concerned lost reserve assets, which signaled the need for measures to correct the external imbalance. In contrast, the reluctance of foreign monetary authorities to accept currency appreciation and their related willingness to accumulate dollars meant that the discipline imposed by losses of reserve assets was felt only infrequently by the United States.

Along with the fading of the perception of the United States as the center country came a reappraisal by

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foreign countries of their attitude toward the American currency. This reappraisal was stimulated, in the most immediate sense, by the American authorities themselves: by the closing of the gold window in August 1971, by the devaluations of the dollar negotiated late in that year and again in early 1973, and by subsequent indications that the administrations in Washington were little disposed to intervene in the exchange markets in order to defend the external value of the American currency and even hankered, on occasion, for some further depreciation of the dollar against major currencies. When such attitudes in Washington were accompanied by continuing massive increases in foreign claims against the United States, it was hardly surprising that monetary authorities abroad began to seek ways to diversify their international reserves into assets other than the dollar. Toward the close of the seventies, a few important countries came to see appreciation as a means of curbing domestic inflation at about the same time that the United States authorities began to recognize how much dollar depreciation was adding to America's inflationary difficulties. Thus, the willingness of foreign monetary authorities to intervene in support of the dollar declined just as the Administration became more fully aware of the benefits of such support for the United States.

These changes in the position of the dollar reflected more fundamental developments here and abroad that may be viewed from several angles. From the narrow perspective of this country's balance of payments, the weakening of the dollar can be attributed to a growing disequilibrium between other countries' demand for the American currency and the supply of that currency flowing into foreign markets. Especially in the 1970s, the total of dollars that foreigners desired both to pay for net imports of goods and services from the United States and to increase their official reserves tended to fall well below net financial outflows from the United States.[1] The causes of this disequilibrium are numerous and not fully understood but clearly lie in both financial and goods markets. On the financial side, it has long been accepted that a wealthy economy is likely to be a supplier of capital, on balance, to the rest of the world. This has, in fact, been true of the United States throughout the postwar period. During the 1970s, however, these financial outflows became exceptionally large by historical standards. The expansion was associated with a variety of developments, including the depreciation of the dollar against other major currencies and increased borrowing by nonoil-producing countries. These countries, being faced with sharply rising import costs, turned to dollar markets here and abroad to finance payments deficits (especially for oil) as well as to increase their international reserves.

But, while the world continued to rely heavily on dollar financing, the relative economic position of the United States was changing fundamentally from what it had been in the earlier postwar years. With growth abroad more rapid than in this country, the United States share of world production dropped from about two fifths in 1950 to only a little over one fifth at the close of the seventies. Abroad, high levels of savings and investment expanded productive capacity and narrowed the technological lead that had previously been enjoyed by American industry. Increasingly, technologies and managerial methods employed by foreign firms became equal to, or even surpassed, those employed by their United States competitors. At the same time that the industrial lead of the United States was narrowing, its dependence on foreign sources for primary commodities, particularly petroleum, was increasing. This tendency reached back into the fifties and sixties but became a matter for broad public concern only after 1973 when the sharp rise in oil prices began.

The upshot of these various developments was that, for sustained periods during the seventies, dollar transfers from the United States for imports of goods and services and financing exceeded—sometimes by substantial amounts—the total that foreigners spent on purchases of goods and services from this country and desired to add to their dollar assets. This disequilibrium resulted, of course, in downward pressure on dollar exchange rates which raised questions about the advisability of continuing to hold existing stocks of dollars. Bearishness about the dollar thus tended at times to become self-aggravating and cumulative.

These difficulties could, in theory, have been handled by appropriate international adjustments. However, throughout most of the sixties and seventies, the adjustments that were in fact achieved—although sometimes substantial—nevertheless fell far short of those required to restore and to maintain equilibrium between the United States and the rest of the world. The causes of this shortfall are complex and many of the explanations are controversial. However, two long-term causes are generally accepted. In the United States, economic policy has provided inadequate incentives for saving and productive investment. This lack has had adverse effects on both the financial and goods sides of the balance of payments. On the financial side, the weaker incentives to invest in the United States than abroad led to larger private capital outflows

[1] Financial outflows are defined hereafter as remittances, direct investments, official and private grants and loans, and the statistical discrepancy in the balance-of-payments accounts

than would have occurred with more appropriate economic policies. In the goods market, the international competitive strength of the United States has been impaired because the growth of productivity has been far lower here than in most other major countries. The other long-term obstacle to the improvement of this country's balance on goods and services has been the various tariff and other barriers to imports maintained by Japan, most developing countries, and—as regards agricultural products—the European Community (EC) In attempting to persuade other countries to reduce such barriers, American negotiators have been handicapped because special interests here—ranging from dairy producers to steel makers—have themselves obtained various degrees of protection against foreign competitors. Although several rounds of multilateral trade negotiations made progress in reducing them, such barriers were still creating significant difficulties for international adjustment at the close of the seventies.

At various times, other difficulties also worsened the international economic problems of the United States. A majority of economists would probably agree that international adjustment was complicated prior to 1971 by the rigidity of the exchange rate structure and, particularly, by the reluctance of such surplus countries as Germany and Japan to appreciate their currencies against the dollar. Most observers would also agree that the inflationary financing of the Vietnam war contributed significantly to the weakening of the dollar. After the breakdown of Bretton Woods, the United States authorities failed, more often than not, to accompany dollar depreciations with policies designed to release domestic production in order to strengthen the trade balance. Major countries abroad also played a role in the adjustment difficulties. Giving high priority to curbing inflation, they were reluctant to adopt expansionary policies either when this would have been appropriate because of the appreciation of their currencies or when they were urged to follow the lead of the United States during the recovery from the 1974-75 recession.

At the beginning of the 1980s, a new perception of the international economic role of the United States was coming into focus. It was no longer the center country but only one—albeit still the largest—of a growing number of industrial countries. The change was symbolized by the reduced willingness of foreign countries to add to their balances of American currency as well as by the related need for the American authorities to borrow key foreign currencies in overseas bond markets in order to reinforce their ability to support the exchange rate of the dollar Throughout the postwar years, other countries had defended their currencies primarily by drawing down their foreign exchange reserves. Now, the same was becoming true for the United States, although still on a relatively small scale.

These borrowings to strengthen its international reserves reflected a growing recognition in the United States of the importance of exchange stability in national stabilization policy. Bitter experience had forced many countries abroad to see the link between exchange depreciation and domestic inflation and to adopt stabilization policies that sought—not always successfully—external as well as domestic objectives. In the United States, the experience of the 1970s underlined the interdependence of these two aspects of stabilization policy: not only did the outcome of Government programs to reduce inflation partly depend on the avoidance of exchange depreciation, but the success of official intervention in the exchange markets rested in large measure on the adoption of sound domestic economic policies. Thus, the final years of the 1970s saw Federal Reserve policy influenced more than at any previous time since the war by the need to support the dollar in the exchange markets. Other policies were also being influenced increasingly by external considerations. For example, changes in tax policy aimed to strengthen the international competitiveness of United States industry by providing greater incentives to invest while energy policy sought to reduce dependence on imported petroleum. In these and other ways the United States was attempting to strengthen its external position and to adjust to the ever-changing international economy.

In the pages that follow, the developments that have contributed to the change in the international economic position of the United States are analyzed in greater detail. The analysis begins with a brief survey of developments in the overall balance of payments of the United States since 1950. The growth and cyclical pattern of the financial outflows as well as the various factors that have influenced the balance on goods and services are then reviewed. The large role of cyclical and other temporary factors in the strengthening of the United States balance of payments during 1979 is underlined. Against this background, the conclusion emphasizes that this improvement, while welcome, did not diminish the urgent need for policies designed to provide more enduring strength to this country's external position.

United States balance of payments, 1950-79

Net financial outflows from the United States exceeded net exports of goods and services by $168 billion during the years 1950-79 inclusive (Table 1). Such excesses—reflected in reserve transactions—occurred in

Table 1

Balance of Payments of the United States, 1950-79

Annual averages in billions of dollars

Component	1950-57	1958-64	1965-69	1970-74	1975-76	1977-78	1979
Goods and services	**3.6**	**5.5**	**5.4**	**5.3**	**16.3**	**−8.9**	**5.3**
of which							
Merchandise trade balance	3.1	4.5	2.8	−2.1	−0.1	−32.3	−29.4
Investment income	2.7	4.0	5.5	9.9	14.4	19.8	32.3
Financial transfers	**−4.5**	**−8.0**	**−5.5**	**−18.6**	**−26.7**	**−26.5**	**9.8**
Unilateral transfers (excluding military)	−2.8	−2.5	−3.0	−4.4	−4.8	−4.9	−5.6
United States Government (excluding reserve assets)	−0.3	−1.1	−2.0	−1.5	−3.8	−4.2	−3.8
United States banks, net	0.1	−0.2	3.5	−4.1	−11.6	−10.4	6.6
United States claims reported by United States banks	−0.3	−1.1	−0.1	−6.6	−17.5	−22.2	−26.1
United States liabilities reported by United States banks	0.4	0.9	3.6	2.5	5.8	11.8	32.7
Other United States private assets	−2.3	−4.1	−6.9	−11.4	−22.5	−22.2	−32.4
Other foreign private assets in United States	0.5	0.5	3.1	6.1	7.9	10.2	16.4
Errors and omissions	0.3	−0.5	−0.2	−3.2	8.1	4.9	28.7
Allocation of special drawing rights	—	—	—	0.5	—	—	1.1
Allocation of SDRs plus total financial transfers	**−4.5**	**−8.0**	**−5.5**	**−18.1**	**−26.7**	**−26.5**	**11.0**
Reserve transactions, total	**0.9**	**2.5**	**0.1**	**12.9**	**10.5**	**35.4**	**−16.3**
United States reserve assets (+ = decline)	0.1	1.2	0	0.7	−1.7	0.2	−1.1
Claims of foreign monetary authorities on United States, (+ = increase)	0.7	1.3	0.2	12.2	12.2	35.2	−15.2
of which changes in liabilities reported by United States banks	0.6	0.5	0.6	2.1	−0.6	3.1	6.6

Because of rounding, figures may not add to totals

Sources: United States Department of Commerce, *Survey of Current Business*, various issues. Data for 1950-59 are from the October 1972 *Survey*, 1960-78 from the June 1979 issue, and 1979 from the March 1980 issue Banking flows and changes in claims of foreign monetary authorities on the United States for 1950-59 are partly estimated Short-term liabilities to foreign monetary authorities reported by United States banks for 1950-59 are from the Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics*, 1941-70, page 932

twenty-four of the twenty-nine years ended 1979—the five exceptions being years of monetary stringency in the United States (Chart 1) Until 1979, the excesses tended to increase, not only in current dollar terms, but also relative to United States gross national product (GNP) (Table 2).[2] The transfer gap—as it may be called—between financial outflows and the surplus on goods and services averaged about ¼ percent of United States GNP in the fifties and sixties but well over 1 percent in 1970-78. In 1979, the transfer gap was reversed as financial movements shifted to heavy inflows while the balance on goods and services strengthened.

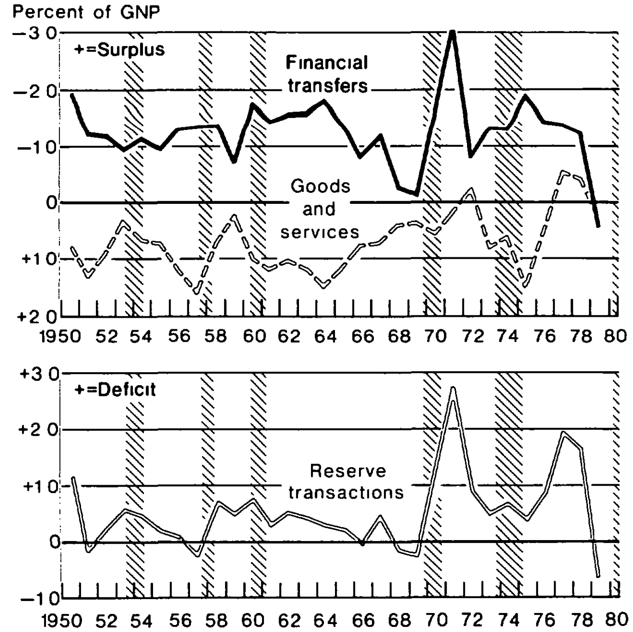
The growth of the transfer gap, until last year, was reflected principally in increased claims on the United States by foreign monetary authorities. Only about one twentieth was settled by United States reserve assets, primarily gold sold by the Treasury during the late fifties and during the sixties before the breakdown of Bretton Woods. In contrast, foreign official claims on the United States, which were reported at less than $3 billion at the end of 1949, amounted to $31 billion in mid-1971, before the closing of the gold window, and to $143 billion in December 1979.[3] Including an additional $61 billion of balances of central banks in the Euromarkets, the total of official dollar assets comprised 63 percent of reported foreign exchange reserves at the end of 1979, compared with only 27 percent thirty years earlier.

[2] The general approach to the analysis of the balance of payments follows Fritz Machlup's paper on "The Transfer Gap of the United States", *Banca Nazionale del Lavoro Quarterly Review* (September 1968)

[3] Includes Bank for International Settlements and European Fund United States Treasury *Bulletin* (May 1980, Table IFS-3), page 91

Chart 1

Cyclical Movements in the United States Balance of Payments



Shaded areas represent periods of recession, as defined by the National Bureau of Economic Research

Sources Balance-of-payments data are from the sources cited for Table 1 GNP data are from the Economic Report of the President (January 1980), page 203, recent data have been updated

Table 2

Major Components of the United States Balance of Payments

In percent of gross national product

Period	Balance on goods and services	Financial transfers*	Reserve transactions*
1950-57	0 95	−1 22	0 28
1958-60	0 65	−1 27	0 62
1961-69	0 94	−1 12	0 18
1970-74 ...	0 43	−1 61	1 14
1975-78	0 29	−1 49	1.20
1975-79 .	0 28	−1 11	0 82
1979	0 22	0 42	−0 69

The periods selected generally cover full business cycles as measured by the National Bureau of Economic Research The first year of each period is that in which the trough occurs, the final one includes the peak or, in the case of 1979, the most recent data However, the 1950-57 period covers virtually all of the two cycles of which the first trough is dated October 1949

* Allocations of SDRs (special drawing rights) are included in reserve transactions but excluded from financial transfers, this inclusion has negligible effects on the ratio of reserve transactions to GNP, reducing it by 0 04 percent in 1970-74 and increasing it by a similar amount in 1979

The great bulk of these foreign official dollar gains reflect financial outflows from the United States. In only three years—1972, 1977, and 1978—did deficits on goods and services contribute to such foreign official gains. Over the rest of the period, net sales of goods and services absorbed dollars from abroad. Although total financial outflows have expanded greatly in current dollar terms, in relation to United States GNP they have shown remarkable stability. Measuring them over full business cycles, as is done in Table 2, the outflows have fluctuated in the neighborhood of 1-1¼ percent of GNP, except in 1970-74, when the breakdown of the Bretton Woods arrangements doubtless explains most of the rise to 1 6 percent Within each cycle, striking shifts have occurred. Outflows have surged in periods of monetary ease but have subsequently declined sharply—sometimes changing to inflows—under monetary stringency. Illustrative are the large outflows in the recession years 1970 and 1975 and the virtual drying-up of such flows in 1969, when monetary conditions were tight. Although other factors played a role, the successive moves toward increased monetary restraint, made in late 1978 and during 1979, were essential in bringing about the dramatic reversal of financial flows last year

In contrast to the general stability over the cycle of financial outflows, the average annual surplus on goods and services declined to only 0 3 percent of United States GNP in 1975-79 from almost 1 percent in the fifties and sixties. Within the total of goods and services, the two most important components are the merchandise trade balance and income on account of foreign investments (Table 1) The latter has shown a rising surplus throughout the period under review, reflecting earnings on the large placements abroad of American capital[4] On the other hand, the

[4] Only part of the income from foreign investments is repatriated to the United States, the rest being plowed back into foreign economies The reinvestment abroad of such earnings is taken into account as an increase in United States private assets abroad, *i e*, as a financial outflow from the United States Under an earlier presentation of the United States balance-of-payments statistics, reinvested earnings were omitted from both the balance on goods and services and the capital account The change in the presentation of the balance of payments does not, of course, affect the size of the gap between financial outflows and the surplus on goods and services

merchandise trade balance has tended to weaken. Showing expected cyclical fluctuations, the surplus peaked in 1964 at almost $7 billion, then declined, shifting to a deficit in 1971 for the first time since 1893. After recovering to a record surplus of $9 billion in the recession year 1975, the balance again shifted to heavy deficit as the United States economy moved back to full capacity in 1977 and 1978, while the recovery in other industrial countries lagged. Despite the depreciation of the dollar and a reversal of cyclical pressures, the deficit—though smaller than in the two previous years—remained substantial in 1979. The problems behind the weakness in the United States merchandise trade balance occupy the bulk of this paper, following a discussion of financial outflows.

Financial outflows from the United States

Financial outflows from the United States over the past twenty-five to thirty years are explicable in terms of this country's wealth relative to the rest of the world, the commitment of successive United States administrations to the principles of a market economy, the rapid recovery and growth of most major countries abroad and many smaller ones, and the reluctance of most of these countries to go very far in dismantling restrictions on capital outflows. The upsurge in outflows during the seventies was, at times, associated with private portfolio shifts out of the depreciating dollar into assets denominated in currencies that were expected to appreciate[5] as well as with increased borrowing by foreigners to finance payments deficits, particularly with the Organization of Petroleum Exporting Countries (OPEC), and desired increases in international reserves.

Despite the wealth of the United States, the private markets here were slow in beginning to supply resources to the rest of the world after World War II (Table 3). Many financial institutions still held bonds and other claims on which foreigners had defaulted during the depression of the 1930s. The American banking system, chastened by the unhappy experiences of the interwar years, had retreated from the foreign field.

With recovery among the war-torn countries and impressive growth elsewhere, the attractions of foreign markets increased. Dollar financing, funneled through official grants and loans both from the United States Government and international institutions, was supporting expansion in the world economy. Closely related to United States financial support, American policy was committed to reducing the barriers to trade and payments that had sprung up during the depression and the war. As international prospects improved, United States companies increasingly ventured abroad. Often they established manufacturing subsidiaries overseas to avoid barriers such as the external tariff of the EC as well as to benefit from relatively favorable labor market conditions in host countries. Keeping pace with the growing international activity of American manufacturing firms, United States commercial banks increasingly established branches and offices abroad, strengthening their links with foreign financial markets. Foreign banks followed suit by setting up numerous offices in the United States. At the same time, the New York bond market—with resources several times greater than those of the largest foreign competitor—gradually reopened to foreign borrowers.

[5] H R Heller, *International Reserves and World-Wide Inflation*, International Monetary Fund *Staff Papers* (1976), pages 68-70

Table 3

Composition of Private Capital Flows, 1950-79

Annual averages as percentage of gross national product

Period	Direct investment (net)	Banking flows (net)	Other recorded nonofficial capital (net)	Total recorded private flows	Statistical discrepancy	Total
1950-57	−0.43	0.02	−0.03	−0.44	0.09	−0.36
1958-60	−0.45	0.03	−0.17	−0.59	−0.02	−0.61
1961-69	−0.54	0.19	−0.04	−0.39	−0.08	−0.47
1970-74	−0.57	−0.38	0.12	−0.83	−0.29	−1.12
1975-79	−0.58	−0.44	−0.16	−1.18	0.53	−0.64
1979	−0.72	0.28	0.04	−0.40	1.21	0.81

Totals may not add because of rounding

The sources are the same as in Table 1 and the periods selected are for full business cycles as described in the note to Table 2

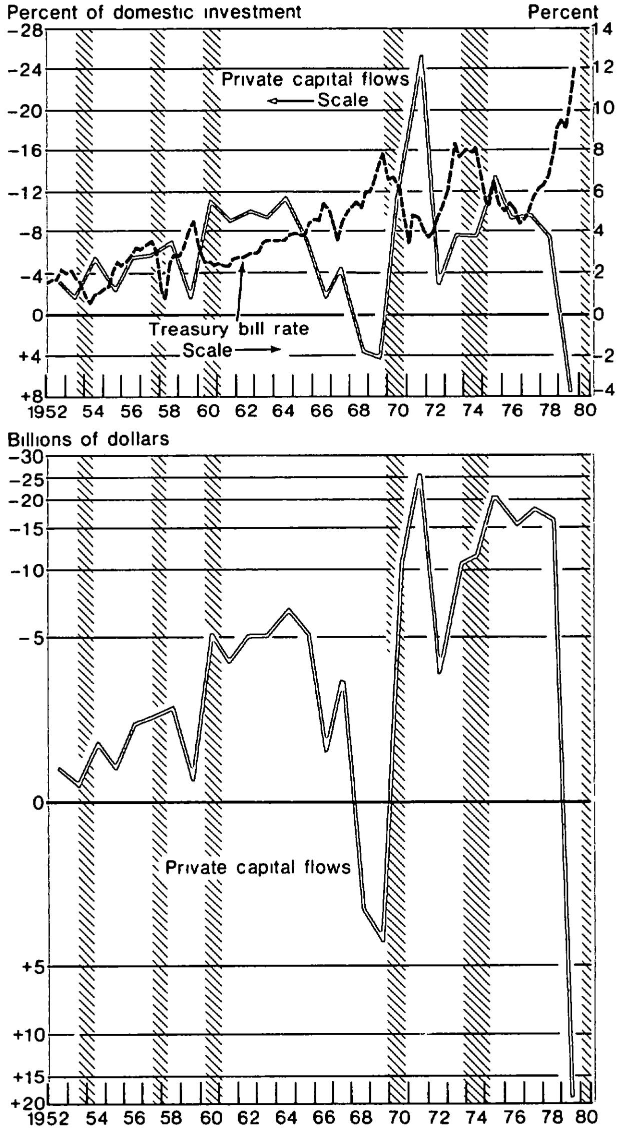
The reinvolvement of our financial markets with the rest of the world has not always been regarded as an unmixed blessing. The expansion of United States private lending abroad in 1958-60 came at a time when this country's merchandise trade balance was showing distinct signs of weakness. Having rebuilt their holdings of dollars, some major central banks abroad began to convert continued inflows of dollars into gold. Some $5 billion of the metal was bought from the Treasury in the three years ended December 1960. Although its gold stock still totaled almost $18 billion, greatly exceeding the holdings of any other country, the continued rise in United States liquid liabilities to foreign monetary authorities raised questions about the future stability of the dollar. As part of a program to calm these fears, the United States authorities instituted various restrictions on capital outflows, beginning in 1963 with a tax that discriminated against borrowings by most of the industrial countries. This tax was subsequently reinforced by so-called voluntary controls on specified lending abroad by commercial banks and by large nonbank corporations. Finally, in a classic example of the tendency of controls to spread, mandatory restrictions were imposed in 1968 on a wide range of United States direct investments abroad.

Whether these controls did more than divert financial flows into uncontrolled channels has been much debated. What does seem clear is that monetary conditions in the United States continued to have the predominant influence on private capital flows (Chart 2).[6] Such outflows contracted sharply during the 1966 credit crunch and, after recovering somewhat the following year, changed into substantial inflows under the pull of taut monetary conditions in 1968 and 1969. Thereafter, when the boom gave way to recession in 1970, the flows were again reversed, becoming heavily outward. This, combined with a shift of the United States trade balance into deficit and the breakdown of the par value system, led to the explosion of private capital outflows in 1971. After the closing of the gold window, the collapse of Bretton Woods, and the floating of the major currencies removed the original basis for the attempts to restrict capital outflows from the United States, the controls were lifted in early 1974. From then on, the flows responded freely to the increased demands of foreigners for financing as well as to changes in relative monetary conditions and exchange rate expectations. Outflows in the recession year 1975 were almost as large as during the 1971

[6] Private capital flows exclude private remittances and Government grants and loans which are counted in the broader category of financial flows considered above

Chart 2

Private Capital Flows in the United States Balance of Payments



"Private capital flows" are the total of changes in the United States private assets abroad, net (line 47), other foreign assets in the United States, net (line 64), and the statistical discrepancy (line 75) from Table 1 of the "United States International Transactions", published in the Department of Commerce, Survey of Current Business (March 1980 and earlier issues) "Domestic investment" is gross private fixed nonresidential investment as given in the Economic Report of the President, January 1980, page 219 Data for 1979 have been updated

Shaded areas represent periods of recession, as defined by the National Bureau of Economic Research

Table 4
Role of the Dollar in International Finance

International claims	1974	1975	1976	1977	1978	1979
(1) Increase in gross external claims* as reported by banks in major financial markets (billions of dollars)†	90	140	117	156	256	276
of which. Percentage denominated in dollars	78	79	77	54	59	63
(2) Gross international bond issues (billions of dollars)‡	7	20	33	34	34	41
of which Percentage denominated in dollars	63	51	61	56	38	42
(3) Total (1) + (2) (billions of dollars)§	97	160	150	190	290	319
of which. Percentage denominated in dollars	77	76	73	55	57	61

* Includes claims both in domestic currency on nonresidents and also in foreign currency on residents and nonresidents

† Includes Belgium-Luxembourg, France, Germany, Italy, the Netherlands, Sweden, Switzerland, United Kingdom, Canada, Japan, and the United States plus the United States offshore centers in the Bahamas and Cayman Islands for the entire period. Austria, Denmark, and Ireland are included in 1977 and thereafter.

‡ Includes Eurobond issues as well as issues on behalf of nonresidents in the major national markets

§ Increases in gross external claims and in gross international bond issues are not strictly comparable because refinancing is treated differently. Refinancing of bank-reported external claims leaves the total of such claims unchanged As regard the bond series, comprehensive data on maturities and refinancing are not available It is therefore not possible to distinguish between issues that are for refinancing purposes and those that provide new money

crisis. The outflows then receded as the economy recovered during the following three years. Within the generally declining trend, however, there were outward surges in the final quarters of 1977 and 1978, when pessimism about the outlook for the dollar became pronounced. The change in market sentiment after the November 1, 1978 measures, as already noted, shifted the financial movements to heavy inflows in 1979.

Standing back from short-term fluctuations, two points are worth noting. In contrast to the previously observed stability of *total* financial flows, *recorded private* capital outflows have tended to increase in relation to United States GNP over the five business cycles covered in this study (Table 3). The tendency is gradual for net direct investment abroad but is pronounced for bank flows which were generally inward during the fifties and sixties, subsequently shifting to substantial outflows in the seventies. However, the rising tendency of recorded private outflows was checked by the shift in the statistical discrepancy—believed to reflect primarily unrecorded capital movements—from outflows in the troubled period around the breakdown of Bretton Woods to substantial inflows in the latter half of the seventies.

The second striking feature is the continued heavy dependence of the world economy on dollar financing, not only from the United States, but also from the Euromarkets. Despite the shift in the United States international economic position, two thirds of international lending was still denominated in dollars in 1974-79 (Table 4). True, the dollar proportion showed a declining trend during those years. Part of this decline was doubtless structural, in the sense that it reflected the desire of lenders to diversify at the margin into assets denominated in such currencies as the Deutsche mark and the Swiss franc. But another significant part of the decline was almost certainly a cyclical phenomenon, associated with the tightening of United States monetary conditions relative to those in other major financial centers. To the extent that it was cyclical in origin, the recent decline in the dollar proportion of international financing is likely to be reversed when the balance of monetary pressures moves against the United States.

Although the high proportion of dollar financing was to be expected in the early postwar years, the extent of the continued dependence seems somewhat anomalous now. In the early years, major countries abroad were still reconstructing their economies. Almost universally, controls were maintained to channel national savings into the building of domestic productive capacity. By so doing and by attracting capital (mainly in the form of dollars) from abroad, foreign countries strengthened their economies to the point where several of them now vie in per capita wealth with the United States. Yet, until the recent abolition of exchange controls in the United Kingdom, few were willing to go as far as the United States in opening their financial markets to international pressures. Even those countries which were most devoted to market principles still maintained informal controls over foreign access to their financial markets. Where devotion to such principles was less strong, the authorities severely restricted foreign borrowing, not only from their bond markets, but also from their commercial banks. Experience suggests, it is true, that such controls rarely succeed in attaining their full objectives. Nevertheless, they probably did divert a significant proportion of the demand for international capital to the huge and freely accessible dollar markets. Although restrictions on capital flows have now been significantly reduced by Britain's recent move, foreign reliance on dollar financing is likely to remain excessive until other major countries follow suit.

Weakness of merchandise trade balance

While one aspect of the expanding transfer gap has involved large financial outflows from the United States, another concerns, as previously noted, the weakness of this country's merchandise trade balance. This weakness has resulted from numerous related factors:

(1) More rapid growth and technological advance abroad;

(2) An exchange rate structure that, until the depreciation of the dollar in the early seventies, gave a strong competitive advantage to foreign countries;

(3) The adverse shift in the terms of trade of the United States since 1969, *i.e.*, prices of imports increased more rapidly than those of exports;

(4) The increased dependence of the United States on imported raw materials, particularly petroleum;

(5) The prevailing domestic orientation of United States firms resulting in general lack of interest in export markets, in contrast to competitors in other countries, more dependent on international trade, and

(6) Foreign barriers against some products in which the United States has a significant competitive advantage.

All these factors have had a bearing on the weakness of the merchandise trade balance at one time or another since World War II, but their influence has varied. The following analysis will discuss them separately and suggest how, in successive periods, each interacted with the others.

More rapid growth and technological advance abroad

More rapid advance in many foreign countries than in the United States tended to weaken this country's merchandise trade balance. This result was the outcome of opposing tendencies. While certain tendencies strengthened America's external position, others—yet more powerful—impaired it.

The strengthening tendencies are clear. In the early postwar years, the United States was the world's economic colossus, accounting for almost 40 percent of global GNP. Its undamaged and highly productive economy was the source from which the rest of the world sought the materials, plant and equipment, and above all the advanced technology with which to repair the damage of hostilities and to lift living standards, often from poverty levels. In this period, recovery abroad improved the merchandise trade balance of the United States—huge foreign demand for our products was circumscribed only because financing was limited. Even after the worst shortages of the early postwar years had been relieved, relative demand pressures continued to favor the trade balance of the United States because the economic growth of many foreign countries was more rapid than here. Although the 3.8 percent average annual increase in the real GDP (gross domestic product) of the United States in 1950-73 was in line with this country's historical performance, its growth rate was less than three quarters the corresponding weighted average expansion in the thirteen other principal industrial countries.

However, such favorable influences from the demand side were countered by opposite pressures from the side of supply. The view that more rapid growth abroad favors the trade balance of the slow-growing country assumes that productive capacity, technology, and product design are not changing in the competing economies or are everywhere changing at the same rate. As regards economic behavior since the war, such an assumption is erroneous. For many foreign countries, the wealth and prosperity of the United States established a standard toward which economic policy was directed; their aim was to narrow the gap in productivity and technology that lay between them and the American colossus. A related aim, encouraged by the United States especially in the Marshall Plan years, was the restoration of external economic strength to bring an end to dependence on American aid. Thus, rapid growth abroad involved, above all, the expansion of capacity that embodied advanced technology and the designing of superior products that would penetrate foreign markets, particularly those of the United States. For these purposes, governments abroad encouraged saving and productive investment which absorbed, in many countries, a substantially larger proportion of GDP than in the United States, the contrast with Japan being especially striking (Table 5). For this as well as other reasons, productivity per man-hour in manufacturing grew substantially more rapidly in major foreign countries than here,[7] thus helping strengthen their competitiveness in relation to the United States (Table 6).

Policies to stimulate saving, investment, and technological advance bore fruit across a wide spectrum

[7] Angus Maddison, *Long Run Dynamics of Productivity Growth*, Banca Nationale Del Lavoro *Quarterly Review* (March 1979).

Table 5

Gross Domestic Investment in Selected Countries

As percentage of gross domestic product

Country	1960	1976	1977
Industrial countries:			
France	24	23	24
Germany	27	24	22
Italy	24	18	21
Japan	34	33	32
United Kingdom	19	17	19
United States	18	16	18
Developing countries:			
Brazil	22	26	22
Egypt	13	24	24
India	17	19	21
Korea, Republic of	11	25	26
Mexico	20	26	20
Philippines	16	31	30
Spain	21	24	23
Taiwan	20	28	27

Source The World Bank, *World Development Report*, 1978, pages 84-85, and 1979, pages 134-35

Table 6

Output per Man-hour in Manufacturing, Selected Countries

Average annual growth rates

Country	1960-72	1973-78	1979
United States	3 2	1 8	1.6
Japan	10 4	4 8	8 3
Germany	5 9	5 2	5 2
France	5 9	4 9	5 4
United Kingdom	4.0	1.1	2.2
Italy	6.2	4 3	8 7
Canada	4.2	3.2	0.8

Source United States Department of Labor, Bureau of Labor Statistics, *International Comparisons of Manufacturing Productivity and Labor Costs*

Table 7

United States Balances of Trade in Technologically Intensive Manufactures*

Selected years; annual averages in billions of dollars

Area	1962	1970	1971-74	1975-76	1977-78	1979
Western Europe	1 6	2 4	1 6	4 0	1 8	2.9
Japan	0.3	−1.0	−3.1	−5.4	−11.7	−14.1
Total, all countries	6.6	7 2	16 0	22.0	15 3	19 9

* Technologically intensive manufactures include chemicals, nonelectrical and electrical machinery and equipment, transportation equipment, ordinance, and instruments and controls

Sources: Peter G. Peterson, *United States in the Changing World Economy*, Vol. 2 (United States Government Printing Office, 1971), Charts 30 and 32, United States Department of Commerce, Bureau of the Census, "Highlights of U.S. Export and Import Trade", FT 990 (December 1977, December 1978, and December 1979).

of countries, from the older industrial ones to others like Brazil, South Korea, the Philippines, and Taiwan that previously had little or no industrial base. Many lines of production, for which the United States was the only, or one of the few, suppliers in the early postwar years, were replicated abroad. With a view to capturing export markets, foreigners not infrequently manufactured products incorporating more advanced design and technology than those of their American competitors. Indeed, the rapid rise in exports was a major force behind the faster growth of foreign countries than of the United States. The counterpart of the growing share of foreign countries in world GNP was, therefore, a decline in the share of the United States in world exports of shoes, steel, automobiles, motorcycles, tools, and various types of machinery. Even in the field of technologically intensive manufactures, where its lead has been the greatest, the United States trade balance, while remaining strong overall, has weakened sharply in relation to Japan (Table 7). Increasingly, therefore, the United States has become only one—albeit still the largest—of a number of industrial economies competing for a share of the world market.

Structure of exchange rates

The recovery and expansion of the rest of the world was fostered by the exchange rate structure that characterized the twenty to twenty-five years immediately following World War II. Particularly after the devaluation of sterling and numerous other currencies in September 1949, prices—measured in dollars—in major countries abroad were substantially lower than in the United States. How large this disparity was is open to debate, but the evidence suggests that the gap remained significant until the United States closed the gold window and the dollar depreciated on the exchanges in the early 1970s.

Evidence of this disparity in prices—while far from complete—relates, not only to particular manufactures, but also to traded goods generally. Dollar prices of iron and steel products averaged 15-27 percent less in Germany than in the United States in 1953-64, 8-24 percent less in the United Kingdom, and 25-30 percent less in Japan, for which available data cover only 1961-64. Somewhat smaller but still significant disparities existed for machinery and transportation equipment.[8] For traded goods generally, estimated prices in 1970 were 7-17 percent lower in major foreign countries than in the United States (Table 8). An exception was Germany which had eliminated the estimated disparity by means of an 8 5 percent appreciation of its currency against the dollar in the fall of 1969. No comparable figures for traded goods are available for earlier years, but the rise in the general price level shown in Table 9 suggests that the disparities are likely to have been significantly larger in the early fifties, particularly in the cases of Germany and Japan.[9]

The disparity in prices between the United States and its major competitors was only one of the several key elements in a policy environment that favored the recovery and growth of countries abroad. In the early postwar years and, for many observers, even in the sixties, it was unthinkable that the gold value of the dollar would change. Accordingly, entrepreneurs in foreign countries could feel assured that their competitive positions in dollar markets would not be impaired by devaluation of the United States currency. This, combined with the commitment of successive American administrations to the reduction of tariffs and other barriers to trade, gave foreigners strong encouragement to invest in capacity designed to produce not only for their domestic markets but also for export. Thus, the advantageous structure of prices along with expectations about stability in the gold value of the dollar and about commercial policy all created an international environment that facilitated rapid economic advance abroad. At the same time, this environment probably also contributed to the relatively low rate of business investment in the United States as well as to the attractiveness for United States corporations of direct investments abroad.

Although, in retrospect, the competitive advantage that the price structure of the fifties gave to countries abroad seems clear, it was less so to contemporaries.

[8] Irving B Kravis and Robert E Lipsey, *Price Competitiveness in World Trade* (New York National Bureau of Economic Research, 1971) and "Export Prices and the Transmission of Inflation", *The American Economic Review* (February 1977), pages 156-57

[9] In a perceptive note appended to a study of the United States balance of payments published in 1960, Theodore O Yntema wrote "On the basis of fragmentary evidence, it seems to me that our exchange rates are incompatible with the fundamental relation between costs of production here and abroad The effects on our balance of payments resulting from the disparities in costs here and abroad are limited now by market imperfections—by lack of knowledge, inadequate procurement arrangements abroad by U S purchasers, and inadequate distribution systems here for foreign producers In the future the effects of these disparities in costs will be felt increasingly as foreign capacities expand, as economies of scale in production and distribution of foreign products increase, as more U S know-how is exported, as U S procurement abroad becomes more efficient (and more extensive) and as distribution systems for foreign products in the U S improve

"The balance-of-payments problem we have now results mainly from the phenomenal recovery and the great forward surge in productivity in the economies of Western Europe and Japan This is cause for rejoicing We should not be ashamed or afraid to make a readjustment in our exchange rates when it is necessitated by such good fortune Price fixing (even in exchange rates) cannot long ignore the realities of costs " Committee for Economic Development, *National Objectives and the Balance of Payments Problem* (February 1960), pages 3-4

Table 8

Relative Prices of Traded and Nontraded Goods for Selected Countries, 1970 and 1973

Level of United States prices = 100

Country	Traded goods* 1970	Traded goods* 1973	Nontraded goods* 1970	Nontraded goods* 1973
Japan	83	112	52	75
Germany	100	139	63	91
France	93	119	65	82
Italy	93	110	53	64
United Kingdom	86	97	58	69

* Traded goods are defined to cover all commodities Construction and all services are included under nontraded goods.

Source Irving B. Kravis, *et al, International Comparisons of Real Products and Purchasing Power* (published for the World Bank by the Johns Hopkins University Press, 1978), page 126.

Table 9

Dollar Cost of Representative Baskets of Goods in Selected Foreign Countries

Cost of basket of goods in United States = 100

Country	1950	1955	1970	1973	1977	1978
Japan	50	*	67	94	103	127
Germany	72	70	82	116	121	135
France	74	95	80	101	103	114
Italy	67	69	73	87	84	92
United Kingdom	70	77	72	84	85	96

These estimates represent for each country the local currency cost, converted into dollars at the exchange rate of the relevant year, of representative baskets of goods that would cost $100 in the United States. The baskets reflect the whole range of goods and services in each country's gross domestic product

* Not available

Sources Milton Gilbert, *et al, Comparative National Product and Price Levels* (Paris, Organization for Economic Cooperation and Development, 1958) pages 29-31, is source for 1950 and 1955 estimates for European countries, Michael Boretsky of the United States Department of Commerce provided the figure for Japan in 1950, Irving B. Kravis, *et al, International Comparisons of Gross Product and Purchasing Power* (Johns Hopkins University Press, 1978), page 21, provided the estimates for all countries for 1970 and 1973, for other years the estimates are based on the Kravis figures which are adjusted for changes in GDP deflators (from the Organization for Economic Cooperation and Development, *Main Economic Indicators)* and in exchange rates (from the Annual Statistical Digest of the Board of Governors of the Federal Reserve System)

In the early postwar years, indeed, the opposite impression prevailed. The competitive strength of the United States was regarded as unassailable; many expected that it would continue indefinitely as a chronic problem for other countries. Such impressions had some basis in fact. While reconstruction abroad was progressing, many countries still suffered severe shortages of coal, certain types of steel, and other industrial materials.[10] Many foreign firms still lagged far behind their United States competitors in technology and design. Basic materials and advanced American products were frequently bought almost regardless of price.[11] Consequently, quantitative restrictions were required abroad throughout the early postwar years to prevent dollar imports from exceeding the limits established by reconstruction and development programs and by foreign authorities' desire to rebuild their international reserves.

With the rapid recovery of economies abroad, the shortages and bottlenecks of the early postwar years gradually disappeared. By the midfifties, the industrial countries had removed most quantitative restrictions against imports of nonagricultural products from dollar sources. Their competitive strength justified them in doing so. True, prices in the United States generally rose more slowly in the decade ended 1963 than in the other industrial countries However, although the price advantage enjoyed by foreigners was smaller than it had been in the early fifties, it was still significant in the midsixties. Thereafter, rising inflationary pressures growing out of the Vietnam war combined with devaluations by other countries—notably Britain in 1967 and France in 1969—shifted the relative price advantage further against the United States. Thus, on the eve of the breakdown of Bretton Woods, prices measured in dollars among most of our major competitors were still substantially lower than in the United States, although not so much as they had been twenty years before.

This disparity in prices between the United States and abroad was generally removed by the realignment of exchange rates during the seventies. In some cases, indeed, the opposite disparity developed, giving rise—as many American tourists have discovered—to substantially higher prices in such countries as Germany, Switzerland, and Japan than in the United States.

The question whether the exchange rate crises of the early seventies could have been avoided or, at least, mitigated is of course surrounded by contro-

[10] Hal B Lary, *Problems of the United States as World Trader and Banker* (National Bureau of Economic Research, 1963), page 52

[11] Geoffrey Crowther, *Balances and Imbalances of Payments* (Harvard Graduate School of Business Administration, 1957), page 46

versy. With major countries abroad catching up with the United States in capacity to produce technologically advanced goods, international monetary arrangements that had been appropriate in the early postwar years inevitably required modification Even so, the necessary adjustments might have been achieved within the basic framework of the Bretton Woods arrangements had the major countries followed more appropriate policies. If, for example, the authorities had succeeded in maintaining inflation in the United States below that in other countries and also in providing greater stimulus to productive investment in American industry, the strengthening of this country's trade balance that occurred in the early sixties might not have been aborted. Likewise, if surplus countries such as Germany and Japan had been more willing to accept imports and/or to appreciate their exchange rates, the essentials of the par value system established at Bretton Woods might have survived. At least the adjustment crisis, when it came, would probably have been less severe and disruptive. In the absence of appropriate stabilization policies, however, a sharp depreciation of the dollar was probably the only practicable alternative by which to restore the external competitive position of the United States. But this gain came at the cost of an aggravation of inflation which, itself, added to the economic uncertainties and disturbances experienced later in the seventies.

Worsening terms of trade

Since 1969, increases in the dollar prices of United States imports have been substantially greater than those of exports, reversing the tendencies that prevailed during most of the fifties and sixties Although this broad conclusion seems clear, measurement of the changes is more than usually imprecise because it depends on unit value indexes whose deficiencies are well known Judging by these indexes, export prices were 151 percent higher in 1979 than they were a decade earlier, while import prices were up no less than 230 percent (Chart 3). The rise in import prices was primarily attributable to the devaluation of the dollar, to the huge jumps in oil prices, and to smaller, yet significant, increases in the cost of coffee, cocoa, and various other imported foods and raw materials Since the volume of United States imports was about 75 percent larger last year than in 1969, our export volume would have had to rise 135 percent to achieve a merchandise trade surplus comparable to that of a decade earlier. In fact, the volume of United States exports increased some 93 percent over the period. Although this was no small accomplishment, the shortfall amounted to $33 billion, somewhat more than the merchandise trade deficit in 1979.

Increased dependence on imported oil

Increased dependence on imported oil was by far the largest single element in the worsening of the merchandise trade balance of the United States during the seventies. This increase went a long way toward setting the stage for the quadrupling of oil prices by OPEC in 1973 and for the previously noted deterioration of our terms of trade since that time. With rises both in the physical volume of oil imports and in prices, the value of the oil obtained from abroad in 1979 was $50 billion higher than it had been six years before, greatly exceeding the improvement in our balance of trade in other commodities over the same period.

Although oil became a subject of broad public concern only in 1973, the increase in United States dependence on imports of that commodity began a generation before. Early in the postwar period, the United States changed from a net exporter of oil to a net importer Although domestic oil production rose in the fifties and sixties, domestic consumption grew even faster (Chart 4). Yet in 1970, when it peaked, domestic output still met 77 percent of United States consumption. Thereafter, however, the gap between domestic production and consumption widened dramatically

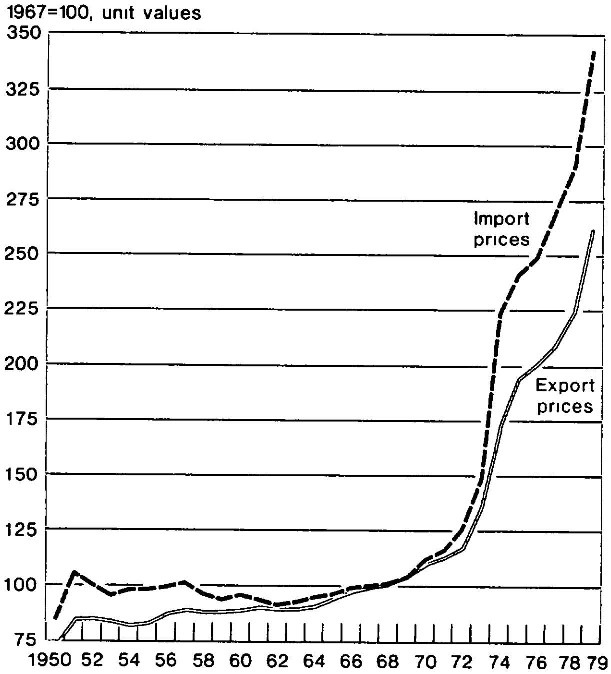
A small part of this widening was attributable to declining production. Domestic petroleum supplies that could be exploited profitably at existing market prices were diminishing and even such exploitation was discouraged by Government price controls. Consequently, domestic oil production stopped rising in 1970, then declined until 1976, recovering only part of the drop when output from the North Slope of Alaska began to flow in 1977.

The bulk of the increase in net oil imports stemmed from rising domestic demand which, despite rising prices, was 25 percent higher in volume at the end of the seventies than at the beginning (Chart 4). By the close of the decade, almost half of United States consumption of petroleum was being met from abroad, compared with 23 percent in 1970 and only 11 percent in the early fifties.

The international economic position of the United States was adversely affected, not only by increased dependence on imported oil, but also because this country was perceived to be dealing less successfully with the oil problem than other major countries. It is true that, in the late seventies, most major countries abroad remained dependent on imported oil for a larger proportion of their energy needs than the United States (Table 10). Consequently, such countries as France, Germany, Italy, and Japan were more exposed to the uncertainties of the international oil market For

Chart 3

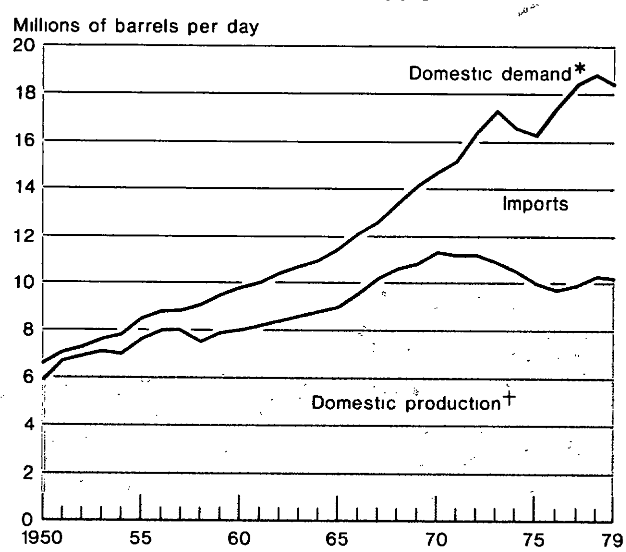
Prices of Exports and Imports of the United States



Source International Monetary Fund

Chart 4

United States Petroleum Supply and Demand



*Includes changes in reported private stocks and in Strategic Petroleum Reserve

+Includes natural gas liquids

Source Data for 1950-74 from American Petroleum Institute, Basic Petroleum Data Book (Washington, D C , 1977), data for 1975-79 from Department of Energy, Monthly Energy Review

Table 10

Dependence on Net Petroleum Imports* of Major Countries, 1973-79

Country	Millions of barrels per day 1973	1978	1979	Percentage of total energy requirements 1973	1978	Ratio to real GNP† (1973 = 100) 1978	1979
United States	6.0	8.0	7 8	17	22	118	112
Japan	5 5	5 3	5 6	83	73	80	80
France	2 6	2.2	2 4	71	59	73	77
Germany	2 9	2 7	2.8	55	53	84	84
Italy	2 1	1 9	2 0‡	79	69	81	81
United Kingdom	2.3	0 9	0 4	52	20	37	16

* Net imports of petroleum and petroleum products.

† GDP for France, Italy, and United Kingdom.

‡ January-September

Sources Central Intelligence Agency, *International Energy Statistical Reivew*, April 23, 1980, pages 9-11, International Energy Agency, *Energy Balances of OECD Countries, 1974/1978*, pages 149-50; and International Monetary Fund, *International Financial Statistics.*

this reason, perhaps, the pressure to reduce dependence was felt more keenly abroad than here. In any event, dependence on imported oil declined significantly in most of the major countries abroad in the five years following the OPEC shock. In contrast, despite last year's dip in domestic demand, United States dependence on imported petroleum was substantially greater at the close of the decade than in 1973.

The failure to deal successfully with its oil problem undermined the United States international economic position in several ways. At the most basic level, America's voracious appetite for petroleum was, as already noted, the largest force expanding imports. In addition, it pushed up oil prices not only for the United States but for the world at large. Such upward pressure on prices was tolerable for a time because the process of adopting an effective energy program inevitably involved prolonged debates, negotiations, and compromises within the political arena. By the late seventies, however, the time for decisive action was long past. By then, the failure to adopt an energy program designed substantially to reduce dependence on imported oil suggested that America had not faced the realities of the country's vulnerability to shocks from unstable foreign sources of petroleum. Viewed from abroad, America was perceived, not as a leader in dealing with the international oil problem but as unwilling or incapable of responding to the challenge from OPEC. Resistance to the adoption of effective energy policies thus undermined the Government's efforts both to reduce the trade deficit as well as to enlist the cooperation of other major countries in dealing with a variety of other international concerns.

Two illustrations may be given of the way in which the international economic position of the United States was injured by the inadequacies of cooperation. Despite the declared intentions of the major countries to curb oil imports,[12] the prospect of inadequate supplies and of rising prices in 1979 induced buyers to build up oil inventories, in some cases to the limits of storage capacity. Such precautionary buying, undertaken by many countries, drove up oil prices in the spot markets and so contributed to the enlargement of the United States deficit. In addition, the inflation of oil prices complicated the efforts of the United States authorities to support the dollar in the exchange markets, not only because of the widening of the trade deficit but also because market participants feared that other countries might pursue exchange market policies incompatible with our own. More specifically, foreign countries, faced with increases in the dollar price of oil, might better resist inflation in their economies if their exchange rates were allowed to appreciate against the dollar. Indeed, such tendencies added to other domestic and international pressures that induced the United States monetary authorities to play a relatively enlarged role during 1979 in the conduct of official intervention in dollar exchange markets.

The continental economy of the United States

The continental market is a mixed blessing for the international economic strength of the United States. It is advantageous because it provides American firms with huge potential demand for their output. Long production runs and economies of scale are therefore possible. However, these very advantages are in some ways a handicap in international trade. Although there are notable exceptions, many American firms feel little incentive to venture into uncertain foreign fields because their capabilities are adequately, and frequently fully, occupied in the domestic market. In contrast, firms in many foreign countries—especially the smaller ones—can secure long production runs and economies of scale only by exporting to world markets. Such firms are therefore more willing than their potential American competitors to seek out foreign customers aggressively, to learn their languages, to tailor their products to foreign tastes, and to provide after-sales service.

This gap between the performance of American and foreign firms was especially wide in the early postwar years when the prestige of the United States products was unsurpassed—when, indeed, some were virtually the only ones of their kind available. American firms had no need to search foreign markets for customers; buyers came to America. However, the complacency of many American firms tended to outlast their competitive strength. The recovery and growth of countries abroad was based on rising sales, not only in domestic but also in foreign markets. In capturing such markets, these countries frequently had the advantages of currencies that were undervalued against the dollar, at least until 1973. Although this advantage receded during the seventies and the United States was exporting a greater proportion of its output, most American firms still have a long way to go before they match the efforts of their foreign competitors in world markets.

Barriers to trade

Trade barriers are a long-standing problem for American exporters. They consist not only of tariffs and quantitative restrictions but also of various other devices, including Government regulations designed ostensibly to protect the health and safety of buyers.

[12] Declaration of June 29, 1979 at the Economic Summit in Tokyo, United States Department of State *Bulletin* (August 1979), page 8

Table 11

Ratios of Imports of Manufactured Goods to Gross National Product

Annual or annual averages

Year	United States	Germany	Japan	Canada	United Kingdom	France
1960	1 3	5.8	2.3	10.1	5.5	3 9
1966-72	2 5	8.4	2 4	13 3	8 4	7 3
1973-79	4.0	10 8	2.5	16 0	14 5	10.3*

* 1973-78.

Source United States Department of Commerce, *International Economic Indicators*

The incidence of all these barriers was most severe in the early postwar years, when most foreign countries were attempting to employ their limited dollar resources for priority purposes, including the rebuilding of their international reserves. As foreign countries gained in economic strength, many barriers were removed or reduced, particularly as the result of successive rounds of multilateral trade negotiations. However, some of the gains were offset by the erection of other barriers, notably the external tariff of the EC which discriminates against imports from nonmember countries and in favor of the products of certain ex-colonial countries. EC restrictions against agricultural imports—where the competitive strength of the United States is great—are especially severe Elsewhere, protective devices, established on infant industry grounds by developing countries and by Japan, have remained in effect long after the infants became hardy young giants. The case of Japan is especially notable because of the difficulty that American firms have experienced in penetrating its market The problem is illustrated by Table 11 which shows the ratio of imports of manufactured goods to GNP in the major countries. This ratio increased significantly during the sixties and seventies in all major countries except Japan, where it stayed virtually flat. It remains to be seen whether the reduction of barriers achieved under the recently concluded multilateral trade negotiations will increase the accessibility of the Japanese market to foreign products.

Conclusion

Just as the problems of the United States balance of payments arose from developments both in this country and abroad, so the correction of these problems involves the adoption of appropriate policies here and in other major countries. Inevitably, the prime responsibility falls on the United States. The task is formidable but probably not more so than a number of earlier payments adjustments successfully accomplished by other major countries. In some of these earlier instances, once vigorous corrective measures were adopted, the shift from external weakness to strength came with dramatic rapidity.

Insofar as the responsibility of achieving such a correction falls on the United States, the broad aims of policy are simply stated. The transfer gap must be narrowed to the point where foreign monetary authorities are accumulating no more dollars than they wish. Conceivably, they might wish, not to increase their dollars, but to run them down. In this case, the United States would need to absorb official dollars from abroad by running a surplus on goods and services that exceeded its financial outflows. However, it seems likely that, were the United States to adopt a vigorous and sustained adjustment policy, the appetite of foreign monetary authorities for dollars would strengthen. For purposes of exposition, this analysis takes the middle position, assuming that adjustment policies result over the longer term in the elimination of the transfer gap through some combination of reduced financial outflows and increased surpluses on goods and services.

Without going into detail on how to accomplish such an adjustment, some general pointers for policy are in order. The adjustment of the United States balance of payments calls for both medium- and longer term measures For the medium term, fiscal and monetary measures are required to restrain domestic spending and thus make available an enlarged proportion of output for sales abroad. For the longer term, a strengthening of policy in at least two major fields is required A great deal remains to be done to conserve energy use as well as to develop domestic energy supplies in order to reduce significantly this country's dependence on foreign sources of petroleum, especially from the Middle East. In addition, a substantial increase is required in the proportion of output devoted to productive investment not only to increase the country's energy independence but also to strengthen the competitiveness of United States goods in domestic as well as foreign markets Since such enlarged investment should be financed from noninflationary sources, a corresponding increase in the proportion of saving to GNP is also required In short, policy should be directed toward reducing the proportion of GNP devoted to personal consumption and government so that the proportion allocated to domestic investment and net exports of goods and services can be increased.

Even if adjustment policies could be precisely specified, it would, of course, not be possible accurately to predict their effects on the balance of payments However, it may be useful, for illustrative purposes, to compare one hypothetical outcome with the actual situation in the late seventies. Thus, the transfer gap might be eliminated through a decline in financial outflows to 1 percent of GNP, matched by an equivalent surplus on goods and services. This compares with *actual* financial outflows averaging 1.3 percent of GNP in the two years 1977-78 and *actual* deficits on goods and services averaging 0.45 percent.

As events developed, the strengthening of United States external payments in 1979 accomplished almost half of the hypothesized adjustment for goods and services and far overshot that for financial flows. The balance on goods and services swung to a $5.3 billion surplus, equal to 0.22 percent of GNP, from the substantial deficits of the two previous years. As already noted, financial movements shifted from the outflows that had previously been characteristic to substantial inflows in 1979—with large inward movements both in the early months of the year and in the final quarter, partially offset by outflows only during June-September

Unfortunately, past experience cautions against premature rejoicing over last year's strengthening in the United States external position. The improvement was based to an uncomfortably large extent on temporary factors, most notably the substantial depreciation of the dollar in earlier years, the more rapid growth of major countries abroad in 1979 than of the United States, and the relative tightness of monetary conditions here. If shifts from balance-of-payments weakness to strength can occur with surprising rapidity, so too can shifts in the opposite direction Financial outflows virtually disappeared in 1969 under the pressure of stringent monetary conditions in the United States, but then ballooned when monetary policy relaxed during the 1970 recession Similarly, the surplus on goods and services rose to a record high in the recession year 1975, only to give way to the heavy deficits of 1977 and 1978. Clearly, these earlier swings, combined with recognition of the role that temporary factors played in last year's improvement in America's external position, underline the need for fundamental measures designed to stimulate saving and productive investment and to decrease dependence on foreign energy supplies While some steps in these directions have already been taken, additional vigorous measures are required to hold as much as possible of the ground gained in 1979 and to provide an enduring foundation for America's external strength.

Viewed from a longer term perspective, the task that now confronts the United States is in some ways similar to that which faced foreign countries in the early postwar years. The need then, as now, was to redirect resources into productive investment in order to redress the imbalance in the international economy and to provide the basis for higher standards of living. In the early postwar years, it was the destruction and neglect of hostilities that had to be made good so that countries abroad could compete on more equal terms with the United States. Now, the earlier imbalances have long since been corrected but others have taken their place. For a generation or more, the proportion of GNP devoted to productive investment in major foreign countries has been far above that in the United States As a result, technology in some American industries trails that of their foreign rivals and a growing proportion of many goods consumed by Americans is produced not in this country but abroad This penetration of the American market, while generally beneficial to consumers, has not always elicited a positive response from producers. Some, like those in textiles, have revitalized their industries to meet foreign competition. In contrast, others have sought various forms of Federal protection. Against this contingency, foreign firms have sometimes found it desirable to locate production facilities in the United States. In doing so, they followed the earlier example of American firms that established subsidiaries abroad in order to surmount foreign barriers against imports. Likewise, the increased competitiveness of American wages and other attractions seen by foreign firms in this country's labor market during the seventies are reminiscent of similar attractions that induced United States firms to invest abroad in the fifties and sixties. The transfer of advanced technology and managerial know-how has thus become two-way. Benefits that the rest of the world obtained from international direct investments in the earlier postwar years are now being shared by the United States.[13]

Although the similarities are clear, handling the task

[13] See Dorothy B Christelow, "International Policies toward Foreign Direct Investment", this *Quarterly Review* (Winter 1979-80), pages 21-32

that confronts the United States is in many ways more difficult than that which faced policymakers abroad after World War II. At that time, the penalties for failure were stark: low living standards, hunger, and always the threatened loss of political independence. Now, the penalties for the United States—even when they are recognized—seem less compelling: a drop in American living standards below those of the most advanced industrial countries and declining influence in the world political arena. Clearly, the motivation for economic discipline and international cooperation was far stronger thirty years ago than now. Moreover, the United States—the dominant economy in the early postwar years—had a clear view of its role: to stimulate and to assist in the reconstruction of a prosperous and integrated world economy. Today, leadership is divided among a number of major industrial and oil-rich countries which—while generally agreeing on the desirability of an open, stable, and expanding international economy—frequently differ about the most desirable means to attain these objectives.

Yet another handicap is that, with most countries struggling to reduce inflation and to adjust to sharply rising oil prices, the prospects for economic growth are far less bright than a generation ago. In the 1950s and 1960s, shifts from external weakness to strength were facilitated by widespread and rapid economic growth as well as by the progressive reduction of trade barriers—itself a development that was heavily dependent on the prosperity of the world economy. If growth does indeed slacken significantly in the 1980s, the accommodation of a significant and lasting shift from deficit to surplus in the United States balance on goods and services may well present difficult problems to foreign countries. Such difficulties would be likely to test the ability of the authorities both here and abroad to work together in handling mutual problems and to avoid further serious slippage into protectionism.

By the same token, slackening growth, combined with an increase in the attractiveness of the United States economy for long-term investors, would further complicate the financial problems of debtor countries abroad at a time when their borrowing needs are likely to be rising. In this area, accommodation of the required adjustment in the United States external position calls for a further loosening of restrictions on capital outflows from major financial centers abroad to reduce the excessive dependence of foreign borrowers on dollar markets. Clearly, the accommodation could also be facilitated by such institutions as the International Monetary Fund and the World Bank. While their resources will doubtless be adequate to meet appropriate borrowing needs in the immediate future, further substantial increases in their lending capacities are likely to be required in the years ahead.

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