A REVIEW OF BALANCE OF PAYMENTS POLICIES

435

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-FIRST CONGRESS

FIRST SESSION

JANUARY 13, 14, AND 15, 1969

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

25-765 WASHINGTON : 1969

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $1

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.]

WRIGHT PATMAN, Texas, *Chairman*

WILLIAM PROXMIRE, Wisconsin, *Vice Chairman*

HOUSE OF REPRESENTATIVES	SENATE
RICHARD BOLLING, Missouri	JOHN SPARKMAN, Alabama
HALE BOGGS, Louisiana	J. W. FULBRIGHT, Arkansas
HENRY S. REUSS, Wisconsin	HERMAN E. TALMADGE, Georgia
MARTHA W. GRIFFITHS, Michigan	STUART SYMINGTON, Missouri
WILLIAM S. MOORHEAD, Pennsylvania	JACOB K. JAVITS, New York
WILLIAM B. WIDNALL, New Jersey	ABRAHAM RIBICOFF, Connecticut
DONALD RUMSFELD, Illinois	JACK MILLER, Iowa
W. E. BROCK 3D, Tennessee	LEN B. JORDAN, Idaho
BARBER B. CONABLE, JR., New York	CHARLES H. PERCY, Illinois

JOHN R. STARK, *Executive Director*

JAMES W. KNOWLES, *Director of Research*

ECONOMISTS

RICHARD F. KAUFMAN   ROBERT H. HAVEMAN   JOHN R. KARLIK

FRAZIER KELLOGG   DOUGLAS C. FRECHTLING (*Minority*)

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

HENRY S. REUSS, Wisconsin, *Chairman*

HOUSE OF REPRESENTATIVES	SENATE
RICHARD BOLLING, Missouri	WILLIAM PROXMIRE, Wisconsin
HALE BOGGS, Louisiana	STUART SYMINGTON, Missouri
WILLIAM S. MOORHEAD, Pennsylvania	JACOB K. JAVITS, New York
WILLIAM B. WIDNALL, New Jersey	CHARLES H. PERCY, Illinois
W. E. BROCK 3D, Tennessee	

CONTENTS

WITNESSES AND STATEMENTS

JANUARY 13, 1969

	Page
Reuss, Hon. Henry S., Chairman of Subcommittee on International Exchange and Payments: Opening remarks	1
McQuade, Lawrence C., Assistant Secretary of Commerce for Domestic and International Business	3
Arey, Will, Acting Director of U.S. Travel Service	29
Surrey, Hon. Stanley S., Assistant Secretary of the Treasury	35

JANUARY 14, 1969

Gaud, Hon. William S., Administrator, Agency for International Development, Department of State; accompanied by Paul Clark, Assistant Administrator for Program and Policies, AID	85
Moot, Hon. Robert C., Assistant Secretary of Defense (Comptroller)	97
Passell, Peter, doctoral candidate in economics, Yale University	109

JANUARY 15, 1969

Fiero, Charles E., Director, Office of Foreign Direct Investments, U.S. Department of Commerce	141
Brimmer, Hon. Andrew F., Member, Board of Governors of the Federal Reserve System	155
Deming, Hon. Frederick L., Under Secretary of the Treasury for Monetary Affairs	168
Costanzo, G. A., executive vice president, First National City Bank	187
Danielian, Dr. N. R., president, International Economic Policy Association; accompanied by Ronald L. Danielian	212

ADDITIONAL SUBMISSIONS

Reuss, Hon. Henry S.:	
Announcement of hearings and schedule of witnesses	1
McQuade, Lawrence C.:	
Annex A—Tables:	
U.S. balance of payments on a liquidity basis, 1958—January–September 1968	18
U.S. imports of principal products, 1967 and January–November 1968	19
U.S. exports of principal products, 1967 and January–November 1968	20
Annex B—Table: Relationship of U.S. foreign trade to gross national product, 1948–68	21
Annex C—Department of Commerce export expansion activities	21
Annex D—Chart: Export prices: Index 1963-100	24
Annex E—Report by the National Export Expansion Council	24
Précis: Anticipated contribution of agricultural products to growth of U.S. exports	76

Surrey, Hon. Stanley S.: Page
Prepared statement 40
A Value-Added Tax for the United States—A Negative View, remarks before the 73d Annual Congress of American Industry of the National Association of Manufacturers at the Waldorf-Astoria, New York, Friday, December 6, 1968 50
A Commentary on Two Critiques of "Overseas Manufacturing Investment and the Balance of Payments" by Gary C. Hufbauer and F. Michael Adler (commentary prepared by Gerard Brannon, Director, Office of Tax Analysis, U.S. Treasury Department) 61
The NFTC critique 62
The MAPI critique 64
Additional comment by MAPI on preceding commentary 66
Gaud, Hon. William S.:
Prepared statement 90
Table I. AID expenditures for economic assistance and their direct impact on U.S. balance of payments 96
Table II. AID fiscal year 1968 gold budget 96
Table III. Estimated direct and indirect balance-of-payments impact of AID program 97
Moot, Hon. Robert C.:
Table I. U.S. defense expenditures and receipts entering the international balance of payments, fiscal years 1961–68 107
Table II. U.S. defense expenditures entering the international balance of payments by major area, fiscal years 1961–68 108
Table III. U.S. defense expenditures and receipts entering the international balance of payments, by country, fiscal years 1961–68 108
Impact of the Vietnam conflict on the U.S. balance of payments: analysis of Dudley and Passell article "The War in Vietnam and the U.S. Balance of Payments" 123
Additional budgetary costs associated with the Department of Defense balance-of-payments procurement programs 136
Passell, Peter:
"The War in Vietnam and the U.S. Balance of Payments," by Leonard Dudley and Peter Passell: reprinted from *The Review of Economics and Statistics,* November 1968 109
Reply to Defense Department comments on the impact of the Vietnam conflict on the U.S. balance of payments 126
Fiero, Charles E.:
Chart 1. Foreign direct investment (excluding Canada) by U.S. companies 152
Chart 2. Use by direct investors of long-term foreign borrowing for direct investment at yearend 153
Chart 3. Purchases by foreigners of U.S. corporate stocks and convertible debentures issued abroad 154
Brimmer, Andrew F.:
Appendix: A progress report on the Federal Reserve foreign credit restraint programs 163
Deming, Hon. Frederick L.:
Supplemental statement 185

Danielian, Dr. N. R.: Page
Chart: U.S. share of world trade 1948-67 ---- 224
Tables:
1. Private and Government sectors in the U.S. balance of payments, 1962-68 ---- 225
2. U.S. merchandise trade balance excluding military in millions of dollars and percentage increase in exports and imports, 1965-68 ---- 226
3. U.S. direct investment position 1964-67 according to schedules A, B, C of foreign direct investment regulations under Executive Order 11387 as originally issued ---- 228
4. Theoretical levels of allowed investment in schedules A, B, C countries under Executive Order 11387 ---- 230
5. Effects of OFDI controls on direct investments, 1964-67 ---- 230
6. Effects of new IEPA proposal on U.S. direct investment, 1964-67 ---- 231
7. U.S. military expenditures and sales, 1958-67 ---- 232
8. Average financial terms of official bilateral loan commitments, 1963-66 ---- 233
Letter to Chairman Reuss from Dr. N. R. Danielian ---- 240
Exhibits I and II: Tables from *U.S. Survey of Current Business* ---- 242
Agency for International Development: Comparison of AID gold budget estimate with those given in testimony of N.R. Danielian ---- 241

APPENDIXES

Appendix I:
Letter to Chairman Reuss from Somerset R. Waters, president, Child & Waters, Inc ---- 247
Accompanying statement, "Tourism—A Practical Way for the United States To Increase Its Foreign Exchange Earnings by $2.2 Billion Annually" ---- 247
Letter to Chairman Reuss from Tore H. Nilert, president, Scandinavian Airlines System, Inc ---- 248
Text of brochure published by European Airlines Research Bureau, "European Travel to U.S.A." ---- 249
Appendix II:
Statement presented by Adrienne Curtin on behalf of the Irish Industrial Development Authority ---- 251
Statement by Richard W. Lindholm, dean, Graduate School of Management and Business, University of Oregon, Eugene, Oreg ---- 253
Appendix III:
Statement presented by Paul D. Seghers, president, Institute on U.S. Taxation of Foreign Income, Inc ---- 255

A REVIEW OF BALANCE OF PAYMENTS POLICIES

MONDAY, JANUARY 13, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND
PAYMENTS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on International Exchange and Payments met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss, Moorhead, and Brock.

Also present: John R. Stark, executive director; John R. Karlik, economist, and Douglas Frechtling, minority economist.

Chairman REUSS. Good morning. The Subcommittee on International Exchange and Payments of the Joint Economic Committee will be in order.

Today we begin 3 days of hearings to review the balance-of-payments policies of the United States over the past 4 years. Since at least 1958 the United States has suffered from a large and persistent series of deficits in its balance of payments. Both the Kennedy and the Johnson administrations have initiated steps to curtail our external deficits. Many of these measures have been highly unpopular with either academic economists, bankers, businessmen, or with all three.

However, I think we must concede that at least a portion of the reduction in 1968 in our payments deficits has to be attributed to these governmental efforts.

At this point in the record we will include the announcement of these hearings and the schedule of witnesses.

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

REPRESENTATIVE REUSS ANNOUNCES JANUARY HEARINGS TO REVIEW U.S. BALANCE-OF-PAYMENTS POLICIES

Representative Henry S. Reuss (D-Wis.), Chairman of the Subcommittee on International Exchange and Payments, today issued the following statement: "In order to glean the collective wisdom of the officials who have administered United States balance-of-payments policies during the past four years, the Joint Economic Committee's Subcommittee on International Exchange and Payments has scheduled hearings for January 13, 14, and 15, to review the effectiveness and continued desirability of these policies. The hearings will examine three major

areas of U.S. external economic relations: (1) private current-account transactions; (2) governmental military and economic assistance programs; and (3) exports of capital by corporations, banks, and individuals.

"At this time of transition, I feel a summary and re-evaluation of efforts to reduce our payments deficits will be particularly useful. The Subcommittee will request estimates of the amount by which U.S. external deficits would have been larger without these special measures. It is possible that some programs have never been vigorously implemented, while others may be losing their effectiveness. Moreover, we are interested in whether official programs have contributed to a fundamental strengthening of our external position, have only temporarily dammed up a stream of net payments to foreigners, or may even have undermined the U.S. balance of payments for years to come.

"Detailed topics to be covered in the hearings include the following:

"(*a*) Efforts to promote U.S. exports, and foreign travel to this country;

"(*b*) Possible tax revisions that would foster exports or curtail imports;

"(*c*) The size of the contribution that U.S. military commitments abroad an economic assistance programs make to our payments deficits;

"(*d*) Whether existing controls over capital exports (the Commerce Department direct investment program, the credit restraints imposed on banks by the Federal Reserve, and the Interest Equalization Tax) must be retained.

"On the basis of the information gathered at these hearings, we will be able to determine whether existing programs should be continued, modified or scrapped. This knowledge will aso be useful in evaluating the forthcoming balance-of-payments proposals of the Nixon Administration."

The hearings will begin at 10:00 a.m. each day and will be held in the Banking and Currency Committee Hearing Room, 2128 Rayburn House Office Building.

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

Hearings—January 13, 14, 15, 1969

A REVIEW OF U.S. BALANCE-OF-PAYMENTS POLICIES

Place: Banking and Currency Committee Room

2128 Rayburn House Office Building

Monday, January 13, 10:00 a.m.—Private Current-Account Transactions

Lawrence C. McQuade, Assistant Secretary of Commerce for Domestic and International Business.

Will Arey, Acting Director, United States Travel Service, Department of Commerce.

Stanley S. Surrey, Assistance Secretary of the Treasury (Tax Policy).

Tuesday, January 14, 10:00 a.m.—Government Expenditures

Robert C. Moot, Assistant Secretary of Defense (Comptroller).

William S. Gaud, Administrator, Agency for International Development, Department of State.

Peter Passell, Doctoral Candidate in Economics, Yale University.

Wednesday, January 15,10:00 a.m.—Private Capital Exports

Charles E. Fiero, Director, Office of Foreign Direct Investments, Department of Commerce.

Andrew F. Brimmer, Governor, Federal Reserve System.

Frederick L. Deming, Under Secretary of the Treasury for Monetary Affairs.

Gesualdo Costanzo, Executive Vice President, Overseas Division, 1st National City Bank, New York City.

Wednesday afternoon:

Dr. N. R. Danielian, President, International Economic Policy Association.

Chairman REUSS. The purpose of these hearings is threefold: First, to give the gentlemen administering these programs an opportunity to explain and, if necessary, to defend their actions.

Secondly, to give the Congress an opportunity to question them before they relinquish their responsibilities.

Finally, the information gathered in these hearings will be combined with that obtained during the Joint Economic Committee's regular annual hearings to be held next month, and will be used by members of the Joint Economic Committee in evaluating the policies to be followed by the incoming administration.

This morning's session is devoted to private current account transactions. Tomorrow we will cover the governmental accounts, primarily military and economic aid, and Wednesday will be devoted to the various measures introduced to it or control capital exports.

This morning we have Mr. Lawrence C. McQuade, Assistant Secretary of Commerce for Domestic and International Business; Mr. Will Arey, Acting Director of the U.S. Travel Service, a subsidiary of the Department of Commerce; and, very shortly, Mr. Stanley Surrey, Assistant Secretary of the Treasury for Tax Policy.

All three of our witnesses have submitted very full statements embodying their individual contributions to this symposium, and we look forward to very interesting and informative hearings.

I would now like to ask the witnesses to proceed in their own way.

Mr. McQuade, would you start off, please.

STATEMENT OF LAWRENCE C. McQUADE, ASSISTANT SECRETARY OF COMMERCE FOR DOMESTIC AND INTERNATIONAL BUSINESS

Mr. McQuade. Thank you very much. I appreciate the opportunity to make this presentation.

Obviously, my objective is to respond as usefully as possible to your inquiry about the trade element in the current account of the U.S. balance of payments.

I start with the basic premise that the U.S. trade programs and policies at this time should concentrate on improvement in the U.S. balance of payments. Trade objectives can be stated simply—the United States will continue to need a large trade surplus, about $5 billion a year or more, until such time as an acceptable and stable balance-of-payments position can be confidently achieved by other means.

Before I go into the specific topic of the trade account, I would refer to annex A of my prepared testimony which has a couple of useful things to note. The first table shows the annual overall balance-of-payments figures for 1958 through the third quarter of 1968 in a format which makes clear three interesting aspects. (See p. 18.)

The first is the balance-of-payments results if all "special transactions" are eliminated. As you can see, in the last 3 years "special transactions" have become an increasingly important item in our overall accounts. In 1967 without such transactions the balance-of-payments deficit would have been $4.5 billion instead of $3.6 billion. In the first three quarters of this year special transactions have come to $1.5 billion, well above the $950 million total in 1967.

My point is not to disparage the importance of the special transactions in our balance of payments. The improvements reflected in the special transactions have had a salutary effect in restoring confidence and in providing time for fundamental factors to operate on our balance-of-payments problem.

But in discussing what our national goals in the trade account should be, we have to be mindful of the impact of special transactions,

and the need for a larger trade surplus, as well as other improvements in our accounts, looking to the day when it is no longer possible or desirable to rely on special transactions.

The second is the current account. Since 1964 the surplus on current account (balance on good and services) has steadily declined. In 1964 the surplus was $8.4 billion but in 1967 we had a surplus of $4.8 billion and this year it showed a further sharp decline. Partly offsetting this dreary picture on current account has been improvement in our capital account in 1968. The main factors have been increased purchases of U.S. securities by foreigners and the effect of the capital-restraint program.

The third concerns export figures. It should be remembered that they include exports without regard to the method of financing, that is AID and Public Law 480 shipments are included. This accords with general international statistical practices, of course, but in the case of the United States the quantities are sufficiently large to take note of separately. Over the past 5 years, AID and Public Law 480 shipments of U.S. commodities have averaged about $2.7 billion annually. Most of these exports do not yield receipts in the current year. Most of the AID exports are on an extended loan basis, and in 1967 repayments were the equivalent of $250 million. And AID and Public Law 480 do result in some follow-on business of a normal commercial character.

A substantial trade surplus remains today the keystone of a sound international financial position for the United States and the dollar. It seems likely, however, that the basic "mix" of our international accounts will shift over time. The very large growth in the overseas investment by U.S. corporations has, with a time lag, begun to be reflected in repatriated earnings.

It may be expected that in the coming decades' earnings on capital account will be an increasingly significant factor among the plus factors in the balance of payments. However, the volume of our nontrade needs, including the cost of mutual security, the flow of private foreign investment, and the desire of Americans to see the world, will continue to require a large trade surplus.

The Trade Account

To achieve a sufficient trade surplus I think we need to do three principal things:

First, we need to manage our domestic economy in a manner that will preserve the competitiveness of American goods within the domestic market and in foreign markets. Foremost, we must eliminate as soon as possible the inflationary pressures which have resulted in an excessive import demand and which are beginning to erode the competitive position of our exports.

Second, we must adopt policies to induce profit-motivated business decisions which will shift a larger share of the gross national product to export.

Third, the United States, by actions which it can take alone or which must be negotiated, must achieve parity with its principal competitors with respect to international trade rules and practices. We are presently confronted with a structural disadvantage in world trade which arises in part from differences between the U.S. tax system and

the tax systems being adopted by some European countries, and in part from the prevalence of a wide variety of nontariff barriers which make other markets less open to U.S. products than the U.S. market is open to foreign products.

Historical and Current Trade Performance

The present trade problems confronting the United States are largely problems of adjustment in a period of dynamic growth in international trade and investment, and problems of relating domestic economic policies and performance to international trade and payments needs. Since 1950 world production has approximately doubled and world trade has trebled. For comparison, between World War I and World War II world production grew only by 40 percent and international trade by half as much. Particularly in the years since 1960 growth in both the United States and most other industrial nations, which are our principal markets, has been uncommonly strong.

A look at the movement of the U.S. trade surplus since 1950 focuses the problem somewhat more clearly. In the years 1950–55, the surplus, on the basis of Census Bureau figures, averaged $2.2 billion or 0.6 percent of average GNP for that period; in 1955–60, it averaged $3.7 billion or 0.8 percent of GNP; and in 1960–65, it averaged $5.4 billion or 0.9 percent of GNP. Our trade surplus reached an all-time high of $7.0 billion in 1964; however, since 1964, it has tended to decline. The surplus narrowed to $5.3 billion and $3.9 billion in 1965 and 1966, respectively. The 1967 surplus moved marginally upward to $4.1 billion. In 1968, our trade surplus has deteriorated sharply from the 1967 level, and it is expected that it will be in the neighborhood of $1 billion, or about 0.1 percent of expected GNP.

The performance of the trade account in 1968 has been very disappointing. Through November exports were running at a very high annual rate—$33.7 billion or 9 percent above the 1967 total. The extremely rapid growth of imports—up 22 percent over 1967 to $32.7 billion at an annual rate—threatened to wipe out the surplus entirely.

The 1968 surplus has been adversely affected by a number of special developments. Most notable among these have been the copper strike, hedge buying in anticipation of a steel strike and work stoppages in the Port of New York early in the year.

The disturbing aspect of the sharp decline in the trade account is that trade is not balance of payments "funny money"; trade is a basic element in the payments account.

The convenience of talking about the trade surplus should never obscure the fact that different dynamics are at work on the export side and on the import side of that balance.

Imports

The pace of the domestic economy is the most important factor affecting imports. Annex B to my testimony gives the percentage relationships over the last two decades between our imports and the Gross National Product, and the same relationships for exports and GNP. After fluctuating within a relatively narrow range until 1966, the import ratio moved up strongly. So far this year it has reached 3.8 percent, the highest point since World War II. The inflow of foreign goods

helps offset inflationary forces. But it hurts the balance of trade and payments. In 1966 and in the first 9 months of 1968—periods of an overheated domestic economy—imports jumped around one-fifth from preceding periods. In 1967, when the domestic economy was in better balance, imports rose only 5 percent over the preceding year. Put another way, in 1965 and 1966 when the GNP rise averaged 8½ percent, the average annual growth rate for imports was nearly 17 percent. The 9 percent rate of increase for GNP in the first 9 months of 1968 has exerted a similar strong pull on imports.

Over the last 5 years, the annual rate of increase in imports averaged $3.1 billion, outpacing export growth by an average of $800 million a year.

Since America has rightly eschewed efforts to control the gross volume of imports by artificial limitations, the key to an impact on the volume of imports lies in the pace at which we run the domestic economy. It not only affects overall demand, including the demand for imports; it also affects the relative availability and competitiveness of U.S. goods and imported goods within the U.S. market.

The largest component of our imports during the past several years has been made up of industrial materials, which amounted to $12.8 billion or 42.6 percent of the January–November 1968 total. Iron and steel mill products, crude petroleum, petroleum products, industrial chemicals, and copper were among the largest items in this category. Consumer goods accounted for $8.3 billion of imports, 27.5 percent of the total, with new automobiles by far the most important single item. Food and beverage imports contributed 16 percent or $4.8 billion to the 11-month total and capital equipment $3 billion or 9.9 percent. I have provided more detail on 1967 and 1968 imports in annex A.

Exports

Our economy here at home is also an important factor in our export picture. The competitiveness of U.S. nonagricultural goods in foreign markets has declined as a result of a sizable increase in unit labor costs in manufacturing since 1964 compared to a decline in the early years of the decade. From 1964 to 1967 our unit labor costs rose by 6.9 percent and in the year 1968 they continued to move sharply upward. In contrast, the increases in unit labor costs of our major European competitors and Japan have generally slowed in the last several years. (See annex D for chart on export prices.) Nevertheless, U.S. exports have grown at a slightly faster pace than has the gross national product in this period. Overall we have apparently not yet priced ourselves out of foreign markets. Depending upon quality, marketing and other factors, the effect of a rising domestic price level will be felt differently by different U.S. products or services.

The second major element in our export picture lies in the purchasing power and relative strength of the economies of our major trading partners. For example, the slow down in economic expansion in Western Europe in 1966 and 1967 caused our exports to that area to suffer. Likewise our exports to Canada and Japan have prospered when their economies have been running at a strong pace.

A third element in our export picture consists of the institutional climate faced by American exporters in foreign markets. Part of this

consists of the cultural and buying habits which put our marketing abilities to a test; part consists of the tariff, nontariff, and tax circumstances distorting our access to foreign markets in comparison to their indigenous producers.

A fourth element lies in the institutional environment here in the United States. The comparative attractions of the domestic market and overseas markets to the U.S. businessmen affect the energy and priority with which they involve themselves in exporting. With a big $790 billion market in 1967, U.S. exports were a mere 4 percent of our GNP compared with 9 percent of GNP for Japan, 10 percent of GNP for France, 13 percent of GNP for Italy and the United Kingdom, 18 percent of GNP for West Germany, 32 percent of GNP for Netherlands, and 35 percent of GNP for Belgium-Luxembourg. This dramatizes the understandable internal orientation of American marketers, as a whole, as compared with some of their major competitors.

It also dramatizes the value of a program of trade promotion, export credit, and other incentives as a means of stimulating greater attention to the international market, where there is room for greater U.S. success if the ingenuity and attention of the American businessman is fully applied.

A brief look at the kinds of products we export will round out this analysis of exports. In discussing exports we are really talking about two quite distinct categories of products, agricultural and nonagricultural. It is expected that exports of agricultural products will be static during the next several years.

My discussion of exports is primarily applicable to nonagricultural products.

Among nonagricultural products, machinery exports totaled $8.1 billion during the January–November 1968 period, or 26 percent of total exports. Engines and parts and agricultural equipment made up an important part of this total. Exports of transport equipment contributed 16 percent, or $5 billion, to the 11-month export total, with cars and trucks, automotive parts and accessories, and civilian aircraft making up about 75 percent of this category. Chemicals accounted for $3 billion, or 9.6 percent of the 11-month export total; and other nonagricultural products, $9.4 billion, or 30.1 percent of total exports for the 11 months. Nonagricultural products totaled $25.1 billion, or 81.8 percent of the total for the first 11 months. The figure for agricultural products, most importantly wheat, soybeans, and corn, was $5.7 billion. More detail on 1967 and 1968 exports is provided in annex A.

The Outlook for Trade During the Next 5 Years

What the future holds in store for the trade surplus and the balance of payments cannot be accurately forecast. Speculation and projections are, however, possible and useful so long as it is clearly understood that these are at best heavily qualified possibilities.

The Commerce Department has been thinking about setting an export goal of $50 billion for 1973—roughly 4.3 percent of projected GNP in 1973.[1] To reach that level, exports must grow at an average

[1] GNP for 1973 is projected at $1,132 billion, a figure having no official sanction but one which has been used in congressional testimony by a representative of the Office of Business Economics. The figure assumes annual average growth of 6.2 percent in GNP in the period 1969–73.

annual rate of 8.3 percent, as they have since 1962. Nevertheless, $50 billion in exports represents a very ambitious goal and one that will not be achieved without vigorous, across-the-board Government action.

If exports were to remain at a level of 4 percent of the gross national product (see annex B), they would total $45.3 billion in 1973. If imports, which rose to 3.8 percent of the gross national product in 1968, maintained that ratio in 1973, they would amount to $43 billion. The $2.3 billion surplus that would result would be significantly below the level which we believe will be needed to support balance-of-payments equilibrium.

A great number of factors will help decide whether these are realistic estimates.

I do not think we can safely rely on imports dropping off materially in relation to the gross national product:

(1) To the extent that the economy continues to have a strong inflationary aspect, we would expect imports to be higher than the foregoing projection.

(2) Consumer preferences for some foreign products such as small cars, certain kinds of transistor radios and certain styles of footwear may not readily shift to U.S. products.

(3) Foreign manufacturers have begun to recruit American skills in advertising and merchandising and to build effective organizations for penetrating the U.S. market. Also many foreign companies now scale their operations to be more successful in the U.S. market.

(4) As we saw last year, imports are also subject to fluctuations as the result of random events, such as actual or potential work stoppages.

The longer term outlook for export growth does not seem to have any important, foreseeable dynamic promising a better-than-average future performance:

(1) The most important determining factor for U.S. exports over the next few years will probably be the conditions that exist in our major foreign markets. Continuing increases in economic activity in these markets appear probable, though at a somewhat slower rate. This would slow the rate at which our exports to these markets will grow.

(2) In due course, tariff reductions agreed to in the recent Kennedy Round should increase both our imports and our export opportunities. However, since the reduction will not become fully effective until 1972 the effect of the Kennedy Round during the next 5 years probably will not be large.

(3) The outlook for stopping the current inflationary situation and reestablishing the price stability of the early 1960's is not all that clear or certain.

(4) U.S. exporters will continue to face a variety of measures, in addition to tariff duties, which inhibit full access to foreign markets, especially for agricultural commodities.

Some important unknown factors in the longer term outlook include the net effect upon the distribution of international trade patterns of (*a*) the growing scope of large international corporations and (*b*) the greater diffusion of technology into the industrial plant and equipment of more and more countries.

The operating scope of the large, international corporation—sometimes rightly and sometimes wrongly called a multinational corpora-

tion—offers it choices which complicate any assessment of its impact on the U.S. balance of payments. When such a firm invests in overseas production facilities, at least the following may be elements in determining the final impact on the U.S. balance of payments:

—The construction of the new plan may involve major exports of capital equipment from the United States for installation.

—The new plant may displace exports which the parent company had been previously shipping from the United States, both to the country where the new plant is located and perhaps to nearby third markets.

—The existence of the new plant may mean major continuing increase in exports from the U.S. parent in the form of materials to be further processed or packaged by the new plant for sale in a widening market.

—There may be an increase in export shipments from the United States of other elements of the company's product line which are not made in the new plant yet which can ride piggyback on the sales outlets incident to the investment.

—Exports from the United States might have faced elimination by a competitor's act or a change in economics and the new plant serves to preserve the business for a U.S. entity which will at least remit earnings to the United States.

U.S. manufacturing affiliates abroad generate a large market for U.S. exports which might be difficult to obtain in the same magnitude by other means. In some cases as much as 50 percent of a manufacturer's exports goes to its own affiliates.

Large U.S. corporations tell us that it is easier for them to forecast their total foreign sales than the specific part provided by their exports from the United States. Export from this country is only one of the options open to these multinational corporations. The options for supplying foreign markets from overseas affiliates have multiplied in recent years.

Large business entities with plants in the Unied States and in foreign countries can be expected to shift the source of their "third country" exports to their foreign plants unless (*a*) their U.S. production is equally competitive and (*b*) the array of credit facilities and other incentives available to their U.S. operation are competitive with those available to their foreign operation.

The large, international corporation also plays an important role in the stepped-up rate at which technology is being diffused among industrial nations. The U.S.-controlled international corporation inevitably transfers at least some of the technology of the parent company to its foreign affiliates. Major transfers also occur through licensing agreements. While U.S. firms both give and receive new technology through licensees, the net flow is outward.

The consequences of the accelerated diffusion of technology certainly include added difficulties for U.S. manufacturers to offset by technological superiority wage differentials. Japanese steelmaking facilities are very modern indeed, as any U.S. member of the industry will be quick to acknowledge.

This phenomenon reinforces my concern that there be a minimum of self-imposed, artificial limitations upon getting the fullest use of advances—such as containerization to move cargo, new techniques for

building houses, and automation—which increase the productivity of the U.S. economy.

Current Export Stimulation Activities

It is clear from this review of the export and import projections of the next 5 years that we cannot rely upon any built-in corrective forces to re-establish the substantial trade surplus which the country needs—or, for that matter, any trade surplus at all. We need aggressive, deliberate action.

Before outlining the additional measures which may meet this requirement, it will be helpful if I first briefly review the current export promotion activities of the Department of Commerce, as the committee requested.

They can be grouped into four broad categories; direct overseas promotion; promotion here at home; collecting and disseminating commercial and economical information; and creating a better climate overseas for U.S. exporters, Annex C provides details of the promotion activities.

I would, however, like to call your attention to three types of direct overseas promotion activities—trade fairs, trade centers, and America Weeks. The first involves Commerce sponsorship of exhibitions of U.S. products at international trade fairs abroad. The second, trade centers, are permanent overseas showrooms which the Department operates in six foreign commercial centers. America Weeks are Commerce-arranged promotions of American consumer goods in foreign department stores.

While we cannot precisely measure the export results of all of our programs, we have been able to measure with a good deal of accuracy the results of our trade fair, trade center, and America Week promotions. During fiscal years 1964 through 1967 Commerce spent $20 million on these three types of promotions. Confirmed first-year export sales resulting from these events amount to $300 million. This means that every $1 of Commerce appropriated funds spent on trade fairs, trade centers, and America Week generated $15 in export sales within 1 year of the promotional event. The balance-of-payments return of these activities is even more striking. Since only about half of the Commerce expenditures are made overseas, every $1 spent by Commerce abroad resulted in about $30 in export earnings.

Recent analysis indicates that $300 million in sales will generate tax receipts by the Treasury of $18 million. Thus the net cost of the program during this 4-year period, on the basis of 1-year sales results, was $1.9 million. Succeeding year sales and revenue receipts are obviously very large and could more than offset this cost.

I would emphasize again that the $300 million represents first-year results only and that these are the results of only three of Commerce's activities. As mentioned earlier, the results of other elements of our export expansion program cannot be measured precisely. I can only say that we strongly believe that the promotion we have given to exporting and the wide range of services and information we have provided have had an important stimulative impact on U.S. exports.

Commerce export expansion services are used by both large and small firms but are particularly helpful to the smaller firms that can-

not afford to maintain a large foreign sales organization. Commerce services provide a relatively inexpensive method for the small, medium, or large-size firm to research a foreign market, test it, find an agent, and begin exporting. But large firms are more likely to have foreign marketing departments and/or overseas subsidiaries to handle these matters. Nevertheless, some of the largest U.S. companies do come to us for information and large firms provide about half of the participants for our overseas exhibition activities.

Perhaps the single most significant development in our trade promotion program came about in 1968 as a result of President Johnson's New Year's Day balance-of-payments message. That message contained two specific proposals related to Commerce export expansion activities—"an intensified 5-year, $200 million Commerce Department program to promote the sale of American goods overseas," and "a joint export association program" through which "we will provide direct financial support to American corporations joining together to sell abroad."

The call for a 5-year program resulted from a study of export promotion by one of the action committees of the National Export Expansion Council, a group of 72 business and professional leaders who advise the Secretary of Commerce. The report of this action committee, issued in March of 1967, called for a long-range export expansion program around which business and industry could plan and program their international export business. The committee felt that business should have a long-term commitment by Government to export expansion as a prerequisite for greater business cooperation and interest. The committee urged a program of specific targets, specific

The objective of the 5-year program developed in response to the committee's recommendation is to raise the level of exports from 4 percent of GNP—the level at which it has remained for the past decade or so—to 4.3 percent of GNP. Had exports been at the 4.3 percent level in 1967 we would have added almost $2.5 billion to our trade surplus. To do this, we must motivate American industry to alter its basic assessment of domestic marketing versus international marketing so as to induce a greater allocation of corporate resources to export. Specifically, over the 5-year period the Commerce program calls for—

A doubling of our commercial exhibitions in our trade fairs and trade centers overseas, with a trebling of business participants;

A substantial increase in our export stimulation efforts;

Increased foreign market research and export market development work, with a much higher degree of automation of data;

A Joint Export Association (JEA) program for cooperative Government-industry export market development under which the Department will share with groups of U.S. companies the cost of development. We signed the first five JEA contracts last Friday (January 10, 1969); and

The development jointly with industry sectors of 5-year export targets to meet the national export expansion goal.

Appropriations for Commerce Department export expansion activities totaled $4.6 million in fiscal year 1960, the year in which the program began. Funds had increased to $12.2 million by fiscal year 1964. Reduced payments deficits and other spending priorities, how-

25-765—69——2

ever, resulted in only very small funding increases in 1965, 1966, and 1967, with total export expansion funds in the last of these years amounting to $14.7 million. Appropriations began growing again in 1967 and reached $19 million in the current 1969 fiscal year.

The Commerce Department's efforts to assist in expanding exports are not limited to overseas promotion programs and information services to business. There are a number of Government agencies other than Commerce whose programs and activities have a major impact on U.S. trade. Effective export promotion requires a broad, comprehensive approach. Consequently we have been active in interagency councils in order to create a better climate for trade and to help insure that American business is competitive in areas where Government export credit and insurance are involved. For example, the Department has always been one of the two or three key agencies in the formulation and administration of trade policy. It worked closely with the Office of the Special Representative for Trade Negotiations (STR) during the Kennedy round and continues to work with STR and the other relevant agencies on such current problems as border taxes and other nontariff trade barriers.

Commerce is unique among the Federal departments and agencies involved in trade policy matters in the diversity of the expertise it can bring to bear on trade policy problems. It is the only agency with a staff of trade policy specialists, country specialists for all areas of the world, and commodity specialists for virtually all products, including some of the important agricultural products. It has responsibilities and programs dealing with foreign investment, export finance, and trade promotion—activities which have an important bearing on the formulation and administration of trade policy.

Commerce has worked closely with the Export-Import Bank to improve export financing and credit. About 5 years ago, I was chairman of an interdepartmental committee examining the export credit policies of the U.S. Government. This led to the first formulation of the proposal for a special facility at the Export-Import Bank to take a more aggressive role in export lending, guaranteeing, and insuring of U.S. exports. Last year, the Congress authorized Eximbank to earmark $500 million of its lending authority for such a special facility. The facility permits financing of export transactions that may not meet the Bank's traditional "reasonable assurance of repayment" standards so long as the financing, guarantee, or insurance of the transactions can be judged to improve the balance of payments and foster the long-term commercial interest of the United States. We were a prime advocate of this new $500 million export expansion facility at the Bank and the President appointed the Secretary of Commerce as Chairman of an Export Expansion Advisory Committee to help guide the use of this facility.

Members of this Committee, which also include the Secretaries of State and the Treasury and the Chairman of the Board of Eximbank, with the Federal Reserve Board as an observer (or their designees) meet regularly. While a main function has been to advise on specific transactions recommended by Eximbank for the special facility, as well as on matters of general policy affecting the long-term commercial interest of the United States, in practice it is having a liberalizing effect upon the regular operations of the Bank as well.

Among other things, we have moved significantly toward a more effective coordination of the Commerce Department export strategy and the Eximbank programs. Under a recent agreement, Eximbank has undertaken to work closely with our trade promotion people to assure that fiancing will be available to U.S. exhibitors at trade shows and fairs and to members of Commerce sponsored trade missions. We hope that this interagency cooperation will amplify the sales efforts of U.S. exporters in promising overseas markets, thereby increasing on-the-spot and follow-on sales resulting from Commerce's promotional programs and related activities.

We have cooperated closely with—

The Foreign Credit Insurance Association to assist in improving its insurance coverage for U.S. export sales;

The Agency for International Development so that companies might make current sales in the developing countries and concurrently establish valuable trade relations for the future;

The Small Business Administration to get smaller businesses more active in overseas selling; and

The Agriculture Department to get mutual support out of our parallel programs.

A Program of Greater Action

While export expansion activities are not as decisive as other forces affecting ourt export outlook, they can be highly effective in stimulting exports. At current levels, these activities will not, of course, generate all the increased volume of exports needed. These activities should be expanded and should play a useful part, along with other actions, in helping the United States achieve a $50 billion 1973 export target. The most important of the required additional measures are the following:

1. Manage our domestic economy in a manner that will preserve the competitiveness of American goods both in the domestic market and in foreign markets

A. The most important help to our trade balance would be price stability in the domestic economy. Inflation at home tends (*a*) to attract more imports, (*b*) to absorb domestic production in the home market, and (*c*) to raise the prices of domestic goods and services so they are less able to compete either in the home market or in foreign markets.

B. The United States should also focus more intensely upon increasing domestic productive efficiency. In trade terms, this will help us remain competitive in spite of our marketedly higher standard of living compared to our competitors. For example, we should rethink our approach to labor-management relations with the objective of removing impediments to greater economic productivity. The economic security of the worker should be attainable by a more sensible means than featherbedding and artificially impeding the introduction of containerization and other steps toward greater productivity. It would help us preserve our high wage economy in real terms if we change our laws and practices to promote rather than impede rising productivity.

2. Make further progress toward an improved international monetary system which can assure adequate liquidity for rising levels of trade and a timely adjustment of imbalances between different national economies.

Monetary instability usually stems from shifting relative values of currencies without adequate adjustment. The current international monetary system, with its fixed exchange rates, has no easy means of achieving a new equilibrium. The pressures of persistent disequilibrium eventually force adjustments—sometimes domestic austerity of buoyancy, sometimes devaluation or revaluation.

These steps have often been negotiated or unilaterally adopted in moments of international financial turmoil. Recent events suggest some possible directions.

The British are moving away from maintaining the pound as a reserve currency.

In this most recent crisis, the Germans reduced their "border taxes" to cut down on their trade surplus; the French did the reverse. We witnessed an important, conscious use of tax and trade measures as a part of an international payments adjustment process.

The pragmatists have created a new element of liquidity in special drawing rights at the International Monetary Fund (IMF) and have split the gold market into two.

Theorists are putting forward a variety of more automatic ways to adjust exchange rates to changes in relative currency values. The names are perhaps more ingenious than the ideas: "Floating exchange rates," "wider bands," "the crawling peg," "the self-adjusting crawling peg," etc. The idea is to let market forces play a more significant role in the adjustment process. More flexibility is desirable.

Much is happening. The United States has some important thinking to do if we are to support our trade goals with adequate world liquidity and a system in which orderly adjustment replaces evolution by crisis.

3. Develop economic incentives to greater export effort

I suspect that the United States will not succeed in achieving a goal of $50 billion of exports by 1973 without some special spur to the businessman. The objective would be to switch his concept of the relative merits of sales within the U.S. economy and sales in foreign markets. For some, perhaps, this incentive is not needed; but those who are disposed to ignore or give second-class service to their export markets need a greater incentive to get them to upgrade their export effort.

The incentive could take many forms. But the biggest sure-fire incentive would be sufficiently greater profitability so that top management sees a profit "plus" in exporting.

The most common suggestion, of course, is the tax incentive. Such an incentive can obviously change the profit prospects and therefore do the job. There are defects to it: (1) In some forms, it might violate the antisubsidy provisions of GATT, but I believe this could be avoided, (2) it would have a significant revenue cost if it were sufficiently big to do a really useful job of stimulation; conversely, however, an incentive that generated significant amounts of new business could generate new tax revenues to offset the costs of the incentive; (3)

it could give a windfall to some exporters, in the sense that they would get a tax benefit whether or not their export growth would have occurred for normal business reasons anyway.

The National Export Expansion Council has offered a number of proposals for tax incentives which seem to be permissible under GATT of which two are briefly described below:

The first is a proposal to liberalize sections 970–972 of the Internal Revenue Code dealing with the deferment of U.S. tax on income earned by export trade corporations. The change would increase the base on which deferment could be claimed and would be primarily of interest to large firms.

The other proposal would give taxpayers an extra deduction—in addition to the full deduction now allowed—for increases in certain export promotion expenses in excess of the average of these expenses during the prior 2-year period. This device is designed to stimulate entry into foreign markets particularly by smaller firms.

4. Assure U.S. exporters an adequate supply of export credit

Credit plays an important role in export sales. U.S. exporters' requirements for financing are expected to grow faster than the availability of loanable funds from both private and official sources. These two ideas put a premium on opening up sources of export credit both by direct action through the Government and by removal of impediments to the flow of private credit for this purpose. Two limitations which bear watching are: (a) overall budgetary restrictions operating on the Eximbank and (b) limitations on commercial export financing arising from the Federal Reserve Board's voluntary credit restraint program.

On the positive side, the Eximbank has created a rediscount facility for export paper which encourages banks to finance exports since they know that, in a time of need, they can free-up their money. A further step has been suggested, namely an automatic rediscount facility for export credits, possibly within the Federal Reserve System. The FRB views this idea with caution. From the export expansion point of view, however, such a major change would increase the available funds for export finance and encourage greater reliance on private sources.

A second useful forward step is the export expansion facility to which I have already referred. Some additional things can be done within this authority to beef up the export credit provided by Eximbank.

A third initiative may lie in the planning now underway to develop a new organization to deal with the growing need for financing so-called big-ticket transactions either through an Eximbank affiliate or a wholly private institution. The idea would be to mobilize long-term private funds and remove larger export transactions from present U.S. budgetary constraints.

A fourth and continuing action lies in further strengthening and simplifying Eximbank's procedures and criteria for granting export credit guarantees and insurance, and adding new coverage. The Eximbank and the affiliated Foreign Credit Insurance Association operate complementary and somewhat overlapping facilities for insuring medium-term export transactions. Consideration could be given to a merger of the two and the opening of well-staffed field offices in major U.S. commercial cities.

I also think that there is room for some new types of coverage in the export credit guarantee and insurance programs, such as somewhat greater coverage for local cost financing.

5. Enlarge and improve the effectiveness of a Government-industry, 5-year export expansion program

The new 5-year, systematic Government export promotion program should be further developed and pressed forward vigorously. Full implementation of this program (*a*) will bring the U.S. Government's export expansion efforts more in line with those of governments of competing nations, (*b*) will provide the additional resources needed to exploit the increased opportunities generated by the lowering of tariffs in the Kennedy round negotiations, and (*c*) will serve to facilitate long-range Government and industry export planning.

The enlarged export effort provides for both the strengthening of the Commerce Department's basic promotional program—overseas trade fairs and trade centers, trade missions, America Weeks, and overseas market research and other commercial information services—and the introduction of new programs.

The new programs constitute a planned system of long-range export promotion. This involves:

—setting overall U.S. export targets in relation to the potential size of the world market and the probable strength of the competition;
—developing export goals or targets for certain industries or categories of goods;
—developing measures that the U.S. Government can take to make exporting more attractive;
—monitoring U.S. export performance to help assure that the export potentials are realized with the assistance of appropriate government policies and incentives; and
—conducting a continuing dialog with business, at both the national and local levels.

An "export market identification" program that spots specific markets for specific U.S. products overseas is in the initial stage of development. This program will use automatic data processing techniques in collecting and analyzing foreign market data and in finding U.S. firms capable of taking advantage of the opportunities so identified. The U.S. business community is being encouraged to become an active partner in this project.

The ability of the Government to sustain the systematic long-range export effort pledged last January will depend on continued budget support.

6. Press vigorously for removal of foreign nontariff barriers to U.S. agricultural and industrial goods, especially those with a large negative impact on U.S. export sales

This program should concentrate on those foreign nontariff barriers which violate the GATT or other international obligations and on those arguably sanctioned under GATT but significantly impeding U.S. exports.

Among the kinds of restraints upon U.S. exports which merit attention is the growing practice of many industrial nations to insist that

certain types of U.S. exports, such as civilian aircraft or military equipment, include locally made components as a condition of their purchase. This is also true in less developed countries, many of which regard Mexico's economic progress as evidence that such restrictions are sensible.

A first step to deal with this melange of trading problems would be a clear congressional mandate to the administration to undertake negotiations on nontariff barriers, subject to review and confirmation of the results by Congress.

7. The United States should continue to work for revised GATT rules on the taxation of exports and imports

Existing GATT rules have the effect (*a*) of penalizing countries like the United States which rely primarily upon income taxes rather than indirect taxes as the principal source of tax revenue and (*b*) of rewarding the European countries which have the reverse situation. The present lack of parity tends to promote imports into the United States, and to impede U.S. exports. Conscious of this, the National Export Expansion Council recommended a formal study of the merits of a value-added or other broad-base indirect tax for the United States as a means of helping our trade account. These studies would include substitution of the turnover value added tax (TVA) for a portion of the corporate income tax, institution of an optional form of tax payment by business based in part on the TVA or equivalent and in part on income tax, and substitution of a manufacturer's excise tax for some part of corporate income tax. This would allow us to parallel the border tax/tax rebate scheme of the Europeans and stay within the GATT.

I would not favor adopting a TVA system for the United States unless it met the test of being desirable in terms of our domestic tax and economic system.

If that is not the case (and I have no clear knowledge about the merits of such a system within the U.S. economy), then I believe we should seek from the Europeans a relaxation of the GATT rules and and of the practices under them so that direct-tax countries like the United States are not a disadvantage in world trade because of the peculiarity of the rules.

Conclusion

To regain a substantial trade surplus and thereby augment the current account part of the balance of payments is of major importance. I have suggested a range of measures which are among those which would help us reach the goal. There are, no doubt, a number of other actions that can be taken to enhance U.S. export performance. There are not easy choices in the balance-of-payments business. No panaceas. A careful balancing of the many competing national interests means that our financial objectives sometimes must give way to other important national aims. The American people, in electing the new administration, have given it the difficult job of choosing and implementing a program balancing these interests as wisely and effectively as possible. I wish it well.

ANNEX A

U.S. BALANCE OF PAYMENTS ON A LIQUIDITY BASIS, 1958—JANUARY-SEPTEMBER 1968

[In millions of dollars]

	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	January-September 1968 [1]
Exports, adjusted [2]	16,264	16,295	19,487	19,944	20,606	22,071	25,297	26,244	29,176	30,468	25,089
(Exports, excluding estimated Public Law 480 and AID shipments)	(14,800)	(15,000)	(17,900)	(18,200)	(18,500)	(19,400)	(22,500)	(23,600)	(26,500)	(27,700)	(23,200)
Imports, adjusted [2]	12,952	15,310	14,744	14,522	16,219	17,014	18,648	21,516	25,541	26,991	24,765
Trade balance	+3,312	+985	+4,743	+5,422	+4,387	+5,057	+6,649	+4,728	+3,635	+3,477	+324
Military transactions	−3,135	−2,805	−2,752	−2,596	−2,449	−2,304	−2,129	−2,115	−2,906	−3,100	−2,310
Investment income	+2,176	+2,215	+2,286	+2,935	+3,309	+3,324	+3,930	+4,164	+4,178	+4,565	+3,641
Other goods and services	−147	−248	−307	−303	−262	−265	−41	+124	+173	−174	+141
Balance on goods and services	+2,206	+147	+3,970	+5,458	+4,985	+5,812	+8,409	+6,901	+5,080	+4,768	+1,796
Unilateral transfers	−2,361	−2,448	−2,361	−2,578	−2,697	−2,808	−2,784	−2,835	−2,925	−3,076	−2,109
Capital transactions, excluding special transactions	−3,713	−2,425	−4,678	−5,094	−4,180	−5,818	−7,785	−4,981	−4,880	−5,681	−1,724
Errors and omissions	+511	+423	−892	−847	−997	−244	−860	−315	−210	−532	−228
Balance, excluding special transactions	−3,357	−4,303	−3,961	−3,061	−2,889	−3,058	−3,020	−1,230	−2,935	−4,521	−2,265
Special transactions	−8	+433	+60	+690	+685	+388	+220	−105	+1,578	+950	+1,455
Balance on liquidity basis	−3,365	−3,870	−3,901	−2,371	−2,204	−2,670	−2,800	−1,335	−1,357	−3,571	−810

[1] Data are seasonally adjusted.

[2] Balance-of-payments merchandise trade data are census statistics, adjusted primarily to exclude military sales and to include nonmonetary gold and silver.

Note: Military grant transfers are excluded.

Source: Prepared in the International Trade Analysis Division, Bureau of International Commerce, Department of Commerce, Jan. 8, 1969.

U.S. IMPORTS OF PRINCIPAL PRODUCTS, 1967 AND JANUARY-NOVEMBER 1968

[Dollar amounts in millions]

	1967		January-November 1968	
	Value	Percent of total	Value	Percent of total
Total	$26,812	100.0	$30,093	100.0
Industrial materials, total	11,772	43.9	12,817	42.6
Iron and steel mill products	1,289	4.8	1,801	6.0
Iron ore	444	1.7	422	1.4
Copper	656	2.4	817	2.7
Aluminum	244	.9	323	1.1
Nickel	203	.8	193	.6
Other nonferrous metals	373	1.4	367	1.2
Nonferrous base ores	455	1.7	395	1.3
Crude petroleum	1,167	4.4	1,181	3.9
Petroleum products	921	3.4	944	3.1
Chemicals [1]	780	2.9	865	2.9
Lumber	390	1.5	517	1.7
Woodpulp	396	1.5	391	1.3
Newsprint	864	3.2	778	2.6
Textile fibers	306	1.1	312	1.0
Textile yarns, fabrics, and twine	710	2.6	777	2.6
Other industrial materials	2,574	9.6	2,734	9.2
Capital equipment, total	2,696	10.0	2,982	9.9
Machinery	2,265	8.4	2,398	8.0
Civilian aircraft and parts	129	.5	172	.6
Trucks and buses, including chassis	302	1.1	412	1.3
Consumer goods, total	6,537	24.4	8,270	27.5
New automobiles	1,695	6.3	2,481	8.2
Automotive parts and engines	615	2.3	919	3.1
Motorcycles	104	.4	105	.3
Clothing	649	2.4	788	2.6
Footwear	265	1.0	353	1.4
Gem diamonds and other stones	436	1.6	430	1.2
Radio and TV receiving sets	298	1.1	416	1.4
Musical instruments; sound recorders	224	.8	276	.9
Other consumer goods	2,251	8.5	2,502	8.4
Food and beverages, total	4,586	17.1	4,815	16.0
Coffee	964	3.6	1,076	3.6
Meat	645	2.4	697	2.3
Fish	522	1.9	572	1.9
Sugar	588	2.2	583	1.9
Whisky and other alcoholic beverages	528	2.0	386	1.3
Other food and beverages	1,339	5.0	1,501	5.0
Other products, total	1,221	4.6	1,209	4.0

[1] Excludes uranium oxide and consumer items.

U.S. EXPORTS OF PRINCIPAL PRODUCTS, 1967 AND JANUARY-NOVEMBER 1968

[Values in millions of dollars]

	1967		January-November 1968	
	Value	Percent of total	Value	Percent of total
Total	30,934	100.0	30,758	100.0
Nonagricultural products, total	24,491	79.5	25,072	81.8
Machinery, total	8,277	26.2	8,116	26.0
Engines and parts	1,046	3.3	1,064	3.4
Agricultural machinery; tractors and parts	844	2.7	800	2.6
Office machines and computers	707	2.2	684	2.2
Metalworking machinery	339	1.1	312	1.0
Other nonelectrical machinery	3,244	10.3	3,164	10.1
Electrical power machinery and switchgear	510	1.6	485	1.5
Telecommunications apparatus	475	1.5	487	1.6
Other electrical apparatus	1,112	3.5	1,120	3.6
Transport equipment, total	4,296	13.6	5,007	16.0
New motorcars and trucks, nonmilitary	1,150	3.6	1,196	3.8
Parts and accessories for automotive vehicles	1,110	3.5	1,326	4.2
Civilian aircraft	789	2.5	1,272	4.1
Military aircraft	305	1.0	352	1.1
Parts and accessories for aircraft	425	1.4	464	1.5
Other transport equipment	517	1.6	397	1.3
Chemicals, total	2,803	8.9	3,012	9.6
Chemical elements and compounds	1,098	3.5	1,144	3.7
Plastic materials and resins	473	1.5	539	1.7
Other chemicals	1,232	3.9	1,329	4.2
Other nonagricultural products, total	9,706	30.8	9,400	30.1
Coal, petroleum and products	1,040	3.3	898	2.9
Iron mill and steel mill products	539	1.7	518	1.7
Nonferrous base metals	517	1.6	546	1.7
Textiles and clothing	695	2.2	613	2.0
Scientific and controlling instruments	628	2.0	611	1.9
Paper and manufactures	466	1.5	495	1.6
Other nonagricultural products [1]	5,821	18.5	5,719	18.3
Agricultnral products, total	6,451	20.5	5,686	18.3
Wheat	1,120	3.6	891	2.8
Corn	704	2.2	660	2.1
Other grains and preparations	857	2.7	675	2.2
Soybeans	772	2.4	708	2.3
Cotton, excluding linters	464	1.5	426	1.4
Fruit, vegetables, and nuts	492	1.6	427	1.4
Unmanufactured tobacco	498	1.6	466	1.5
Other agricultural products [1]	1,544	4.9	1,433	4.6

[1] Includes reexports.

Note: Values for total exports, and total agricultural and nonagricultural products exclude military grant-aid. Commodity detail includes these shipments.

ANNEX B

RELATIONSHIP OF U.S. FOREIGN TRADE TO GROSS NATIONAL PRODUCT, 1948-68

[Dollar amounts in billions]

		Exports		Imports	
	GNP	Value	As percent of GNP	Value	As percent of GNP
1948	$257.6	$12.7	4.9	$7.1	2.8
1949	256.5	12.1	3.7	6.6	2.6
1950	284.8	10.0	3.5	8.9	3.1
1951	328.4	14.0	4.2	11.0	3.3
1952	345.5	13.2	3.8	10.8	3.1
1953	364.6	12.3	3.4	10.9	3.0
1954	364.8	12.9	3.5	10.3	2.8
1955	398.0	14.3	3.6	11.5	2.9
1956	419.2	17.3	3.1	12.8	3.1
1957	441.1	19.5	4.4	13.3	3.0
1958	447.3	16.4	3.7	13.2	2.9
1959	483.7	16.4	3.4	15.6	3.2
1960	503.7	19.6	3.9	15.0	3.0
1961	520.1	20.2	3.9	14.7	2.8
1962	560.3	21.0	3.7	16.4	2.9
1963	590.5	22.4	3.8	17.1	2.9
1964	632.4	25.7	4.1	18.7	3.0
1965	684.9	26.7	3.9	21.4	3.1
1966	747.6	29.4	3.9	25.5	3.4
1967	789.7	30.9	3.9	26.8	3.4
1968[1]	851.7	33.8	4.0	32.7	3.8

[1] January-September at seasonally adjusted annual rates.

ANNEX C

DEPARTMENT OF COMMERCE EXPORT EXPANSION ACTIVITIES

Direct Overseas Promotions

Trade fairs.—Since March 1963, the Department has sponsored the participation of groups of U.S. firms in international trade fairs overseas. The firms invited to participate produce products that market research has shown to have substantial sales potential in the target market. The trade fair is selected because it provides an appropriate vehicle to present the selected product group. Since 1964, 3,900 exhibitors have participated in 85 Commerce-sponsored trade shows. Over this period the trade fair activity was improved and expanded. Exhibitions were staged for the first time in developing countries in 1966 and in that same year the first U.S. solo exhibition was held in Madrid, Spain. The Department undertakes "solo" exhibitions to take advantage of the identified market opportunities where appropriate fairs do not exist.

In 1967 Commerce mounted a full-fledged commercial trade show in Belgrade, the first such exhibit by the Department in an Eastern European country. This show, along with various other Commerce activities in Eastern Europe, was aimed at a sizeable potential market for non-strategic U.S. products in bloc countries.

Trade centers.—The scope of our Trade Center activity was also increased between 1964 and 1968. Trade Centers are permanent overseas "merchandise marts" established in central marketing areas where the potential for American products is high and continuous. Every year each Center stages six to eight major product exhibitions. The Centers are also available to American firms for between show promotions. New Centers were opened in Milan in 1964 and in Stockholm in 1965, joining the already existing Centers in London, Frankfurt, Bangkok, and Tokyo. A seventh Center will be opened in Paris this year.

These exhibitions are built around product themes selected on the basis of (1) continuing market research that identified products with high sales potential and (2) market development work that identified the target audiences for the exhibitions. Once the product theme has been decided upon, Commerce solicits the participation of U.S. firms manufacturing the products to be featured. Solicitation is done through telephone contact from Washington, contact by Field Offices, and publicity.

Approximately 50 percent of the firms participating in our trade fair and trade center activities are small firms, i.e., firms with less than $1 million net worth.

Trade missions.—The Trade Missions program of the Department underwent a dramatic change during the past five years. Prior to 1964, the emphasis was on U.S. Government-organized Missions which were sent abroad for three or four weeks to look for trade opportunities. Since all expenses were paid by the Government, conflict of interest considerations precluded the members from doing business for their own account. This problem has been overcome and the effectiveness of the program has been improved by the development of the Industry-organized Government-approved (IOGA) Mission.

Under the IOGA Mission program trade associations, chambers of commerce, cities and states are encouraged to organize their own Missions.

The number of IOGA Missions grew from 3 in 1963 to 30 in 1968. At the same time, the number of Government-organized Missions was reduced from 9 in 1963 to 3 in 1968. Since 1964 Government-organized Missions have been sent primarily to the less-developed countries of the world while the IOGA Missions have been concentrated in the developed countries which offer the best potential for short-term results.

Mobile trade fairs.—In 1964 the Mobile Trade Fair program was introduced; it is designed to give the widest possible exposure to U.S. products overseas by transporting them on ships or planes for exhibition in various important commercial centers in foreign markets. The Department provides technical and financial assistance to approved private Mobile Trade Fair Operators. In 1966 the Department began combining Mobile Trade Fairs with IOGA missions in order to increase the effectiveness of the mobile fair by bringing buyer, product and seller together.

Sample displays.—Sample Displays were initiated in 1965 to give exposure to American products in selected developing countries which offer the most promising sales prospects for American products. Located at our Embassies in Beirut and Nairobi and at the Trade Center at Bangkok, the primary objective of these showrooms is to help small and medium sized firms obtain overseas agents and distributors for their products.

America weeks.—In 1966 the America Weeks program was introduced. America Weeks are retail promotions of U.S. consumer goods mounted in cooperation with foreign department stores. Upon agreement by the store to purchase a specific amount of American goods, Commerce supplies special promotional support and purchasing advice.

Export Promotion Activities Within the United States

The domestic export promotion efforts of the Department have in the past been primarily carried out by Field Offices and by speaking engagements of Washington-based Commerce officials.

The 42 Field Offices conduct over 1,000 seminars each year aimed at helping American firms export. The seminars bring to the attention of participating businessmen the techniques that can be used and the services that are available in the export business. Field Office International Trade Specialists also make approximately 20,000 visits to firms in their areas to encourage entry into export. The Field Office can make available to these firms a large quantity of commercial information about foreign markets.

Field Offices also work through the Regional Export Expansion Councils which are organized at most of these offices. These regional advisory councils keep Commerce informed of problems they and their associates are encountering in exporting and work to make the benefits of exporting better known to non-exporting firms in their area.

The Commerce Department is currently developing a new plan of action which will provide greater ammunition for our domestic promotion efforts. We are increasing our efforts to identify sales opportunities for specific products in

specific countries. When identified, the opportunities will be publicized in the American business community by means of mailings to those of the 23,000 firms registered on our American International Traders Index who might be interested in the opportunity. Also, armed with this better, more specific market data, Field Office personnel will be in a better position to interest firms in exporting.

Commercial Information

Through a network of commercial and economic officers at our embassies and consulates overseas and country desk officers and trade specialists in the Department, Commerce gathers and disseminates information on commercial and economic conditions overseas, on trade opportunities, and on foreign traders. Dissemination takes place through special publications, through articles in the Department's weekly foreign trade magazine, *International Commerce*, and through personal contact in Washington and at Field Offices. Foreign traders who are potential agents for U.S. manufacturers are identified by means of Trade Lists and World Trade Directory Reports.

These information services are designed to make it easier for U.S. firms to export.

For example, a firm wishing to enter a foreign market might begin by talking with the Department's specialist on the country concerned. This specialist can tell him what the general economic situation is in the market, whether his product is being produced there, whether it is being imported, and what the duty and other entry requirements are. If, on the basis of this information, the exporter wanted to pursue the project further, he could consult a trade list of firms in the target country who deal in his type of product. For more detailed information on firms that looked promising, he could purchase World Trade Directory Reports from the Department. These reports give details of size, type of business, company officers, bank references, and general reputation in the local community. Both the trade lists and the World Trade Directory Reports are prepared by our commercial officers stationed at Foreign Service posts abroad.

Having decided on firms that appear to be good prospects, the potential exporter would then contact them to determine interest. Our commercial officers abroad would be ready to give an assist should the business relationship hit a snag. Commerce can also advise the exporter on the services available from the Export-Import Bank and the Foreign Credit Insurance Association.

Or, the interested exporter could participate in a trade fair or a trade center show, if they were available in the target country, and thereby test the saleability of his product in the foreign market and take advantage of the agent-finding services that Commerce provides in connection with these exhibitions.

Exporters might also get leads on new markets through articles or trade opportunities published in *International Commerce*. He could then proceed along one or a combination of the lines mentioned above to consummate an export deal.

Creating a Better Climate Overseas for U.S. Exporters

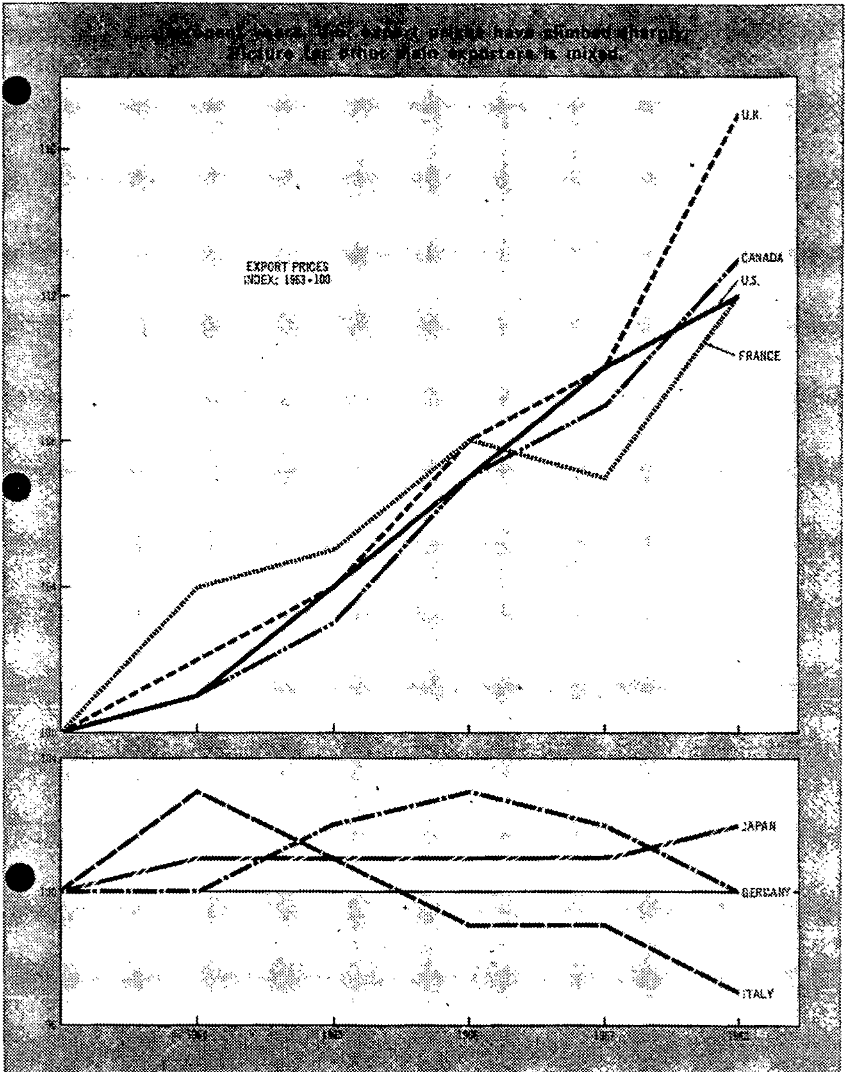
Efforts to provide a better climate overseas for American business takes many forms. It involves an active role in developing and administering U.S. trade policies, in trying to persuade foreign government to alter their trade policies through such action as reducing tariffs and eliminating non-tariff trade barriers, and in developing the U.S. approach to international trade problems in such international bodies as GATT, the OECD, and UNCTAD.

Also included in this category of export promotion effort are activities to help American firms to protect the patents and copyrights in foreign countries and to help U.S. firms cope with foreign discriminatory business practices.

Under this heading the Department also involves itself in transportation policy especially discriminatory freight rates and other transportation factors adversely affecting exports.

In the field of international finance, the Department presents the American business viewpoint in developing policies for loans as well as the views of the U.S. business on specific loans made by the Export-Import Bank, Agency for International Development and international lending organizations.

ANNEX D



ANNEX E

Report by the National Export Expansion Council

(Based on Plenary Council Meeting, November 15, 1968)

The National Export Expansion Council (NEEC), initially formed in 1960 and now comprising 72 business and professional leaders, serves in an advisory capacity to the Secretary of Commerce and other Government agencies concerned with United States foreign trade policy and performance.

In 1966 and 1967 the NEEC recommended a series of actions to expand further United States exports. These recommendations are embodied in five Action Committee Reports concerning Export Financing, Taxation in Relation to Exports,

Transportation and Ocean Freight Rates, Trade and Investment in Developing Countries, and Export Promotion.

Some, but by no means all, of these recommendations have been adopted and implemented.

Over and above the specific accomplishments, summarized below, the continuing dialogue between the Department and the NEEC and its Action Committees has proved most useful by providing concrete data on the business effects of policy decisions and operational procedures in the various Government agencies concerned with the balance of payments program. It is our understanding that this also has made it possible for the Department of Commerce, operating through the Cabinet Committee on Balance of Payments or via other coordinating mechanisms such as the National Advisory Council, the Export-Import Bank Board, and the Development Loan Committee to suggest specific measures for consideration by Treasury, the Federal Reserve Board, AID, Eximbank, and other agencies with program management responsibilities.

Export Financing

The most noteworthy accomplishment has been the creation of a new export expansion facility which can use up to $500 million of Eximbank's authority for export transactions that foster the balance of payments and long-term commercial interests of the United States but entail more risk than the Bank would consider acceptable under its "reasonable assurance of repayment" criteria. At the same time, the Bank has taken significant steps to liberalize its insurance guarantee and direct lending programs. A rediscount facility was established by Eximbank in September 1966 and has been progressively modified to make it more attractive to the commercial banks. Eximbank and the FCIA have shown responsiveness to NEEC recommendations by furnishing clear guidelines and criteria to exporters. Significant progress has been made—notably in connection with jet aircraft sales—in mobilizing non-governmental funds to supplement the Eximbank's availabilities.

Taxation

The Tax Action Committee's wide-ranging review of incentives available for stimulating U.S. exports has led to tangible governmental action on several fronts. The Internal Revenue Service has issued liberalized guidelines on intercompany pricing, and has accorded more favorable treatment to income earned abroad under certain circumstances. The U.S. Government is currently exploring with a number of its major trading partners the border tax practices of a number of countries and their effects on international trade. The result of this exploration—which is taking place in a GATT working party set up at U.S. urging—may help improve the competitive position of traders in countries which, like the U.S., do not rely heavily on the indirect taxes. These indirect taxes are reflected in border charges on imports and tax rebates on exports in a number of continental European countries which rely on them. Despite the fact that the fiscal climate has been unfavorable for the submission of any legislative recommendations to the Congress, intensive study has been undertaken within the Executive Branch of possible export tax incentives. In this connection, Commerce has presented to Treasury a specific proposal for an "over-expensing" allowance which would compensate exporters for overseas promotional expenses.

Transportation

The Transportation Action Committee made a number of recommendations designed to reduce freight costs and improve services so as to make U.S. exporters more competitive in international trade. Commerce and the Federal Maritime Commission have taken steps to inform shippers more fully about rate-making procedures. The Department of Commerce is actively cooperating with other Government agencies in measures to facilitate the use of containers in international trade, in simplifying export documentation, and in fostering the establishment of joint rates.

Developing Countries

The Action Committee on Trade and Investment in Developing Countries has been instrumental in impressing upon the Agency for International Development the importance of administering foreign assistance programs in a way which will assist the establishment of long-term commercial export markets. The Committee's comments on the inter-relationship between trade and investment have been a factor in strengthening AID's guarantee programs. The Committee's

expression of interest in the export potential for agricultural production inputs in the developing countries was the major impetus behind the establishment recently of a jointly-sponsored Commerce-Agriculture Department Agribusiness Industry Advsiory Committee.

Export Promotion

The Action Committee on Export Promotion urged the Government to adopt a long-range approach to export expansion, so that business could plan in reliance on a firm basis of official support to their efforts. A long-term export promotion program was embodied in the President's New Year's Day 1968 Message on the Balance of Payments, and has been the keystone of Commerce Department actions to reinforce and expand its existing trade promotion services. Long-range export targets are being developed within a global export strategy program which will identify by country or regional area the specific products which offer the best prospects for U.S. firms over a five-year period. Additionally, progress has been made in encouraging foreign buyers to visit the United States, in arranging cooperative programs with the Small Business Administration, in gaining better patent, trademark and copyright protection for U.S. firms abroad, and in providing for freer movement among foreign countries of sales promotion materials.

Such responsive action by our Government is gratifying. However, it is the sense of the NEEC that international business is growing more competitive. At the same time, some of our industries and products are becoming less competitive. Inflation at home and improved technology abroad are contributing factors. It is becoming increasingly difficult, particularly in the manufactured goods area, to maintain our fair share of world markets by relying on exports from the U.S. In many cases, American corporations must establish overseas plants in order to compete effectively in those markets. The Committee is convinced that more imaginative and vigorous action is needed *now* to make exporting from the United States more profitable and attractive to our producers.

Thus, following a year of heightened concern over a decreased trade surplus and a continued balance of payments deficit;

and on the eve of assumption of office by a new Administration in Washington;

it is deemed now to be timely and appropriate for the NEEC to state the broad trade and balance of payments considerations which, in its judgment, should govern the formulation of future domestic and foreign economic policies;

and to propose specific actions which should receive prompt attention in order to improve the United States export performance.

BROAD TRADE AND BALANCE-OF-PAYMENTS POLICIES

1. Domestic economic policies should be framed with due regard to their consequences for trade and balance of payments and the need to avoid pressures that unnecessarily add to imports or reduce exports.
2. The U.S. Government should take a firmer role in dealing with inflationary pressures that threaten to weaken our international and domestic competitive position.
3. Export promotion activities should be pursued actively within the context of a five-year coordinated trade expansion program.
4. The U.S. should continue to follow a generally liberal trade policy while seeking to remove both tariff and non-tariff foreign trade barriers, including overcomplicated foreign documentary requirements, inimical to U.S. interests.
5. Increased attention should be given to positive measures to make U.S. industry more competitive in the U.S. market, vis-a-vis overseas producers of imported manufactured products.
6. While special governmental financial transactions and military offset arrangements should be actively pursued, it should be recognized that they are no substitute for the necessary steps to improve our trade performance. Thus, increased efforts to expand exports are essential, including promotional activities, improved financing and insurance, and other positive incentives for exporters.
7. Efforts to improve the U.S. trade position and overall balance of payments should not be considered successful until a position approaching equilibrium can be reached without continuation of such restrictive measures as the current foreign credit and direct investment control programs. Elimination of these programs as early as possible is highly desirable.
8. To help achieve the foregoing policy objectives, improved organization of the Executive Branch is required to give more coherent and consistent direction

in the fields of trade policy, trade promotion, export credit, investment policy, and related areas. To this end a study is recommended, on a priority basis, to review the interrelationship of Governmental organizations responsible for export promotion, export financing, trade policy, and investment assistance to private enterprise in developing countries, with a view towards creating a more effective organization for the U.S. Government's efforts affecting overseas trade and investment.

Specific Actions Needed To Improve the U.S. Balance of Trade

Export Financing

1. Export credit should be exempted from the Federal Reserve guidelines.
2. Mandatory U.S. investment controls should be revised to exclude sales by U.S. parent firms to their subsidiaries, and the A, B, and C country categories should be consolidated in order to provide investors with necessary flexibility on the use of their investment funds.
3. The rediscount facility should be improved and consideration should be given to the Federal Reserve taking over this function, as is the case in other countries.
4. The Council recommends consultations between the Export Expansion Facility Advisory Committee and private industry and banking in order to maximize the benefits of the EEF.
5. Further improvements are required in the Eximbank and FCIA programs, including maximum use of commercial banking resources, support for the Dillon-Read PEFCO Report, a broadening and greater utilization of Eximbank's public advisory board, and further improvements in FCIA administration and policies.
6. The Council further recommends that present emergency measures be replaced by a more meaningful long-term solution of our trade and payments problems, which arise in large measure in the area of public financial and fiscal management.

Taxation

Recommended Administrative Actions

1. The Administration should increase its efforts to have the international trading rules which govern the granting of export subsidies changed so as to permit rebates or other tax concessions relating to direct taxes. This change would put countries which have a predominantly direct tax base on a par with countries having heavy indirect taxes on business with regard to tax treatment of imports and exports and make the international trading rules apply in the same fashion in both cases.
2. Sponsor a formal study of the advantages and disadvantages of substituting a value added tax or other broad base turnover tax as a major source of revenue in place of part of the revenue raised by our existing income tax. Such a study should determine the possible effects on exports of changing to a turnover tax system.
3. Recommendations issued under Section 482 of the Internal Revenue Code on intercompany pricing should be amended to proide that profit allocations would not be questioned for certain types of export activity involving U.S. parent companies and their foreign sales subsidiary or Western Hemisphere Trade Corporation subsidiary.

Recommended Legislative Actions

1. Liberalize and simplify the requirements for obtaining tax benefits as an Export Trade Corporation.
2. Allow companies an extra incentive deduction for promotion expenses incurred in overseas market development.
3. Provide a rebate on exports and a border tax on imports based on existing indirect taxes entering into the cost of production.
4. Provide an additional capital allowance each year for equipment produced in the U.S. used in producing goods for export.

Transportation

1. Government agencies should support developments in containerization and through documentation with a view to stimulating export expansion.
2. The NEEC recommends early legislative action on a Trade Simplification Act as well as on the Brussels Protocol (and related aspects of the Carriage of

25-765—69——3

Goods By Sea Act) on limitation of carriers' liability as supportive to the promotion of containerization and through rates.

3. The Council urges support by Government and business of the work of the National Committee on International Trade Documentations designed to standardize and simplify international trade documents as a means of reducing transportation costs.

4. The DOT's Transportation Facilitation Committee should be supported in its efforts to facilitate the international movement of goods.

5. The Secretary of the Interior, in cooperation with other Government Departments, should undertake further discussions with the coal-carrying railroads to reduce the railroad freight rates on coal for export.

6. Government agencies should encourage U.S. exporters to sell on a CIF basis to facilitate the placement of insurance and freight with American insurers and carriers, and U.S. shippers should make greater use of U.S.-flag vessels.

7. The Government should adopt an incentive-oriented subsidy program to encourage modernization of the U.S. merchant fleet.

8. The Department of Commerce should further improve its export licensing procedures, particularly with regard to the Eastern European countries, with a view to putting U.S. exporters on an equal footing with their Western European competitors.

9. AID should review its procedures for shipment of AID goods in order to reduce the volume of paperwork presently required.

Trade and Investment in Developing Countries

1. The Departments of Commerce and Agriculture should utilize the NEEC/REEC mechanism as a major channel for encouraging business implementation of recommendations by the Agribusiness Industry Advisory Committee. To this end, liaison arrangements should be established between interested REECs and the three AIAC subcommittees dealing respectively with Communications, Export Promotion, and Export Development.

2. The Department of Commerce should continue to work closely with AID on "Additionality" activities designed to expand commercial exports in conjunction with foreign assistance program administration.

3. The Department of Commerce's OFDI controls on direct investments should be operated so as to minimize their deterrent effects on the export of capital goods and production components from the U.S. to the developing countries.

4. AID should continue to strengthen its programs in support of export-related U.S. private investment in the LDCs, in particular: investment guarantees; local currency loans; and the provision of follow-on maintenance imports of raw materials, components, and spare parts for manufacturing operations organized by U.S. investors.

5. The Government should assure adequate export credit to permit U.S. suppliers to develop LDC markets, with specific attention to: Eximbank loan, guarantee, and insurance programs utilizing the new Export Expansion Fund Facility; and liberalization of Federal Reserve restrictions on overseas lending directly related to export transactions.

Export Promotion

1. The Council endorses the Department of Commerce's new five-year export strategy concept, export targeting, and automation of commercial information and foreign market data. In implementing this program, the Department is urged to take into account the need for expanding the export of services as well as our merchandise trade.

2. The establishment of NEEC committees organized along industry lines could be of significant benefit in the formulation of export targets, for both products and markets.

3. Responsibility for development of U.S. international trade must be centralized, with permanent provisions for the representation of international trade interests in the highest councils of Government (at the Cabinet level).

4. The United States should pursue aggressively the building of economic bridges to the bloc countries with a view to encouraging more commercial ties with the West.

5. The Council urges a change in the rules governing direct foreign investment to provide (1) an allowance for that portion of capital transactions represented by exports from the U.S., and (2) a higher allowance to companies showing a particularly strong export growth.

6. The Department of Commerce should continue to enlist trade association participation in the national export promotion effort.

Chairman REUSS. Mr. Arey, will you now proceed to tell us about the tourism aspect of the balance of payments?

STATEMENT OF WILL AREY, ACTING DIRECTOR OF U.S. TRAVEL SERVICE

Mr. AREY. First, I wish to thank you, Mr. Chairman and members of the subcommittee, for the opportunity to review with you the efforts of the U.S. Government during recent years to encourage travel by foreign citizens to the United States.

As you know, the International Travel Act of 1961, established the U.S. Travel Service as part of the Department of Commerce for the primary purpose of attracting visitors to this country. The Travel Service serves as the focal point around which the U.S. travel industry and other government agencies involved in international travel cooperate in shaping policies and operations in the visit U.S.A. program. Although the Travel Act does not specifically direct the U.S. Travel Service to concern itself with the balance-of-payments problem, it is quite obvious that the activities of the Travel Service have an immediate and important impact in that area.

The basic reason for this close relationship has been the increasing recognition by the Travel Service that its most effective role in the area of travel promotion lies in its willingness and capability to support and supplement, where necessary, the activities of private industry, trade groups, and State and local government. These groups are primarily concerned with identifying markets which offer the greatest potential revenue and then developing strategies to capture that revenue. By working with these groups to accomplish their goals, we, in turn, serve the national goal of achieving a favorable growth in receipts of foreign currency.

Before discussing our current program, I should like to describe briefly some aspects of foreign travel and tourism as they relate to world trade in general and to the foreign trade of the United States in particular.

One of the most understated of current economic facts is that tourism is the most important element of world trade today. In 1967, tourism generated over $16 billion of exports. This is a sum greater than that spent for any single internationally traded commodity.

Moreover, tourism as a factor in world trade has been increasing at a rate faster than the average value of all other world exports. Recently, the Organization for Economic Cooperation and Development (OECD) reported that world receipts from tourism increased from 5.5 percent of the value of world exports in 1961 to approximately 6.7 percent in 1967.

In many nations, particularly in the developing nations in the world, tourism represents the basic source of the foreign currency so urgently needed to finance their other developmental activities.

But what of the United States? Is American travel abroad something to be tolerated because it can be justified as an aid to developing countries?—or because it builds good will and understanding among nations? On the other hand, is American tourism a frivolity—an un-

necessary luxury that should be restricted because it benefits already developed nations, hard currency nations, that will use their earnings from American tourists to drain our exchange reserves?

In a very real sense, these questions really do not apply. All too often in the United States, international travel is discussed primarily in terms of American dollars being spent in foreign nations by U.S. residents. Indirectly, if not directly, international travel is singled out as an activity that is a burden to be supported by our so-called trade surplus.

Discussions of this type, Mr. Chairman, blur the very significant fact that a major contributor to our earnings of foreign currency is in fact our earnings from foreign travelers. In 1967, the United States earned approximately $1.9 billion from foreign travelers. Of this amount, approximately $235 million were paid by foreign visitors to the U.S.-flag carriers and more than $1.6 billion were spent for accommodations and miscellaneous items within the United States.

It is interesting to compare these amounts with our nation's earnings from other export industries. In 1967, our cotton exports amounted to less than one-half billion dollars. Beverages and tobacco were valued at $625 million. Our earnings from petroleum and petroleum products were approximately $434 million. From iron and steel, we earned $561 million; agricultural machinery earned $628 million and electrical machinery $1.9 billion. Of the items on this list only the last had earnings that approached the value of our earnings from foreign visitors.

A significant but very seldom mentioned fact is that our receipts from foreign travelers currently represent about 6.1 percent of our total exports. Moreover, the share of our exports represented by foreign travel has steadily increased since 1962 when it represented only 5 percent of the total.

Not only do our exports of international tourism represent a significant share of our total export trade, but they are growing at a rate that is about double that of our total export trade. Since 1963, total U.S. exports have increased at an annual rate of 6 percent. During that same period, receipts from foreign travel have increased at an annual rate of approximately 11 percent.

In view of the significance of international travel as a major earner of foreign currency for this country, not to mention its significance as a meaningful force in building genuine international understanding, the really appropriate question, Mr. Chairman, that should be asked is, why has not this industry received as much concern about its promotion and growth as other industries that cannot really compare with it as producers of foreign earnings?

Answers to that question are almost always preceded by discussions of the so-called tourist or travel gap. This gap is the other side of the coin and, indeed, it needs to be discussed.

I have attempted here to show that receipts from foreign visitors are an important sector of our current account having a comparable favorable effect as achieved by exports. Also, I have tried to show that the international travel industry, a major producer of foreign currency in our balance of payments, is in every sense of the word a growth industry. While this is true, however, our imports—our expenditures by U.S. residents abroad for travel—have increased, in

absolute terms, more rapidly than our receipts. This decade, this gap between our receipts and expenditures has widened from $1.2 billion to $2.1 billion.

In 1963, expenditures by U.S. residents abroad amounted to $2.7 billion, while receipts from foreign visitors to the United States were $1.1 billion. By 1967, expenditures had mounted to $4 billion while receipts increased to only $1.9 billion. It is obvious that the absolute change in expenditures for foreign travel by U.S. residents has been much greater than the absolute change in receipts earned from foreign visitors. This idea, in essence, is the so-called travel or tourist gap.

Now, Mr. Chairman, I come to the point I wish to stress today. I believe that the justified concern over the balance of payments has led to a misplaced emphasis on the absolute size of the travel gap. The important fact is that while it is true that the gap has grown larger in absolute terms, it has actually been shrinking in percentage terms.

This phenomenon is the positive side of the tourist gap. It is the side at which we should be looking. Rather than deploring the fact that each year we are spending more abroad than we are earning, I feel that it would be more useful to recognize that in recent years our earnings are growing faster than our expenditures; and that, with prompt and positive action, we can accelerate this trend.

Never in our history, from colonial times to the present, have we earned more from foreign visitors than we have paid out for our own travel. For example, in 1911, our receipts of $38 million amounted to only about 14 percent of the $265 million spent by U.S. travelers abroad.

In that year, the absolute gap between expenditures and receipts was only some $227 million, but in percentage terms, the gap was quite large compared with what it is today. In 1960, receipts from foreign visitors were about 39 percent of our expenditures for foreign travel. In 1967 receipts amounted to 47 percent of expenditures. I should recognize that 1967 was a particularly bad year because in 1966 receipts amounted to more than 50 percent of expenditures. But 1967 was an extra-ordinary year in that Expo 1967 drew a large number of American visitors to Canada. Despite this 1 year, the trend during this decade has definitely been toward a faster growth of earnings from foreign visitors than toward a faster growth of expenditures by Americans for foreign travel.

The first 11 months of 1968 have been a record year as far as visitors coming to the United States is concerned. Total overseas visitors (including business, pleasure, students, and transits) reached a high of 1,666,055, a gain of nearly 3 percent over the similar 1967 11-month period. This new high was primarily attributed to an increase in the business and pleasure sector. For the entire year, we anticipate approximately 1.8 million foreign visitor arrivals from overseas—representing a 5-percent increase over 1967.

Based upon preliminary expenditure estimates, we expect visitors from abroad to spend a total of $2 billion here during 1968, up 6 percent over 1967. Expenditures of U.S. residents for travel abroad is anticipated to be approximately $3.98 billion—a decline of 1 percent from the previous year. These figures bring the 1968 travel deficit to $1.98 billion—down approximately 8 percent from 1967.

Visitors from both Mexico and Canada, not included in the preceding totals, have increased substantially this year. We anticipate visitor arrivals from Mexico to increase approximately 7 percent in 1968 over 1967, while Canadian arrivals are expected to increase 10 percent.

As can be seen, our efforts are being rewarded. There is a gathering momentum. The travel gap is something that we can come to grips with. The gap in percentage terms is closing. But I will be the first to admit that it is not closing fast enough—not with a speed that makes complacency appropriate—not so fast that we can look forward to a surplus in the travel account in the immediate future. But, nevertheless, the gap is narrowing from the receipts side up. It is essential that we keep this point in mind.

There is much work ahead if we are to accelerate this trend. This concentration on the positive side of the account will prove more constructive than would measures that close the gap by limiting American travel abroad. Let us remember that when we manipulate one side of the economic equation, the other side will be affected also. Restrictions will invite reprisals—reprisals, I might add, that would fall on that sector of our foreign trade that has been growing at remarkably favorable rates. We cannot expect that we shall have continued rapid growth in our receipts from foreign visitors if we take steps to limit the freedom of Americans to travel abroad.

As other nations prosper, as the discretionary income of their people grows, the United States will enjoy an increasing comparative advantage as a tourist destination. There are many things which can be done by Government in cooperation with private enterprise to motivate the foreign citizen to visit this Nation.

The burden of this motivation will continue to fall upon private industry. However, the Federal Government must do more than it has in the past in this international travel sector to assist their efforts. The Government, through the U.S. Travel Service, should be seen as providing support and coordination to a diverse and complex industry. USTS should assist in identifying prime overseas markets. Although we are receiving an increasing number of foreign visitors each year, the number coming here is small compared with the existing potential. To the extent possible, we should promote the United States, using appeals which complement industry and local government efforts. In general, we should provide the services needed by the travel industry and local areas as travel destinations as a whole but which no one firm or sector can afford to do on its own.

Since the establishment of the U.S. Travel Service in 1961, its average annual appropriations have been approximately $3 million. This year our total budget was increased to $4.5 million. The current U.S. Travel program is administered by a staff of 70 individuals—34 here in Washington and 36 abroad. With the increased funding level, the internal reorganization, and the new emphasis of working with the travel industry we have taken a number of steps to improve our effectiveness. Let me cite just a few examples of these changes.

1. PROMOTION

Our seven regional offices abroad are currently emphasizing service to the foreign travel industry. Through an educational process involving local travel agencies and major airlines in foreign countries, we are seeking to encourage these prime promoters of travel to actively sell the United States as a travel destination. For example, this year our agency has sponsored, in conjunction with the travel industry, familiarization tours to the United States for over 1,200 foreign travel agents, tour operators, and travel writers. This program, which is in keeping with a recommendation of the Presidential Travel Commission, has offered tours covering 23 cities and 2 national parks in 17 States.

To complement industry's promotional efforts in motivating and encouraging citizens of other countries to visit the United States, USTS has allocated $1.2 million, or approximately 25 percent of our total budget for consumer advertising, in 18 major overseas markets. In both the construction and scheduling of this campaign, the travel industry was consulted and their comments incorporated into the plan. Two major foreign airlines, SAS and Alitalia, are participating by direct financial support with USTS in the VISIT USA promotional programs in Scandinavia and Italy. In addition, all major flag carriers, both United States and foreign, have designed advertising campaigns complementing the VISIT USA program.

The theme of the 1969 campaign stresses the low cost of travel within the United States and thereby attempts to correct the image of the United States as a high-cost travel area. We believe this theme will strike a responsive note overseas. We realize we are undertaking a large task with the bare minimum of resources. We also realize that in order for a worldwide advertising campaign to be effective in changing images and in motivating individuals, far more effort needs to be expended. A critical mass of resources needs to be utilized. This $1.2 million merely represents the beginning of an effective campaign.

Compared with the amounts other nations spend on travel promotion, $1.2 million is a relatively insignificant sum. In 1967 the United States ranked 20th with respect to the promotional budgets of other Governments' tourist offices. In addition, you might say that these 20 countries have a definite advantage over the United States in attracting tourist dollars for two reasons: first, they have larger promotional budgets; and second, they can concentrate all their efforts in relatively few markets—primarily in the United States.

2. PRODUCT

It is not enough to market the United States overseas. In truth, USTS efforts in this area are dwarfed by the marketing efforts of both United States and foreign firms with an interest in promoting travel to the United States. Thus, in addition to our direct promotional efforts, we must be concerned with the adequacy of the product we are selling. We are engaged in programs to improve visitor services in this country and to encourage the development of an interest in

foreign visitors by our domestic travel industry. We are attempting to ease the entry of foreign visitors to the United States through efforts to encourage less-restrictive policies with respect to customs procedures, visa regulations, and other bottlenecks which tend to hamper the flow of foreign visitors. Examples of this activity would include our being responsible for the installation of multilingual signs at John F. Kennedy International Airport which facilitate the movement of international travelers. Another example of our efforts is seen in the adoption of the airport accelerated or one-stop entry inspection system at Kennedy International, Washington's Dulles, and San Antonio. We have established a close working relationship with the local government offices in each of the 50 States in promoting their specific attractions. We are constantly working with the travel industry in developing pricing patterns and discount programs that have appeal to the foreign visitor while at the same time offering profit to the American businessman and sound wages to the American worker.

3. RESEARCH

Before we can make really significant progress in improving our marketing technique and in building our capability to accommodate an increased flow of foreign visitors, we need better information. We know that there is a desperate need on the part of industry and States and local government for information as to where our visitors come from, what they do when they arrive here, how they spend their money. Information is needed to direct our activities so that our marketing strategies will have the highest payoff in terms of additional visitors, and dollar earnings. Just last week, for example, the Secretary of Commerce was asked by the National Association of Travel Organizations to increase the Department's efforts to meet the urgent needs of the U.S. travel industry for uniform and reliable statistics to which everyone in the industry can relate.

We recognize this need and we intend to meet it. We have established an Office of Research and Analysis at USTS with an annual budget of approximately $200,000 or approximately 5 percent of our total appropriations. The primary mission is to develop in a timely and concise manner information on the international travel market needed by industry and State and local government. Data have never been adequately developed in this area and our increasing activities here represent our assumption of a traditional Government obligation to an important industry.

A project currently underway is the development of a market potential index. This index is designed to reflect visitor potentials in terms of both numbers and dollars, country by country, on a worldwide basis. I have directed the individuals of this office to meet with the leaders of industry and State officials in order to develop, on a timely basis, the specific kinds of information needed by these decisionmakers to make the United States an easy-selling travel destination.

4. NEW DIRECTION FOR TRAVEL PROMOTION

We cannot afford to stand still. The competition for the tourist and his money is worldwide and is growing in intensity. Every major and minor nation in the world has seen the potential, and will be competing

for this sector of world trade with all the resources at their disposal, both public and private. We must be continually adaptive and innovative to stay abreast of this rapidly changing international market.

As you know, Mr. Chairman, the joint industry-Government task force on travel transmitted, this year, its report to the President. This report contained over 70 recommendations that, when considered as a whole, are of significance in the totality of their impact on international travel promotion. We have recommended strongly that this totality and comprehensiveness be preserved and that the Federal Government approach travel promotion with a single voice. An industry typified by a diversity of interests should be able to look to one program activity in the Federal Government to provide this unifying force.

I believe that we are now moving in the right direction. I believe that the record of significant increase in both numbers of foreign visitors and their expenditures will continue. How much of the increase in our overall national performance in this area can be attributed to the activities of the U.S. Travel Service? I do not know the dollar return for the dollar expended; but, I sincerely believe that the Government's limited investment has already had extensive effect in the United States and abroad. While it is difficult at this juncture to make such an assessment of the recognized improvement in the traffic to this country from abroad, the fact that conspicuous gains have been enjoyed from those areas to which the Travel Service has directed its energies and its promotion expenditures serve to confirm preliminary evaluation of the positive results achieved. Although not specifically measureable, at this point in time, certainly we have contributed to the momentum which is now underway. Let us strive to keep this momentum going.

That concludes my statement. Thank you, Mr. Chairman.

Chairman REUSS. Thank you, Mr. Arey.

We will now hear Assistant Secretary of the Treasury, Stanley Surrey.

Mr. Surrey, your entire paper has been made part of the record and perhaps you could summarize it and emphasize the high points.

STATEMENT OF HON. STANLEY S. SURREY, ASSISTANT SECRETARY OF THE TREASURY

Mr. SURREY. Yes, Mr. Chairman, I will be glad to proceed that way in going through it in summary fashion.

You have asked me to discuss the relationship between the U.S. tax policy and tax policies of other countries and the current amount of the U.S. balance of payments.

That really involves two questions: One, what effect does a country's tax system or a country's tax policy have on its international trade and, then, looking at the international trade position of the United States, what should be the reaction of our domestic tax policy and changes in our domestic tax system, if any, to the present picture we see in our international trade?

I will go first to the question of how does a country's tax structure affect international trade? Well, generally speaking and this is, I think, typical all over the world, if a country is to impose what people

have called indirect taxes, excise taxes, it will automatically attempt to see that the introduction of these taxes will not affect international prices.

For example, when the United States imposes a manufacturers' tax on automobiles it automatically exempts exports of automobiles from that tax because it does not want the excise tax, on automobiles to affect our export price for automobiles.

Conversely, when we have a manufacturers' tax on automobiles we impose a parallel tax on automobiles coming into the United States so that those foreign automobiles coming into the United States will pay the same tax as would a domestic automobile. We would do the same thing for cigarettes and alcohol and any excise tax that this country has imposed. It has automatically exempted exports and imposed a reciprocal tax on imports. Other countries do exactly the same with their excise taxes, the general understanding being that if that were not done, the tax would be immediately reflected in foreign prices and that is not the intention of the legislatures.

On the other hand, when a country imposes an income tax it does nothing to insulate export prices from the effects of the tax. It simply goes ahead and imposes the income tax, whether it is a corporate income tax or the individual income tax. The same with a payroll tax. This equally is the practice around the world.

Now, these practices of legislatures were, in a sense, codified in the GATT rules. The GATT rules say that a country can make adjustments for its excise taxes but it cannot make adjustments for other taxes. If it were always true that indirect taxes are shifted forward in price and direct taxes and income taxes are not shited forward in price these rules, these traditional approaches, would really insulate foreign trade from a country's tax system.

This leads us to the question of whether the assumptions behind these working rules are really valid; in other words, is an excise tax always shifted forward in price and is an income tax not reflected in price.

We could spend hours and hours in analyzing and debating that question. Economists have spent years and years in doing that, and there is probably not full agreement. I think there is widespread agreement that generally these are valid approaches but, on the other hand, an excise tax might not always be reflected in prices, and the corporate income tax may to some extent be shifted forward in price. But I don't think there is general agreement from one economist to another on the extent of this, except, I think, most of them would say that the excise taxes are pretty well shifted forward and that income taxes are not generally shifted forward to a degree that approaches the same extent.

Now, if all indirect taxes are not fully shifted forward, then what are the consequences for international trade?

Well, let's take a situation in which a country has a general sales tax. The domestic producer finds he cannot fully shift that tax forward to the consumer, meaning he has to absorb some of the tax on domestic sales out of his profits, so his profits would be somewhat less from domestic sales.

On the other hand, under the traditional approach, exports are not subject to that tax. He then may be induced to put more effort into his export trade on the ground that the profits from exports have not

been affected whereas the profits from domestic sales are, and export trade, therefore, may be advantaged. Conversely, persons wanting to sell into that country may have to take somewhat lower profits and, therefore, trade to that country falls off.

Now, if that were the case, a country with a high indirect tax could have some trade advantages opposed to countries that do not have high indirect taxes.

In applying that to the real world what do we find?

We find that, by and large, the European countries are countries with very high rate indirect taxes. Their indirect general sales taxes run in the range between 10 and 20 percent.

It is not that they rely more heavily on indirect taxes and less on direct taxes, and we do the converse. It is rather that they are high tax countries in total, and to enable them to take the amount of taxes that they do in relation to their gross national product, they have to have high taxes all around.

The United States ranks pretty well near the bottom of all industrialized countries, insofar as the amount of taxes obtained in relation to gross national product is concerned. In other words, we are a low tax country compared to the rest of the world. So that consequently the high European indirect taxes are simply a reflection of the fact that they are higher tax countries. Their corporate taxes are roughly the same as ours. Whether you look at the nominal rates of corporal tax or whether you do it to try to find information on the effective rates, by and large the corporate sector is probably taxed about the same in European countries as in this country.

It may well be that our individual income taxes are at a somewhat higher level than theirs and with a deeper impact in the population but, on the other hand, their indirect taxes, as I say, are much higher, largely because they simply collect more taxes than we do.

Chairman REUSS. When you say that are you taking into account the total U.S. tax system, Federal, State, and local?

Mr. SURREY. Yes. Mr. Chairman. These statements are based upon the total taxes of the country. They take into account the fact that in some countries one kind of tax may be imposed locally while in others it is imposed nationally. For example, we have no national sales tax, but 44 of our States have retail sales taxes and if you put them altogether they come, in effect, to a national sales tax imposed locally.

Now, under these circumstances it is possible that the highrate indirect tax countries may have an advantage in foreign trade. For this advantage to be significant, the tax would have to be imposed at a high rate. I would add one other thing: I do not believe it makes any difference what the nature of the sales tax is for this to occur. Whether it is a value-added tax of the kind that European countries are now turning to, whether it is multistage turnover tax, whether it is the Canadian manufacturers' tax, whether it is the British wholesale tax, I think the net operative result would be the same.

Now let me just mention one other factor. I have indicated one way in which a country's tax structure may affect its international trade. There is one other thing that should be mentioned and that is that changes in a country's tax structure may also have an effect on its trade.

The European countries, most of them, for many years had so-called multistage turnover taxes. As goods went through the economy they were taxed at each stage at rates of 2, 3, and 4 percent at each stage. But these transaction taxes at such stage cumulated into a rather heavy tax at the consumer level. That tax at the consumer level varied depending upon whether goods moved through an integrated industry or a nonintegrated industry, since the cumulative burden of the tax depended on the number of independent stages through which the goods passed.

When these countries attempted to figure out how to relieve their exports from these turnover taxes, they had to make estimates as to the amount of tax the goods bore as a result of this cumulative turnover tax. They based their rebates at the border and their compensating import taxes on these average estimates. In all probability they undercompensated their exporters.

As a result of changing to the so-called value-added tax, which enables the country to know precisely the amount of the rebate that it should make at least in an accounting sense, their rebates to exporters to relieve them of the effects of the tax have increased over what they used to be. This change has occurred without any basic change in the domestic tax picture, because the changes from one type of excise tax to another have largely been designed to be neutral within the country, neither to produce more nor less revenue but just to change the structure.

The result is that European exporters may have received a one-shot trade advantage in that they were getting, when they exported, a rebate of, say, 7 percent of the price of goods to compensate for the taxes that had been paid on those goods and suddenly that 7 percent is raised to 10 percent with no other change occurring.

That can give them a trade advantage if they decide to pass along this increased export rebate in price. It appears that the Germans, for example, have done just that, and have thus received a one-shot trade advantage.

Against that background, what can other countries, particularly the United States, do to meet that situation if one, high indirect taxes, which we don't use, give another country a trade advantage, and two, recent changes are giving the European countries a trade advantage?

That is a difficult question to answer, what our response should be. One approach would be a multilateral response, and in that regard we have been discussing in GATT what are the possible changes that could be made in the GATT rules so as to bring about trade neutrality as respects the external effects of a country's tax system, and these efforts are continuing.

Our goal is that each country should be able to work out its own domestic tax structure without either suffering a trade disadvantage or incurring a trade advantage, and the GATT rules should work in that direction.

We are also concerned with another problem. The only way GATT now permits a country in balance-of-payments difficulties to have temporary assistance is to have quota restrictions. That is the only permissible temporary adjustment under the GATT rules.

Germany has indicated, in a recent measure, that there may be another way to handle temporary balance-of-payments adjustments.

What Germany has done is to separate its border tax adjustments from its excise tax system. In other words, they have an 11-percent, value-added tax, and theoretically they should give rebates at that level.

What they have decided to do temporarily is to give rebates at a lower level of 7 percent, and to impose their compensating import tax at a 7-percent rate simply to put restraints on trade, thereby divorcing the external effects of their tax from their internal effects.

Now, they are surplus country and other countries are not going to object to their doing that. But the question is: If you turned the situation around, could a deficit country put into effect temporary higher border tax adjustments unrelated to its domestic system? That would be the converse of what Germany is doing. The question is whether the world would welcome that response on the part of a deficit country.

As to unilateral responses, there are two possible things that were considered in the United States. We do have a lot of indirect taxes in this country imposed at the State level, and we have some at the Federal level, such as the automobile tax, telephone tax, the gasoline tax, and the like.

To some extent obviously the costs of these taxes enter into our export prices. If a company that is exporting buys gasoline for any purpose or buys automobiles for any purpose, our gasoline taxes and our automobile tax enter into the cost of the product it finally exports, as do State and local retail taxes on goods that are used by business.

Now, we made an estimate of how much these taxes are and we think on the whole these taxes amount to about 2 percent of our export prices. So in a sense, if we wanted to eliminate the effect and influence of these indirect taxes on our export trade, we could put on an average rebate of 2 percent.

The amount of these taxes, however, varies from product group to product group. It varies probably from 1 to 4 percent and at best these estimates are only averages and, therefore, they have defects because they are very imprecise.

The second thing we could do to protect ourselves is simply to put on border adjustments unrelated to our tax system—simply say we are going to make payments to our exporters, at whatever level we want, in order to improve our trade, and we are going to put on an import tax at whatever rate we want to improve our trade.

Now, this presumably would be regarded as inconsistent with the present GATT rules. It would also be trade restrictive and it would be a serious measure to take.

Representative MOORHEAD. Would the 2-percent rebate be consistent with GATT rules?

Mr. SURREY. It would be consistent with the GATT rules, I think, as the European countries interpret them. It would not be consistent with the interpretations which we tend to be urging in the GATT on this matter.

Another type of unilateral response which has been suggested is that we simply introduce in the United States a national excise tax—a value added tax of our own—and, therefore, we can have some rebates and border taxes.

There are arguments made that this would improve our domestic system on the one hand, and that it would help our international trade

on the other. I have discussed this at length in my statement and elsewhere. I recently gave a long discussion on this before the NAM, and I would like to submit that for the record at the conclusion of my written statement. (See p. 50.)

Let it suffice to say here that I think the introduction of the value added tax would not help our domestic tax system, but would be a step backward insofar as a progressive and adequate domestic tax system was concerned, and it would not provide much help for our international trade. So I would find it defective on two counts.

Then finally, I would say if we ever were to consider having a national excise tax in the United States, the most logical form it should take should simply be that of a national retail sales tax. We already have a sales tax in 44 of our 50 States. Over 95 percent of our retail trade today functions under a retail tax and the administrative structure is there to handle it. We should, therefore, retain that form rather than shift to the far more cumbersome European-type value-added tax.

The rest of my statement deals with some other suggested changes in the domestic tax system to improve our trade. These are so-called tax incentives to the export trade.

The Treasury has studied these at considerable length working with other agencies over a period of 3 or 4 years. We have always come up with a negative point of view with respect to changing our domestic tax system for these reasons. In part this is a reflection of our general point of view, that if it is desired to give governmental assistance to particular activities in the United States for social or other reasons the best way of doing it is through direct measures of the kind Secretary McQuade has indicated rather than through changes in a country's tax system. The latter is generally inefficient and in the end much more cumbersome.

Finally, Mr. Chairman, there is a discussion here which I don't think I have to go into now on tax policy and foreign travel. It would be support for the view advanced by my associate, Mr. Arey, with respect to funding the budget to encourage foreign travel in the United States.

And, finally, I would like to take this occasion to submit a document dealing with the effect of direct investment on our balance of payments from the standpoint of the period of time necessary, when we make a direct investment abroad, before we get the funds returned to us in dividends and other payments.

The Treasury had issued a study on this subject about a year ago, hoping it would draw public discussion. It has. Two other studies have appeared criticizing certain aspects of our study. I would like to submit a paper which carries on this dialog, since it does relate to our balance of payments, and the subject of direct investments will be coming up later in your hearings. That will finish my present statement.

(Prepared statement and additional submission follow:)

PREPARED STATEMENT OF ASSISTANT SECRETARY OF THE TREASURY STANLEY S. SURREY

Mr. Chairman and Members of the Subcommittee:

I am happy to have this opportunity to discuss with you some of my views on the relationship between tax policy and the current account of the U.S.

balance of payments. The major portion of my remarks will deal with the question of tax policy and U.S. foreign trade. I will also deal, in somewhat briefer form, with tax policy and overseas travel by Americans, and I will offer a few words on some comments on a recent Treasury sponsored study on the balance of payments effects of foreign investment.

I. Tax Policy and International Trade

One matter I have been asked to discuss is that of the relationship between tax policy and the level and structure of international trade. I would like to discuss both the effects of the overall tax structure and changes in it on a country's ability to compete internationally and the effectiveness and desirability of tax incentives or other specific provisions of the tax laws designed to promote a country's export trade.

A second matter is that of the relationship between the external effects of a country's tax system, particularly the impact of taxes on trade, and its domestic economic impact. Even if we allow that the overall tax structure may have trade effects, to what extent, if at all, should we feel constrained by balance of payment considerations in making the tax policy decisions which are most appropriate for the domestic economy? The recognition of the need for Government action to improve our trade surplus should not automatically lead us to the conclusion that a change in tax structure is the appropriate Government response. There are other means at our disposal for achieving the desired trade objectives, through the sorts of programs now being developed in the Commerce Department or, if necessary, through other forms of direct assistance, which can avoid many of the undesirable economic effects inherent in the use of tax devices.

TAX STRUCTURE AND INTERNATIONAL TRADE

Typically, when a country imposes a indirect tax, it does so with the intention that the tax should not affect the ability of the country to compete internationally. In order to achieve this objective such taxes, whether they be multistage turnover taxes, single stage sales taxes, value-added taxes or specific excises, are not imposed on exports, while imports are subject to tax at the same level as are comparable domestic products. These border tax adjustments—a term covering both the export exemption or rebate and the import tax—are applied on the view that indirect taxes are always shifted forward and fully reflected in product prices. The adjustments are designed to prevent this from happening in the case of exports and to require imported goods to bear the same competitive tax burden. When a country imposes an income tax, however, no such adjustments are made at the border. This approach is based on the view that income taxes are not shifted forward into prices, and, therefore, no adjustment is required to free exported goods from the price effects of these taxes or to impose a tax on imports.

These traditional approaches are reflected in the rules of the General Agreement on Tariffs and Trade (GATT) which provide that countries may exempt exports from indirect taxes, or remit indirect taxes already paid on goods which are exported, and may also impose such taxes on imports up to the level of these taxes on comparable domestic products. Under the GATT no such adjustments at the border are permitted for direct taxes. Though there was no systematic analysis preceding the codification of these rules in the GATT, the rules seem to have been based on the existing practices which all countries utilized and on the implicit tax shifting assumptions which I have described.

If it were true that generally applicable indirect taxes are always fully shifted forward into higher prices and direct taxes are not to any extent reflected in product prices, then the GATT rules and these practices should give us no cause for concern regardless of inter-country differences in tax structure. Their result would be a system of world prices free of tax induced distortions.

This is not the place to review in detail the literature and theory of tax shifting. Let it suffice to say that studies have indicated that taxes on business profits to some extent may be shifted forward into prices, at least under some circumstances. There also is widespread agreement among economists that indirect taxes may not in all cases be fully shifted forward for, like other costs, the extent to which tax costs are recoverable depends in large measure on general economic conditions and on conditions in particular markets or at particular points in

time. On neither of these propositions is there agreement on the extent of shifting. However, the most general view held by economists is that indirect taxes are, as a working rule, largely shifted forward while business income taxes are much less likely to be shifted forward.

If all indirect taxes are not fully shifted forward, and some direct taxes are partially shifted, at least under certain conditions, then the GATT rules relating to adjustments at the border for domestic taxes do not necessarily render domestic tax systems trade neutral. Under these circumstances the structure of a country's taxes may affect its international competitiveness. A country which relies heavily on high rate indirect taxes and derives little revenue from direct taxes, would be favored in this regard over a country which relies heavily on income taxes and derives a small part of its revenue from indirect taxes. To keep the discussion in proper perspective, however, we must note that most of the European countries, whose high rate indirect taxes represent a greater proportion of their GNP than ours, also tend to be higher tax countries, in total, than the United States, in relation to GNP. The situation is not that the United States has high income taxes and the Europeans have high sales taxes, but rather that both have high income taxes, especially in the corporate sector, and, in addition, the Europeans have higher indirect taxes than we do. The corporate tax burden in the United States is not significantly different from that in most of the major European countries both in terms of the ratios of corporate taxes to GNP and in terms of effective rates of tax. Thus, if there is some shifting of the corporate income tax to roughly the same extent in all countries, this factor alone should not affect the structure of world trade, since prices in all countries would be affected in roughly the same degree by the domestic income taxes, leaving relative international prices unaffected. We have, however, no a priori reason to expect that the extent of corporate tax shifting is necessarily the same in all countries.

If a country imposes high indirect taxes as a major part of a relatively high overall level of taxes, in terms of the ratio of taxes to GNP, the consequent relatively large border adjustments may provide a trade advantage compared to a country with low indirect taxes as part of a lower overall level of taxes only to the extent that the indirect taxes are not fully reflected in product prices. This assumes, as seems to be the case, that the effective level of corporate income tax in countries with high overall tax burdens is not appreciably different from that in countries with lower overall tax burdens, and that the differences in overall tax burden are a reflection largely of the differences in the levels of indirect taxation. It also assumes that the degree of shifting, if any, of the corporate tax is not substantially different between countries.

We should keep in mind that this discussion of indirect taxes is relevant regardless of the type of broad-based indirect tax we are considering. A high rate retail sales tax, a manufacturers' sales tax, a wholesale sales tax, a value-added tax or a cumulative turnover tax, if they impose comparable overall burdens, will all affect overall international competitiveness, if at all, in the same manner and to roughly the same extent. The effects may differ for different products, firms or industries, however, depending on the nature of the tax.

The advantage which may accrue to high rate indirect tax countries is most likely to manifest itself in the following way: A manufacturer in a country imposing a value-added tax or other form of sales tax which cannot be fully shifted forward would absorb a part of the tax on its domestic sales and reduce its profits. But its tax exempt export sales would not force a reduction in profits from those sales. In such cases, the higher profits earned from export sales provide an incentive to devote greater effort to exporting to countries with a correspondingly high indirect tax. Similarly, foreigners exporting into the country will be forced to absorb a part of the tax in order to compete with domestic producers and will be less likely to push exports into the country. Thus, a value-added tax or other sales tax which is not fully shifted coupled with full border adjustments, would provide a trade advantage to the country imposing the tax in the form of an export incentive an import disincentive. For this advantage to be significant, the rate of the indirect tax must be high, in the general range of the present European taxes.

CHANGES IN TAX STRUCTURE AND INTERNATIONAL TRADE

While the extent to which differences in overall tax structure per se necessarily affect the character of level of world trade may not be altogether clear, certain types of changes in tax structure, such as those which are associated with the

present shift to a harmonized value-added tax in the EEC, may have substantial trade effects, beneficial to the country making the change, regardless of the assumption one makes as to the shifting of the taxes involved. These are changes which, in one way or another, result in an increase in the level of border adjustments with no overall changes in the effective level of domestic indirect taxation, and therefore presumably no effect on internal prices.

A shift from a cascade type cumulative turnover tax to a value-added tax was made in Germany in 1968 and in the Netherlands on January 1, 1969. These shifts involved changes from a tax system where appropriate border adjustment levels are difficult to determine and are frequently below the comparable level of domestic indirect tax burden to a system where the domestic tax can, in an accounting sense, be accurately and fully reflected in the level of border adjustments. This is true because the cascade tax levied at one stage becomes imbedded in the cost structure of the product at subsequent stages and cannot be separately identified. The value-added tax, on the other hand, is separately invoiced and, therefore, the cumulative tax payment can be identified at any stage. Such a shift from partial compensation to full compensation through changes in border adjustments can only benefit the trade of the country making the change, at the expense of its trading partners, even though it is perfectly legal within the present GATT rules. Countries making such changes, however, generally argue that they are not creating a trade advantage for themselves but are eliminating the disadvantage which arose from the previous undercompensation, with which they have lived for many years. What they fail to recognize, however, is that previous changes in exchange rates and in price levels around the world may have adjusted for this past "undercompensation", so that the current change in the level of border adjustments does, in fact, result in a present trade advantage for that country at the expense of others.

In speaking of full or undercompensation at the border, in this context, I am speaking only of the relationship of border rates to nominal domestic rates without prejudging the question of full or partial shifting of the domestic tax. This benefit would result even with full shifting. The benefit, a fortiori, would be greater to the extent that there is less than full shifting.

The German Economics Ministry, in a recently published paper has said that, contrary to its prior expectations of negligible improvements in German export competitiveness from the shift to TVA, German export prices have declined by 2.2 percent since the introduction of TVA. The Economics Ministry has not explained the cause of this price decline, but the amount of decline is presumably, at least in part, an indication of the increase in the effective level of border adjustments.

Still another variety of tax structure change which affects a country's trade resulted from the November 1968 monetary crisis. The French Government in an effort to improve the French trade balance, eliminated a payroll tax, for which no adjustments were made at the border, and replaced it with increases in the value-added tax, with a presumably equivalent revenue impact, for which border adjustments are made. This change was intended to improve French trade performance and is likely to have that effect. There is no reason to assume that other countries could not benefit their trade accounts from similar changes in tax structure.

There are a number of examples in recent European experience of countries increasing the levels of their border adjustments under a cascade tax without making any change in their domestic taxes. Such changes are rationalized as necessary to eliminate undercompensation. They frequently take the form of adjustments to reflect taxes paid on certain types of expenditures which had not previously been accounted for at the border, such as the purchase of capital goods and certain business services. Countries making these changes consider them to be consistent with the GATT rules, though it is not at all clear that the drafters of the GATT intended the rules to be construed to include adjustments for taxes on outlays which are not directly related to the traded goods. Changes of this type necessarily have beneficial trade affects, since there is no domestic change associated with the change in border adjustments, and therefore no possibility for a tax-related change in domestic prices.

RESPONSE TO THESE ISSUES

As the level of indirect taxation and accompanying border adjustments has, in recent years, risen in many countries, we have come to recognize more and more clearly that we are operating in an international system based on a set of

25-765—69——4

rules which, rather than neutralizing the trade affect of domestic tax systems, may have the effect of creating a trade advantage for countries relying heavily on high rate indirect taxes. It certainly has the effect of creating an advantage for countries which—under the rules—change their level of border adjustments without changing domestic tax levels.

What are the possible ways of dealing with this situation? Before considering that question, let me state one overriding caution: We must be very careful, in considering these possible alternatives, that we avoid the danger that these problems may force us, in making domestic tax policy decisions, to give a far greater weight to external effects than would otherwise be considered appropriate or desirable. For example, in the recent discussions in this country of the desirability of imposing a Federal value-added tax, many of the proponents of adopting such a Federal tax, in an effort to achieve a possible trade advantage, have ignored serious potential adverse effects on the domestic economy, on tax equity and on tax administration of the introduction of a value-added tax.

A variety of approaches to remedy the present international situation have been considered, both unilateral and multilateral. We have chosen first to exhaust the possibilities for a multilateral solution, within the GATT and the OECD.

The U.S. Government was instrumental in initiating a discussion and analysis in the OECD of the problems which the present border tax adjustment rules and practices create. This discussion alerted other countries to the seriousness with which we view this problem. It resulted in the establishment of a procedure whereby member countries must notify the OECD of any changes in their border adjustments. The option is then open to any member to request consultations on the trade effects of such changes. During the past year and a half, this consultative procedure has been used three times: with Germany, to examine the trade effects of the shift from cascade to value-added taxation; with the Netherlands, to examine the effects both of increases in border adjustments under the cascade tax, in anticipation of the shift to TVA, and of the shift to TVA itself; and with Belgium, to examine the trade effects of increases in border adjustments under the cascade tax. The consultations have not been successful in producing general agreement on the trade effects of these changes, but they have been most useful in providing an opportunity for all of the participants to sharpen their understanding of the issues and to establish a record of their positions.

The basic rules which govern the conduct of international trade rest in the GATT, and the United States has focused its efforts to achieve a permanent change in the rules on that body. In response to an American initiative, agreement was reached in early 1968 among the Contracting Parties of the GATT to set up a working party to study the border adjustment problem. This working party was convened last April, and has been meeting at regular intervals since then. In his opening statement, and in subsequent remarks, the U.S. delegate has clearly stated the view that the present rules are illogical, inequitable and ambiguous, and that the absence of a limit on the level of border adjustments for indirect taxes could lead to a proliferation of border adjustments which would operate to the detriment of world trade.

Under its terms of reference, the working party has examined the basis for the present border adjustment rules—their legislative history, as it were—and is currently engaged in a detailed examination of border adjustment practices in those countries participating in the working party. This has built on the work of the OECD in focusing clearly on the inadequacies, for the world economy in 1969, of the present rules.

The next and clearly the most important task of the working party is to come forward with a workable alternative to the existing provisions. This phase of the discussion should begin with a minimum of delay. In reaching its solution, the working party must be guided by several important considerations:

(1) That a country should be free to employ the structure and level of domestic taxation which is consistent with its own assessments of tax equity and economic growth and stabilization policies and should not be unduly constrained in this respect by international trade considerations nor should it be put at a competitive trade disadvantage or obtain a competitive advantage because internal fiscal policies require a tax structure of this or that nature;

(2) That a continuation of the present system, with no effective limitation on the level of border adjustments, could lead to trade wars which would play havoc with the orderly functioning of world trade; and

(3) That the degree of administrative discretion permitted in determining border adjustments, largely as a result of the ambiguities in the present rules, affords far too much freedom to tax administrators to affect world trade by administrative fiat.

Any solution which gives adequate recognition to these three considerations should be satisfactory both from the point of view of the United States and the world trading community.

While one U.S. concern in the GATT is with effecting a change to rationalize and clarify the provisions regulating the permanent border regime to be followed by the Contracting Parties, there is a second, somewhat related objective which we should also consider. GATT signatories, operating within the terms of the Agreement, are limited to a single tool, quantitative controls, to assist during the correction of a temporary imbalance in the international payments. A more flexible tool, and one that is less damaging to the ultimate objective of free trade, may be desirable. I have pointed out elsewhere that a temporary border tax on imports and/or an export payment might permit this flexibility. The amount of this adjustment need not be related to the level or structure of a country's tax system, and could be determined, presumably in consultation with trading partners, solely with reference to a country's balance of payments position.

Germany, in its response to the November 1968 currency crisis, has set an example for this sort of provision. In recognition of its responsibility as a surplus country, Germany has reduced the rate of its border adjustments below its domestic tax rate and thus shown that there need not, in all circumstances, be an exact relationship between the domestic tax system and the system of border adjusments. Of course, it is easy for trading partners to accept this sort of a change by a surplus country. Countries must be educated to accept the opposite change on the part of deficit countries.

I must emphasize, again, however, that this search for a flexible and responsive balance of payments adjustment tool to be used as a temporary measure must be kept separate from the search for a set of equitable permanent border adjustment rules. The two are not substitutes for each other, but rather are complements in a package of trade-tax policy measures which are relevant in the world of today.

Studies have also been made regarding the possibility of introducing a system of border adjustment for the United States. Two approaches were considered. The first approach would have involved an export-import border adjustment for the indirect taxes now being paid by American producers, which taxes contribute to the costs of production of traded goods. These taxes include state retail sales taxes on machinery and business services, and Federal and state excise taxes on such items as motor vehicles and parts, petroleum products, and telephone services when used by business concerns. According to our analysis, these taxes amount, on the average, to about 2 percent of product prices, though they vary widely among industries or product groups, from about 1 percent to over 4 percent.

The second approach would have involved border adjustments, limited to charges on imports or payments on exports or both, unrelated to domestic taxes and set at a level necessary to achieve the desired balance of payments result. These border adjustments would not be a part of a value-added tax or other sales tax, and would not involve any changes in domestic taxes. Rather, they would simply be border adjustments at the rate thought appropriate in the existing international setting. These border adjustments could be administered by the Customs Bureau. The appropriate level for this purpose would have been determined on the basis of demand elasticity estimates for U.S. exports and imports. These estimates would indicate the response in trade volume to a price change consequent on the given border adjustment. Both solutions were rejected at the time in favor of a multilateral approach.

A border adjustment of the second type would not be regarded as consistent with the present GATT rules. An adjustment related to domestic taxes, that involved in the first approach, would be consistent with the interpretations of the GATT rules followed by many European countries. It would not, however, be consistent with the interpretation which we consider more appropriate, because it would include many taxes on transactions which are not directly related to final products and because it would require considerable use of broad averages to calculate the appropriate rates.

Another type of unilateral response being currently advanced by some persons in the United States is that of introducing a Federal value-added tax.[1] Such a change in our tax system would have far-reaching effects. The proponents of such a change generally suggest that this tax be used to replace a part of the corporate income tax. They argue that a greater reliance, at the Federal level, on indirect taxation would spur economic growth, result in a more efficient utilization of capital resources, be more neutral (i.e., apply with equal weight to all goods and services), provide a flexible tool for fiscal policy adjustments and finally—and this is the primary argument in the view of many people—lead to an improvement in our trade balance by permitting a broadened use of border tax adjustments.

For each of these arguments for the tax there is an answer. Thus, there is little evidence, from recent European history, that a heavy indirect tax leads to a faster rate of economic growth nor is there reason to suspect that the absence of a broad-based national sales tax (for this, in fact, is what a value-added tax is) has retarded our own growth rate, which certainly has been highly satisfactory in recent years.

Regarding the alleged distributional inefficiency of the corporate tax, to the extent that there are unwanted distributional effects of that tax many can be corrected within the structure of the corporate tax itself, so that all of the advantages of the corporate tax need not be thrown out to eliminate a few disadvantages.

The neutrality claimed for the value-added tax would be likely to prove at least partially illusory. The European experience with value-added taxes has shown us that substantial departures from generality, and thus from neutrality, are the almost inevitable result of the political process necessary to establish the tax. France, for example, applies four different rates under its TVA, and provides special treatment for financial institutions, agriculture and small business. These pressures for departures from generality would probably be particularly strong in this country where, unlike most European countries, there is no tradition of broad-based indirect taxation at the national level.

There is no reason to assume that a more rapidly responsive flexible fiscal policy can be achieved by adding a TVA to our present tax structure. The record of our 1968 10 percent tax surcharge shows that once the decision is made to adjust taxes, the income tax can be adjusted quickly with full agreement on the structure of the adjustment. The difficulties involved in reaching the basic decision to adjust taxes, however, would be present regardless of the type of tax being considered for adjustment.

Thus, I find the arguments advanced for a shift to a value-added tax or a sales tax in the United States to be weak indeed. Moreover, the proponents of a Federal TVA give hardly any consideration to the major disadvantages of a TVA: It would be a far more regressive tax than the income taxes which it would replace, even if adjustments in the tax base were made to reduce the regressivity (a change which would also reduce the neutrality and allocative efficiency of the tax). Assuming the TVA is shifted forward to a greater extent than the corporate tax, the substitution of TVA for the corporate tax would increase the domestic price level and have a similar effect on labor costs through the action of escalator clauses in labor contracts. The costs of compliance and collection to both the public and private sector would be high. Assuming quarterly reporting with exemption for farms, medical services and certain financial services, the number of returns per year to be processed would be between 25 and 30 million, a 25 percent increase in the total number of returns now handled by the Internal Revenue Service.

This entire discussion of the possible adoption of a TVA is, in a sense, too narrowly focused. The initial question should be do we, in this country, need a national broad based indirect tax? Only if this question is answered in the affirmative should we then proceed to the question of the form which a national sales tax should take—a manufacturer's or wholesale sales tax, a retail sales tax, or a value-added tax. A value-added tax of the form used in Europe is equivalent in every respect but the method of collection to a retail sales tax. We have acquired substantial experience in this country in administering a retail sales tax, since such a tax is now in use in 44 states and a number of major

---

[1] For a full discussion of this issue, see "A Value-Added Tax for the United States—A Negative View," by Stanley S. Surrey, remarks before the 73d Congress of American Industry of the National Association of Manufacturers, Dec. 6, 1968. Treasury release F–1427.

cities. A retail tax, therefore, should be considered as a much more preferable alternative to the value-added tax, if a decision is made to move in this direction, since it would involve fewer firms in the tax collection process. The Europeans have opted for a value-added tax because they feel, for a variety of reasons, that they are unable to administer adequately a retail tax. We have already demonstrated our capacity for administering such a tax. But I do not want to be misunderstood—I am not suggesting a retail sales tax or any other kind of sales tax for the United States. I am only saying if ever a decision is made that we adopt a national sales tax for domestic policy reasons, it should take the form of a retail tax.

Finally, there is the question to what extent, if any, a value-added tax with full border adjustments may benefit U.S. trade. Clearly the benefit would be much less than the full amount of the associated border adjustment. Trade would be benefitted only to the extent of the sum of the non-shifted portion of the TVA and the shifted portion of the corporate tax which it replaces. In any event, as I have noted, the rate of the TVA would have to be quite high, in the general range of the European rates in order for the trade effect to be significant. However, even a 10 percent rate would yield revenues in excess of the yield of our total corporate tax. (Each 1 percent in the rate for a TVA for the United States would yield $4 to $5 billion depending on the base.) The question, then, which is not adequately considered by proponents of a value-added tax and which, in my view, should be given a negative answer is this: Are the costs in domestic tax equity and efficiency worth incurring in order to achieve a possible, and no more than relatively small, trade advantage? As I have noted, there are other means of achieving a trade improvement which do not impose such high costs on the domestic economy.

THE USE OF SPECIFIC EXPORT TAX INCENTIVES

My comments thus far have been related to the question of the effects of overall tax structure on trade—what might be summarized as the "border tax adjustment problem." I would like now to comment briefly on a second aspect of the relationship of tax policy to international trade—the use of specific export tax incentives.

The Treasury Department, working both alone and in cooperation with other agencies, considered this question at great length. A number of possible tax incentives related to exports were considered. These included a credit against income taxes equal to some percentage of the value of a firm's exports, or increases in exports; additional depreciation allowances or investment credits on assets used in export production or in production for increased exports; and additional deductions for current expenditures incurred in the promotion of exports.

These were rejected for one or more of several reasons. The introduction of a tax credit or other form of tax incentive for export trade would make it difficult to resist similar tax incentives for other, equally worthy social or economics objectives. But such a proliferation of tax incentives would quickly erode the revenue base and seriously weaken the income tax as an effective fiscal policy tool and as an efficient and equitable tax.

These incentives could generate the charge that we were in a position of violating the GATT subsidy rules. This could well lead to retaliation by our trading partners, both unilaterally and multilaterally, under the terms of the GATT. Such retaliation could neutralize any initial benefit which we might achieve from the incentive, and there is no assurance that we would not, in fact, come out as the net loser from such an exchange. In addition, we would be placed in the difficult posture of arguing that the rules should be changed, while we were, at the same time, being charged with violation of those rules.

Furthermore, even abstracting from the problem of retaliation, it cannot be shown convincingly that any of these incentives would be able to produce a substantial increase in exports except at a substantial budgetary cost. The effect on exports depends in large measure on the assumption one makes as to the elasticity of demand for American exports. If, as many suggest, this elasticity figure is in the neighborhood of −2, the increase in exports resulting from a tax credit equal to a percentage of the value of exports would be roughly equal to the revenue cost if the full effect of the credit is reflected in export prices.[2] If the tax

[2] A demand elasticity measures the responsiveness in demand to small changes in the price of a good. An elasticity of −2 denotes that with a 1 percent decline in price, the quantity demanded increases by 2 percent. If, therefore, a tax credit equal to 3 percent of

reduction serves to increase export profits, rather than reduce export prices, the resulting increase in export effort could generate a greater increase in exports.

The implementation of these proposals would create difficult administrative problems. In order to provide the greatest return per dollar of lost revenue, any export incentive should be placed on an incremental basis, i.e., related only to increases in exports, increases in export promotion expenditures, etc. This approach, however, raises a variety of problems associated with establishing an equitable base period. As an example, I have only to refer you to our past experience with excess profits taxation. An incremental basis also creates an incentive to firms to create new export subsidiaries or to otherwise shift the channels for exports in order to benefit from a low level of base period exports, though there may be no increase in total U.S. exports.

If an incremental basis is not used, then substantial windfall gains to some exporters would result, as they receive tax benefits for activities which they would be carrying on in the absence of the incentive. This, clearly, would be a costly and inequitable way to promote exports.

The question of who receives the tax relief must also be considered. If the benefit accrues to the actual exporter, we can expect to see a disruption in the established exporting patterns as manufacturers assume exporting functions previously carried out by independent export merchants, in order to increase their tax benefit. This can have a deleterious effect on exports, as the merchants who have developed overseas markets and have the knowledge and experience to exploit them are displaced by manufacturers who have less exporting experience. If the tax benefit goes to the manufacturer, (and which manufacturer—that of the components or that of the end product) regardless of who does the actual exporting, the difficult administrative problem of tracing exports is created.

CONCLUSION ON THE RELATION OF TAX POLICY AND TRADE

I might summarize my remarks on the relationship between tax policy and trade with the following thought: Domestic taxes should not be viewed merely as tools which can be shifted back and forth in order to affect balance of payments adjustments. If the rules governing international trade are such that they impose undue constraints on the determination of sound domestic tax policy or dictate the direction of such policies, thus requiring a country to accept second-best alternatives in terms of tax equity or administration, then these rules should be changed. I can conceive of few, if any, cases where a change in domestic tax law purely for balance of payments purposes would be appropriate, as long as there are other means available to achieve a similar objective. Unless the tax change in itself is desirable for reasons of domestic tax equity, tax administration or fiscal policy, it should not be undertaken.

II. Tax Policy and Foreign Travel

I turn now to another facet of the relationship of tax policy to the current account of our balance of payments—the potential use of tax policy to affect our net travel balance.

Foreign travel by U.S. residents constitutes a large minus item in our balance of payments. The latest review of the travel account by the Department of Commerce for the year 1967 estimates that U.S. residents spent over $4 billion for travel in foreign countries and for payments to foreign carriers. Foreign residents traveling in the United States in turn are estimated to have spent $1.9 billion in this country and as fares to U.S. transocean carriers as part of a visit to this country. On a net basis, this works out to a deficit in the travel account of over $2.1 billion. We do not expect any improvement for 1968, as compared with 1967, despite the fact that the 1967 deficit reflected an unusually large increase because of the attractiveness of Expo 67.

Our travel account deficit has been growing bit by bit for a long time. Going back ten years ago to 1958, the deficit as computed by the Department of Commerce was $1.4 billion. It has been estimated that by 1975 it could, if unchecked, exceed $4 billion if the trend is not altered while our receipts from foreign travelers have been growing at a faster rate than our expenditures for foreign travel,

---

the value of an export were fully passed on in the form of a 3-percent reduction in price, the quantity demanded of that product would increase by 6 percent. However, total receipts would rise by less than 6 percent, since each unit purchased would be valued at the lower price. The increase in balance-of-payments receipts in this case works out to be approximately equal to the aggregate reduction in price which is, by assumption, equal to the aggregate reduction in revenue receipts.

the absolute dollar gap can widen for a long time because the growth of our expenditures started from a much larger base than that of foreigners.

The President in his 1968 New Year's Day Message to the Nation on the balance of payments recommended reduction of the travel deficit by $500 million in 1968. This result was to be achieved by attracting more foreigners to travel in this country and by a reduced level of travel expenditures by U.S. residents to foreign countries outside the Western Hemisphere. The President asked for voluntary restraint by U.S. residents and legislation if this seemed appropriate. On a long-term basis we have always recognized, of course, that the solution to the travel deficit must largely be sought through expansion in the number of foreign visitors to the United States.

A number of steps have been taken to attract more foreign visitors to the United States in accordance with the report last February of the Industry-Government Special Task Force on Travel. Here our task is one of maintaining the momentum of a going program; and, in part, this means adequate financing of the Federal tourist agency—the U.S. Travel Service.

The other side of the coin is less cheerful. As the *1968 Progress Report* of the Treasury on *Maintaining the Strength of the United States Dollar in a Strong Free World Economy* points out, ". . . our progress in the travel area has been one of the most disappointing parts of our 1968 balance of payments program."

Last February Secretary Fowler recommended a three-part travel tax program. On a permanent basis the program would have provided an extension of the present 5 percent tax on domestic air tickets to all airline transportation and a reduction in the $100 duty-free tourist exemption and the $10 exemption for gift parcels arriving by mail. Then, for trips outside the Western Hemisphere, it was proposed that a tax be levied on water transportation and on tourist expenditures abroad in excess of a minimum amount.

A bill reducing customs exemptions and extending the 5 percent ticket tax to all air travel was passed by the House, but no action was taken by the Senate Finance Committee.

The letter of December 17, 1968 by Secretary Fowler as Chairman of the Cabinet Committee on Balance of Payments to President Johnson re-emphasized the necessity to commence the long-term efforts needed to halt the mounting trend in our travel deficit. He noted the need for adequate budgetary funds to stimulate foreign travel to this country.

III. Treasury Tax Policy Research Study on Overseas Manufacturing, Investment, and the Balance of Payments

There is one further point which I would like to raise with you dealing with the restraint of foreign direct investment. Though it is not a current account problem, it is clearly a related issue.

One effective program that we have pursued in the interest of achieving some short-term improvement in our balance of payments has been the program governing direct foreign investment. In 1968 the Treasury Department released a study entitled "Overseas Manufacturing Investment and the Balance of Payments," written by Professors Gary C. Hufbauer and F. Michael Adler. This study investigated in detail the effect of direct foreign investment on the balance of payments, and the study results indicated that a full payback, in balance of payments terms, of an overseas direct investment would require a period of up to 8 to 10 years to be achieved. This study has been subjected to some criticisms by two industry associations representing foreign investors, the National Foreign Trade Council and the Machinery and Allied Products Institute. The substance of payments, and the study results indicated that a full payback, in balance of payments loss associated with the initial investment is considerably shorter than estimated by Hufbauer and Adler. The viewpoint published by the National Foreign Trade Council in particular would suggest that the recoupment period is as short as two years. Many of the criticisms as to methodology and analysis appear wrong. Those which appear to have validity do not significantly alter the Hufbauer-Adler results. For the information of the Committee I would like to include in the record of the hearings at this point, as a supplement to this statement, a detailed discussion of these criticisms.

A VALUE-ADDED TAX FOR THE UNITED STATES—A NEGATIVE VIEW[3]

Tax meetings this year have found a new topic for discussion—or what is advertised as a new topic: Should the United States have a value-added tax? The question appears to be a new one when so phrased, especially since some speakers seldom bother to explain what a value-added tax is and how it functions. But if the topic were phrased more accurately "Should the United States have a national sales tax?", then we would at once perceive we simply are carrying on a discussion that has been with us for three decades or more—and posing a question to which the answer has consistently been in the negative.

The value-added tax properly comes in only as a subtopic: If the United States is to have a national sales tax, should it take the form of a value-added tax or some other form, such as a retail tax, a wholesale tax or a manufacturers tax? Nor, really, when put this way, is the subtopic a new one. Treasury Department files contain a lengthy analysis of the value-added tax made in 1941, when consideration was being given to the choice of tax measures to finance military expenditures.

BACKGROUND—EUROPEAN USE OF VALUE-ADDED TAXES

What is new today is that the European countries are in the process of adopting value-added taxes—France has had one for many years, Germany adopted one this year, the Netherlands, Sweden and Belgium will do so next year, and so on. But a word of perspective is in order. All of these countries have had a national sales tax of one form or another for many years, usually the inefficient turnover tax. Hence the main topic for them therefore was not whether to have a national sales tax but whether—in order for them to harmonize their tax systems under the European Economic Community—they should adopt the value-added form of sales tax as the common denominator. For reasons growing out of their political and tax histories, which in some countries involved the inability to effectively collect a mass income tax, they had already chosen to utilize high rate sales taxes. The significant point is that they were concerned with the subtopic, i.e., the form of a sales tax to achieve harmonization, and not the main topic, should there be a sales tax at all. They had answered that question, as I have said, many years before, for their national sales taxes go back at least to post-World War I days.

Now we all know what is a retail sales tax—forty-four States and some cities have this tax. We also know what is a wholesale sales tax and we know what is a manufacturer's sales tax. What then is a value-added tax? A valued-added tax is merely a complex method of collecting a retail sales tax.[4] Using the recent German tax as a model, let me explain how it works:

The German tax is imposed at a 11 percent rate on almost all sales of goods (and some services) by any business. Let us start with a manufacturer: He applies an 11 percent rate to his total sales to find the preliminary tax due. From this he subtracts the taxes he has paid on his purchases and the net is payable to the Government. In essence, the tax is thus on the "value-added" by him as represented by the difference between the value of his total sales and the value of his total purchases. "Purchases" include all types of goods (and some services)—components either as raw materials or semi-processed goods; capital goods, such as plant machinery and equipment; goods used up in manufacture; business furniture, etc. The manufacturer, of course, will bill his wholesale customer for the 11 percent tax on the sales price of the articles he sells, just as the manufacturer was earlier billed 11 percent on his purchases from his suppliers. The tax is invoiced separately on all sales and is thus not hidden in the sales price.

The process is repeated at the wholesale stage—the wholesaler pays the Government 11 percent of his sales less the taxes paid previously by the wholesaler

---

[3] Remarks by Hon. Stanley S. Surrey, Assistant Secretary of the Treasury, before the 73d Annual Congress of American Industry of the National Association of Manufacturers, the Waldorf-Astoria, New York, N.Y., Friday, Dec. 6, 1968.

[4] The authorities recognize the value-added tax for what it is—a sales tax. For example, a publication entitled "Tax Harmonization in Europe and U.S. Business," published this year by the Tax Foundation, contains the flat statement "The consumption type of value-added tax (one in which capital equipment items are deductible) can be described as a retail sales tax." A look at the index of a recent public finance book, "Modern Public Finance," by Bernard P. Herber, Richard D. Irwin, Inc., Homewood, Ill., 1967, for value-added tax encounters the familiar instruction, see "Sales taxes."

on his purchases—and the wholesaler then bills the 11 percent tax to his customers. But of course no pyramiding should occur since the taxes paid by the wholesaler are kept apart from the price of the goods he purchased and he can subtract this tax cost. The process is repeated once again at the retail stage—the retailer pays the Government 11 percent of his sales, less the taxes the retailer paid—and of course the retailer charges his customer for the 11 percent tax. The process ends there if the retail sale is for personal consumption—food, an automobile, furniture, clothing. But if a business concern buys the article for use in its business—say an automobile or a desk—the process begins again as the concern will subtract the tax on the automobile or desk from its tax bill.

There is one additional important facet to note: Under the German system, tax is due each month. Suppose a concern has paid more tax on its purchases than is due on the sales to its customers—its sales may be slow, for example. The Government then makes a refund each month of any excess tax paid, so that the cost of carrying the value-added tax is not borne by the concern beyond a month or two.

All this adds up to an 11 percent retail sales tax on personal consumption—the 11 percent value-added levy is designed to be passed along from concern to concern until the consumer is reached and he is left with the tax. The 11 percent tax is not intended to enter into the price structure until that final sale—until then it is a tax item that accompanies each sale, is kept separate on the books, and is so indicated. If the tax item is not promptly moved along the business chain, the Government refunds it promptly. (If a concern has to finance the tax during this month or two, this financing cost would enter into the price structure.)

Should the United States Have a National Sales Tax—Domestic Considerations

Against this background, let us return to the main question: Should the United States have a national sales tax? Proponents of the idea have two courses of action open. One is to argue that our tax system should bring in more revenue and the added revenue should come through a sales tax. They seldom take this route however. What arguments there are for higher tax revenues come from those seeking greater Federal expenditures to meet social problems, and the proponents of value-added sales taxation are usually not in this camp, but rather most likely to be in the camp of reducing Federal expenditures. Moreover, if we need higher revenues, our Federal income tax system is capable of producing those revenues.

The other course of action is to say the sales tax should be substituted for part of the income tax, generally the corporate tax. So the general question comes down to: Should we reduce, for example, our corporate tax to about 30 percent and make up the $15 billion in revenue through a 3 percent sales tax?

What would the United States gain through this change? Those who support Federal use of a value-added tax generally start by stating that the United States should derive a larger portion of its revenue from indirect taxes, that is, sales taxes. This view is often supported by resort to foreign experience. If certain foreign countries relying heavily on indirect taxes are growing relative to ours, the conclusion is drawn that the faster rate of growth is the result of the emphasis on indirect taxation. This argument in turn is usually associated with the idea that substitution of a tax on sales to raise part of the revenue now derived from the corporate income tax would stimulate growth through enhancement of the profitability of investment in corporate equity. If foreign examples are not favorable, the enhancement of corporate investment to stimulate growth is presented alone.

But if one looks at the tax systems of various industrialized nations over a period of time and relates them to the rate of growth of their economies, there seems to be no relationship—or one strong enough to be observed in the total effect of all factors—as is sometimes claimed to exist between the components of the tax system of a country and its economic growth. Of course, the tax systems of countries do have economic consequences or President Johnson wouldn't have proposed the recently enacted surcharge to help restrain our overheated economy. But to say that heavy reliance on indirect taxes compared to direct taxes is a significant factor in economic growth is a naive view of a complex problem. As a matter of fact, one would be just as naive to say that the reason the United

Kingdom has had a relatively slow rate of growth in recent years is because it raises a high proportion of its revenues from indirect taxes. France is another country with a high indirect tax ratio—the highest in Europe—which has had considerable problems in maintaining an adequate growth rate over the years.

On the other hand, we have been doing pretty well in the United States as far as growth is concerned—at least for the past eight years—and we do not have a national sales tax. While there were significant changes in the Federal income taxes and excises in the last eight years, the emphasis of our Federal revenue system on individual and corporate income taxes was not changed. We believe the revisions made, especially the investment credit and the depreciation guidelines, are in considerable part responsible for our eight years of economic expansion. During the period from 1960 to June 1968 employment increased by 13 million persons or 20 percent. Unemployment declined from 6.7 percent of the labor force in 1961 to less than 4 percent today. Business investment for new plant and equipment increased from less than $36 billion in 1960 to the current level of $65 billion. And gross national product grew by 46 percent in terms of constant dollars between 1960 and the third quarter of this year. The business profits picture has been bright indeed in these eight years. Corporate profits *after* taxes were less than $27 billion in 1960—the annual level for the third quarter of 1968 was $51 billion. So it is hard to see how one can complain about the absence of a sales tax on grounds of economic growth here in the United States.

Such facts as these naturally have required the more sophisticated proponents of greater reliance on indirect taxation to minimize pure growth as an argument for changing the character of our Federal tax system. A more subtle variation of the growth argument then is that the corporate income tax leads to tax induced distortions in the flow of capital that lowers the total efficiency of the economy. Then there are those who merely stand by the old assertion that the corporate income tax is so high as to be unfair to corporate equity owners.

The argument as to the "fairness" of taxing corporate income and the incentive and distributional effects of such taxation will continue as long as there is a corporate tax. Far be it for me to try to deny that a separate tax on corporate profits does not have capital distributional and incentive effects. It does—and some could be corrected by appropriate revisions in our corporate tax rules. But the real question is whether there are advantages to corporate profits taxation which offset the disadvantages. I believe so. The history of corporate income taxation in this and other industrialized nations has shown that there is a significant tax-paying capability inherent in the corporate structure. And the taxation of corporations and their dividends hardly seems to noticeably dampen the advantages that investors find in corporate equities. Moreover, if we desire to adjust our income tax structure to tilt it, or rebalance it, or what you will, so as to favor investment, there are ways to accomplish this—witness the investment credit—without having to resort to an entirely new tax.

Since proponents of a value-added tax for the United States so often refer to the tax system of foreign countries as a precedent or model for the use of indirect taxes, I wonder why, if they are so worried about the level of our corporate tax, that they so conveniently ignore the corporate tax rates in the same countries. Heavy reliance of a country on indirect taxation does not mean low corporate rates. Both Germany and France have a rate of over 50 percent on undistributed corporate profits. The United Kingdom's rate is in the 40's. Moreover, we have reasonable assurance from United States firms with international operations and through our data on the foreign tax credit that the effective rate of European corporate income taxes is quite comparable to that of the United States.

One is tempted to deduce from this that there is a type of Parkinson's law in taxation, to wit, for every type of taxation used by a Government the legislators will find expenditure needs that require raising the tax rates to the maximum politically tolerable level. In any case, anyone interested in substitution of a value-added tax for part of the corporate income tax should very carefully consider the overall tax burden in foreign countries. He will find that every European country (with Switzerland the only exception) raises a far higher amount of taxes, in relation to GNP, than does the United States. Is it because they have *both* income and sales taxes at the national level and we have only the income taxes?

Certain virtues have been claimed for the value-added tax in the name of "neutrality". Neutrality means a great many things to different people and it is

surrounded with a highly favorable semantic aura. As best I can judge, the claim for neutrality comes down on final analysis to the contention that all end-products and services would be taxed at the same rate. This only means that the value-added tax like any other sales tax may theoretically be designed—although this doesn't happen in practice—not to be selective and not to discriminate among goods and services. For the business sector, the neutrality of the value-added tax simply means the neutrality of the nontaxpayer—for the value-added tax is not designed as a tax on business, but merely casts the business unit in the role of a collector of taxes from the ultimate consumer.

Let us take a closer look at the supposed advantages of neutrality. The value-added tax is claimed to apply equal burdens on businesses in both profit and loss positions, thus removing the corporate tax immunity of a loss enterprise. The claim is also made that with a value-added tax, unlike the corporate income tax, industries presently enjoying a preferred tax position as well as those not occupying a preferred tax position will begin to pay the same tax. These claims obscure what is now happening under the corporate tax and what would happen in the event of a switch to a value-added structure.

The corporate tax now applies with different weight among firms and industries depending upon their profit status and the tax rules that have evolved. These differentials would be reduced *pro tanto* with the lightening of the corporate tax. Instead of being corporate taxpayers these buisnesses would all be intended to become, under the structure of the value-added tax, as I have just indicated, tax collectors from final consumers.

In the same way a switch from the corporate tax to value-added taxation would result in different benefits as between corporate and noncorporate sectors and activities, the benefits of course going to those activities now predominantly conducted in the corporate form. There would be no relief for those now operating in the noncorporate form. All, however, would become collectors under the value-added tax as distinguished from actual burden bearers.

We might also look more carefully from the standpoint of neutrality at what would happen to different industries and business units in their new role as tax collectors under the value-added tax system. Elasticities of demand for different goods and services are not the same, so that even a flat rate of value-added tax is not neutral except in a highly formal sense. In practice, consumer response and sales volume changes will vary as between industries, and this consequence might not appeal to many who may have been initially beguiled by the neutrality argument.

In practice, also, "neutrality" in the various value-added tax countries has yielded to a structure of preferential rates, so that even the equal consumer tax rate claim of neutrality would seem highly problematical. If we look at the political realities and the use of the value-added tax abroad, they discriminate among types of product and exempt some activities. In view of this background and the trend in State retail sales taxation, we would foresee some type of exemption for food and medicine along with medical and hospital services, education, and similar activities in the event of any value-added tax experiment in this country. No matter how desirable we may consider these exemptions, they detract from the purported neutrality of the value-added tax for a significant proportion of consumer expenditures.

European value-added taxes reveal, as I have suggested, important departures from "neutrality." The German tax, probably in large degree because of technical problems, exempts financial institutions. The French tax exempts them, but includes a special tax on part of their activities. Small firms are another special aspect. In France, small businesses can pay a flat sum instead of computing tax on value added. The French tax has four rates: a normal rate; an increased rate for luxury items; an intermediate rate for certain utilities, hospital care, certain food stuffs, etc.; and a reduced rate for widely consumed foods, tourist hotels, etc. The German tax has two rates: a general 11 percent rate and a 5½ percent rate for agricultural products in general.

One should not overlook the fact that the changes involved in adapting to a value-added tax structure would have differing impact on different sectors of the economy and would require some time to complete the resulting economic adjustments. The initial effects of substituting a value-added tax for part of the corporate income tax could thus be far from "neutral" as between different business firms and industries.

Another argument for a value-added tax used by some—indeed, it seems to be the only argument that Professor Harberger strongly advances for the

tax [2]—is its potential as an instrument of flexible fiscal policy. The claim is made that there is only one way to change its effect—raise the rate up or down—while there are many ways in which income taxes can be adjusted and thus controversy and delay are bound to ensue if the latter are used for countercyclical adjustments. But this view underestimates the ability of legislators to find ways in which to vary a tax—one can readily imagine some legislators insisting that only the value-added rates on "luxury goods" should be raised when a temporary tax increase is needed, and so on. (Witness the recent French changes in which each of the four different rates in the French value-added tax was changed by a different amount.) Moreover, the statement that necessary adjustments would be effected more speedily for a value-added tax than for an income tax because the character of the income tax adjustments—should it be the individual tax or the corporate tax, should the progression be altered, should exemption levels be changed?, etc.—is always controversial and hence involves delay is simply wrong.

The history of the 10 percent surcharge clearly demonstrates this. The lengthy legislative gestation period for that surcharge was caused by differences of opinion as to the economic outlook and fiscal policies, especially expenditure policy, and not as to the details of the change as such. Indeed, in the whole period of eleven months in which the surcharge was before the Congress, the Tax Committees spent less than one-half hour on the details of the surcharge recommendation, and this was on the last day of the Conference Committee discussion. Moreover, the final product varied hardly at all from the form recommended by the President. The debate was entirely over the need for the surcharge and whether it would be accompanied by expenditure restrictions—and any consideration of a comparable change in a value added tax would have been subject to exactly the same debate. Our problems relating to the use of the income tax for countercyclical purposes are not problems of technique or mechanics.[3] They are issues of fiscal policy at the political level—differences between Presidents and Congresses over the fiscal policies to be pursued—and the nature of the tax involved will not alter those issues.

I thus can find no persuasive reasons to shift to a national sales tax. The Conference Report of the National Bureau of Economic Research and the Brookings Institution in 1964 on the subject of "The Role of Direct and Indirect Taxes in the Federal Revenue System" ends with the same conclusion: "It is hard, then, to find much support for more reliance on indirect taxation in the record of the conference, even though some participants came, and left, with a disposition toward this view."

Indeed, there are a number of persuasive reasons against such a shift. It would mean the substitution of a regressive tax for a progressive tax and on equity grounds this would be a distinctive step backwards. Value-added tax proponents meet this objection in three ways. One course is to argue that the corporate tax itself is shifted forward, so no change in regressivity would be involved. This argument of 100 percent forward shifting of the corporate tax is of course difficult to sustain, and if true would undermine the argument by some proponents that shifting to a value-added tax would increase after-tax corporate profits. Another course is to acknowledge some increase in regressivity but consider this a lesser disadvantage than the purported advantages of the tax in fostering economic growth and giving corporate investors more "reasonable" tax treatment. But this defense is only as good as those "purported advantages" and as shown above they do not carry the needed weight.

A third course is to minimize the regressivity objection, either by arguing that the degree of regressivity would not really be burdensome or by suggesting that it could be removed by appropriate exemptions, particularly one for food. There also is another "anti-regressivity" approach to sales taxation which could be used, although I personally have not seen it mentioned in connection with value-added tax proposals. This is the annual income tax credit (or refund if no income tax is due) that has been introduced by six of the States with sales taxes. But a food exemption, or a personal credit or refund system, would only roughly compensate for the regressive feature of a value-added tax. The device of a food

---

[2] Harberger, "A Federal Tax on Value Added, in the Taxpayers' Stake in Tax Reform" (Chamber of Commerce of the United States, 1968), p. 21.

[3] The recent Brookings book, Agenda for the Nation, contains in an article by Herbert Stein a proposal to use systematically a positive, negative, or zero surcharge on income taxes as a countercyclical device.

exemption, for instance, would give a larger advantage to the family which, for whatever reason, spent a larger proportion of its income on food than another unit with the same income. The device of a per capita credit or refund system would benefit most those units which put a larger portion of their income to nontaxable uses, such as savings.

As a practical matter, any measure instituted to minimize or remove the regressive effect on consumers of a value-added tax would still leave the tax less progressive than the corporate tax which it is intended to supplant. Here, of course, I am assuming that a considerable portion of the corporate income tax is not shifted forward.

The addition of a new mass Federal tax also has its costs in taxpayer compliance and administration. The proponents of a value-added tax tend to gloss over this factor—and indeed they would be well advised not to discuss it. They admit there will be the start-up problems associated with any new tax. Since this is an admitted problem, I will not elaborate on it except to say that putting into effect a tax which is as pervasive as a value-added tax could be a real administrative task because of the large number of units involved.

Let us skip over the initial process and assume that the tax is in working order. The first aspect to be noted is that the number of returns to be handled would run between 25 and 30 million a year, about a 25 percent increase in the present level of returns now processed by the Internal Revenue Service. This figure assumes quarterly returns (as in the case of excises) with exemption for farms, medical services, and certain financial services. Without these exemptions, the number of returns would be increased by another 15 million. Taxpayers would be burdened with a number of new tasks. If we followed our present excise tax procedure for current payment, and I see no reason why we would not, they would have to compute and pay their tax liability to bank depositories twice a month. Internal bookkeeping of firms also would be increased by the need to keep records of the tax paid on purchases.

The United States all in all probably has the world's most carefully structured and administered income tax. Is it because it is essentially our only national tax and therefore we work hard at continually improving it? The European countries must spread their efforts over both an income tax and a sales tax. The more children in a family, the less attention each gets.

To sum up this part of the discussion, from a domestic point of view it is hard to see how a national sales tax has anything to offer for our Federal tax system. It would add another large layer of work for taxpayers and the Internal Revenue Service without any reduction in current workloads. There seem to be no offsetting economic benefits to be gained that cannot be accomplished without that step. Substitution of a sales tax for part of the corporate income tax (or the individual income tax for that matter) would lessen the equity of our Federal tax system.[4] And our experience in recent years shows that the necessary degree of economic growth can be assured within the structure of our income tax system.

Clearly, a proposal for a value-added tax would involve a political battle of the first order. The Democratic Party platform for 1968 stated:

> "The goals of our national tax policy must be to distribute the burden of government equitably among our citizens and to promote economic efficiency and stability. We have placed major reliance on progressive taxes, which are based on the democratic principle of ability to pay. We pledge ourselves to continue to rely on such taxes, and to continue to improve the way they are levied and collected so that every American contributes to government in proportion to his ability to pay."

The AFL-CIO platform proposals presented to the two conventions in 1968 were specific on this issue:

> "All efforts to make inroads on the progressivity of the federal tax structure should be repulsed. These include proposals for a national sales, transaction, or value-added tax."

Many business groups and businesses would also oppose the tax. Our country would not be well-served by provoking such a political battle for a tax that has so little to offer to our tax system.

---

[4] If we are looking around for taxes to be substituted for, it would seem more appropriate to offer the Federal payroll taxes as a candidate rather than the income taxes.

All in all a sales tax is a second-best tax to an income tax, and why do we need a second-best tax.[5]

A Retail Tax Is Preferable to a Value-Added Tax

So, as to the major topic, "Should the United States have a national sales tax?", I would answer in the negative. But even if the answer were yes, why should a value-added tax be chosen as the form of the sales tax? Why not a retail sales tax?

In the United States, forty-four of our States have retail sales taxes. So do some of our cities. Over 97 percent of our population live in States with sales taxes. Over 97 percent of our retail establishments are located in States having such taxes. Thus, today, a retail sales tax is being administered in the United States—and successfully administered. Therefore if the Federal tax system is to have a national sales tax, why not simply use the retail tax structure we already have. We could adopt a national retail tax and allow uniform credit of so many points for State sales taxes. States that wanted a higher rate than the credit could "ride" the Federal tax.

What is gained by having a value-added tax rather than a retail sales tax? As far as I can see, the answer is more paper work and administrative chores—and greater temptations for exemptions and special rates.

As pointed out earlier, the end result of a value-added tax is that the retailer collects the tax from his customers. Let us assume a 5 percent rate. Under a 5 percent *retail sales tax,* a retailer collects 5 percent of the sales price from its customers and pays the full 5 percent to the Government. That's the end of the matter. Under a *value-added tax,* a retailer first pays 5 percent to its wholesaler on goods purchased, then collects 5 percent from its customers on the retail price and pays the net difference to the Government. Thus, if the wholesale price is $70 and the retail price is $100 before tax, the retailer pays the wholesaler $3.50, collects $5 and pays $1.50 to the Government. Clearly the retailer is worse off, since it has had to carry the cost of paying the $3.50 until it makes the sale to its customer, whereas under the retail tax the retailer pays nothing until a sale is made.

Clearly the Government is worse off because it is collecting the $5 in bits and pieces: $1.50 from the retailer; say $1.00 from the wholesaler (suppose the manufacturer's price is $50—the wholesaler collects $3.50 from the retailer but has paid the manufacturer $2.50, leaving a net of $1.00); say $1.50 from the manufacturer and the rest from various suppliers of the manufacturer. While the Government gets part of the $5 in earlier, it has the administrative problems of dealing with all the other units in the productive process. These units in turn—wholesalers, manufacturers and suppliers are all involved in paper work under the value-added tax whereas they are free of it under the retail tax. The retailer itself has an additional burden under the value-added, for it must keep track of purchases and sales alone whereas only sales records are involved in a retail sales tax.

Hence it is really nonsense for a country with an already functioning retail sales tax structure to add a value-added structure that collects in more complex and burdensome fashion the amounts that could be collected under the retail sales tax procedure.

Proponents of the value added tax like to say the tax is a "form of tax on business." This is pure obscurantism. It is a tax on household and other non-business customers and all the rest is paper work and accounting imposed on business to end up with the retailer collecting the tax from the customers. Maybe a country that can't collect a retail tax successfully takes out insurance against too much revenue being lost in poor compliance at the retail level by collecting a tax at least at the wholesale and manufacturer's level. But a country that can collect a retail tax doesn't need all this wasteful paraphernalia.

---

[5] Prof. John Due, an acknowledged authority on sales taxes, has concluded: "On the whole, the sales tax must be regarded as a second-best tax—one to be employed only if various circumstances make complete reliance on income and other more suitable taxes undesirable. A carefully designed sales tax is not perhaps as objectionable as it was once regarded; it offers definite advantages over widespread excise tax systems, with their inevitable discrimination among various consumers and business firms and their tendency to distort consumption patterns; and it is definitely superior to high rate 'busness' taxes with uncertain incidence and possible serious economic effects. But it must be regarded as secondary to income taxation, in terms of usually accepted standards of taxation." Due, Sales Taxation (1957) 41.

INTERNATIONAL CONSIDERATIONS

Let us now return to our main topic—Should the United States have a national sales tax? The discussion above states my view that on the basis of domestic considerations such a step would not be desirable and would not be an improvement in our Federal tax system. The next question is whether, if we accept this conclusion, should the answer nevertheless be altered because of international considerations? Many proponents of a value-added tax would reply in the affirmative, and indeed rely on international considerations to differentiate the present discussion of the need for a sales tax from the previous debates on that subject in this country. This reliance on international considerations is based on the structure of a value-added tax as applied to international trade.

In examining this structure, let us first consider exports. A country with a value-added tax, while recognizing the effect of the tax on domestic prices, will attempt to prevent the tax from increasing export prices. It does so by not requiring a manufacturer (or other exporter) to pay the value-added tax on its exports. It also rebates to that manufacturer (or exporter) the value-added taxes it has paid to its suppliers so that it does not incur those tax costs for its exports. Step two, however, is not unique to exports, for the manufacturer selling in the domestic market also receives a rebate of its tax costs. At the same time, the country will see that imports are subject to the value-added tax by imposing a border tax on the imports equal to that tax, thereby making imports subject to the same tax as domestically produced goods. There is nothing mysterious or tricky in this approach. We do the same in the United States for our single stage manufacturer's taxes on automobiles, cigarettes, alcohol, and so on—namely, rebate the tax (if previously paid) on that part of the output which is exported and collect an equivalent excise tax on imports.

Why then is it said that a county having a value-added tax is favored thereby in its international trade. Some business concerns and groups have a simple, first level answer—they say that a German exporter of machine tools, for example, is exempted from an 11 percent value-added tax if it sells for export but not if it sells domestically, so that exports are favored by the 11 percent differential. This simply means, however, that a German exporter of machine tools does not pay a sales tax in Germany—but neither does a United States exporter of machine tools pay a sales tax in the United States. Hence both in this respect are on the same basis. They also say a German exporter receives a rebate of 11 percent of the cost of its purchases, while the American exporter does not. But the German exporter has paid taxes equal to that 11 percent rebate, while the American exporter did not. So in this respect they also end up on the same basis.

And so it is with imports—machine tools coming into Germany must pay an 11 percent tax because machine tools produced in Germany pay that tax. Machine tools coming into the United States do not face a border tax in the United States because machine tools produced in the United States do not pay such a tax.[6]

Clearly we must look beyond these first level contentions to find an international trade effect. Some proponents of a value-added tax assert that while this system of border tax adjustments keeps that tax from affecting international prices, we in the United States—who do not have a sales tax but do have a corporate tax—do not have comparable border tax adjustments to reflect that corporate tax. But this argument has validity only if the corporate tax is shifted forward in prices and thus, without the rebate, would affect the export price—a point we can consider in a moment. At any event, since the principal European counrties also have corporate taxes at about the same effective level, they are in the same posture in this regard and this argument thus has no weight.

Let us move from these clearly inadequate first level arguments of the proponents of a value-added tax to a further analysis, in the context first of an increase in United States tax revenues through a value-added tax.

If we assume that a newly imposed value-added tax is fully reflected in domestic prices—an assumption that is strengthened if the tax is introduced under full employment conditions since the monetary policy accompanying such a tax

[6] See the statement of Roy A. Wentz, Chief Counsel, Federal and Foreign Tax Division, E. I. du Pont de Nemours & Company, to the National Foreign Trade Convention, Nov. 20, 1968, pointing this out.

change would presumably be designed to permit that result—but refunded or rebated on exports. there would be no change in export prices, and imports will be subject to a border tax adjustment in the same percentage as domestic prices have been increased. This should leave the overall terms of international trade as neutral as possible, although equal percentage increases in prices of all domestic and imported products and services may cause some shifts in demand between various types of products and services.

Now we have to work into our analysis the possible effects of reducing the corporate income tax and substituting the value-added tax which, of course, is really the major objective of the value-added tax proponents. In order for this substitution to advance our trade we must assume that the corporate tax was shifted forward to an appreciable extent and the lack of rebate for that tax on exports keeps the forward-shifting in the export price. On the other hand, the price-increasing effect of the value-added tax through the forward-shifting of that tax is kept out of the export price under the exemption and rebate process. We here reach the unsettled controversy as to whether the corporate tax is and if so, to what extent, shifted forward in prices. I still take the consensus of economic thought as favoring the view of a less than full shifting, and for many economists considerably less, so that the possible benefit for trade would be related to the degree of shifting.

Let us try another avenue of analysis. The value-added tax, as we earlier noted, is passed forward in an accounting sense and expected also to be shifted forward in an economic sense through a price rise. But suppose it is not fully shifted forward in prices due to market conditions. Then a manufacturer forced to absorb some of the tax effects on its domestic sales and thus reduce its profits, but not having that consequence on its exempted export sales, could well turn more of its energies to exporting its product and thereby enlarge the country's international trade. Similarly, foreigners exporting the same product to the value-added tax country will suffer lower profits and be less induced to push those exports.

If this be so, a country with a value-added tax would have some trade advantage through such an incentive to exports and the disincentive for imports. The situation can vary from product to product depending on price elasticities. Moreover, as respects the European tax systems, the advantage can have disappeared under earlier exchange rate and other international adjustments.[7] We could also add the comment that given full employment, the absence of full forward shifting would presumably be due to a reasonably tough monetary policy. If it takes such a policy to produce a trade advantage, then presumably the advantage could also be obtained by the same monetary policy without the accompanying resort to the value-added tax. And finally, for the trade advantage to be significant the rate of value-added tax must be quite high, at levels commensurate with the European rates. But a value-added tax applied in the United States at such levels would swamp our existing tax system—even a 10 percent rate would mean a revenue yield considerably greater than our total corporate tax.

In this view, to complete this discussion, there can be some trade advantage in having a value-added tax in a tax system. What then should the United States do? In considering this question, we should note that the advantage would not be unique to the value-added tax. It would exist, under this analysis, for any type of sales tax where that tax—be it a value-added tax, retail tax, wholesale tax, or manufacturer's tax—could not be fully passed forward in price. Business groups asserting there are trade advantages for the European countries with value-added (and formerly turnover) taxes have not fully perceived this and hence have often excluded the British who have a wholesale tax, or the Canadians who have a manufacturer's tax, from the list of trade-favored countries. But the presence of the paraphernalia of border tax rebates and compensating import taxes under a value-added tax and its absence under a retail sales tax or any other single stage tax (since all the explicit paraphernalia are not needed but are implicit in the single stage system) should not prevent them from recognizing that if indirect

[7] The Europeans could be deriving a present advantage in substituting value-added taxes for their existing turnover taxes. Thus, the export rebates under the prior turnover taxes probably undercompensated exporters for the costs of those taxes, so that the introduction of the full compensation possible under the value-added tax structure, without a concomitant change in the domestic price level, could assist those exports. And in countries (Sweden) where the existing retail tax did not exempt sales of goods consumed by businesses, substitution of a value-added tax would have a similar effect.

taxes do produce a trade advantage, then that advantage will exist whether the structure of the indirect tax be a multiple or single stage sales tax.

Now, back to the question of what the United States should do to offset the trade advantage considered to accrue to a country with a relatively high sales tax system. Some Europeans say the answer is simple—let the United States adopt a sales tax. But this answer would mean that those countries with a sales tax would be imposing their tax will on the rest of the world—and in effect intervening to affect the free domestic choice of a country's tax structure. Remember, our hypothesis here is that absent international considerations the United States should not adopt a sales tax.

We in the United States want to retain our freedom of action to maintain a tax system of our own design. We are glad to take ideas from other countries. However, we are, and rightly should be, independent in wanting to select the types of taxes, rates, exemptions, and other features, and the division in our Federal system of taxing powers and tax decisions between the various levels of government. After all, the American Revolution was fought in part to win the right to determine our own tax system.

On the other hand, we do live in a world economy. Our balance of trade is important. We need to be aware of the extent to which the tax systems and nontax measures of other countries can affect our exports and imports and our general trade position.

The question then comes down to this: How can the United States—or other countries—continue to exercise full freedom in the design of our domestic tax system, consistent with our notions of tax equity, tax efficiency, proper economic growth and all the other relevant considerations, and still live on trade competitive terms with countries which, exercising a similar freedom, choose to have high rate sales taxes?

Under these circumstances, an appropriate solution for us would be to adopt border adjustments, limited to charges on imports or rebates on exports or both, rather than to overturn and revamp our existing tax system which has evolved over many decades to meet our needs. These border adjustments would *not* be part of a value-added tax or other sales tax, and would *not* involve any changes in domestic taxes. Rather, they would simply be border adjustments at the rate thought appropriate in the existing international setting. Since there would be no change in the domestic tax system and hence in the domestic price structure, a border charge on imports would tend to raise the prices of imports to American buyers or reduce the profits of foreign sellers, thus improving the competitive position of United States producers and discouraging imports. On exports, the rebates would tend to lower the prices of United States goods in world markets or increase the profits of American exporters and thus tend to increase exports. These border adjustments could be administered by the Customs Bureau.

It is interesting to note that Germany in the converse situation—when it desired to dampen its trade surplus—has recently done just this. It has adopted border adjustments—independent of its tax system—by taxing its exports at a 4 percent rate and reducing the compensating import tax from 11 percent to a net 7 percent (though still allowing an 11 percent credit to the importer on his resale). Under the German view of its tax system, with its 11 percent value-added tax, "neutrality" as to exports and imports—in the sense of attempting not to have its domestic tax system affect the prices of exports or favor imports—existed at an exemption for exports (and an 11 percent rebate on purchases representing taxes paid) and an 11 percent tax on imports. A 4 percent tax on exports and a 7 percent tax on imports—in effect a 4-point burden on exports and a 4-point benefit to imports—is thus an unneutral posture favorable to other countries. In the United States national tax system with the absence of a national sales tax, "neutrality" in the indirect tax area exists at a zero tax on exports (and no rebate) and a zero charge on imports.[8] If we were to adopt a 4 percent export rebate and a 4 percent import charge, then we would achieve an un-

[8] The text here oversimplifies the U.S. tax system. We do have selective national excises, e.g., on gasoline, automobiles, telephone use, and State and local retail taxes, and the like. In many cases these taxes enter into the cost of doing business and hence affect export prices and favor imports. On the *average* an export rebate around 2 or 2½ percent would reflect these tax costs and keep them out of world prices; there could also be an equivalent 2 or 2½ percent import tax. The impact of these tax costs on the various product lines differs of course, with the range running from about 1½ percent to 4 percent of export sales prices. Similar situations exist for some other countries.

neutral posture vis-a-vis our domestic indirect tax system to protect our trade.[9] (We would be taking such a posture because we felt our trade position was adversely affected by the existence per se of high indirect taxes in other countries, the assumption we are here making in this part of the discussion.)

Under the present GATT rules, border adjustments are permitted for indirect taxes—sales and excise taxes—but not for other taxes. The United States this year asked for and obtained the establishment of a Working Party to reexamine the whole aspect of border adjustments under GATT. One aspect of the re-examination could well be to permit countries not having a high indirect tax system permanently to adopt within limits border adjustments independent of their domestic tax structures if they so desire. It could result also in imposing some upper limits on the total border adjustments countries with indirect tax systems could make. This approach would provide an appropriate international accommodation to the basic question we are considering, that of freedom for domestic tax action without prejudiciing a country's trade position.[10]

Conclusion

Our existing Federal tax system, in varying degrees, provides equity, incentives, certainty, and familiarity. It is by no means perfect but any change should be in the direction of improvement, balancing the various goals it seeks to achieve. Viewed from the standpoint of domestic considerations the addition of a national sales tax would clearly not improve our present Federal tax system. And, *if* a national sales tax were ever thought desirable, it should take the form of a retail tax and not a value-added tax. In this light, to change major parts of our tax system and adopt a value-added tax or other form of national sales tax for the primary purpose of encouraging exports or discouraging imports would mean incurring severe losses as to several other equally or more important objectives.[11]

Such a change is clearly undesirable. It is also unnecessary because there exists an alternative which permits accomplishment of both goals—preservation of our existing tax system and improvement in our trade position if we consider it disadvantaged because other countries have high indirect taxes. That alternative consists in adopting limited border adjustments for the United States that are not dependent on our adopting a value-added tax. The present GATT review is one way of reaching an international trade accommodation that would produce this method of achieving world-wide tax harmonization combined with freedom of choice and absence of trade disadvantage in structuring domestic tax systems.

---

[9] The recent French change is of a different order from the German action. The French repealed a 4¼ percent payro'l tax paid by employers, which had gone to general revenues, and increased the value-added tax rates from 1 to 5 percentage points on various goods to make up the loss in revenue. The purpose was to stimulate French export trade. Initially, the payroll and value-added tax changes would aid French exports and dampen imports *provided* businesses adjust prices to reflect repeal of the 4.25 percent wage tax. If the wage tax repeal reduces costs by, say, 2 percent and the value-added tax is raised on the average by the same percent, the result would be that prices in France of domestically produced products would be unchanged, the price of imports (assuming no backward shifting to the foreign supplier) would increase by 2 percent, and prices of products exported would decline by 2 percent.

Actual results could be much less favorable than the above. The chances of French businessmen (faced with cost increase pressures) reducing prices by the full amount of the wage tax repeal are problematical, even though pressured to do so by the Government. The transportation, gas, and electricity price increases also imposed will be offsets to part of the wage tax repeal. (British exporters picked up a lot of the pound's devaluation by raising their export prices in British money units.)

[10] In essence the GATT discussion comes down to the United States asserting that if the existence of a high indirect tax per se helps the trade position of a country, then GATT should permit a country without such a tax a method of defending itself without having to change its domestic tax structure. If the existence of a high indirect tax per se does not so help the trade position, then there is no point to our considering a value-added tax on urging a GATT change.

[11] Foreign trade, although of substantial importance, represents only a small part of U.S. gross national product. U.S. exports, for example, have accounted in recent years for about 5.8 percent of GNP. Exports for most other industrial countries represent much larger percentages of their GNP's—between two and four times as large as the U.S. percentage for Britain, Canada, France, West Germany, Italy, Japan, and Sweden, for example. Thus these other countries have stronger reasons to tailor their basic tax systems to reflect their dependence on foreign trade. Even so, the origin of their reliance on high indirect taxes traces to domestic tax considerations.

A COMMENTARY ON TWO CRITIQUES OF *Overseas Manufacturing Investment and the Balance of Payments, by Gary C. Hufbauer and F. Michael Adler*

Prepared by Gerard Brannon, Director, Office of Tax Analysis, U.S. Treasury Department

JANUARY 13, 1969.

In the spring of 1968 the Treasury Department published a study prepared by Professor Gary Hufbauer (University of New Mexico) and Professor F. Michael Adler (then of the University of Pennsylvania, now of Columbia University). The study, *Overseas Manufacturing Investment and the Balance of Payments* (hereinafter cited as H–A), was a statistical-economic investigation of the effect of U.S. foreign investment on the balance of payments.

The Treasury Department regarded that study as an outstanding piece of research in an area where there are limited data and few previous studies. The authors themselves realized the limitations they worked under. The study conclusion nevertheless bears rather directly on a critical problem of U.S. policy, the role of foreign investment restraint in any program to deal with the U.S. balance of payments deficit.

That study has drawn some criticism from two organizations which represent U.S. foreign investors. One *Direct Manufacturing Investment, Exports and the Balance of Payments* by Professor Jack Behrman was published by the National Foreign Trade Council (hereinafter cited as NFTC). The other *The Role of U.S. Manufacturing Abroad* was published by the Machinery and Allied Products Institute (hereinafter cited as MAPI).

The objective of the Treasury release of the H–A study was to stimulate a creative dialogue that would throw some light on a difficult subject that is relevant to current policy issues facing the U.S. This objective calls for some commentary to these published criticisms.

We can say initially that, despite allegations in the NFTC paper, there was no bias in the study design given by Treasury to Hufbauer and Adler. They were asked to investigate a problem and to let the data dictate the results. At several stages the work was exposed to detailed criticism by outside experts who were acknowledged in the study. The MAPI study acknowledges the "scholarliness, intellectual effort, and depth of research" of H–A.

THE POLICY PROBLEM

The H–A study is not a defense of a direct foreign investment control program of the U.S. but only a prediction of certain consequences of variations in the level of direct foreign investment. It should be obvious that there is no easy solution to a country's balance of payments problems. There is merely a menu of more or less unpleasant things that can be done. These unpleasant things differ in the degree in which they save foreign exchange, and they differ both in the degree to which they impose burdens on Americans and the particular Americans on whom they impose burdens. Thus, a policy of controlling direct foreign investment imposes burdens mostly on the particular Americans who make such investment. A restraint on foreign travel imposes burdens on Americans who plan to travel abroad. A lower level of U.S. economic activity would impose burdens on the people who become unemployed.

No one denies that there are burdens involved in restraint on direct foreign investment. There are probably in the long run disadvantages to the U.S. balance of payments from such restraints, as was argued by one of the authors of H–A in a separate article. We can say that neither Hufbauer nor Adler would put direct restraint on foreign investment very high on their preferred policy list. but obviously alternative policies, such as a tax on tourist expenditures, or floating exchange rates do not meet with much widespread support either. Nevertheless. the fact that one may oppose a particular policy is no reason to make inaccurate statements about its consequences.

The U.S. decision to deal with its balance of payments deficit in part by investment restraint did not in fact rest on the conclusion of H–A. There were various grounds for the judgment that in general foreign investment does not involve a near immediate recoupment by the investing country. For one thing less developed countries have sought foreign investment as a way of acquiring

the foreign exchange needed for growth. This would be a strange policy for them if foreign investment resulted in a nearly immediate recoupment by the investing country of the foreign exchange acquired by the less developed countries.

Another major study, the Reddaway Report in the United Kingdom, provides some additional support for the judgment that it should be a number of years, say, 6 to 10 before an investing country recovers the balance of payment loss involved in making the foreign investment. The detailed analysis of this problem in H–A supported this conclusion.

THE NFTC CRITIQUE

The NFTC critique raises specific issues with H–A beginning at page 3.

FLOW OF FUNDS

The first NFTC criticism asserts that "the authors' (H–A) implicitly reject the idea that an outflow of funds creates its own adjustment mechanism." This criticism is simply wrong. The whole study deals with adjustment mechanisms and meticulously catalogs the elements of the adjustment process. Not surprisingly the study finds that these adjustment mechanisms are not perfect, nor even very rapid. If they were, no countries would have balance of payments problems.

FINANCING AND INCOME REMISSIONS

The second and third points raised in NFTC are interrelated and need to be discussed together. H–A assume that a dollar invested yields a profit based on the average rate of profit to book value of equity; that a portion of this is distributed in dividends and part retained (based on the average division of after-tax profits); and also that the part retained earns increased profit which is divided between earnings and retentions, etc. They estimate the income remission part of the recoupment by comparing the flow of dividends with the *original* financial investment.

The NFTC study takes a different approach to this calculation, following a method previously urged by Behrman. H–A refer to the previous Behrman analysis and explain their reasons for rejecting it (pages 68–69). The NFTC study observes that direct equity investment covers only about 30 percent of total investment (the balance coming from retained earnings and debt). Then it assumes that for recoupment to occur, the consequences of the total investment may be counted but the amount of recoupment need only cover the 30 percent which was direct equity and that earnings retained abroad should be counted as recoupment. These steps are clearly inappropriate to the problem at hand which is to calculate the consequences for balance of payments of a change in ownership dollars from the U.S.

To deal first with what is to be recouped, suppose that some new equity *investment is made*. The fact that this additional equity investment is made or not does not change the use of retained earnings in the same year nor does it change foreign borrowing. Assume a company has, from its existing foreign business, $70 of retained earnings and new borrowings in Europe and is considering a new investment of $30 from U.S. sources. If this new investment is made, then the book equity will be higher by $30 and the difference in earnings on the extra equity ought to be calculated in the way set out in H–A; and the capital equipment and other effects have to be calculated from the marginal investment of $30. Behrman calculates the recoupment effects on the whole $100 ($70 of retained earnings and borrowings plus $30 new investment) and concludes that the balance of payments loss would be recouped in two years or less. The H–A calculations, which are properly keyed to the marginal investment provide a much longer recoupment period.

The H–A analysis is relevant also to the issue of investment from retained earnings. If the U.S. parent in the case cited decided to reduce subsidiary dividends by $10 and increase its retained earnings, our balance of payments "loss" is $10 and the investment is increased $10. This can be expected to give rise to recoupments based on a $10 investment in the way calculated in H–A.

The critique of the method of calculation in H–A (on p. 6 of NFTC) is simply wrong. To continue the previous case, H–A looked to data on past earnings with respect to total equity including retained earnings. It was assumed that the foreign earnings would increase from the marginal investment of $30 in the example earlier discussed by $30 times this rate of return. If this was 14 percent

and 7 percent was repatriated as dividends and 7 percent was retained, H–A treats the income remission in year one as $2.10 and calculates the income for the second as a return on $32.10, etc.

NFTC calculated the income remissions as including retained earnings. That this argument is fallacious can be seen in two ways. In the first place, the whole balance of payments problem is a liquidity problem. No one doubts that our total claims against foreigners, including equity ownership of foreign assets exceeds in value foreign claims against the U.S. Our balance of payments "deficit" relates to excess *liquid* claims by foreigners on the U.S. We do not acquire liquid claims from continuing business ownership of a foreign subsidiary, except by repatriating foreign profits as dividends.

The problem in the NFTC argument can also be seen by assuming two identical U.S. investments of $10 million in a German subsidiary. Each earns 10 percent. One pays all of its profits in dividends, the other reinvests all of its profits. Since we are discussing only the income remission behavior, we can ignore all the other balance of payments effects. The dividend paying firms would produce dividends which in ten years would offset the balance of payments, i.e., liquidity loss associated with the investment. In ten years the nondividend firm would have done nothing to offset the liquidity loss. We can agree that due to the operation of the nondividend paying subsidiary Americans collectively would own a very valuable German asset worth about $26 million (compounding 10 percent growth for ten years). But this would not enter the balance of payments calculation, and the H–A study is only about the balance of payments consequences of direct foreign investment.

ASSUMPTIONS AS TO ALTERNATIVE INVESTMENTS

H–A examined the balance of payments problem under three assumptions:

Classical.—Without the foreign investment there would be more U.S. domestic investment and no substitute investment in the host country.

Reverse-classical.—Without foreign investment by a U.S. company, someone else would have built the plant in the host country.

Anti-classical.—There would be no substitute investment in either the U.S. or the host country.

NFTC takes H–A to task for ignoring the "real" case which, it alleges, is that *both* investments by the U.S. owned company and by the foreign company take place in the foreign country. This is a convenient case for the NFTC point of view because it makes it possible to combine two favorable factors in the balance of payments problem. By assuming that the U.S. owned plant abroad is *an addition to* foreign construction, the export of capital equipment is maximized. (If the U.S. owned plant abroad was built *instead of* the foreign plant, the only gain in balance of payments through capital exports is whatever propensity a U.S. owned firm has to buy U.S. equipment.) Also, by assuming that the foreign firm is being constructed anyway, NFTC can insist that there is no export displacement. (We were going to lose the export markets anyway.)

But this NFTC assumption is not consistent with the given problem. What is under investigation is the *consequences* of U.S. investment. That a foreign firm was going to build a plant anyway is irrelevant to this problem. The question is whether *as a consequence of the U.S. investment decision* the foreign investor builds anyway (in which case the U.S. investment is "in addition to" the foreign investment, classical or anti-classical case) or whether the foreign investor builds less (in which case the U.S. investment is a substitute for the foreign investment, the reverse classical case). The NFTC assumption really amounts to saying that the foreigners build more *because of the U.S. investment*—which is hardly plausible as the general case. In most situations foreign economies are near full employment and making as much domestic investment as their resources, and their consumption needs, will permit.

In any case the NFTC assumption does ont avoid the problem that some U.S. foreign investment can displace U.S. exports. To assume that any reduction of U.S. direct overseas investment would be immediately replaced in one year is to assume that capital is a free good when in fact it is scarce. A more realistic appraisal is the one offered in H–A that in the short run U.S. financed investment in a foreign country, particularly less developed countries, is an addition to investment, but these investments would have been made anyway by foreign capital in a few years if there had been no U.S. investment. This suggests that the real recoupment periods are somewhat longer than those shown under the reverse-classical assumption. (Cf. H–A. pages 69–70.)

THE ORGANIC THEORY

NFTC takes H–A to task for rejecting the organic concept of investment advanced by Judd Polk and others in a study for the National Industrial Conference Board. This holds that except for new investment of U.S. funds the profits from existing overseas investment would decline. This implies that marginal rates of return are very high. To illustrate, if average returns are 15 percent and it might be that when the investment was 100 the profit was 15 and with new investment of 10 profit went up to 16.5. H–A calculate the profit on the extra investment at 1.5. The organic thesis says that if there had been no new investment profit would have declined to, say, 10; and the new investment should, therefore, be credited with earning 6.5. No statistical evidence has been advanced to say what the decline would have been. H–A explain that they are not following this theory for several reasons: They know of no way to get the data that would implement it, and the problem is not to estimate the consequences of completely stopping overseas investment but of making marginal adjustments to the amount of new investment. The NFTC paper does not use the organic theory either.

CAPITAL EQUIPMENT EXPORTS

H–A attempt to estimate how much U.S. exports of capital equipment are increased by direct foreign investment. NFTC rejects the H–A calculations and insists upon "solving" the problem by dividing the total of U.S. capital goods exports to foreign subsidiaries by the direct investment outflows of U.S. funds to these subsidiaries. H–A divides the capital goods exports by the total plant and equipment expenditures of subsidiaries.

The difference is part and parcel of the problem of retaining earnings discussed above under financing and income remissions. This can be seen by looking at the figures for one country in one years. The direct foreign investment by U.S. owners in Canadian subsidiaries in 1964 was $74 million. Due to borrowing and retained earnings, these subsidiaries made plant and equipment expenditures of $771 million of which $494 million came from U.S. suppliers. NFTC would divide $494 million by $74 million and conclude that for each $1 of net investment there was $7.70 of capital exports from the U.S. The H–A calculation divides $494 million of U.S. supplied capital goods by $771 million of plant and equipment expenditure and concludes that for each dollar of direct investment $0.65 of capital exports are supplied. Basically, H–A assume that whatever investment occurs from retained earnings, foreign borrowing is going to take place anyway. NFTC assumes that investment from retained earnings and foreign borrowing is cut back in proportion to any cutback in direct investment. The H–A assumption is clearly relevant to current policy discussions. Where foreign subsidiaries have reduced their drawings of U.S. funds, they have borrowed *more* from abroad and kept up their level of investment. Reducing U.S. outflow did not greatly cut back capital exports. (The NFTC study seemed embarrassed about the size of their capital equipment effect for Canada based on 1962–64 figures, the cited 770 percent, and decided to use the 1965 figure which was *only* about 160 percent. Apparently by inadvertence in the table of recalculations, page 15, this was reduced to 16 percent.

SUMMARY ON NFTC

On balance the NFTC work does not provide a basis for significantly modifying the H–A estimates.

THE MAPI CRITIQUE

The MAPI critique concentrates most of its criticism on the export displacement effects estimated by H–A. This is the problem of calculating the extent to which increased sales by U.S. foreign subsidiaries displace exports by U.S. domestic firms. Before entering any discussion of the substance of the criticism here, it would be well to make some general remarks about the role of this estimate and its significance for the results.

In the first place, as a technical matter, H–A estimates the "export displacement" effect together with the related "associated exports." When a U.S. food firm establishes, for example, a pickle factory in Europe, it may find opportunities to increase its sales of U.S. made food products in Europe under the same brand name, using the same trade outlets. The available data cover fairly broad product groups, so it is impossible to measure these two effects separately. Thus the net estimate here could be either an increase or decrease in U.S. exports

depending on whether the export displacement effect through the reduction in U.S. pickle exports or the associated exports effect through the sales of other U.S. foods is the larger.

Secondly, it is clear that the broad character of the export effect is dependent on whether the U.S. foreign investment is *in addition to* or *instead of* some other investment in the particular line of business in the host county. H–A does not try to estimate statistically which is the case, but instead assumes each case separately and works out the consequences of these assumptions. A common reaction to this estimate is that "in most cases the U.S. companies have to invest in a foreign subsidiary or someone else will preempt the market." This is not basically a disagreement with H–A not only an assertion that their estimate in the reverse classical case is the important one. (This is the case where the U.S. investment discourages another investment that would have been made.) In that situation the export effects are positive; that is, the associated export effect predominates (except for the "rest of the world category" where the H–A result may be dominated by poor data).

Thirdly, H–A offer some general observation about the relevance of the alternative assumptions. They argue that in the advanced countries the investments made by U.S. owned subsidiaries would probably have been made fairly soon by someone else if not by the U.S. subsidiary, because capital is not so scarce there. In the less developed countries it might be a number of years before other capital made the investment. Since the reverse classical case shows the shortest recoupment period, they judge that this is the important estimate for investment in Europe.

Fourthly, H–A conclude that where the U.S. investment is in addition to foreign investment, i.e., the classical and anti-classical case, the recoupment period will be very long and possibly infinite. It must be kept in mind that this folows from the assumption that the U.S. investment is in addition to what would have occurred. This is the assumption which gives rise to export displacement. In view of the considerations in the third general remark above, the H–A judgment as to the significance of this result is not necessarily that recoupment periods for investments in less developed countries are necessarily infinite, but they are something like the reverse-classical recoupment period plus the time lag that would ensue before the investment would have taken place in that country.

Having clarified the issue, we can turn to the specifics of the MAPI paper which is an assertion that H–A overestimate the combined export effects of direct overseas investment. The paper does not so much attack the general strategy of the analysis outlined in the preceding four general remarks as it attacks the estimating procedure. As H–A make clear the procedure is not without its problems. In principle to estimate the effect of increased subsidiary sales on exports from the U.S. we need to predict what these exports would have been without the subsidiary sales. There was not sufficient data about the export market for each product type in each region to make good predictions of this sort.

What H–A does is first to collect a great deal of data on sales by product types for each region. They then expressed the *percentage* share of each of four seller classes, viz.:

Imports from U.S.
Imports from others.
Sales by U.S. owned subsidiaries.
Sales by native firms.

They investigated by multiple correlation how changes in the percentage shares of sales by U.S. subsidiaries and by native firms respectively affected imports from the U.S. Increased shares by U.S. owned subsidiaries generally reduced imports from the U.S. less than did increased sales by native firms (the associated export effect). Thus when sales by U.S. subsidiaries replace sales by native firms, imports from the U.S. generally rise. When the U.S. subsidiary sales are a net addition, the share of imports from the U.S. declines.

The MAPI study calls attention to a number of statistical difficulties with this procedure, difficulties which were discussed for the most part in H–A. They need not be elaborated here. MAPI does not come up with any alternate procedure but is content to estimate that the true export effects were only one-third as large as those estimated in H–A (in some cases even less). Why this fraction, instead of, say, seven-eighths is not clear. No reasons are given. The figure is only presented as the reasoned judgment of the investigator, but the study is unsigned!

Without agreeing or disagreeing with the MAPI conclusions, which are the H–A figures with the export effects reduced, it is interesting to comment on the implications of this kind of change. In the first place this kind of a change reduces the recoupment period under the classical and anti-classical assumptions (where it was very long in H–A) and increases it slightly in the reverse classical (where it was shortest in H–A). MAPI does agree with an 8–10 year judgment on European investment.

When the export effects are reduced as drastically as in MAPI, the recoupment period under the classical and anti-classical assumptions comes all the way down to four years for Canada and Latin America. This may be a reasonable estimate. H–A suggest at one point (page 67) a reason for expecting that the real recoupment periods for Latin America are less than their results showed. Their reason is that these countries have active balance of payments control programs. Any U.S. action which involves a balance of payments loss for the U.S. is apt to be matched by some relaxation of the Latin American control program, which effectively would provide a source of balance of payments gain for the U.S. This kind of reaction is not measurable in the H–A data.

The following material was subsequently submitted by Machinery and Allied Products Institute as further comment on the above subject:

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., January 27, 1969.

Hon. HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments, Joint Economic Committee, U.S. House of Representatives, Washington, D.C.

DEAR MR. REUSS: I am sure that you as Chairman of the Subcommittee on International Exchange and Payments of the Joint Economic Committee, other members of the Subcommittee, and your staff desire that the record developed by your recent hearings on a review of U.S. balance-of-payments policies should be as complete and, if I may use the word, "balanced" as possible.

We feel, first, that some additional material in the form of a critique of certain aspects of the government's program addressed to U.S. balance-of-payments policies is necessary in order to insure that the record is not overweighted with government rationalization after the fact of policies already arrived at. Second, in a more narrow sense, one portion of the total presentation by Assistant Secretary of the Treasury Stanley S. Surrey will be quite misleading without further comment. We request, therefore, that this letter and attachments thereto be included in the printed record of proceedings of your Subcommittee's hearings.

On Monday, January 13 in testimony submitted to your Subcommittee, The Honorable Stanley S. Surrey, then Assistant Secretary of the Treasury, discussed the relationship between tax policy and the current account of the U.S. balance of payments. In the course of that statement, Mr. Surrey commented on a Treasury-sponsored study entitled, "Overseas Manufacturing Investment and the Balance of Payments," by Professors Gary C. Hufbauer and F. Michael Adler, on the balance-of-payments effects of foreign investment. The major purpose of that study was to estimate the time it takes for U.S. capital outflows into manufacturing investment abroad to be recouped in the form of net return flows generated by such investment (referred to in the study, and below, as recoupment periods). Included in his remarks was reference to a critique of the study by the Machinery and Allied Products Institute (MAPI) and a request to submit for the record a detailed discussion, prepared by Gerard M. Brannon, Director of the Treasury Department's Office of Tax Analysis, of that and another critique.

In order that the Subcommittee can have direct access to the document which is the subject of the Treasury commentary, and especially inasmuch as the Treasury failed to deal with the main thrust of our position as developed in that document, we are attaching it to this letter. In general, we feel that the Treasury comment on our criticisms is superficial in substance—indeed almost frivolous in certain respects, although it may be read as implying a good deal more. In this connection, we might point out, for example, that of four and one-quarter pages devoted to a section headed "The MAPI Critique," three only further elucidate upon the Hufbauer-Adler study.

Inasmuch, however, as the Treasury under President Johnson's Administration saw fit to comment on our study for the record, we appreciate this opportunity to respond. We should add that we are refraining from comment on those portions of Mr. Brannon's commentary directed to other critiques because we cannot, of course, accept responsibility for statements other than our own. We have five points to register with respect to the Treasury comments and we will try to keep our responses brief. Four of these points deal with Treasury criticisms of the MAPI study while the fifth is a more general Treasury comment but has relevance to our study.

Summarizing our points:

1. The Treasury does not deal with the central point of our critique which is that the inadequacies of the Treasury study assumptions underlying their economic models invalidate its conclusions.
2. The Treasury was critical of MAPI for not developing an alternative procedure to that of the Treasury. In so doing, they misread the purpose of our critique which was solely to point up the lack of reliability in the Treasury conclusions. Until greatly improved models are developed in this area, government policy makers should rely on other approaches, with heavy reliance on practical experience as to foreign investment.
3. It is implied in the Treasury comments that the balance-of-payments problem is short-term in nature and hence that the absence of near immediate recoupments of investment abroad justifies the imposition of investment controls. We have vigorously opposed this proposition in the past and do so again.
4. The Treasury commentary also indicated that MAPI agreed to a payback period of 8 to 10 years on European investments. Even working within the framework of the Treasury study, our illustrative estimates were shorter than that and industry experience as distinguished from theoretical analysis suggests the strong likelihood that even these estimates may be too long. Further, given the long-term nature of the balance-of-payments problem, both our illustrative estimates and those of the Treasury with respect to Europe support the proposition that investment control programs are self-defeating.
5. Much is made of the fact that the MAPI study was unsigned. This point simply reflects, in our opinion, the Treasury's difficulty in finding any solid grounds for refusing our analysis.

We will now cover these points in greater detail.

Inadequacy of assumptions invalidates Treasury conclusions as to recoupment periods.—Mr. Brannon states "[t]he MAPI study calls attention to a number of statistical difficulties with [the Treasury study's] procedure, difficulties which were discussed for the most part in H–A. They need not be elaborated here."

This misses the central point of our critique which was directed not so much at the statistical difficulties as with the inadequacies of the assumptions underlying the models in the Treasury study. There were statistical difficulties only in the sense that inadequate statistical data prevented, at least in part, the adoption of more realistic assumptions. Our purpose was to demonstrate that these inadequacies invalidate the study's conclusions. Explicit recognition by the authors of many or most of these inadequacies does not change this fact.

MAPI critique intended to assure against government reliance on conclusions of Treasury-sponsored study.—The Treasury made another comment as follows:

> "MAPI does not come up with any alternate procedure but is content to estimate that the true export effects were only one-third as large as those estimated in H–A (in some cases even less). Why this fraction, instead of, say, seven-eighths is not clear. No reasons are given. The figure is only presented as the reasoned judgment of the investigator, but the study is unsigned!"

Again, the main purpose of our critique was to put the Treasury study in proper perspective by pointing up the inadequacy of many of its underlying assumptions and the extent to which its estimates of payback (in balance-of-payments terms) on U.S. investment abroad were overstated as a result. Indeed, a primary purpose was to make it clear that any ratio as high as "seven-eighths" of the alleged export displacement effect would clearly be a gross overstatement of the true effect for the many reasons which are spelled out in our analysis. The development of our own admittedly speculative or judgmental estimates of export displacement were for the purpose of dramatizing the extent to which pay-

back periods were overstated as a result of the authors' dependence on the export displacement effects, and we felt our estimate to be reasonable considering the extent to which the Treasury study's assumptions failed, in our judgment, to accord with reality.

Lack of resources and shortage of adequate data prevented our developing a model, based on our own assumptions, as we pointed out in the study. Indeed a limitation of time and resources explains why we were unable to go beyond an analysis of the export displacement effect as developed in the Treasury study. We selected that element because of its major impact in two of the authors' three models and because of its obvious shortcomings. Our revision of the study's conclusions was arrived at, therefore, without addressing ourselves to the remainder of their analysis which also needs a critical reappraisal.

We feel, quite frankly, given the present state of the art in this field, that more direct approaches such as in-depth interviews with corporate personnel experienced in the international area would provide a basis for more realistic estimates than does the Treasury model. We do not wish to detract unduly from theoretical study work in this field. We encourage it and we hope that efforts will be continued as a follow-on to this one. But at this juncture, such studies should, in our view, be restricted to the type of dialogue that the Treasury claims was the intended purpose of their study. They are by no means ready to be included in the working papers of government's policy-making officials and it is quite dangerous to rely upon them as an actual basis for policy making on its retrospective review.

Disagreement on time dimensions of balance-of-payments problem.—A third point should be raised although it was not directed specifically to the MAPI study. Mr. Brannon, in his general comments, implies that the absence of a "near immediate recoupment" on investment abroad justifies the imposition on an investment controls program. This appears clear from his following observation.

> The U.S. decision to deal with its balance of payments deficit in part by investment restraint did not in fact rest on the conclusion of H-A. There were various grounds for the judgment that in general foreign investment does not involve a near immediate recoupment by the investing country.

This implies, in turn, that the balance-of-payments problems is transient or short in term in nature, a point of view which we have taken issue with time and again. Indeed, we discussed this question in the first two pages of our critique. As to this, we would only stress two points.

First, given present world circumstances, the outlook for our balance of payments over the next decade appears no more promising at this time than it did a decade ago when our payments situation was first recognized to be a problem. We say this despite the balance-of-payments surplus which we enjoyed in 1968 and we assume that the Treasury in President Johnson's Administration would have agreed with our opinion that we are not "out of the woods." Otherwise, they would no doubt have been amenable to dismantilng investment controls immediately. This is hardly the case.

In the second place, if a program to restrain U.S. direct investment abroad along the lines of the present one had been instituted for 1959, we would confront a problem of far greater dimensions today. For the favorable effects on such controls would have been largely or entirely dissipated and we would have no controls programs to fall back on in an attempt to alleviate the situation. (For a statistical analysis underlying this assertion, we refer the Subcommittee to the Suppplement in *The Case Against Balance-of-Payments Controls*, Machinery and Allied Products Institute, 1968, pages 43–67, a copy of which is enclosed for your staff's reference.) A continued extension of current controls to deal with this alleged "short-term" problem which already has been with us for 11 years can lead us into just such difficulties in the future.

Disagreement on recoupment periods.—The Treasury testimony indicated agreement on the part of both MAPI and the authors of the Treasury study that the recoupment period on investments in Europe is 8 to 10 years. This is not correct.

Depending upon which of the Treasury study's models is used, the recoupment period can, if we read the study correctly, range from 6.5 years to infinity on investments in Europe. Our own understanding (based on the authors' comments) is that they lean toward the conclusion that the recoupment period is something over 6.5 years in the case of Europe; it ranges to something over 10 years in Canada and a much, much longer period in the case of Latin America and the Rest of World.

As it happens, our numbers seem in line with those of the Treasury with respect to Europe (although nowhere else). We suggest a recoupment period for Europe ranging between 6.5 and 8.9 years after appropriate reduction of the export displacement effect. But again we emphasize that our estimates were primarily for expositional purposes in order to stress the frequently excessive estimates in the Treasury study and in order to warn against relying on the Treasury study as a basis for policy in this area. Based on our own industries' experience, a payback period any longer than 6.5 years seems excessive. Further, even this period, i.e., a little more than 6.5 years, is, in our opinion, too short to warrant the imposition of controls.

Identification of authorship.—Finally, we wish to take note of the Treasury comment, as quoted above, that our study was unsigned. The Institute does not, as a rule, follow the practice of issuing studies under the signature of staff personnel. However, we are pleased to submit this information to the Subcommittee. The study was prepared by A. B. van der Voort, Economist, with the cooperation and guidance of Richard R. MacNabb, Vice-President and Economist. Both men have not only studied in this area but worked closely over a long period of time with people active in the international field, many of them representing companies with substantial investments in all parts of the world. The study has, of course, my full endorsement based on my knowledge of business practices and practicalities and my considered judgment as to the public policy aspects of private foreign investment.

Conclusion.—In brief conclusion, we would stress two major points:

1. The Treasury-sponsored study should not be permitted to influence or justify a policy of foreign investment controls.
2. In view of the long-term nature of our balance-of-payments problem, current investment controls should be dismantled at the earliest possible date in order to avoid risking even more serious problems for the U.S. economy in future years. To reinforce these conclusions, we attach for the record a MAPI presentation dated January 7 to President Nixon submitted before his inauguration.

Nothing in the Treasury's comments has served to change our viewpoint in either respect and we submit that any independent analysis of the Treasury study would pinpoint the fallacies and difficulties to which we have called attention.

Respectfully,

CHARLES STEWART,
President.

Chairman REUSS. Thank you very much.

On the subject of a travel tax on American tourist expenditures abroad, which was advanced last year, I gather that is a dead issue now, is it not? Is anybody recommending that anymore?

Mr. SURREY. I can't make that judgment. Secretary Fowler in his letter to President Johnson as Chairman of the Cabinet Committee reemphasizes the necessity to commence the long-term effort needed to halt the mounting trend in our travel deficit and the need for adequate budgetary funds to stimulate foreign travel in the United States. There are various ways in which that can be done.

If the present ticket tax were extended to foreign travel that would be one method of raising funds that could be used for this purpose.

Chairman REUSS. Yes, but I was talking about the proposed tourist expenditure tax which I think was the most questionable item in the administration's package a year ago. Is there any life in that yet? I don't find it in Mr. Fowler's statement, frankly.

Mr. SURREY. No; he made no express recommendations and that tax was not given support by either of the two tax committees in the last session of Congress.

Chairman REUSS. And in Mr. Arey's statement for the Department of Commerce you state there "let us remember when we manipulate one side of the economic equation the other side will be affected also. Restrictions will invite reprisals."

I might add that foreign restrictions would fall on the sectors of our foreign trade that have been growing at remarkably favorable rates. You had in mind something like the proposed tax on tourist expenditures there, did you not?

Mr. AREY. Yes, sir.

Also the fact broadly that particularly in this field, the United States through the years has set a different pattern. It has been one of our purposes as a Government promoter, or stimulator, of travel to this country to utilize our way of life to remove barriers, and to increase travel. Anything we do contrary to that is certainly going to raise the gates for other countries to establish similar taxes and similar restraints.

Chairman REUSS. Mr. Surrey, on this very basic question of the effect of domestic taxation on international trade, we are confronted, it seems to me, with some hardening of the lines. If I understand the Germans correctly, they are determined that the rest of the Common Market will adopt their system of value added taxes. Indeed, I think most of the Common Market has already done so.

Mr. SURREY. I wouldn't put it, Mr. Chairman, if I may, on the insisitence of the Germans. The Common Market countries, I think 5 or 6 years ago, simply recognized that they had to harmonize their indirect taxes and they cast about for the most efficient indirect tax they could impose and satisfactorily collect and there was pretty unanimous agreement, that it was the value added tax for them.

Chairman REUSS. Yes.

In other words, it really is not negotiable for us to go to the Common Market and say "Why don't you throw away your value added tax system, it is regressive. Why don't you have a corporate tax system?" Their answer was "we have got that, too. We need them both, and go away."

Mr. SURREY. That is right.

It is not our concern what kind of tax system they should have and it should not be their concern what we have.

Chairman REUSS. I equally get the message from the British that they are going to have to adopt the value added tax, just like the Common Market, so as not to inhibit their exporters. It seems to me, if I understand correctly the attitude of the British Government, they are shortly going to move in this direction. So I would think that the chances of cranking history backward and getting rid of the value added tax system of the Europeans are practically nil. I gather you don't disagree with that.

Mr. SURREY. No, I presume they will continue to be high rate sales tax countries.

Chairman REUSS. So there we are left with our own tax structure. I completely agree with you that it would be ruinous to make the U.S. tax system totally regressive by adding to our State and local structures an across-the-board Federal sales tax. Pursuit of such a course would be a sure way not only to achieve inequity, but also to bring on a repression, when the consumer didn't have enough purchasing capacity to take the products off the market. I am glad that this idea gets the back of your hand, and I hope it will continue to do so. But we are still left with the problem that American exporters are being somewhat shortchanged by the configuration of world taxes.

I also have the feeling that GATT is not the ITO of the ill-fated Havana charter 20 years ago; it is an organization which can put off interpretive matters for a long time. In that light, wouldn't it be wise if we took the bull by the horns somehow or other and just gave a modest rebate to American exporters on some incremental basis? You have said that you can get reasonable economic estimates of up to about 4 percent as the cost to certain industries of the excise taxes we already have on automobiles, telephone calls and so on. These indirect taxes are, of course, just a drop in the bucket. Why not work up some tax rebate for American exporters geared to the increment in their exports to provide some incentive? We could then just tell our friends what we intended to do.

I don't think they would shout about it for more than a few weeks.

Mr. SURREY. Well, I think there are several parts to that question, if I could separate them, Mr. Chairman. One is: Should we make a payment to our exporters? If so, should it be based on incremental exports or not, how should the amount of payment be measured and should it be done unilaterally?

Now, we could simply say there are a lot of indirect taxes that we haven't adjusted for which are reflected in our exports. In other words, we haven't pursued to the ultimate decimal point the reflection of our taxes in our border adjustments and, therefore, we are now going to do it. But the Europeans could then say to us "you know, that happens to be true with respect to us also. We have a number of taxes which we haven't pursued to the last decimal point either." If it is a question of really making sure that each tax is reflected in adjustments made at the border we will end up about the same place we are today because they can go down that line, too.

If we adopt a border adjustment because we want to fully reflect our indirect taxes they can do the same thing because they haven't pursued this approach fully, either.

Secondly, this approach could have a good deal of unfairness because, at best, it would be based only on estimate. If we were to say that this product should get 2 percent and that should get 3 percent and that should get 4 percent, we certainly would have a lot of pulling and hauling as other proposals would be advanced based on the best guesses of other economists about appropriate rates, and none of them are based on very precise data. I am not sure that would be the wisest path to pursue if we want to do something.

The other alternative, it would seem to me, would be, if I take your assumption that we must do something, to say simply that we are going to impose a flat import tax of 2, 3, or 4 percent on all goods coming in and we are going to give a payment of 2, 3, or 4 percent, to all goods going out. It would have nothing to do with trying to reflect fully the last decimal point of any indirect taxes. We would say, "This is simply what we are going to do because we think we are at a trade disadvantage because of your tax system."

To offer this payment on increments in exports could be rather difficult because you are likely to start disturbing patterns of trade to create artificial export increments. Exporter manufacturer A may be exporting through some export merchant, and he might say "I am not going to export through the export merchant any more. I am going to do it myself." In a sense his exports would show a sharp jump

but there would be no increase in total exports. You would have a lot of alterations of patterns of trade, and all the problems about base periods and the like. It would be a complex system very much like an excess profits tax. You never would get a fair base to measure from. These would be the problems if it were done on an incremental basis. Although in a sense I agree with you that you would not want to give this subsidy unless you got something more for it than just our current activity, but you have to balance these problems of an incremental basis against the windfall gains on a nonincremental basis. As to whether the rest of the world would stand still for this or not is a question that I certainly don't want to answer here.

Chairman REUSS. The part that would infuriate the rest of the world, I should think, would not be the 4-percent rebate to our exporters but the 4-percent tax on our imports.

Mr. SURREY. Perhaps.

Chairman REUSS. Why do you have that in your package, to get the money with which to pay the exporters?

Mr. SURREY. In part, and in part if we are doing this to say that we are trade disadvantaged because of the foreign tax systems, we are trade disadvantaged in two ways. Our exports are hampered going into their countries, and their exports to us have incentives. So if we are trying to neutralize the effect of their tax system, assuming, and this is the assumption you made and it is hard to be too dogmatic about it, assuming their tax systems do give them a trade advantage, an existing trade advantage, it works both ways.

Chairman REUSS. I think you would, if you tried to negotiate this parcel, be likely to have much more success if you didn't have the 4-percent surcharge on imports. Based on my conversations with Europeans, it is taxation of imports that puts the flea in their ear.

Mr. SURREY. As I say, your suggestion need not involve the tax customs service or the Commerce Department simply to pay a sum of money to an exporter equal to what the figure should be, set by the appropriate legislation. It has nothing to do with the U.S. tax system. This is the proper way to handle it.

Chairman REUSS. I find one aspect of our tax system today which, I don't think you have mentioned, probably contributes to our poor export-import performance, and I would like your view on it.

It seems to me that whatever may have been said about the 7-percent investment tax credit when it was first put on the book back in 1962—and in any view not much was to be said for it—this is one of the more completely asinine taxes today. It feeds inflation in the most inflationary part of the economy, the capital goods industry; it costs about $3½ million in revenues a year, and by making capital investment superattractive, it tends to make investments for domestic production just that much more attractive.

Why don't we put on your 4-percent rebate for American exporters, repeal the 7-percent investment tax credit, and use the $3 billion or so of additional revenues to pay for the 4-percent credit to exporters. In that way we might unskew things and make business more export conscious. Another possibility would be to keep a part of the 7-percent investment tax credit for export oriented investments, if we could ever determine which ones they are.

But doesn't our existing tax system have, in fact, considerable anti-export bias in it?

Mr. SURREY. No, that I don't see. In fact one basic reason for the introduction of the investments credit in 1962 was assistance to our export trade. I think one tends to forget the situation at that time, and that is that there was considerable concern about the lack of modernization in U.S. equipment for all purposes, and the investment credit was designed to correct what might have been a bias in our tax system against capital investment. At the time capital investment was certainly lagging. The investment credit was a response to the fact that the Europeans had measures of that nature. The whole question in the final analysis is what is the net effective corporate tax rate. The investment credit was designed to lessen the impact of the corporate tax in a way that would encourage investments in modernization and expansion.

Now, that does produce lower costs, and lower costs have an effect on the export trade. So I would not say that in any way the investment credit acts contrary to our export trade. In fact you can tend to put it the other way, if anything. It tends to be a bias in favor of investment in the United States as against investment abroad.

Chairman REUSS. What you say may have been true in earlier periods. But today there has been so much capital investment that we are only using about 82 or 83 percent of our capacity, and we have got unemployment down to a little over 3 percent.

So I wonder whether the investment tax credit today really does help our exports. I would have thought that it creates enough inflation in the heavy industry area so that it could well hurt our exports of engineering equipment, for example.

Mr. SURREY. I would think that the general effect of price structures and inflation on our export trade and on our imports is a matter of general overall fiscal policy, and that the investment credit still serves a function of making sure that we still maintain investment for modernization in the United States. It is comparable with the general incentives along that line in European countries. On the whole, I would regard it really as a factor helpful to trade, a factor also, as I said, which if it works in any direction, works in the direction of making a company decide to put a plant here rather than abroad, so far as our tax system is concerned.

Chairman REUSS. But what about its export potential?

Mr. SURREY. I don't see that other than, as you say, it may have an effect of increasing capital investment, and thus have an effect upon the price structure generally, but I would say that that effect is swamped by the general overall effect of our whole fiscal and monetary policies.

Chairman REUSS. Mr. Brock?

Representative BROCK. Thank you very much.

To switch into a different phase of the tax structure, would you justify for me the continuation of the interest equalization tax?

Mr. SURREY. Well, I didn't come prepared to discuss that, but I would say that the interest equalization tax is a useful device for the United States to have in that it permits the United States to have an interest rate structure suitable to our domestic situation without necessarily having to have the same interest rate structure with respect to

our foreign investment. Consequently in permits us to have suitable policies in both areas.

Now, I am not in a position to comment upon whether at any given time we need this buffer in between the two. Certainly if one wants to move in the direction of lowering interest rates domestically and at the same time wants to guard against a very rapid outpouring of U.S. funds abroad, if the interest rates remain higher abroad than under our lower system, the interest equalization tax gives us a device to handle that.

It also is a very flexible device because the President has the authority to raise and lower the tax rate and consequently he can attune it to the differentials here and abroad. This permits us to accomplish a domestic policy with lower interest rates, when that is suitable to our overall situation, without necessarily having to make our balance-of-payments situation that much more difficult.

Representative BROCK. I think ever since the inception of the tax that such a large portion of our positive balance came from a return on investments overseas and, as a matter of fact, in the last 4 years when our trade balance has gone down from $6½ billion to 1 the return on investments has gone from $5 to $7 billion so it sopped up a third to a half of your adverse trade balance. That is going to wash out one of these days when this keeps our investments from being made over a period of years and we don't get the return on that investment.

Mr. SURREY. I think you have raised a serious question. We do obviously have an inportant asset in our foreign investment and the return thereon, but the difficulty is that in the short run when an investment goes abroad this year, it takes time for that investment to be recouped by the United States, and the short-run problems are different from the long-run problems.

You have to balance out and that is why these things are so difficult. The return which we are now getting is on investments made in the past. Any investments we make this year may not come back for a number of years. What that period of time is is a matter economists debate. If we put something abroad now and it is not going to come back for 10 years, then the immediate impact on our balance of payments is adverse.

Representative BROCK. Would you, any one of you, give me a capsule version of why we have a decline in our trade position right now? Is it, can we pin it on one aspect of the problem as opposed to another? For example, would you put it more on the relationship between tax structure which Mr. Surrey has addressed himself to, would you put greater emphasis on the competitive viability of our businesses as they relate to cost of doing business, prices, wages, raw materials or would you say that the primary factor of late has been more short term, strikes, and so forth?

Mr. MCQUADE. Well, if I may address myself to that, the export performance of the U.S. economy in nonagricultural products has been quite good, but the trade balance, export less imports, has been the thing which has been declining.

I would ascribe the biggest single factor to the high rate at which we have run the domestic economy in recent years, basically that inflationary force which has caused imports to jump up 22 percent over 1967 so far this year. We had a similar jump of over 20 percent in

1966, whereas in the period when we had a reasonably paced economy in 1967 the increase in imports was on the order of 5½ percent.

Now we did this year have some additional problems to which you referred. We had the copper strike which hit both years, as a matter of fact. We had a stoppage on the docks in the early part of this year. We haven't taken into account the current stoppage, as you know. We had buying in anticipation of the possibility of a steel strike. But if you ask whether there is some generic aspect of this, I don't put my finger on a particular one.

It seems to me that the relative rate at which the U.S. economy runs in relation to the rate of the economies which are our major oversea markets is probably the decisive factor over a long period of time in the trade balance.

Representative BROCK. In other words, inflation?

Mr. McQUADE. Whether it is here or there. I think the rate of technological advance, and the rate of industrialization, will all be important too but I would put it most heavily on that factor.

Representative BROCK. I wonder then if you would agree that we seem to be putting more emphasis on short-term solutions to a fundamental problem than we should have? I think our legislative and administrative response to the balance of payments over the last 6 years, with the interest equalization tax and a number of other windowdressing measures, have been largely short-term in nature and effect and yet the problem seems to be a far more fundamental one.

Would you agree that we have addressed ourselves or have not addressed ourselves to the fundamental question of the competitive viability of our economy.

Mr. McQUADE. I am not sure I do agree with you to this extent that we have adopted a number of short-term measures, at least that is the label, short-term, in the interest of giving a period of adjustment the opportunity to function. The fact that we had major outflows on the national security account has been one of the things which might have adjusted itself down but hasn't, as you know.

The fact is that we have had during this period some periods when we have had domestic price stability, which somewhat modifies my easy formulation that in a period of inflation, getting that out of the way is per se a panacea. I don't believe that is true. I think it is the most helpful single thing that you can do but it is not the final answer.

I wish I had a more optimistic view but I am somewhat sympathetic with your notion that consideration of the short-term in a happening of this kind doesn't make sense unless you are moving toward a more long-term equilibrium.

Representative BROCK. The question that I have in my own mind is I don't see you moving toward the long-range solution. I don't see any real effort to address ourselves to that problem but I will go into that later on. I will pass now.

Chairman REUSS. Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Surrey, are you suggesting that the border tax rebate technique is the best alternative available for neutralizing the tax impact on exports, or just one alternative that should be considered by the Congress?

Mr. SURREY. What I was saying was that if we wanted to make a response that involved adjustments at the border—by adjustments at

the border I mean payments to exporters and taxes on importers—there are two ways in which it could be done. One could be to measure the appropriate adjustments by the extent to which we presently do not incorporate all of our indirect taxes in border adjustments.

The other method is simply to say we will choose a figure which we think appropriate to our present situation and use that figure unrelated to taxes. I would think that the second avenue is better than the first. But the question as to whether the second avenue should be used at all though, is a very serious question, first, because it would be trade restrictive, and second, it can have international effects and reactions. For the moment, I would think that a multilateral effort to continue to talk this matter over in GATT is the best approach.

Representative MOORHEAD. Mr. McQuade, in your testimony you also express concern about the structural disadvantages of various tax systems. Do you agree with Mr. Surrey's recommendations for neutralizing these disadvantages?

Mr. MCQUADE. I though he was marvelously clear in how this works, and the difficulty of identifying the quantitative amount of that disadvantage. I share his concern about changing the U.S. domestic tax structure in order to come within the rules of the GATT. To the extent that there is a disadvantage, and you have a quantifying difficulty, it seems to me the United States ought to try to get some adjustments in the rules and practices which other nations observe and in the GATT rules so that we can remove that disadvantage. I believe that there are things that can be done. They could undercompensate, for example, if you could find the magic number to undercompensate, or they might sanction some degree of tax rebate and a border tax for direct tax countries provided they stayed within that range which overcomes the disadvantage.

There may be other solutions but I do think we ought to strive to achieve some degree of equality in this area by some means.

Representative MOORHEAD. Thank you.

Mr. McQuade, in your testimony you say that you expect that exports of agricultural products will be static during the next several years? Is there any reason for that or is there anything we can do to change your expectations?

Mr. MCQUADE. Well, the judgment which is expressed here reflects talking this through with the Department of Agriculture. The problem is that we have competition overseas in the area of exports of the big items which we send forward in our agriculture exports.

I think the absorbability of the markets is being fed partly by our competitors and I think it is probably true that to some degree we may be suffering from a cost-price squeeze although I really don't feel myself competent to give you an answer to that subject which I can stand on.

If you like, we would be delighted to give you a little précis to enter into the record.

Representative MOORHEAD. I think that might be helpful, Mr. Chairman.

Chairman REUSS. Without objection then that will be received.

(Data referred to, subsequently submitted, follows:)

It is anticipated that the contribution of agricultural products to the growth in total U.S. exports will be modest during the next several years, although some increase in their value is expected.

The relatively small gain will probably be centered in feedgrains and soybeans. Rising standards of living in many countries of the world will lead to continued increases in demand for meat which, in turn, will cause an increase in livestock numbers and feed requirements.

A number of factors are expected to dampen the expansion in exports of farm products:

1. *Policies of increased self-sufficiency in Western Europe.*—The Common Agricultural Policy of the European Economic Community has already depressed import demand and swelled exportable supplies. To dispose of these, subsidies are being offered on some products, e.g., poultry and certain dairy products. Unless some change occurs in this policy, U.S. agricultural shipments may be further affected. The United Kingdom has also announced a goal of gradually reducing food import needs.

2. *Stronger competition in world markets.*—Other major exporting countries are planning expansion of domestic production and will have larger supplies available for foreign sales.

3. *Expanding food production in developing countries.*—Expansion of rice and wheat production from new varieties of seed, together with other efforts to increase farm output, may well reduce the dependence of some countries on food imports. This shift will depend, however, on successful programs for population control in many developing nations.

Representative MOORHEAD. Mr. McQuade, in your statement you talked about a change in the international monetary mechanism, particularly going toward more flexible exchange rates. You also list various alternatives.

Which of these alternatives do you feel is the most viable?

Mr. MCQUADE. I think the problem here is that we need to do a lot more work on it before we know their implications, before we adopt them. I am very much an evolutionist rather than a revolutionist in international monetary matters and don't propose to look upon myself as an expert. But I have a feeling we ought to be doing something and the thing that is most important to me is that we act intelligently and with a full appreciation of the consequences rather than leaping to formulas.

My guess is that out of these mechanisms a moderate increment in flexibility should come so that we could move to adjustment without the jerky quality we have had in the last year or two.

I think Secretary Surrey referred to the Germans' acceptance of a change in their border taxes as a system for easing the adjustment process. He said it is a lot harder to get the same here on the deficit side. But I think that is one of the areas where a lot of careful thinking should go. Maybe a closer interrelation between the trade and the payments mechanisms to make the adjustment process function is something which might be possible.

However, if you listen to my words you see I begged off giving you a flat answer because I have too much respect for what is involved.

Representative MOORHEAD. You mention one that is a new one on me, "The self-adjusting crawling peg." What is the self-adjusting part?

Mr. MCQUADE. As you can read from the introduction, I thought the names were more ingenious than the ideas. I was just ticking off all the varieties which I have heard spilled out in the great debates in the last few months. I don't understand how this would work.

Representative MOORHEAD. Mr. McQuade, at one point in the testimony you talk about having the Congress give a mandate for negotia-

tions to end nontariff barriers. What form do you see that taking? I think it is a good suggestion but I don't see what form it would take.

Mr. McQuade. Well, I think that the area of nontariff barriers is a lot more sensitive than the tariff area. Each of them has a rationale behind it which has lots of appeal. The rationale may be a health measure or a safety measure or joint coproduction or binational production, all these varieties of things which are involved in nontariff barriers. I think it is important that there be a common agreement between the Congress and the administration, that the administration can and should go forward to seek to negotiate in these areas. We will inevitably be dealing with things which have high political content here within the United States, and I think it would be important that we don't go out and undertake negotiations unless we had in effect the agreement of the Congress that this is the course they wanted to follow.

I believe the exact agreements would have to be brought back and considered and passed upon by the Congress but I think that many Members of the Congress have objected strongly to undertaking negotiations about items which they hold very dear here in the United States and say we have no authority to do that.

So I would like congressional support for the administration in undertaking a sensitive activity. It could be a resolution or something of that sort.

Thank you, Mr. Chairman.

Chairman Reuss. Mr. McQuade, you and others have, in commenting on the great increase in our imports in the last year—I think it was 22 percent—have put the monkey largely on the back of what you call inflation. I wonder if it is as simple as that, and whether we shouldn't begin to realize that as our economy grows toward full employment, that inevitably we are going to import more goods from the rest of the world. Far from being bad, this increase in imports is good. I noticed in another connection that you talk about how essential it is to our exports that foreign countries grow and remain prosperous, so they can buy more. Well, I should think it works both ways, and that it would be a mistake to develop a cult in America which had the idea that increased imports are in and of themselves bad. I am sure that isn't what you meant.

Mr. McQuade. I fully agree with that. In fact they are very useful in helping curb inflation because they soak up demand.

Chairman Reuss. Exactly.

In fact I can't see any reason for blaming inflation for the 22 percent increase in American imports except insofar as it can be demonstrated that widening price differentials between U.S. commodities and imported goods actually made the difference in consumer preference. I don't know whether anybody has made that kind of a study. But as far as I am concerned, it is a little loose for everyone to blame inflation. I think that what people should be blaming is full employment. If they can separate out certain cases of price sensitivity—in which Americans stopped buying U.S. goods because identical foreign goods became relatively cheaper—then and to that extent, fine. Let's blame inflation for this phenomenon. I have no doubt that inflation operated to some extent. But can you tell me how much?

Mr. McQuade. I don't think we can quantify it. I think I am merely repeating your point here in different words. When you are working at capacity which I think was more the case in 1966 than today, and deliveries are short, people start to buy abroad. In the machine tools in industry particular, I recall it was getting so that the timelag between giving an order and getting something delivered between Cleveland and Milwaukee was getting really long at that time and imports of Japanese machine tools really leaped up. That is one of the varieties you were pointing out.

The other is, I think, when consumers are feeling much better off, that extra European car, for example, which, of course, is one of the major sources of imports, is again something the family can afford. I think their tastes in the luxury area could end up, in fact do, in the small car area, selecting foreign products.

Chairman Reuss. Is that bad? In my book it is not. What are we going to do, impoverish the American consumer so he can't buy either at home or abroad?

Mr. McQuade. I am not urging that. What I am saying is that by and large inflation is unfortunate for domestic as well as international reasons. If it is in the areas where domestic production is at capacity, people are pushed abroad, and with the extra dollars we must expect that some significant part of the allocation may go to buy foreign goods.

Chairman Reuss. Yes, I will wind up this phase of the questioning by saying that I am a little disturbed at the proposition that a high level of imports may be, in whole or in large part, an evil thing. I would feel better if I knew how much of the 22-percent increase this last year in our American imports was due to full employment and higher incomes, which is good in my book, and how much was due to increases in American prices above foreign prices, or due to lengthy waiting periods for deliveries from American producers, which are both bad in my book. If we could quantify these items it would help a great deal. I suspect that of the 22 percent the great inciting force was something good; that is, full employment and higher consumer income.

One of the reasons I feel this way is that there was a tremendous increase in imports of consumer goods. People were buying more hams, Italian shoes, Japanese transistors, and Volkswagens than ever before; the only way I can see to keep the little darlings from buying so much is to start a recession—a method which I don't think is a good one at all.

Mr. McQuade. In 1967 did you consider that to be an appropriate equilibrium or too slow? You have a comparison of a 5½-percent growth of imports in 1967 and 22 percent in 1968.

Chairman Reuss. Yes, I can't account for that rather low growth in imports in 1967, since 1967 was a year of quite notable GNP growth, I believe. All I am saying is that I am really at a loss with these global statistics. If somehow we coud distinguish the real effect of inflation and thus quantify what is going wrong, we would be better off.

Mr. McQuade. It is very hard.

Representative Brock. Would the gentlemen yield? I just saw a chart whenever the U.S. economy reach a growth rate of 5½ to 6 percent that is when the lid flew off of imports. There is some correla-

tion. I don't know that I have ever seen a definitive study as to the exact relationship. But I would say this, I am not raising inflation as the bugaboo of this particular problem. It has adverse effects both domestically and internationally. I think what we are talking about though, the reason I mentioned it, was that I was far more concerned with the long-range implications of this trend than I am with the short-term panaceas we have had over the last 5 or 6 years. I think it is criminal to ignore the fact we may be losing our competitive viability. Let's find out why and let's do something about it. Let's not put windowdressing on it. That is what I am talking about. I am not talking inflation per se. But there are a lot of other factors.

Chairman REUSS. The tables you have just mentioned, Mr. Brock, do show that in years of large growth in GNP, our imports have stepped up. I read these tables the same way you do, but they include years both when there were and when there were not dramatic increases in prices. Therefore, I think they tend to show that it is good old growth in the United States, which we all love, I think, that is causing this import increase. My only point is that we should not really seek to get our trade account into balance by depressing the U.S. economy. I am sure this is a proposition with which you will agree.

Having said that we don't want to cut down on our imports by having a depression at home, nevertheless, there is a way of cutting down on our imports which I find entirely legitimate and glorious but which has not been much used. There has been very little leadership from Government in this area, and I wonder who has the operative authority here.

As I look at those areas of American industry where import competition has become quite severe, I wonder if in many cases a salutary result could not be produced if American industry got off its dime and did something about it. For example, compact cars. The logy American automobile industry did something about those 10 years ago and it worked fine. It brought Mr. Romney to the Cabinet ultimately, but this has all been forgotten now, and one of the worst items in our balance-of-payments account was the enormous number of Volkswagens imported.

Well, who in the American Government is worried about that? Japanese transistor radios—I don't know why American know-how can't produce transistor radios at competitive prices. Italian lady's shoes—I don't see why these shoes can't be produced by American stylists here in the United States. Steel—the oxygen process was invented abroad, but the American steel industry has been awfully slow to adopt it.

You in the Department of Commerce are worried about our exports and that is fine; many others are also worried about our exports. But who in our Government is charged with the job of worrying about valid and nonautarchic import substitution in the United States? I think you could get just as big a bang for a buck of governmental leadership there. Mind you, private industry has to do the main thing. Private industry that has to export, private has to import-substitute. But who is running the grocery store on import substitution?

Mr. MCQUADE. It is a collective problem. I thought I mentioned in my testimony the problem of making deals which won't allow us to use containers, for example, in international transport which is at

issue, as you know, in the dock strike. That troubles me, and I think I made that point.

I personally feel some adjustment in the practices and laws is called for. I think Secretary Surrey was trying to make the case at least that the 7-percent tax credit was designed to foster a greater efficiency in American industry, which is another piece of this puzzle.

I take it that the collective responsibility of all the economic agencies of the Government is to seek greater productivity, to foster that in American industry, by removing impediments and, if necessary, by certain incentives. That may not be satisfactory.

Chairman Reuss. Well, I will sum up this phase of the questioning by saying that it seems to me, without interfering with private enterprise, that someone in the Government ought to investigate this mystery of why the U.S. industry abdicates so many fields to foreign competition. I can't see any reason why we should. When you are talking about Belgian lace or Italian-tooled leather, fine, I would agree, we can't and shouldn't try to compete. But in the fields I have mentioned, steel and compact cars, and electronics and even leather-goods, I don't see why we can't. I think it is a pretty poor performance on our part.

Mr. Brock?

Representative Brock. I guess we can go on for quite a while. I am always interested when we start talking about Government though it seems that almost every area in which Government has become involved we have got a dead industry. The merchant marine is a classic case, and we are back in a strike on the docks again now with that particular group. The Government has been equally involved in the maritime field. They protected our steel industry to the point where it lost its competitive viability. They protected American textiles or at least cotton to the point where the Japanese began to outproduce us there not only providing cheaper cotton, but with cheaper labor.

I think that the danger is that the Government always tries to repeal the law of supply and demand and it has never been able to do it yet. I would hope we would be pretty cautious about any further interference by the Government in the private sector.

Chairman Reuss. I would have one more. A question of Mr. Arey. Last year, when the administration's tax on travel of Americans abroad was proposed. I suggested that we could obtain a similar benefit to our balance of payments by inducing foreigners travel to this country. I suggested that we would be well advised to forget about the travel tax, which would be a form of retaliation, and instead go all out on a program of attracting foreigners to this country by some system of packaged discounts or deductions. The President's industry-Government special task force on travel, headed by Ambassador McKinney, generally adopted that suggestion. It recommended in February 1968 that, and I am quoting from page 24, "the U.S. Travel Service should issue and distribute to foreign visitors hospitality cards entitling holders to discounts on expenditures in this country."

I envisaged whereby putting together all the airlines, hotels, motels, railroads, restaurants, national parks, and so forth, it might be possible to work up a discount which was very close to 50 percent. Then with adequate advertising you could have big signs on the Champs Elysee saying, "Once in a lifetime opportunity—visit the United States at

half price." You could make this whole trip for $700, Dusseldorf to Dusseldorf, "And just stop by at your nearest U.S. travel service or U.S. consultant and get your handy discount card."

Well, what happened to that? In fact our performance in inducing extera foreign travelers last year, 1968, was not particularly glorious. It was on the order of 5 percent, which isn't a fiasco, but neither is it a dramatic breakthrough. Why didn't we implement that recommendation and what are the chances of implementing it quickly for the 1969 season?

Mr. Arey. In responding to that particular question, Mr. Chairman, I would also like to keep in mind that comments of Mr. Brock regarding the development of short range approaches to our balance-of-payments problems.

The U.S. Travel Service when it was created by Congress in 1961, I think, was created as a definite long-range program, keeping in mind the scope of the problem and the opportunities in this field and realizing that international travel, the flow of international travel in whatever direction, cannot be cut on and off like a faucet. Without the cooperation of the private sector, without the very diverse travel industry rallying around the relatively small Government program in this field, the effort so far could not have been the success it has.

First, let me say that last year the travel service was assigned the responsibility for implementing abroad the discount program as drawn up by the presidential task force. There were over 3 million what we call hospitality discount cards issued and distributed around the world. The program ran into some difficulties in that we attempted within the space of a few months to provide travelers from all areas of the world with a personal identification entitling them to certain discounts after arrival in the United States.

At the same time the task force made an effort to contact industry throughout the country catering to travelers to draw up the discounts that would be rendered. As a result several thousands of discounts were established—very fine discounts. But there arose the problem of the individual traveler not knowing just exactly what his individual identification, his hospitality discount card, entitled him to after arrival.

But despite this problem, we have evaluated the program as having been very effective last year in its role in increasing the volume of travel to the United States.

While it is true that a 5-percent increase in 1968 over 1967 is not dramatic we did have a dramatic increase in each of the preceding 3 years. Thus, the 1967 increase was dramatic indeed, partly because of the flow of travel that was sold through this country en route to and from Expo '67.

Despite the large 1967 base, despite the difficulties in France that caused a dramatic decrease in travel from that country and thus one of our largest markets, despite difficulties last April and May in this country giving us our first minus month-to-month comparison in sometime we still are coming out with a 5-percent increase. And we feel that, while maybe not dramatic, it is a good increase, and that the expenditure figure of our visitors again has grown at a faster rate than has the expenditure figure for our citizens traveling abroad.

But as the number of visitors has grown in number, as they have become more visible, and, I think appreciating the value of a coordinating force in the travel field by government, private industry has been willing to come across with some very fine discounts, especially for the visitor from abroad.

We are just launching this month for the year 1969, a new discount program, and the identification of the individual traveler will be by his passport rather than by trying to distribute these cards throughout the world. We will promote those discounts that are uniform throughout an industry, those that can be marketed abroad and those that can be easily understood by the traveler, and those that can be serviced by the individual industry elements in this country when someone appears and applies for a discount.

So we think we have found a way within our present resources and jointly with industry to have an effective discount program this year.

Also we feel that——

Chairman REUSS. May I interrupt you to say that the main focus of that discount program will be Western Europe, I would hope, because that is where the opportunity lies, in my judgment.

Mr. AREY. That is true. Of the overseas areas Western Europe does rank high in generating tourists to the United States and due to its concentration faciliates good coverage of our promotional campaigns. However, it must be remembered that Canada provides the United States with the greatest number of questions each year; and the Mexico-Central America-West Indies area ranks second in generating visitors to the United States.

Our effort definitely is greater, our promotional efforts are greater, in Europe, and that is where the greatest effort will be made and greatest effort will be made working directly with travel trade.

We will be making quite an effort, particularly in Japan. The increase in travelers from that area of the world has been dramatic in the past year. Whereas there was this dramatic decline in France and a smaller number from some areas, we are coming out probably with a 26-percent increase from Japan, and that establishes Japan as our third largest market by individual countries. So we will be promoting these discounts there.

Just one other point in connection with discounts. We feel that there should be some type of incentive program but that the incentive program can be most effective, at this point in time, by directing it at the travel sales outlets abroad, to those sellers of travel locally who are not actively selling the United States as a destination to the extent that they are selling and promoting other areas often because they know them better. We feel we can perform a service in giving them some support in knowing this product better and having information about it. Also there is proposed an amendment to the International Travel Act of 1961 which would give us the authority to conduct, with private enterprise, incentive merchandising plans where we could provide U.S. products as an incentive to a retail travel agent abroad based on the increased volume of business.

Chairman REUSS. Well, I wish you well with the notion of package tours at a discount because there is a tremendous market which has hardly been tapped.

Any further questions? If not, thanks to you, Mr. McQuade, Mr. Arey, and Mr. Surrey for your great helpfulness. And good luck to all of you. Thank you.

We will stand in recess until 10 a.m. tomorrow in this place.

(Whereupon, at 12:25 p.m., the hearing was recessed to reconvene, 10 a.m., Tuesday, January 14, 1969.)

A REVIEW OF BALANCE OF PAYMENTS POLICIES

TUESDAY, JANUARY 14, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND
PAYMENTS OF THE JOINT ECONOMIC COMMITTEE.
Washington, D.C.

The Subcommittee on International Exchange and Payments met, pursuant to recess, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss and Moorhead; and Senator Proxmire.

Also present: John R. Stark, executive director, John R. Karlik, economist, and Douglas C. Frechtling, minority economist.

Chairman REUSS. Good morning. The Subcommittee on International Exchange and Payments of the Joint Economic Committee will be in order for continuation of its hearings on U.S. balance of payments policies.

This morning we are going to study the matter of government balance of payments expenditures. We are privileged to have with us Mr. William S. Gaud, Administrator of the Agency for International Development; Assistant Secretary of Defense, Robert C. Moot; and Mr. Peter Passell of Yale University——

Representative MOORHEAD. And of the 14th Congressional District of Pennsylvania.

Representative REUSS. And of the 14th Congressional District of Pennsylvania, in both of which you follow an illustrious member of this committee.

First of all, each of you has submitted papers for which we are grateful. They will all be received into the record in full. I would now like to ask each one of you to proceed in whatever way is convenient for you, possibly by summarizing the more important points of your papers, and I will call first on Mr. Gaud of the Agency for International Development.

STATEMENT OF HON. WILLIAM S. GAUD, ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT, DEPARTMENT OF STATE, ACCOMPANIED BY PAUL CLARK, ASSISTANT ADMINISTRATOR FOR PROGRAMS AND POLICIES, AID

Mr. GAUD. Thank you, Mr. Chairman. I am very glad to have this chance to discuss the relationship between our economic assistance programs and the balance of payments. This is a subject which has been very much on our minds in recent years, still is, and, I am sure, will be in the foreseeable future.

It is, relatively speaking, a new issue. During the Marshall plan period and in the 1950s, the balance of payments was not a critical issue in the AID program and we spent our funds where they could buy the most—where prices were the lowest. The result was that by 1960 only 41 percent of our AID dollars were being spent for U.S. goods and services.

But about that time, as the balance-of-payments situation began to get worse, we began to tie our aid to U.S. procurement. Since then we have built up a rather elaborate system of restrictions designed to minimize the balance-of-payments costs of the AID program. These restrictions, unfortunately, have also diminished some of the benefits of the AID program. I would like to talk first about what we have done and then discuss briefly what the effects have been.

There are various ways to measure the impact of the program on the balance of payments, but let me start with the gold budget. Our program affects the balance of payments primarily two ways—one resulting from overseas procurement of commodities and the other resulting from our need to pay part of the local costs of projects in some developing countries.

As shown in the gold budget, in fiscal year 1961, our overseas expenditures totaled $982 million. By fiscal year 1968, the gold budget outflow had been reduced to $178 million, or only 8½ percent of our total expenditure. Now, this has been achieved in very large part by the simple expedient of tying our procurement of commodities to U.S. sources.

As far as the financing of unavoidable local costs is concerned, if we simply bought local currency with dollars to cover these costs, we would cause a dollar outflow. What we have moved to in recent years has been using special letters of credit, which are accepted by host country central banks in return for deposits of local currency which we can use. The funds represented by these special letters of credit can be used by the host country only to finance imports of U.S. origin.

Now, I have said that we have reduced the direct dollar outflow from our program to $178 million in fiscal year 1968. Let me say what this is made up of.

First, about $37 million is from offshore commodity procurement under old loans and grants made before we instituted our tying procedures. This will fall from $37 million in fiscal year 1968 to about $11 million in fiscal year 1970 as these old loans and grants are worked out. Of course, in time, this item will disappear altogether.

There are also about $63 million representing overseas spending by U.S. employees. These can't be tied because of article 8 of the IMF Agreement, which bans convertibility restrictions on member countries' current account transactions. About $12 million is our own AID overseas administrative expenses to which article 8 also applies.

Next, there are about $17 million in cash grants that we make under the program, primarily in Laos, where there is a multilateral exchange operations fund financed by five countries including the United States. Incidentally, that is a very significant figure—that $17 million. Many people think that AID makes a practice of giving money to countries that we are helping. It is only $17 million in cash at the present time out of our entire program.

About $20 million is for certain local costs of contractors and for programs such as American schools and hospitals; $20 million is expenditures by the Social Progress Trust Fund, representing funds that were obligated before the tying procedures were applied to this fund.

Lastly, about $20 million of our total contributions to the United Nations organizations had to be spent overseas.

These figures aggregate to $189 million; $11 million of these costs are paid for by excess currencies, so that the net gold budget outflow is $178 million.

Except for the reduction which will result as some of our old loans and grants are paid out, I think we are just about down to the irreducible minimum of what we can do to limit our direct expenditures overseas.

Now, if you want to take into account $259 million in repayments of interest and amortization on our loans in fiscal year 1968, we had a net inflow for the year. These receipts will increase in the next few years as more loans become due.

Now the gold budget tells only part of the story. What about what you might call real life? What's the real impact on our balance of payments if you take into account indirect dollar flows? To what extent do our AID-financed exports substitute for normal U.S. commercial export sales? It is obvious that there is some substitution. For the last few years we have been working to achieve what we call additionality; that is, we have been trying to devise ways to prevent our AID exports from substituting for imports which these countries would make with their own free foreign exchange if they were not getting aid from us.

We have taken a number of steps to try to increase additionality. They are listed in my statements. The main one which we have come to lately is to allow recipient countries to buy only specific items from the United States with AID funds. These are items in the main which they would not normally import from the United States. We call this a positive list. Working in conjunction with Commerce and Treasury, we try to devise a list for each country which will give additionality.

We have also concerned ourselves with trying to finance items which will create a follow-on demand for future imports from the United States such as industrial spare parts and the like. We have tried to get these countries to remove discriminatory barriers against U.S. goods, and to take a number of other steps to increase imports from the United States and thereby provide additionality.

Now, how successful have we been? Additionality is hard to measure. About the only way we know to measure it is to examine the trends in the U.S. share of commercial imports in a particular aid-receiving country. We have made some aggregate studies of this. We have also made studies of the situation in individual countries.

It looks to us—this is very rough, necessarily so—that in 1963–64, the substitution of AID goods for commercial imports was about 10 percent. In 1966–67, the last year for which we have satisfactory figures, substitution seems to have fallen to about 2 percent.

I want to emphasize that I don't put any great credence in the precision of these figures, but they do indicate a trend. From everything that we can see, the United States has not only maintained but has increased its share of the commercial export market in the AID-recipi-

ent countries taken as a whole. The situations in individual countries vary.

Now, you asked us, Mr. Chairman, to try to estimate what AID's total effect, direct and indirect, on the balance of payments has been. I have a table here in my statement, table III, in which we attempt to give a picture of this for the last 4 years.

On the outflow side, we have started with the gold budget. We have then added estimates of the extent to which it looks as though aid displaces U.S. commercial exports. We have taken into account the full amount of the Special Letters of Credit that we have issued. These outflows have decreased to a very considerable extent over the last 4 years.

What are the offsets—balance-of-payments inflows attributable to AID? First, there are the direct receipts of payments on outstanding loans. Then there is the respending effect—what we get the second time around or third or fourth time around—as some AID money spent overseas comes back to the United States for the purchase of exports. We have given the best estimate that we could of the amount that returns to the United States. Then to some extent, our aid induces economic growth in these countries, which results in increased exports from the United States. We have estimated these exports on the basis of another staff study. Taking all of these inflows into account, as the bottom list shows, there isn't any net adverse effect of the AID program on the balance of payments.

Again, I want to emphasize that there is a fair amount of crystal-ball gazing in here. It is very hard to measure exactly, but we have done the best we could.

What would have happened if we had not followed these policies? First, suppose we had not introduced effective tying in the early 1960's. If that were the case, we would suppose that, as was true back in 1960, only about 40 percent of all of our commodity credits would have been spent in the United States. The direct impact on gold budget outflows might have been an increase of about $800 million a year for the last 4 years. If you take into account your indirect respending effects, we estimate that the net increase in balance-of-payments costs might have been about $500 million a year. So that is the amount that we estimate that our tying policies have saved us in balance-of payments costs.

Now, what about all this additionality business? How much has that saved us? If we take the rough estimates that I mentioned earlier of 10 percent substitution in 1963–64, apparently reduced to around 2 percent in 1966–67, and assume that substitution, remained at 10 percent, this would indicate that all of our additionality efforts have saved us about $35 million a year over the last 4 years, which isn't much.

Now, these efforts have been made at some cost to the AID program. I think it is important to recognize what these costs have been. In other words, to what extent has our effort to be kind to the balance of payments interfered with the effectiveness of the AID programs? I particularly want to draw your attention to certain points.

First, if you tie AID funds to procurement from positive lists of commodities which are not internatinally competitive, you reduce the value of the AID dollar. The money doesn't go as far, because these

countries are buying goods for which they sometimes are paying 10 to 40 percent more than they would pay if they got them somewhere else. This is a serious budgetary cost for us and for the receiving country since it reduces the benefit the country gets from the aid.

Secondly, if you are going to persuade, induce, cajole these countries to switch imports from foreign sources of supply to the United States the most effective way to do this is through import and exchange controls. AID has always taken the position that such controls are serious obstacles to development. It has been one of our goals to encourage removal of these controls, to encourage the free operation of market forces. In this sense, we are working against ourselves when we try to get these countries to switch from their natural sources of supply.

Sometimes our positive lists have been so limited that countries couldn't draw down available funds at a reasonable pace. This slows the processes of development. This has been true, for example, in Chile, in Colombia, and in Tunisia.

Also, we have frequently had to divert attention from negotiations on self help, on reform measures, and other important development objectives, and spend many weeks and a good deal of leverage arguing with these countries about additionality. I feel very strongly that in many cases, if you are looking at this thing from the standpoint of development, our balance-of-payments policies have forced us in the U.S. Government to spend too much time and too much energy talking with aid-receiving nations about the wrong subjects. We dilute the leverage that we have for development objectives by trying to achieve these other objectives.

Finally, I think there is a real risk that, if we carry our additionality policies too far, we may actually harm the U.S. longrun export situation. The reputation of U.S. goods is hardly enhanced in the eyes of other countries when they are forced to buy uncompetitive products on restricted positive lists.

I think we have done what we had to do in the last few years. I think we should have done it. But the important point is that tying does most of the job. Tying has perhaps saved $500 million a year. These additionality measures have saved much less—$35, $40, $45 million a year. So I submit and I feel very strongly that as balance-of-payments pressures ease, one of the first places to relax present restrictions is in the drive to achieve full additionality in the AID program. The cost to the balance of payments would be modest and the benefits to our efforts to stimulate growth of developing countries would be very large.

I don't think any discussion of the relationship of AID to the balance of payments would be complete, Mr. Chairman, without saying just a word about the longrun benefits of AID in this area. Because of the work of AID-financed technicians and contractors using U.S. products abroad and the introduction and wide use of U.S. commodities, AID is indeed a precursor of trade, AID opens the way to future trade which has a very beneficial effect on our balance of payments. This is quite clear from the rising trend of exports to countries such as Greece, Israel, Taiwan, Libya, and Iran, which are no longer getting aid from us. U.S. non-AID exports to these countries have grown by 100 percent between 1960 and 1966, while exports

to all less developed countries have increased by 42 percent. We see the same thing in the trend of rising exports to Korea, and other countries that are making progress in development. So the AID program has a very real direct effect on the balance of payments.

I would like to close, if I may, Mr. Chairman, with just a word of summary. It is perfectly clear from this discussion that our economic aid appropriations would go further—that they would accomplish more—if we didn't have to worry about the balance of payments. But we do have to worry about it. We will continue to have to worry about it. The question is how far we should go in trying to lessen the impact of the AID program on the balance of payments. Should we give absolute priority to measures that will reduce still further the adverse effect of our AID programs, or are the objectives of those programs sufficiently important to justify some balance-of-payments costs?

It is my opinion that we have already gone as far as we should go in trying to minimize the balance-of-payments costs of the AID program. I believe we have reached, if we have not already passed, the point of diminishing returns, the point where the damage to the program exceeds the gain to the balance of payments.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Gaud follows:)

PREPARED STATEMENT OF ADMINISTRATOR WILLIAM S. GAUD

Mr. Chairman and members of the subcommittee:

I appreciate this opportunity to discuss the relationship between our economic assistance programs and the balance of payments. This is a subject which has been very much on our minds in recent years, and still is.

The primary purpose of AID is development. For nearly two decades, assistance to less developed countries has been a major element of U.S. foreign policy. Helping poor countries to help themselves has been recognized as a goal important to the safety of our nation and the well being of our own people.

There is impressive evidence that our foreign aid programs have helped improve the world we live in. Already a few less developed countries have reached the point where they no longer need assistance from AID. Many of those remaining have made substantial progress in increasing food production and reducing dependence on aid.

In carrying out an aid program we must be conscious of our other national concerns—one of these being the balance of payments. We have adjusted the AID program more and more to minimize its balance of payments costs.

During the Marshall Plan and most of the 1950's, the balance of payments was not a critical issue. Aid appropriations were generally spent wherever prices were lowest. For the first few years after the war, the United States was the only major source for most of the goods needed by U.S. aid recipients. Consequently, most aid dollars were spent in this country even though they were not tied to U.S. procurement.

This situation changed dramatically as the European countries recovered and became increasingly effective competitors. By 1960 only 41% of our aid dollars were being spent for U.S. goods and services. In order to improve the U.S. balance of payments, we began to tie our aid to U.S. procurement. Since then we have built up a more and more detailed system of restrictions, designed to minimize the balance of payments costs of AID's program.

AID's Direct Impact on the Balance of Payments

Let me start by examining the *direct* balance of payments effects of the AID program. By this I mean direct expenditure of dollars for goods and services outside the United States. These direct effects are shown in official accounts commonly called the Gold Budget (See table I). In my opinion, our tying procedures have reduced these direct outflows to an irreducible minimum.

In fiscal year 1961, overseas expenditures by AID totaled $982 million, about 54% of our total expenditures. As a result of effective tying, by fiscal year 1968 the Gold Budget outflow had been reduced to $178 million, or 8.5% of our total expenditures.

This reduction has been brought about by tightening procurement and financing regulations and making increasing use of local currencies instead of dollars whenever possible. We have taken several kinds of actions.

The most important step has been to tie AID procurement of commodities and services to U.S. sources. Since 1959 development loans have been tied. In 1960 procurement under grants was restricted to the U.S. or the developing countries, and subsequently to U.S. sources only. Selection of contractors and experts whose services are to be paid for in dollars has been limited to the United States except when the needed service cannot be obtained here.

Measures have also been taken to limit negative effects on the balance of payments of those local costs which we must still finance to carry out our program, and which recipient countries are not able to pay for as a part of their share in our aid effort. AID-financed local costs are primarily for support of U.S. personnel employed in overseas technical assistance projects and for unavoidable procurement of some local supplies and other administrative expenses. In some countries, AID has also financed part of the local costs for certain priority projects—such as in agriculture and education—where these projects could not not otherwise go forward.

Instead of purchasing local currency directly with dollars to cover such local costs, AID has used specialized financial instruments known as Special Letters of Credit. These Special Letters of Credit are accepted by host country central banks in return for deposits of local currency which AID can use. However, recipient countries may use these Special Letters of Credit only to finance imports of U.S. origin.

In the excess currency countries—where U.S. holdings of local currency from PL 480 sales greatly exceed U.S. needs—AID purchases from the U.S. Treasury local currency which the U.S. already owns.

As a result of the above measures, AID has reduced the direct dollar outflow from its program in fiscal year 1968 to $178 million. (See table II). This figure consists of:

$37 million 2% of AID-financed commodities) for offshore commodity procurement. Most of this is from old, untied loans or grants. This outflow is expected to fall to $11 million in fiscal year 1970, as expenditures under these old loans and grants continue to decline.

About $63 million of overseas spending by U.S. employees, which cannot be tied because of an IMF article banning convertibility restrictions on member countries' current foreign exchange earnings.

About $12 million of overseas administrative expenses, to which the same IMF article applies.

$17 million in cash grants—mainly in Laos, where special circumstances call for a multilateral untied fund with other donor countries to stabilize the Laos currency.

About $20 million for certain local costs of contractors and for programs such as American schools and hospitals, where excess currencies were not available for this purpose.

About $20 million in expenditures by the Social Progress Trust Fund of the Inter-American Development Bank. These are expenditures of funds obligated before 1964 when we began tying our donations to this Fund.

Some $20 million of our contributions to U.N. organizations which had to be spent overseas for the first time in several years.

Use of excess currencies provided an offset of $11 million against these items, reducing the final Gold Budget outflow from $189 to $178 million.

We think that this is about as far as we can go in our direct Gold Budget outflows, except for further modest reductions as old, untied loans and grants are drawn down.

As measured by the Gold Budget, almost 92% of our total expenditures last year were in the United States. When we allow for $259 million of receipts of interest and amortization on previous loans, we had a net dollar inflow of about $81 million. We expect this net inflow to continue to increase in the next few years.

25-765—69——7

Indirect Effects on the Balance of Payments

Tying alone, however, does not forestall *indirect* dollar outflows. Such indirect outflows occur when AID-financed exports substitute for normal U.S. commercial export sales. Recipient countries may use AID credits partly for purchases they would have made with their own free dollars. To the extent that this happens, some commercial U.S. exports will be displaced, and there will be an indirect loss on the trade account of our balance of payments.

In free-enterprise economies, it is not host governments that do the importing, but rather local importers who must act according to commercial motives to remain in business. Some substitution must, therefore, be expected. It can be avoided entirely only if inducements or controls cause importers to divert some purchases from normal sources to U.S. suppliers.

Attempts To Gain Full Additionality

Increasingly over the last four years AID has sought by various means to prevent any substitution. We have tried to ensure that AID-financed exports were fully additional to U.S. commercial exports.

Beginning in 1964, special provisions were written into a number of loan agreements which required that the funds be used only for imports in excess of the recipient country's normal marketing requirements for certain commodities, such as fertilizer. In 1965, we further modified our financing policies to include U.S. export promotion as an explicit criterion for selecting capital projects and commodities for AID financing. Moreover, we have been giving increasing weight to choosing capital projects which have a "follow-on" export potential.

We first began to use negative lists for additionality purposes in 1966. These were lists of commodities which could *not* be financed with AID funds. Negative lists had always been used to bar certain imports, such as luxuries. Then items were added for which the United States was already a major supplier. The object was to reduce substitution by forcing a recipient to purchase commodities other than those it usually purchased from the United States.

In 1967 we first used positive lists for additionality purposes—that is lists of commodities which were the only ones which *could* be financed with AID credits. We are moving to this new policy as rapidly as possible in countries receiving program loans.

Commodities on these lists are selected jointly by AID, Commerce, and Treasury according to several criteria. We attempt to identify particular commodities where we believe we have a competitive advantage, but which are not yet well represented in the recipient country's markets. We also seek to finance items which will engender a follow-on demand, often for industrial spare parts. For the most part, however, positive lists are made up of commodities in which the United States is relatively less competitive, and which we would otherwise be unlikely to export in any great volume.

In order to ensure that AID credits restricted in this way are absorbed, recipient governments must take collateral measures to induce local importers to shift their purchases to U.S. suppliers. We try to bring about removal of any discriminatory barriers to the import of U.S. goods. In addition, where credit is very scarce, recipient governments may give easier credit terms for imports from the United States or permit importers of U.S. goods to make smaller down payments. They may selectively reduce tariffs in such a way as to favor U.S. exports. In countries with import and exchange controls licensing may be used to favor U.S. exports so as to ensure additionality. All of these efforts, except the removal of discriminatory barriers are restrictions on the operation of free market forces.

AID works closely with the Treasury and Commerce Departments to devise additionality measures as conditions of particular loans. Since 1967 an "Additionality Working Group" of the Cabinet Committee on the Balance of Payments has attempted to extend and refine these approaches to additionality.

How Much Additionality Has Been Achieved?

Additionality is usually measured by examining trends in our share of commercial imports of commodities by a particular recipient country. These measurements are rough since it is difficult to determine whether changes in commercial market shares are due to substitution or to other factors, such as changes in relative competitiveness. The results are probably less reliable for individual countries than for a group of countries considered together.

A study examining *aggregate* U.S. commercial exports in all major countries receiving AID assistance, and comparing them with exports projected on the basis of pre-tying commercial market shares, suggests that substitution has been small and falling. Taking 1958–60 as the base period (before tying or additionality efforts), it appears that in 1963–64 substitution was about 10 percent. By 1966–67 it seems to have fallen to about 2 percent. Such calculations are not precise, but they do suggest some success in our efforts to achieve additionality. The trend is clear, in any case, that the United States has maintained its share of the commercial export market in the aid-recipient countries.

In another calculation, we analyzed 1967 market shares in twelve individual recipient countries. Of these twelve, we found only three—Colombia, Turkey and the Dominican Republic—where the U.S. commercial market share had declined significantly since 1958–60. In Colombia, however, the decline in U.S. commercial exports was double the *total* AID–financed exports. It is clear that factor other than substitution were at work. In two of our biggest recipients—India and Pakistan—the United States maintained its commercial market share even while AID inputs were rising. In two other countries—Thailand and Vietnam—the U.S. has actually increased its earlier commercial market share significantly while providing large volumes of aid.

The record is less impressive with respect to the additionality of Special Letters of Credit used to tie local cost financing. These Special Letters of Credit are difficult to tie effectively since they are typically issued in countries where there are few import or foreign exchange controls, and where the government therefore cannot divert imports from other countries to the United States to prevent substitution.

Despite our attempts to achieve full additionality, there is some indirect outflow of dollars attributable to the AID program. On the other hand there are other important indirect effects which has a favorable effect on the balance of payments.

One we call the respending effect. Respending is increased U.S. export sales that result from AID dollars spent abroad. AID dollars that enter the economy of a recipient country may later be used to buy goods from the United States. Or they may go through trade channels to a third country which will use them to purchase goods here. Although experts differ on the size of the respending effect, AID's calculations suggest that about half of AID's direct and indirect dollar outflow eventually returns to the United States.

Economic assistance from the United States and other surces is in large part responsible for the growth of the developing countries. As a country grows, its imports increase. We have calculated that about 20 percent or about $380 million of increased U.S. exports to the developing countries between 1960 and 1965 moy be attributed to economic growth induced by U.S. assistance.

Total Direct and Indirect Effects on the Balance of Payments

In your letter, Mr. Chairman, you asked me to try to estimate AID's total effects—direct and indirect—on the balance of payments. Table III gives a rough estimate for the last four years.

The first column in the outflows shows the direct costs in the Gold Budget. These have been falling, from $335 million in Fiscal Year 1965 to $178 million in Fiscal Year 1968.

The next kind of outflow is indirect costs from substitution of commodities. Using the overall additionality percentages discussed above, it appears that these costs were somewhat over $100 million in fiscal year 1965, and had fallen to around $25 million in fiscal year 1968.

The third kind of outflow is for substitution under Special Letters of Credit. In the table we have simply entered their gross value without considering any respending. This outflow amounted to $100 million in fiscal year 1968.

But there are offsetting inflows too. First, there are direct receipts from interest and amortization from past AID loans. These have gradually risen from $173 million in fiscal year 1965 to $259 million in fiscal year 1968.

Second, we estimate that about half of any Gold Budget outflow or any substitution will come back to the United States for increased purchases of U.S. goods and services by recipient countries and third countries through respending. Since gross outflows were falling over the period, respending probably also fell from about $255 million in fiscal year 1965 to about $145 million in fiscal year 1968.

Finally, roughly $75 million a year in increased exports can be attributed to that portion of income growth in recipient countries which stems from U.S. aid itself.

Thus the overall picture of AID's impact on the balance of payments, considering both direct and indirect outflows and inflows, has shifted from a small net outflow in fiscal year 1965 to a net inflow of roughly $175 million in fiscal year 1968. We expect this net inflow to rise further, principally because of growing receipts of interest and amortization.

Alternative Policies

It is rather difficult to say what the record would have been if we had not followed the policies we did. But let me begin making two assumptions.

First, if we had not introduced effective tying in the early sixties, we could reasonably expect that only about 40% of all commodity credits would be spent in the United States, as was the case in fiscal year 1960.

The direct result on Gold Budget outflows might have been an increase of about $800 million a year from fiscal year 1965 through fiscal year 1968. Taking into account indirect respending effects, the net increase in balance of payments costs might have been approximately $500 million a year.

Second, let us assume that we had continued tying but had not imposed additionality restrictions since 1964. Accepting the validity of the 10% substitution figure which we calculated for 1963–64, and taking respending into account, it appears that all our additionality efforts only saved us about $35 million a year over the last four years. It is striking that the balance of payments benefits of additionality efforts are so much smaller than those of the original tying.

Some Related Programs

Let me mention briefly two programs important for development abroad—multilaterial banks and private investment flows. In both areas, significant steps have been taken to limit U.S. balance of payments costs. However, tying and additionality efforts have rightly not been carried quite so far as in AID, because of other important U.S. purposes in these fields.

In the Inter-American Development Bank (IDB) and the Asian Development Bank (ADB), U.S. contributions to ordinary capital are untied, like those of other member countries. U.S. contributions to the Special Funds of the IDB are tied, however, and proposed contributions to the Special Funds of the ADB will be tied. Bond sales in the U.S. market by the IDB and the World Bank to raise ordinary capital are not tied. But the managments of these banks, in consultation with the Treasury Department have sought to limit the net foreign exchange cost of their operations.

Finally, contributions of all the donor countries to the International Development Association have traditionally been untied. For the IDA replenishment now before the Congress, however, a special arrangement has been negotiated. It provides that during the first three years of the replenishment period, or as long thereafter as other contributions are available, U.S. contributions will be drawn down only to the extent of IDA-financed purchases in the United States. I certainly hope that as our balance of payments strengthens, the United States will not again have to ask for such special treatment. A multilateral institution like IDA ought to be able to operate worldwide without this kind of restriction.

Overseas private investment by U.S. business firms is also crucial to development in poor countries. The transfer of technology, growth of financial and managerial skills, expansion of commercial activity, and mobilization of local resources associated with private investment are as important as the transfer of capital.

Private investment flows have averaged $1.2 billion annually in recent years—about a third of total U.S. public and private flows to these countries. AID programs such as investment guaranties and investment surveys have helped stimulate part of this flow. While for the most part it has not been practicable or desirable to tie private investment explicitly to U.S. procurement, such investment clearly generates initial orders for U.S. equipment and construction services, and then follow-on orders for U.S. raw materials, spare parts and components.

The Commerce Department's system of private direct investment controls, which the committee is considering tomorrow, of course limits the balance of payments cost of such flows. I am pleased that from the beginning, the system has been designed to permit an increase in U.S. financing of investment in developing

countries while reducing investment in the developed countries. The limit on private investment in less developed countries has been set at 110% of the base year level. This is considered a target as well as a ceiling. Moreover, as Commerce Undersecretary Bartlett stated in announcing the 1969 program, ". . . In keeping with the Administration's desire to encourage increased private investment in less developed countries, special consideration will be given to applications from companies which are considering developmental projects in less developed countries but which have insufficient investment quotas and cannot arrange foreign financing in compliance with the Regulation."

THE FUTURE: SOME WORRIES ABOUT ADDITIONALITY

This brings me to a major point about future directions of policy in this area. Over the course of our experience with additionality policy in the last few years, we have become increasingly aware of some of the costs which attend this policy. We must ask ourselves the question: Has it been worth it? Does it conflict too much with the basic business of AID?

Tying AID funds to procurement from a positive list of commodities, which are not internationally competitive, reduces the value of the AID dollar. Although measurement of comparative costs is difficult, some AID-financed goods may cost 10 to 40% more than comparable goods from other suppliers when delivered to particular host country markets. This differential is particularly burdensome with recent severe cuts in aid appropriation levels.

Moreover, as I noted earlier, if AID credits are to be covered fully by additional U.S. exports, part of a host counrty's imports must be diverted from foreign sources of supply to the United States. The most effective way to do this is through import and exchange controls. The United States has long viewed such controls as serious obstacles to efficient development. It has been a goal of AID to encourage removal of these controls to encourage free operation of market forces. Although systems of controls have not actually been established as a result of our efforts to obtain additionality, those efforts may serve as an incentive to delay dismantling of existing systems.

In several instances AID positive lists have been so limited that countries could not draw down available funds at a reasonable pace, and put them to use for development. Importers were simply reluctant to use AID funds to purchase goods subject to our procedures and at higher prices.

Where AID, together with Treasury and Commerce, has been particularly concerned with additionality shortfalls in an individual country, we have frequently had to spend months negotiating an additionality agreement. This is a complex and sensitive subject, and has tended to divert attention from negotiations on self-help and other important development objectives. Both the United States and the host government spend too much time and energy talking about the wrong subjects.

Finally, there is a real risk that our additionality policies may actually harm our long-run export position. Although it is one of those things which is difficult to measure, the reputation of U.S. goods can hardly be enhanced in the eyes of developing country importers by experience with uncompetitive U.S. commodities on restricted positive lists.

In view of the seriousness of the U.S. balance of payments problem in the past several years, what AID had done may have been necessary. But tying does most the job. As balance of payments pressures ease, one of the first places to relax present restrictions is in the drive to achieve full additionality in the AID program. The cost to the balance of payments would be modest, and the benefits to our efforts to stimulate growth of the developing countries would be large.

FUTURE EXPORT EFFECTS OF THE AID PROGRAM

It is also important to recognize that in carrying out its fundamental task of development, AID promotes the long-run prospects for U.S. exports.

In some degree this is a by-product of particular AID activities. AID-financed technicians and contractors tend to recommend U.S. products. AID loans finance the introduction and wide use of U.S. commodities. If their costs are not too far out of line, their quality creates future markets. Foreign nationals trained in this country under AID-sponsored programs become leaders in their own countries, and their familiarity with both our ideas and our products is helpful.

More basically, AID promotes long-run U.S. export markets by enabling poor countries to make economic progress. As they prosper, their demands for imports

from the United States expand. Two AID staff members recently published an article in the *Harvard Business Review* in which they calculated that these income-induced exports by countries receiving AID support were in the range of $380 million during the period 1960 to 1965.

Moreover, as recipient countries become self-sustaining and graduate from AID rolls, we find they become better customers for U.S. exports. The rising trend of exports to countries such as Greece, Israel, Taiwan, Libya and Iran attests to the effectiveness of AID's long-run contributions to the overall growth of U.S. exports. U.S. non-AID exports to these countries grew by 100% between 1960 and 1966 while exports to all less developed countries increased by approximately 42%. During the same period exports to all developed countries rose by only 33%. As other developing countries increase their foreign exchange earnings in the future, we can expect that they too will continue to increase their exports from the United States.

And now Mr. Chairman, one final word by way of summary.

Our economic aid appropriations would go farther and accomplish more if we didn't have to worry about the balance of payments. But we *do* have to worry about it. The question is how far we should go in trying to lessen the impact of the AID program on the balance of payments. Should we give absolute priority to measures that will reduce still further the adverse effects of our aid programs, or are the objectives of those programs sufficiently important to justify some balance of payments costs?

In my opinion we have already gone as far as we should go in terms of taking into account—and trying to minimize—the balance of payments effects of the AID program. I believe we have reached, if we have not already passed, the point of diminishing returns—the point where the damage to the programs exceeds the gain to the balance of payments.

TABLE I.—AID EXPENDITURES FOR ECONOMIC ASSISTANCE AND THEIR DIRECT IMPACT ON U.S. BALANCE OF PAYMENTS

[Dollar amounts in millions]

Fiscal year	Gross expenditures				Net receipts [1]	Direct net impact on U.S. balance of payments
	Total	In United States		Offshore		
		Amount	Percent of total			
1961	$1,801	$819	45.5	$982	$131	−$851
1962	1,849	986	53.3	863	153	−710
1963	2,074	1,369	66.0	705	528	−177
1964	2,022	1,608	79.5	414	207	−207
1965	2,096	1,761	84.0	335	173	−162
1966	2,128	1,766	83.0	362	183	−179
1967	2,336	2,114	90.5	222	294	+72
1968 (preliminary)	2,092	1,914	91.5	178	259	+81
1969 (estimated)	2,206	2,061	93.4	145	302	+157
1970 (estimated)	2,084	1,944	93.3	140	342	+202

[1] Total receipts in dollars and foreign currencies minus receipts in "excess" and "near excess" currencies.

TABLE II.—AID FISCAL YEAR 1968 GOLD BUDGET

[In millions of dollars]

Item	Amount
Commodities	$37
Local costs [1]	112
Personnel support costs	63
Administrative expenses	12
Cash grants	17
Contractor local costs, inter-regional programs, etc	20
International contributions [2]	40
Social Progress Trust Fund (IDB)	20
Other international organizations	20
Total	189
Less use of excess currencies [3]	11
Total outflow	178

[1] Special letters of credit are already taken into account in these calculations.
[2] These are outflows arising from those contributions to international organizations whichare from AID appropriations.
[3] These are purchased from the Treasury for AID activities, but not allocated to particular categories above.

TABLE III.—ESTIMATED DIRECT AND INDIRECT BALANCE-OF-PAYMENTS IMPACT OF AID PROGRAM

Fiscal years	Outflows				Inflows				Net outflow or inflow
	Gold budget	Commodity substitution	Gross SLC's issued	Total	Net receipts	Respending	Growth-induced exports	Total	
1965	−335	−119	−92	−517	173	255	75	503	−17
1966	−362	−67	−129	−558	183	264	75	522	−34
1967	−222	−41	−144	−407	294	196	75	567	+106
1968	−178	−25	−100	−303	259	146	75	480	+176

Chairman REUSS. Thank you, Mr. Gaud.
Mr. Moot?

STATEMENT OF HON. ROBERT C. MOOT, ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

Mr. MOOT. Mr. Chairman and members of the subcommittee, it is a pleasure for me to appear before this subcommittee to discuss with you the Department of Defense program to minimize the balance-of-payments costs of U.S. defense activities.

INTRODUCTION

The Department of Defense continues to be deeply concerned about balance-of-payments matters. We fully recognize that expenditures by the Department of Defense represent a substantial portion of Government expenditures abroad. Therefore, we believe we have a special responsibility to carry out our programs in ways which minimize, to the maximum extent feasible, the impact of our overseas activities on the U. S. balance of payments.

The mission of the Department of Defense is to provide for the security of the United States. Therefore, balance-of-payments considerations cannot be controlling, or indeed, examined independent of requirements stemming from our national security objectives, including our security commitments with other nations. Given the overriding importance of our security objectives and the obligations we have to our personnel, the Department of Defense balance-of-payments program has been developed and is being carried out under two general guidelines: first, essential combat capability must be maintained and second, expenditure reductions must be achieved without creating undue hardships for U.S. military and civilian personnel and their families.

RECORD TO DATE

Despite initial increases in Southeast Asia expenditures beginning early in 1965, we reduced the net adverse balance on the defense account by almost half, from $2.8 billion in fiscal year 1961 to $1.5 billion in fiscal year 1965. As shown in table I, this reduction was achieved by (1) a fourfold increase in our receipts, which stem primarily from sales of U.S. military goods and services to foreign countries (2) a reduction in uranium purchases abroad for defense

purposes and (3) a successful effort to hold down overseas expenditures in the face of substantial increases in foreign prices and wages and in the pay of U.S. Defense Department personnel. In countries where we have large numbers of foreign nationals, wage increases were particularly significant. For example, based on an index of wage levels published by the International Monetary Fund, during the period calendar year 1961 to 1964, the U.S. wage level rose less than 13 percent, but wage levels in France rose by about 27 percent, in Germany by about 30 percent and in Japan by about 33 percent. There also were price increases in supplies and services we procure overseas. Similarly, during the fiscal year 1961–65 period, there were three U.S. military and four civilian employee pay raises and a personal income tax reduction in 1964.

Beginning in mid-1965, our expenditures, as shown in table II, have increased due primarily to the conflict in Southeast Asia. In fiscal year 1968, about $1.6 billion or more than one-third of our total balance-of-payments expenditures were attributable to the Southeast Asia conflict.

In fiscal year 1968, there also was some increase in defense expenditures, other than those attributable to Southeast Asia. These increases included a special payment of $35 million to the United Kingdom to fulfill a commitment related to the trilateral discussions in 1967, and a payment of $31 million in settlement of longstanding Philippine claims arising from service by Philippine personnel in World War II. In addition, following the seizure of the *Pueblo* in January 1968, it was considered necessary to take a number of steps which increased balance-of-payments costs in the Far East area. There also have been continuing increases in the costs of our activities overseas. Since the beginning of calendar year 1965, for example, the International Monetary Fund wage index has risen by 17 percent in Germany and 42 percent in Japan. In addition, U.S. military pay raises during this period were about 17 percent and U.S. civilian pay raises were approximately 11 percent. I would like to turn now to a more detailed discussion of the actions we have taken in recent years which served to minimize expenditures and to increase receipts consistent with our basic guidelines.

Expenditures by U.S. Military, Civilian, and Dependent Personnel Overseas

The Department of Defense balance-of-payments program relating to reductions in foreign exchange expenditures by U.S. personnel has three main focal points: first, a strenuous effort to review requirements for U.S. military and civilian personnel in foreign countries with a view to reducing these requirements where feasible; second, continuing stress on actions to reduce personal spending on the local economy; and third, efforts to hold down balance-of-payments expenditures related to nonappropriated fund activities.

a. Military Strength Levels in Foreign Countries

Special procedures governing U.S. military strength in foreign countries have been developed during the past several years which supplement normal manpower requirements reviews. Under these procedures, an overall end fiscal year ceiling on military strength in for-

eign countries is established for each military department. In certain cases there are additional subsidiary country and/or area ceilings.

Although since 1963 there has been an overall net increase in U.S. military strength in foreign countries, there also have been a substantial number of actions which served to reduce such requirements for military personnel with beneficial balance-of-payments effects. For example, during fiscal year 1964 and fiscal year 1965 there were substantial reductions in the staffs of U.S. Military Headquarters overseas; the Army reorganized its support operations in France; three U.S. Air Defense units in Spain were phased out; and Strategic Air Command Reflex B-47 operations were redeployed from Europe. In fiscal years 1966 and 1967, we gave particular attention to consolidating and streamlining our support and administrative operations and base structure overseas, and more than 20 activities were consolidated, reduced, or discontinued. In fiscal year 1968, the Department of Defense also initiated action to redeploy about 35,000 military personnel from Germany. These troops, however, remain committed to NATO. In total, there was a reduction in U.S. military strength in Western Europe of approximately 90,000 between March 1962—the peak of the Berlin buildup—and March 1968.

b. Expenditures by Individuals

We have made a continuing effort to encourage participation by our personnel stationed in foreign countries in voluntary programs designed to channel available disposable income back to the United States. These programs were initiated by the Department of Defense early in 1961 and expanded it recent years. The programs emphasize and encourage voluntary actions to reduce spending on the local economy, to increase use of payroll allotments and other voluntary savings programs, and to increase spending in U.S.-controlled facilities, including use of U.S.-operated recreation areas.

Since 1966, existing programs relating to voluntary reductions in personal spending by Department of Defense personnel stationed in foreign countries have been intensified and several new programs have been initiated. Disbursement procedures have been modified to make it easier for servicemen to leave their pay "on the books." Regulations were amended to permit servicemen to increase the size of their allotments sent home. In addition, the uniformed services savings deposit program was enacted in August 1966. Participation in the program is limited to military personnel on active duty in a foreign area. As of September 30, 1968, there were $422 million in gross deposits under the program and the balance on deposit, as of August 31, 1968, was about $251 million. We recognize, of course, that these deposits—as in the case of savings associated with similar programs—cannot be equated directly with equivalent balance-of-payments savings since some portion of the new deposits are made in place of other forms of savings or expenditures which would not otherwise enter the international balance of payments.

During 1968, we undertook a general reemphasis of our existing voluntary programs relating to personal spending, such as (1) an expanded internal information program on the balance-of-payments problem and Department of Defense programs, reaching military and civilian personnel serving at home as well as overseas; (2) improved

stocking of American goods in military exchanges overseas; (3) increased use of American sales facilities; (4) greater use of American controlled recreation facilities overseas; and (5) renewed emphasis on current savings programs.

In South Vietnam, efforts to encourage voluntary reductions in personal spending are part of the overall effort to reduce inflationary pressures on the local economy. Additional U.S. actions in South Vietnam include a special piastre budget for spending by U.S. agencies in that country, the use of military payment certificates and a prohibition on the use of regular American currency as part of the effort to eliminate unauthorized currency transactions. In this respect, the rest and recuperation (R. & R.) program in Hawaii for military personnel serving in South Vietnam also serves to hold down the foreign exchange costs resulting from this program. On the basis of an average expenditure of approximately $340 per man on R. & R. in foreign countries during July–September 1968, we estimate that the use of Hawaii as an R. & R. site will result in foreign exchange savings of $35 to $40 million in fiscal year 1969.

Reductions in official travel overseas also were made this past year as part of the President's balance-of-payments program for 1968. In the second half of fiscal year 1968, based on military department reports, Department of Defense obligations for official travel overseas were reduced by about 30 percent below the comparable amount contained in the President's budget—a $10 million savings. The $10 million is not all balance-of-payments savings since it includes payments to U.S. carriers for transportation.

c. Nonappropriated Fund Activities

It is the policy of the Department of Defense to promote the sale of U.S. items in overseas nonappropriated fund activities. Military exchanges and other nonappropriated fund activities in foreign countries have been directed to take whatever steps are feasible, within the limits of sound business practice, to stock merchandise of U.S. origin to the greatest practicable extent. At the same time, we recognize that there is a demand for foreign merchandise on the part of our personnel. Balance-of-payments effects are minimized if such goods are purchased through U.S.-operated nonappropriated fund resale activities rather than procured directly on the local economy or from other foreign outlets. Accordingly, nonappropriated fund resale activities in foreign countries are authorized to procure for resale foreign-made goods available in the local market, subject to certain restrictions. The price of foreign items sold in overseas exchanges and other retail outlets is required to be at least as high as the selling price prevailing on the local economy. This pricing policy in effect permits a lower markup and more attractive prices on U.S. goods because of the additional profit from sales of foreign items, thus, encouraging the purchase of U.S. products. Total military exchange sales overseas increased by approximately $100 million in fiscal year 1968 over 1967 while foreign procurement for post exchange resale declined by about $5 million. If the procurement/total sales ratio experienced in fiscal year 1967 had continued in fiscal year 1968, as much as an additional $25 to $30 million could have been spent for foreign procurement of military exchange items.

Nevertheless, in spite of the actions discussed above, it should be noted that, because of price increases overseas and U.S. pay increases, reductions in personal spending overseas generally do not appear promising within current force levels, even with the heavy emphasis being given to the existing voluntary programs. Therefore, the ability of the Department of Defense to achieve substantial savings in personal spending rests primarily in the area of personnel reductions.

Foreign Nationals Employment

The Department of Defense has made strenuous efforts to hold down employment of foreign nationals to minimum essential levels. Major emphasis on reducing employment of foreign nationals was initiated in July 1963.

Between fiscal year 1963 and fiscal year 1965, there was an overall net reduction of close to 42,000-foreign nationals employed on Department of Defense rolls—from 240,000 to about 198,000 personnel—with a concurrent decrease in balance-of-payments expenditures for foreign nationals of about $30 million, in spite of some upward pressure in this area already being experienced as a result of the conflict in Southeast Asia. However, these savings do not fully reflect the actions taken since foreign national wage costs were steadily rising during the period.

While there has been a net increase in total Department of Defense foreign national employment during the last 3 fiscal years of about 70,000 personnel, attributable entirely to Southeast Asia requirements, the number of foreign nationals in Western Europe declined by an additional 12,000. Between March 1963 and March 1968, there was a net reduction of approximately 36,000 foreign nationals in Western Europe. At an average cost of approximately $3,000, retention of these personnel would have added over $100 million to our wage costs in Western Europe in fiscal year 1968 alone.

Expenditures for Materials, Supplies, and Services and Major Equipment

Department of Defense policies emphasize the use of U.S. materials and supplies in support of U.S. defense activities overseas. Efforts to hold down balance-of-payments expenditures for materials, supplies, and equipment were initiated late in 1960 in accordance with a Presidential directive calling for reductions in Department of Defense procurement abroad during calendar year 1961.

Beginning in January 1961, Department of Defense purchases—excluding Military Assistance Program (MAP)—nonappropriated fund procurement and petroleum (POL) for use outside the United States normally were "returned" to the United States when costs of U.S. supplies and services—including transportation and handling—did not exceed the cost of foreign supplies and services by more than 25 percent. In mid-1962 the 25 percent differential was increased to 50 percent, and on a case-by-case basis could exceed 50 percent. The use of 50-percent differential remains in effect today as part of a Government-wide policy affecting Government procurements for use overseas, except for AID which follows a "tied aid" policy. From calendar year

1961 through fiscal year 1967, about $340 million in procurements were shifted from foreign products to U.S. products or services under this program, at an additional budgetary cost of about $75 million, or 22 percent.

Similarly, for Department of Defense procurement of goods and services for use in the United States, case-by-case review procedures using the 50-percent differential as a "bench mark" were initiated in July 1962. From fiscal year 1963 through fiscal year 1967, based only on cases where foreign source bids were received, approximately $13 million in procurements which normally would have been foreign were returned to U.S. sources at an additional budgetary cost of approximately $4 million, or about 31 percent.

Under a separate balance-of-payments program effort, the Department of Defense during the past 4 years has returned to the United States about $330 million in petroleum at an additional cost of approximately $164 million. Additional returns appear infeasible, principally on economic grounds, for example, the additional budgetary cost would greatly exceed the benefits in foreign exchange savings.

The above policies are considered to be temporary in nature—for example, to be kept in force only as long as is required by the U.S. balance-of-payments situation.

Our research activities overseas are relatively small, but we have placed continuing heavy emphasis on limiting balance-of-payments expenditures for research and scientific activities in foreign countries. Also, in keeping with recent recommendations of the Committee on Government Operations concerning dollar financed overseas research, specific additional actions taken in 1968 include a revision of policy criteria for support of foreign research by foreign performers, a reduction in U.S. military and civilian research personnel overseas, the co-location of European research offices of the Department of Defense in the United Kingdom and additional funding limitations on Department of Defense research assigned to foreign performers overseas.

As a result of a special program undertaken in mid-1967, we also have reduced expenditures for subsistence abroad in fiscal year 1968 about $20 million below the fiscal year 1967 level of about $100 million.

Construction and Operation of Overseas Facilities

Department of Defense efforts to reduce expenditures for overseas facilities have three principal focal points: First, while maintaining necessary combat capability and taking advantage of our increased technological support capabilities, we have attempted, through the consolidation of activities and other measures, to reduce to minimum required levels the number and functions of our existing overseas bases and facilities. Second, we have attempted to operate required facilities at minimum cost. Third, we have eliminated or deferred all construction not essential to military needs and attempted to reduce the foreign exchange cost of essential construction, even where this involves additional budgetary costs.

Proposed construction programs in foreign countries are subject to special reviews, and those which are approved are designed so as to reduce foreign exchange costs to the maximum extent feasible. Under specially developed construction procedures, we emphasize, where

permitted by applicable country-to-country agreements, the use of: (1) U.S.-procured materials, (2) U.S. Government-furnished materials and equipment, (3) U.S.-flag carriers, (4) prefabricated buildings manufactured in the United States, and (5) troop labor, to the extent available. In some cases, the use of these construction procedures results in increased budgetary costs; however, extra budgetary costs generally are considered acceptable provided the added cost over normal construction methods does not exceed 50 percent of the amount of reduction achieved in international balance-of-payments costs. In other words, we have been willing to spend an extra 50 cents in the United States to save $1 in balance-of-payments expenditures. These special procedures also may be applied on a case-by-case basis even though premium costs exceed 50 percent.

An extraordinary effort has been made to reduce the international balance-of-payments impact of the construction program in South Vietnam. Of the over $1.6 billion in approved and funded construction for South Vietnam, approximately $1.2 billion has been expended through fiscal year 1968. But only about $325 million, or approximately 27 percent, of these expenditures were foreign exchange costs.

Military Assistance Program Procurement

Military assistance balance-of-payments expenditures have been reflected in three separate areas: Offshore procurement, NATO infrastructure, and all other MAP expenditures, that is, U.S. contribution to international military headquarters. An intensive effort is being made to hold down balance-of-payments costs in all of these areas.

Proposed offshore procurement for the military assistance program receives careful review. With certain exceptions, such as the fulfillment of U.S. commitments on existing government-to-government cost sharing projects and procurements required under treaty or executive agreement between governments, the 50-percent differential applied to military procurement also is applied to military assistance procurement. Our military assistance program offshore procurement expenditures have been reduced from approximately $160 million in fiscal year 1963 to $75 million in 1965, and to about $20 million in fiscal year 1968.

Miltary assistance program funds also were used during the fiscal year 1961–67 period to provide the U.S. contribution to NATO multilateral efforts, the most significant of which is NATO infrastructure that is, the joint U.S.-Allied funding of airfields, communication facilities, firing ranges, and other facilities. During 1966, the United States negotiated a reduction in its percentage share contributed to NATO infrastructure from 30.85 percent to 25.77 percent.

Stringent control procedures to restrain military assistance program balance-of-payments costs stemming in part from the provisions of the Foreign Assistance Act of 1961, as amended, remain in effect today. For example, in addition to the percentage guidelines noted above, with respect to offshore procurement the Assistant Secretary of Defense for International Security Affairs must certify before foreign procurement can be undertaken that failure to procure outside the United States would seriously impede the attainment of military assistance program objectives.

Foreign Military Sales

In 1961, we undertook to increase sales of military equipment to friendly nations which are economically able to bear a larger part of the total defense effort. The principal objectives of this program are (1) to promote the defensive strength of our allies consistent with our political-economic objectives, (2) to promote the concept of cooperative logistics with our allies, and (3) to offset the unfavorable balance of payments resulting from U.S. military deployments abroad. All important proposals for military sales are reviewed by the Secretary of Defense, with appropriate interagency coordination, and Presidential decision frequently is required. It is important to emphasize that decisions to sell equipment are made only after a determination that it is in the best overall U.S. national interest to make the sale.

Under the objectives outlined herein, Department of Defense cash receipts, which stem principally from military sales, rose from about $300 million in fiscal year 1961 to $1.4 billion in fiscal year 1963. During the fiscal year 1963–68 period, our cash receipts averaged well over $1.2 billion annually, reaching $1.5 billion in fiscal year 1967, due to an unusually high level of payments from the Federal Republic of Germany to complete then existing governmental arrangements for offsetting U.S. defense expenditures in Germany. In fiscal year 1968, cash receipts from military sales were approximately $1 billion; this reduced level of receipts is due primarily to the termination of United States-Federal Republic of Germany offset arrangements which had been in effect in prior years. Foreign military sales have been made primarily to economically developed countries and the equipment involved consists to a great extent of advanced weapons systems, for example, F–111's, F–4's, Polaris equipment, and Hawk and Pershing missile systems.

There have been a few instances where U.S. sales have been associated with arrangements under which the purchasing country gains access to U.S. military procurement requirements on a competitive basis. This special access to U.S. defense procurement is selective and is subject to the condition that the items fully satisfy Department of Defense requirements for performance, quality, and delivery. From an overall national standpoint, such arrangements have been desirable.

Pursuant to the President's balance-of-payments program on January 1, 1968, we have continued efforts, where appropriate, to enlist balance-of-payments cooperation by other countries through procurement of their defense needs in the United States. In keeping with that program, use also has been made of special financial arrangements, principally sales of long-term U.S. Treasury securities, in order to further assist in neutralizing the deficit on the military account. Purchases of such securities by the Federal Republic of Germany and similar arrangements with other countries resulted in a long-term capital inflow of about $800 million during fiscal year 1968. I want to note that the data in our tables do not reflect these financial neutralization actions. If these financial arrangements are considered, the net adverse balance on the military account for fiscal year 1968 is approximately the same as in fiscal year 1967. We fully recognize, of course, that these financial arrangements do not represent a long-run solution to our balance-of-payments problem.

Barter and Excess Currency Programs

The Department of Defense is attempting to achieve maximum feasible use of U.S.-owned excess currencies and barter arrangements as a means of reducing Department of Defense dollar expenditures entering the international balance of payments. Where a choice exists, Department of Defense uses excess currencies before barter for overseas procurements.

Specific policies and procedures have been developed which provide for the use of U.S.-owned foreign currencies rather than dollars for payments of our overseas requirements. Where feasible, such items as (1) overseas allowances, (2) travel, transportation, per diem and related expenses of Defense personnel, dependents, employees of contractors, and (3) contract procurement, are paid for in excess currencies. It should be noted, however, that the bulk of excess currencies held by the United States are currencies of countries where the number of U.S. forces and the magnitude of Department of Defense procurements and expenditures in these countries are relatively small—in fiscal year 1968, less than two-tenth of 1 percent of all military personnel assigned overseas were stationed in excess-currency countries. Although we modified our procurement regulations early last year to further encourage bids on the basis of using excess currencies, there are relatively limited possibilities of using excess currencies to meet requirements in other countries, based in part on the nature of existing country-to-country agreements governing use of these currencies.

With respect to barter, where it has first been determined that excess currencies cannot be used and a determination also has been made under Department of Defense balance-of-payments procurement guidelines that the requirement must be met from an overseas source, an effort is made to use barter procurement, under procedures developed with the Department of Agriculture. In fiscal year 1964, the Department of Defense barter program amounted to less than $25 million. In fiscal year 1968, the barter program amounted to $225 million, or about a ninefold increase over the fiscal year 1964 level.

Miscellaneous Actions

During the past several years, the Department of Defense has improved balance-of-payments reporting and management-control procedures as a means to supplement and enhance the various specific balance-of-payments policies. This includes the use of balance-of-payments targets for components of the Department of Defense and special reviews of balance-of-payments procurement actions and related accounting procedures. These reviews serve to emphasize the need for continuing attention by activities to current procurement policies and to help assure that balance-of-payments accounting reports accurately identify and report properly Department of Defense expenditures entering the balance of payments. Specific procedures also have been included in the annual budget review process to insure balance-of-payments implications are taken into account as decisions are made.

Summary and Outlook

It is extremely difficult to estimate what our expenditures would have been without the programs I have described in this statement. The procurement and construction programs, for example, as they involve the use of premium budgetary costs, can clearly be attributed to our balance-of-payments program. In other areas such as streamlining of support operations, including base closures, our balance-of-payments program has served as an additional impetus to reducing expenditures overseas. But it is equally true that many actions would have been taken in any case in the interest of overall management improvement. As an order of magnitude, however, it is estimated that our balance-of-payments program has reduced our expenditures overseas by about $2 billion during the fiscal year 1961–68 period. Without these actions our expenditures could now be running over $400 million above the current annual rate.

Based on present programs and strength levels, I believe that additional economies can be achieved only with substantially greater difficulty. As a result of our past efforts, the "easy" expenditure reductions have long since been made. Therefore, we can expect under present conditions that continuing price and wage increases, combined with the higher average personnel strengths in Southeast Asia during the year, will result in higher defense expenditures abroad in fiscal year 1969 than in fiscal year 1968—although we anticipate a further slackening in the rate of their growth.

We intend to press, however, our existing programs to the fullest extent to hold down these increases. We also have renewed our efforts to achieve expenditure reductions, principally by further streamlining and consolidating our operations overseas. Some of our studies essentially are complete and we are hopeful that later this year we can initiate a number of separate actions which will have beneficial balance of payments and budget impacts during the next several years, and which will be fully consistent with our security obligations. In the longer, of course, the best hope of our achieving significant new savings in our expenditures abroad would be to achieve substantial reductions in our overseas deployments.

We also intend to stress the ongoing military sales program, where this is appropriate. In addition, we will continue to work with other Government agencies in negotiations with countries for improving the extent and nature of arrangements to offset the foreign exchange costs of our activities overseas. We believe our actions to this end will be furthered within NATO by the views expressed in the communique at the NATO Ministerial Conference in Brussels on November 16, 1968, which specifically acknowledged for the first time as a multilateral policy that balance-of-payments cooperation strengthens the solidarity of the alliance when it stated:

> They (the Ministers) also acknowledge that the solidarity of the Alliance can be strengthened by cooperation between members to alleviate burdens arising from balance of payments deficits resulting specifically from military expenditures for the collective defense.

TABLE I.—U.S. DEFENSE EXPENDITURES AND RECEIPTS ENTERING THE INTERNATIONAL BALANCE OF PAYMENTS, FISCAL YEARS 1961-68[1]

[In millions of dollars]

	1961	1962	1963	1964	1965	1966	1967	1968
Expenditures:								
U.S. forces and their support:								
Expenditures by U.S. military, civilians and dependents[2]	808	791	838	899	973	1,155	1,292	1,525
Foreign nationals (direct and contract hire)	366	396	438	425	408	438	530	573
Procurement:								
Major equipment	62	67	76	93	78	87	144	220
Construction	157	122	101	94	105	256	393	353
Materials and supplies (including POL)[3]	562	597	547	473	415	530	641	757
Services[4]				418	400	491	698	908
Other payments[4]	516	517	536	184	174	213	275	110
Subtotal	2,471	2,490	2,536	2,586	2,553	3,170	3,973	4,446
Military assistance program:								
Offshore procurement	155	122	161	118	75	53	30	21
NATO infrastructure[5]	105	36	90	61	34	50	49	
Other	52	64	67	58	59	54	45	43
Subtotal	312	222	318	237	168	157	124	64
Net change in dollar purchased foreign currency holdings	−2	+13	−6	−8	+1	+12	+26	−8
Total expenditures	2,781	2,725	2,848	2,815	2,722	3,339	4,123	4,502
Receipts:								
Cash receipts[6]	328	922	1,429	1,222	1,268	1,064	1,571	1,014
Barter				23	69	140	204	225
Total receipts	328	922	1,429	1,245	1,337	1,204	1,775	1,239
Net adverse balance (DOD)	2,453	1,803	1,419	1,570	1,385	2,135	2,348	3,263
Other expenditures (AEC and other agencies included in NATO definition of defense expenditures)	343	273	250	136	95	51	28	9
Net adverse balance (NATO definition)	2,796	2,076	1,669	1,706	1,480	2,186	2,376	3,272

[1] The data reflected in this table are on a gross basis. They do not reflect so-called feedback effects; e.g., as U.S. military expenditures increase in a foreign country, that country will in turn be in a position through these increased earnings to increase its imports from the United States directly or through third countries. Expenditure data also include expenditures in foreign currencies purchased from U.S. Treasury. In fiscal year 1968, these expenditures were approximately $170,000,000, of which $8,000,000 were in excess or near-excess currencies. Data differ somewhat from data on the defense account shown in the Department of Commerce publication Survey of Current Business. Commerce data exclude, on payments side, small amounts representing retired pay claims and grants and net changes in DOD holdings of foreign currencies purchased with dollars. On receipts side, Commerce data exclude all military sales through commercial channels and barter. These data are included in Commerce accounts under other entries.

[2] Include expenditures for foreign goods and services by nonappropriated fund activities. Beginning with fiscal year 1968, contains approximately $100,000,000 annually of PCS and TDY travel payments to individuals included in prior years in "Construction," "Services," and "Other payments" categories.

[3] Beginning with fiscal year 1964, includes expenditures primarily for O. & M. supplies and stock fund purchases.

[4] In fiscal years 1961-63, these categories were generally contained in the category "Contractual services"; from fiscal years 1964-67, they were generally contained in the categories "O. & M. (Other)" and "Other payments."

[5] Beginning with fiscal year 1968, NATO infrastructure expenditures included in "Military construction."

[6] Cash receipts data include primarily (a) sales of military items through the U.S. Department of Defense; (b) reimbursements to the United States for logistical support of United Nations forces and other nations' defense forces; and (c) sales of services and excess personal property. They do not include estimates of receipts for military equipment procured through private U.S. sources, except where these are covered by government-to-government agreements, and data are available; i.e., FRG, Iran, Italy, Japan, and Saudi Arabia. Also excludes financial arrangements; e.g., sale of special U.S. medium-term securities, undertaken to neutralize the balance-of-payments impact of defense activities.

25-765—69——S

TABLE II.—U.S. DEFENSE EXPENDITURES ENTERING THE INTERNATIONAL BALANCE OF PAYMENTS BY MAJOR AREA, FISCAL YEARS 1961-68

[Billions of dollars]

	Western Europe	Major Asian countries	Canada	Other	Worldwide
Fiscal year:					
1961	$1.6	$0.7	$0.4	$0.4	$3.1
1962	1.6	.7	.3	.4	3.0
1963	1.6	.7	.3	.5	3.1
1964	1.5	.7	.3	.4	2.9
1965	1.4	.8	.2	.4	2.8
1966	1.5	1.3	.2	.4	3.4
1967	1.6	1.9	.2	.5	4.2
1968	1.6	2.1	.3	.5	4.5

TABLE III.—U.S. DEFENSE EXPENDITURES AND RECEIPTS ENTERING THE INTERNATIONAL BALANCE OF PAYMENTS, BY COUNTRY, FISCAL YEARS 1961-68

[In millions of dollars]

Country	1961	1962	1963	1964	1965	1966	1967	1968
Australia [1]				$11	$14	$23	$26	$23
Austria	$6	$6	$4	4	3	4	4	4
Azores	7	6	6	6	5	7	5	4
Bahrain Islands	40	43	35	31	33	38	43	70
Belgium-Luxembourg	20	14	14	11	11	12	19	42
Bermuda Islands	13	14	14	12	9	9	10	12
Canada	398	322	324	273	208	181	222	259
China, Republic of	25	22	19	21	19	38	75	70
Denmark-Greenland	47	38	38	38	36	36	38	35
France	300	268	257	231	204	218	165	40
Germany, Federal Republic of	641	699	734	702	702	760	799	887
Greece	21	13	30	25	32	27	20	28
Iceland	14	14	10	14	13	16	23	24
Indochina [2]	8	27	42					
Italy	105	94	109	103	98	106	109	99
Japan	419	377	391	338	329	397	539	547
Korea	100	110	100	93	80	123	178	240
Morocco	21	20	18	11	5	5	5	7
Netherlands	35	33	30	37	39	42	47	43
Netherlands Antilles	64	54	52	57	46	29	25	46
Norway	17	10	19	19	28	26	29	34
Pakistan	8	6	4	6	5	5	3	3
Philippine Islands	52	51	52	53	71	120	165	193
Portugal	8	7	5	4	4	7	4	6
Ryukyu Islands	86	96	103	113	130	140	193	200
Saudi Arabia	45	42	46	42	36	48	48	65
Spain	55	56	49	48	44	49	49	42
Switzerland	8	5	7	9	11	10	11	11
Trinidad-Tobago	17	18	17	26	25	31	24	21
Turkey	66	57	46	64	38	51	45	53
United Kingdom	246	206	189	181	161	152	156	212
Venezuela [3]				33	25	23	19	32
Vietnam [2]				60	95	302	538	576
Other American republics	61	63	74	55	55	62	67	72
Other	171	207	260	220	203	293	448	511
Total expenditures	1,124	2,998	3,098	2,951	2,817	3,390	4,151	4,511
Receipts	328	922	1,429	1,245	1,337	1,204	1,775	1,239
Net adverse balance	2,796	2,076	1,669	1,706	1,480	2,186	2,376	3,272

[1] Included in "Other" through fiscal year 1963.
[2] Includes Laos, Cambodia, Vietnam through fiscal year 1963; beginning fiscal year 1964, Laos and Cambodia included in "Other" and Vietnam separately identified.
[3] Included in "Other American republics" through fiscal year 1963.

Chairman REUSS. Thank you very much, Mr. Moot.
Mr. Passell?

STATEMENT OF PETER PASSELL, DOCTORAL CANDIDATE IN ECONOMICS, YALE UNIVERSITY

Mr. PASSELL. Thank you, Mr. Chairman.

The chronic U.S. balance-of-payments deficits of the past few years have presented serious economic and political problems. From the point of view of planning future policy, it is important to examine the possibility that these deficits have largely resulted from Government activities. Of course, the balance-of-payments position of the United States is determined by the independent transactions of many parties—private, corporate, and governmental. No single Government program or other economic activity alone "caused" the deficit. It is still useful, however, to estimate what the U.S. payments position would have been in the absence of large-scale military involvement in Vietnam.

The U.S. Treasury and other Federal Government departments have estimated that the war in Vietnam contributes approximately $1.5 billion annually to the net outflow of American dollars. I will present an alternate calculation estimating the net balance-of-payments cost of the war at slightly in excess of $4 billion. This larger figure may partially explain the rapid deterioration of the U.S. surplus on current account, which declined approximately from $8.8 billion in 1964 to $4.4 billion in 1967 to approximately $2 billion in 1968. (See table A for alternate measures of changes in current account payments since 1964.)

The research leading to the larger estimate was undertaken by Mr. Leonard Dudley and myself at Yale University, and is described in more detail in the November 1968 issue of the *Review of Economics and Statistics*. If the chairman has no objection, I believe it would be appropriate to place this article in the record.

Chairman REUSS. Without objection, we will do so.

(The article referred to follows:*)

THE WAR IN VIETNAM AND THE UNITED STATES BALANCE OF PAYMENTS**

LEONARD DUDLEY AND PETER PASSELL†

It is generally recognized that the international monetary crises of late 1967 and early 1968 were precipitated by large, continuing deficits in the United States balance of payments. Underlying these deficits was a steady erosion of the United States surplus on current account, which fell from 8.5 billion dollars in 1964 to 4.8 billion dollars in 1967. Despite government programs restricting foreign investment by United States residents,[1] therefore, the overall deficit on a liquidity basis reached a level of 3.6 billion dollars in 1967. The resulting outflow of dollars and gold greatly reduced the confidence of speculators and central banks in the ability of the United States to maintain the international value of its currency.

---

*The Department of Defense later supplied comments on the following articles to which Mr. Passell subsequently replied. See beginning p. 123.

**Reprinted from "The Review of Economics and Statistics," November 1968, Harvard University Press. Cambridge, Mass.

†The authors are grateful to Robert Triffin and Richard Cooper for their helpful comments and suggestions.

[1] Note that this practice of restricting capital cannot be continued indefinitely without worsening the balance on current account, because it will of course reduce United States earning assets abroad.

It is of course no coincidence that this deterioration in the current account position of the United States accompanied a rapid expansion of its military commitments in Southeast Asia. But the amount of the deterioration which may be attributed to the War in Vietnam is a point at issue. The Administration has estimated the direct foreign exchange cost of the War to be about 1.5 billion dollars.[2] Many have argued, however, that if secondary and indirect effects are taken into account, the total impact on the balance of payments has been much greater.

In this paper, we shall attempt to reach a more satisfactory estimate—or range of estimates—of the total effect of the War on the balance of payments. In so doing, we shall try to answer the question: What would the United States balance on current account have been in 1967 if real expenditures had been lower by the amount channeled into the military effort in Southeast Asia?

The wording of this question perhaps requires further explanation. We shall assume that the multiplier effects of this hypothetical difference in expenditures could have been completely and precisely offset by monetary and fiscal policy. Thus we suggest that in the absence of the military build-up, expenditures for consumption, investment and government purposes other than the War would have been identical with those that actually occurred.

In addition, it must be recognized that part of the increase in military expenditures would have been spent even without the Vietnam War build-up. The men now serving in the armed forces would have eaten, for example, regardless of whether they were in military or civilian roles. For this reason, we exclude *domestic* expenditures on military pay, provisions and accommodation from our calculations, and consider only those expenditures which may clearly be assigned to the expanded campaign in Vietnam.[3]

One may note several possible effects which this military spending may have had on the United States current account balance:

1. Increased direct foreign purchases of food, services and finished goods to supply the military effort.
2. Greater purchases of foreign goods to be used as inputs in United States defense production.
3. Deterioration in the United States net exports, due to both war-stimulated inflation and to supply bottlenecks in those sectors of production most affected by the increased spending.

In the following sections, we shall examine each of these effects in turn. By summing the three components we hope to provide a relatively accurate and comprehensive picture of the balance of payments impact of the War.

I. DIRECT FOREIGN EXPENDITURES

One obvious effect of the Vietnam War on the United States current account has been an increase in direct foreign purchases of finished goods and services to sustain the military effort. Unfortunately, the Defense Department budget does not separate domestic from foreign spending. As a result, we have been compelled to make some informed estimates.

Undoubtedly, some of this direct spending—for example, purchases of munitions—have been made in the industrial countries. However, to be conservative, we shall assume that these expenditures have been negligible and may be ignored.

A far larger part of direct foreign expenditures has been made in the countries of Southeast Asia, to purchase provisions and services. One possible measure of this flow is the United States deficit on military expenditures with Asia, Africa and Japan, which in the period from 1964 to 1967 increased by 1,475 million dollars.[4] One hesitates, however, to accept this figure as a measure of the direct impact of the War on the balance of payments. In the first place, some of these military expenditures may have been offset in the United States accounts by induced increases in imports from the United States. In the second place, the Vietnam War has probably led to increases in war-related *non-military* expenditures, such as foreign aid and loans to Southeast Asian governments. For these reasons, we have decided to use the change in the United States balance on

[2] U.S. Treasury Department, *Maintaining the Strength of the U.S. Dollar in a Strong Free World Economy* (Washington, 1968), p. 103.

[3] As noted below, *foreign* military purchases of food, etc., by the United States will be included in the direct current account impact of the War.

[4] United States Department of Commerce, *Survey of Current Business*, 48, 3 (March, 1968), pp. 32–33, line 16.

goods, services, unilateral transfers, United States government loans, and holdings of nonreserve currencies with Asia and Africa, augmented by the change in the United States deficit on military expenditures with Japan. Using this measure, we arrive at an estimate of 1,600 million dollars for the direct balance of payments impact of the Vietnam War[5]—a figure which corresponds quite closely to the Administration estimate of 1,500 million dollars.

II. WAR MATERIALS IMPORT CONTENT

A second portion of the impact on the United States balance of payments of the War in Vietnam results from induced expenditures for imported raw materials and intermediate goods used in the production of military goods and services. In order to measure these war-induced imports, a number of assumptions must be made about the cost of the War and the prevailing pattern of interindustry input-output (I-O) relationships.

In view of the difficulty of assigning Defense Department budget expenditures to specific military functions, we have chosen to define the military cost of the War as the difference between fiscal 1965 expenditures and fiscal 1968 Defense Department appropriations, adjusted for price changes. The middle of the calendar year 1965 roughly marked the beginning of the massive American build-up in Vietnam. It should be realized that the definition is conservative in the sense that United States military expenditures for Vietnam undoubtedly exceeded 1 billion dollars in fiscal 1965. Moreover, it has been suggested that non-Vietnam defense expenditures have been reduced durng the 1965–1968 period, further biasing the war cost estimate in a downward direction.

It should be remembered that we have not included domestic expenditures for military pay, family subsistence allowances, or the cost of feeding and housing military personnel. The bulk of these outlays are not war costs within our analytical framework.

TABLE 1.—WAR MATERIALS IMPORT CONTENT

[In millions of U.S. dollars]

Sector name	1965 budget	1968 budget	dB	M coefficient	M content
(1)	(2)	(3)	(4)	(5)	(6)
New construction (11)	1,427.7	1,986.0	488.4	0.03111	15.2
Repair construction (12)	573.7	988.0	382.7	.01892	7.2
Ordnance (13)	2,134.9	7,554.8	5,302.5	.03075	163.1
Apparel (18)	62.6	109.7	46.1	.03479	1.6
Miscellaneous textiles (19)	146.1	256.1	107.7	.05515	5.9
Printing, publishing (26)[1]	90.3	134.7	39.4	.03947	(1)
Chemicals (27)	365.7	658.5	288.8	.06383	18.4
Drugs, cleaning materials (29)	164.1	256.1	102.0	.03233	3.3
Petroleum (31)	1,000.0	1,500.0	445.0	.09552	42.5
Rubber, plastic products (32)	146.1	256.1	99.0	.05827	5.8
Construction machinery (45)	135.0	367.3	218.1	.02413	5.9
Material handling machinery (46)	207.7	711.6	492.5	.03829	18.3
General industrial machinery (49)	135.3	300.1	153.1	.02744	4.2
Computing equipment (51)	187.8	329.1	131.0	.03476	4.6
Electrical equipment (53)	196.4	438.4	231.6	.04013	9.3
Radio–TV, communication equipment (56)	1,130.0	1,644.3	452.2	.02718	12.3
Motor vehicles (59)	580.1	722.4	110.4	.05999	6.6
Aircraft, parts (60)	9,219.5	12,107.6	2,381.0	.02500	59.5
Other transportation equipment (61)	2,224.2	1,770.0	−576.5	.04107	−23.7
Instruments (62)	106.3	178.6	67.0	.04790	3.3
Transportation, warehousing (65)	1,742.5	3,938.0	2,099.7	.05350	112.3
Communications (66)	255.9	326.9	56.9	.00991	.6
Power, power fuels (68)	255.9	326.9	57.4	.01747	1.0
Real estate, rent (71)[1]	255.9	326.9	56.9	.00682	(1)
Business services (73)[1]	1,447.7	2,667.5	1,140.2	.01888	(1)
Research, development (74)	7,402.0	8,025.3	424.9	.02814	12.0
Auto repair (75)[1]	313.0	548.5	218.9	.01872	(1)
Medical, educational service (77)[1]	1,447.7	2,667.5	1,140.2	.00928	(1)
Office supplies (82)	62.6	109.7	43.7	.07106	3.1
Total	33,201.0	51,206.6	16,200.8	.0359	582.4

[1] These sector imports were adjusted to take account of the hypothesis that the Defense Department adds a portion of the value added itself. For instance, the Army may repair its own vehicles, but purchase parts which have an import content.

Source: Survey of Current Business. Appendix to the Budget of the United States 1967; 1969.

[5] Ibid., lines 31, 42, and 43.

On the assumption that none of the net military expenditures in the remaining categories were used directly to purchase imported materials, the import content of the expenditures consisted entirely of goods and services used as direct and indirect intermediate inputs in the production process. The United States Department of Commerce 1958 Interindustry I-O matrix provides the most current input-output data presently available for 82 sectors.[6] By examining the Appendix to the Budget of the United States for the relevant years, it is possible to itemize net changes in military expenditures by I-O sector category.[7] Actual fiscal year expenditure information is not available until the end of the period; hence we have used 1968 appropriations as an approximation of expenditures.

A large portion of the Defense Budget items, such as aircraft and ordnance, fit unambiguously into I-O categories. Other items were divided among I-O categories by common sense criteria. It is important to note that the relatively arbitrary categorization of approximately one-third of the net expenditures considered should have little impact on the quality of subsequent calculations. The input-output import coefficient vector is not sensitive to minor category errors. If biases do exist in the estimates, we believe that they tend to cause underestimation of the import component of Vietnam expenditures. Possible downward bias would be due to the overestimation of direct military demand from the service sectors, which use a relatively small amount of imported inputs.[8]

Table 1 shows the value of fiscal 1965 and 1968 Defense Budget direct demands from 29 I-O sectors. In order to calculate net budget changes in real terms, 1965 direct demands have been inflated to 1968 prices by appropriate sector prices indices available from the *Survey of Current Business*.[9] In cases where specific indices were not available, the wholesale price index was used. Column 5 of table 1 records the coefficient of total direct and indirect import demand for each of the relevant 29 sectors. The import content of net Vietnam War expenditures implied by the assumption of 1958 interindustry relationships is thus:

$$\sum_{i=1}^{29}(D68_i - p68_i D65_i)(m_i) = 582.4 \text{ million dollars}$$

where Dnn_i = direct defense demand from the ith sector in nnth year
$p68_i$ = price adjustment in the ith sector.
m_i = direct and indirect import coefficient for the ith sector.

The 1958 I–O matrix probably greatly unestimates the import content of 1968 war-induced expenditures because of differences in the macro-economic conditions prevailing in the two periods. Nineteen fifty-eight was a year of recession, with substantial underutilization of the labour force and plant capacity. The average propensity to import (including intermediate and final consumption demands) was only 2.91 percent.[10] In contrast, the 1965–1967 period has been characterized by high aggregate demand and near-capacity factor utilization. Not surprisingly, the marginal propensity to import (MPM) for this period was quite high (see table 2).[11] We would argue that the import content of war expenditures calculated from the 1958 I–O matrix should be adjusted for changes in the propensity to import at the margin. To the degree that the aggregate marginal propensity to import is an accurate index of changes in the marginal propensity to import intermediate goods in defense-related industries, it is appropriate to multiply the import coefficients by the ratio of 1964–1967 MPM to 1958 average propensity to import (APM).

Table 2, column 3 shows the estimated import requirements of war materials for each of our two assumptions regarding the MPM. In view of the economic considerations discussed above and possible trade distortions during the period due to international monetary turbulence and the domestic copper strike of 1967, we believe that 1,120 million dollars—based on the 1964–1967 MPM—is the best measure of war-induced imports.

---

[6] "The Interindustry Structure of the United States," *Survey of Current Business* (November 1964), pp. 10–29.

[7] United States Bureau of the Budget, *Appendix to the Budget of the United States*, 1967, 1969.

[8] U.S. Department of Labor calculations of Vietnam War services and materials expenditures made for fiscal 1967 (see "The Employment Effect of Defense Expenditures" by Richard Oliver *Monthly Labour Review*, September, 1967) show relatively smaller service sector purchases and imply an import content 4 percent higher than our calculations.

[9] See, for example, *Survey of Current Business* (March, 1968), pp. S8–S9.

[10] *Survey of Current Business* (March, 1968).

[11] Note also that the *average* propensity to import, at 3.62 in 1967, was substantially higher than in 1958.

TABLE 2.—WAR MATERIALS IMPORT CONTENT UNDER 2 ASSUMPTIONS

Assumption	Import propensity (percent)	Import content (in millions of U.S. dollars)
(1)	(2)	(3)
1958 average propensity to import	2.91	580
1964–67 marginal propensity to import	5.62	1,120

Sources: Table 1 and Survey of Current Business.

III. THE INDIRECT IMPACT

A third and final effect of the Vietnam War on the United States balance of payments is an indirect one. It results from the diversion of current production of tradable commodities from civilian uses—including exports—into military uses. In many industries the demands of the war have undoubtedly led to longer delivery times and a reduction in goods available for sale to non-military purchasers, even though prices may not have increased more rapidly than they would otherwise have done. As a result, United States producers have lost business to foreign competitors, in both domestic and export markets. Moreover, in other industries, the inflationary pressures generated by the War have probably led to a deterioration in the price-competitiveness of American products, and to a further decline in the United States trade surplus. Manpower shortages caused by military recruitment have likely agggravated both of these effects.

For statistical reasons, these two effects on net exports must be measured in aggregate. The procedure we propose involves measuring the change in the United States share of world trade. As a yardstick for evaluating American competitive performance, we have chosen not total world trade but the trade of industrial countries.[12] These countries are similar to the United States in structure of trade. Accordingly, their performance probably provides the best indication of how the United States might have done in world trade under normal conditions.

The reader may notice that the time periods used to measure each of the three components of the war's balance of payments impact do not coincide. Ideally, we would have preferred to calculate each component on the basis of the calendar year 1967. Unfortunately, because of lags in the availability of data, we do not have detailed world trade statistics for that year. We have decided, therefore, to examine the changes in United States share from calendar year 1964 to 1966, rather than from 1964 to 1967. However, since the total United States surplus in commodity trade in 1966 was almost the same as that of the following year, we suggest that 1966 probably provides a suitable indication of how the War has affected United States trade.[13]

There is a further problem with the procedure we have selected. It is conceivable that the United States share of trade would have declined even without the military expansion. If so, by including *all* of the deterioration we will be overstating the indirect impact of the War.

One possible non-military cause of a United States market share loss may be handled fairly easily. Since both the European Economic Community (EEC) and the European Free Trade Area (EFTA) were reducing internal tariffs, one would expect some trade diversion from the United States to members of these economic unions. For this reason, we have subtracted internal trade in EEC and EFTA from total trade.

A second possible reason for a decline in market share for United States producers is somewhat more difficult to treat. It might be argued that even without the War the economy would have been operating at a sufficiently high level of capacity utilization relative to other countries to produce a loss of market

---

[12] For a definition of these countries, see International Monetary Fund, *Direction of Trade. Annual 1962–1966*, p. vii.

[13] The situation with respect to war materials import content, described in part II, is somewhat similar. Fiscal 1968, extending from July, 1967 to June, 1968, which provides the basis for our estimates, is of course not the same as the calendar year 1967. However, we note that aggregate defense spending in fiscal 1967 in the relevant categories was almost the same as that budgeted for 1968, and conclude that fiscal 1968 is probably representative of calendar 1967.

share. However, let us consider the facts. Without the War, under our assumptions, United States real output would have grown at a considerably slower rate—at 4 per cent annually rather than 5 per cent. Moreover, increases in demand would have been spread evenly, rather than concentrated in several key sectors. Finally, without the War, the civilian labour force would have been larger by over 500,000 men in military service related to Vietnam. When these three factors are taken into account, it is likely that without the military build-up any decline in the United States share of world exports would have been small.

What is required is to judge just how large this "normal" deterioration would have been. United States exports, and therefore the United States share in world trade, are highly dependent on movements in the level of economic activity in its principal markets. We have accordingly estimated the following statistical relationship for the period 1955–1964:

$$\Delta Y = -2.99 + \underset{(13.7)}{18.5}\Delta X_1/X_1 + \underset{(9.6)}{32.2}\Delta X_2/X_2$$

$$R^2 = .72;\ d = 2.07$$

where Y = United States percentage share of industrial countries' exports.
X_1 = total real gross national product of Britain, EEC and Japan.
X_2 = gross national product of Canada.
R = multiple correlation coefficient.
d = Durbin-Watson Statistic.

Standard errors are in parentheses. Note that we have included exports to the United States in the denominator of our trade share ratios. Thus ΔY shows changes in the competitive position of United States producers in both domestic and foreign markets. When actual 1965 and 1966 values are subsituted for the independent variables, this relationship yields an expected decline in United States exports from 1964 to 1966 of 0.07 per cent.

As estimate of the indirect balance of payments impact of the War may then be found by comparing the expected loss in market share with the actual loss. To avoid double counting, it is necessary to subtract from the denominator of the share ratio those United States imports from the industrial countries used as inputs for the increase in defense production (based on the calculations of part II). It will be remembered that there are two estimates of these intermediate inputs—one for each assumption with respect to the marginal propensity to import. These assumptions each yield slightly different estimates of the effects on the United States trade position. For reasons explained above, the most appropriate measure probably requires the use of the 1964–1967 MPM. This assumption yields an estimate of 1,290 million dollars for the indirect impact of the War on the United States current account.

Recall that the calculations of part II showed a smaller estimate of war materials import content with the 1958 APM than with the assumption of the higher 1964–1967 MPM. Since this defense import content must be subtracted from United States imports in the calculations of the trade share loss in part III to avoid double counting, the *lower* 1958 propensity to import produced a *higher* estimate of the indirect impact. Under this alternative assumption, the indirect current account impact of the War was 1,390 million dollars.

TABLE 3.—TOTAL CURRENT ACCOUNT IMPACT OF WAR

[Millions of U.S. dollars]

Component of deficit	Alternative estimate	Best estimate
Direct foreign expenditures	1,600	1,600
War materials import content	580	1,120
Indirect impact on trade position	1,390	1,290
Total	3,570	4,010

Sources: Table 2, text.

CONCLUSION

In this paper we have disaggregated the impact of the Vietnam War on the United States balance of payments into three components:

(1) direct overseas expenditures
(2) the import content in domestically produced war materials
(3) the indirect impact on United States net exports due to export diversion and price increases.

Table 3 summarizes our "best" and an alternative low estimate of the balance of payments impact of the War. Taking the three components together, we estimate that the War contributed 4.0 billion dollars to the current account deficit in the calendar year 1967.[14] Further escalation of the War without compensatory fiscal and monetary measures to cut domestic absorption would have more than a proportional effect on the deterioration of the current account.[15]

Our analysis implies that the United States would have been in international payments surplus in 1967 in the absence of Vietnam War expenditures and on the assumptions (a) that the real United States GNP has been less by the amount of war materials and service expenditures; (b) that capital flows remained unchanged.[16] As long as the United States economy remains near full employment, the nation's international payments account will be sensitive to involvement in military conflicts. The payments drain of external military commitments strikingly impinges upon the ability of the United States to maintain both high domestic absorption and the relatively free international movement of goods and capital. It also reduces the capacity of the United States to promote lasting liberal reforms in the international payments system by maintaining the economy role of the United States as the world's primary payments debtor and chief benefactor of additional reserve creation. The modest involvement of the United States in the international economy thus serves to define one dimension of the limits of American military and economic power.

Mr. PASSELL. We believe that the wide divergence of the Government estimate and our own is a result of the exclusion from Government estimates of the secondary and indirect effects of war expenditures.

The effect of the war on the U.S. balance of payments can be broken down into three categories:

1. The direct effect of increased purchases abroad of goods and services as a result of the war effort. These purchases range from labor services of Vietnamese used for the construction of American military bases to the tourist dollar expenditures of American military personnel on rest and recreation visits to Bangkok or Hong Kong.

2. The secondary effect of increases in imports of goods used to manufacture military supplies in the United States. For example, imported metal ores may be needed for the production of military communications equipment.

3. The indirect effect of war expenditures on the ability of the U.S. economy to compete with foreign producers in both domestic and foreign markets. Production for the war at both finished and intermediate stages may make American corporations less able to fill export orders and may encourage larger imports.

The direct effects are the most clearly identifiable and can be estimated with substantial accuracy. One possible measure of this flow is the $1.5 billion net increase in direct military expenditures of for-

---

[14] As noted in part III, calculations for different components were based on different time periods.

[15] Moreover, chronic current account deterioration is likely to induce greater deficits on capital account as private individuals speculate against the United States capacity to maintain the exchange rate of the dollar. This point applies to the general issue of the United States payments problem and is thus not central to the more limited analysis of this note.

[16] A conclusion that should not be surprising in view of the 1963 Brookings projection of a United States surplus in 1968. See Walter S. Salant and Others, Brookings Institution, *The U.S. Balance of Payments in 1968.*

eign exchange in Southeast Asia. This figure is not an adequate measure of exchange losses. On the one hand, it overestimates dollar losses by not accounting for possible offsetting U.S. exports to the area induced by military aid. On the other, it neglects to count the military support operations of other U.S. Government agencies such as the Agency for International Development. The only important changes in U.S. economic ties with Southeast Asia since 1964 have been in some way related to the Vietnam war. With this assumption, a more satisfactory measure would thus be the net increase in payments resulting from current account transactions and government loans and gifts. This results in an estimate of $1.6 billion, an amount which is quite close to current Government estimates of the Vietnam war impact.

A second portion of the impact results from expenditures for imports used in the production of military goods. Defense Department procurement policies limit the use of imported finished goods, but some of the inputs in military production must inevitably be imported. It is quite difficult to measure the import content of the Vietnam war materials because an accurate estimate requires substantial knowledge of both the mix of goods purchased for the military in Vietnam and the processes used to produce them. We arrived at an approximation of the size and composition of Vietnam military production by assuming that net increases in annual defense expenditures for military supplies between fiscal 1965 and fiscal 1968 constituted the cost of the war. We did not include increased expenditures for food, housing, or family allowances, since military personnel and their families would have eaten whether or not they were connected with the military. This specialized concept of the total materials cost of the war leads to an estimate of $16 billion. To calculate the imported portion of this $16 billion, we broke down the expenditures into 29 categories and estimated the import content for each from the Department of Commerce Interindustry Input-Output Table.

This breakdown was of necessity a rough one made from information available in the Appendix to the Budget of the United States. Fortunately, the input-output table results are not very sensitive to errors in these calculations. To the degree that the Defense Department is successful in limiting imported inputs, our estimate will tend to be exaggerated.

Adjusting the figures for the economy's recent propensity to import leaves us with an estimated $1.1 billion in imports used to produce war materials for Vietnam. We are assuming that in the absence of the $16 billion materials expenditure the funds would not be reallocated to other uses. For instance, in 1967, we are assuming the GNP would have been $774 billion instead of the actual $790 billion. Under the assumption, the output of goods and services, except those used specifically to pursue the war, would be the same.

A third effect of the war on the balance of payments is the indirect impact on the economy's capacity to compete in international trade. The war may divert sectors of the economy from producing for export markets. Potential exports may be lost as defense contractors and their suppliers, pressed to meet Government orders, refuse export business or lengthen their delivery lags to foreign purchasers. In some

industries these "bottleneck" problems may have been met simply by raising prices sufficiently to drive would-be foreign buyers to other markets.

A parallel effect may occur on the import side. Domestic purchasers, forced to wait long periods for delivery or to pay uncompetitive prices to American producers, may have switched to foreign manufacturers.

It is again difficult to pin down an exact numerical estimate of these indirect effects. We estimated the share of total industrial world trade which the United States could expect to capture in peacetime. Our expected share was adjusted for growing preferential trade among European Economic Community and European free trade area nations. It was found that American trade since the Korean war has been largely dependent on the level of economic activity in our principal trading partners: Canada, Western Europe, and Japan.

During 1966, the latest year with available statistics, our trade was $1.3 billion below what could be expected had we held our pre-Vietnam trading position. (See table B.) This figure includes both lost exports and additional non-defense-related imports. The $1.3 billion loss in trade may even be larger if recently instituted Defense Department programs have been successful in curbing the importation of defense materials. These controls increase the pressure on American production and may further limit exports and stimulate civilian imports.

Our analysis of the total effect of the war is necessarily inexact. The estimate of the three components combined, $4 billion, is a product of a number of assumptions, and is therefore subject to a wide margin of error. However, the figure does not represent an extreme position. Other assumptions lead to a somewhat smaller or a much larger total.

It is important to separate the effect of the war on the balance of payments from the effect of the boom in the American economy which has accompanied the war years. We believe that our analysis largely skirts this problem. Of course, the direct drain, $1.6 billion, has little to do with high production capacity utilization here at home. Moreover, the calculation of the $1.2 billion secondary effect on imported inputs for war production is based on 3 years' experience through 1967, the period before prices were increasing dramatically in the United States. The same reasoning applies to the calculation of the $1.3 billion indirect effect on trade, which is limited to 1966.

If these calculations were redone using data from 1968, we might expect the resulting number to be larger, but it would also be more difficult to separate the effects of inflation.

The conclusions of the analysis may be briefly summarized:

There has been a decline in the U.S. current account position since 1964 of more than $6 billion. This has been reflected in both slow growth of exports and a boom in imports. The recent European economic slowdown may have contributed to lagging exports. There is, however, substantial reason to believe that the Vietnam war has played

a major role in this rapid deterioration. As noted in figure I, the $4 billion estimate of the war's balance-of-payments impact is greater than the U.S. overall deficit for each of the war years. Restrictions on American investments abroad and shifts in short-term investments to the United States may explain why the deficits have nonetheless been relatively small in the past few years.

A portion of future reserve losses associated with the Vietnam war may be prevented when the war is terminated or reduced in cost. However, the indirect drain resulting from a lack of competitiveness in world trade could conceivably continue. Exporters may find it difficult to recapture lost foreign markets and domestic users of imports may continue to buy abroad. In any case, it is reasonable to expect that the initial salutary effect on the current account resulting from the war's end will not be as great as the long-term improvement.

(Tables A and B, and figure I, of the prepared statement of Mr. Passell, follow:)

TABLE A.—CHANGES IN U.S. CURRENT ACCOUNT AND FOREIGN AID TRANSACTIONS SINCE 1964

[Billions of dollars]

	1964	1967	1968				Change since 1964
			I	II	III	[1] 1968	
Goods, services excluding military transactions	10,577	7,867	1,130	1,353	1,623	5,356	−5,121
Goods, services including military private transfers, pensions	8,853	4,396	296	529	804	2,172	−6,681
Goods, services including military, all transfers, foreign aid	5,625	1,692	−316	−121	124	−416	−6,041

[1] Estimated at first ¾ rate.

Source: Survey of Current Business.

TABLE B.—FOREIGN TRADE POSITION OF UNITED STATES AMONG INDUSTRIAL NATIONS

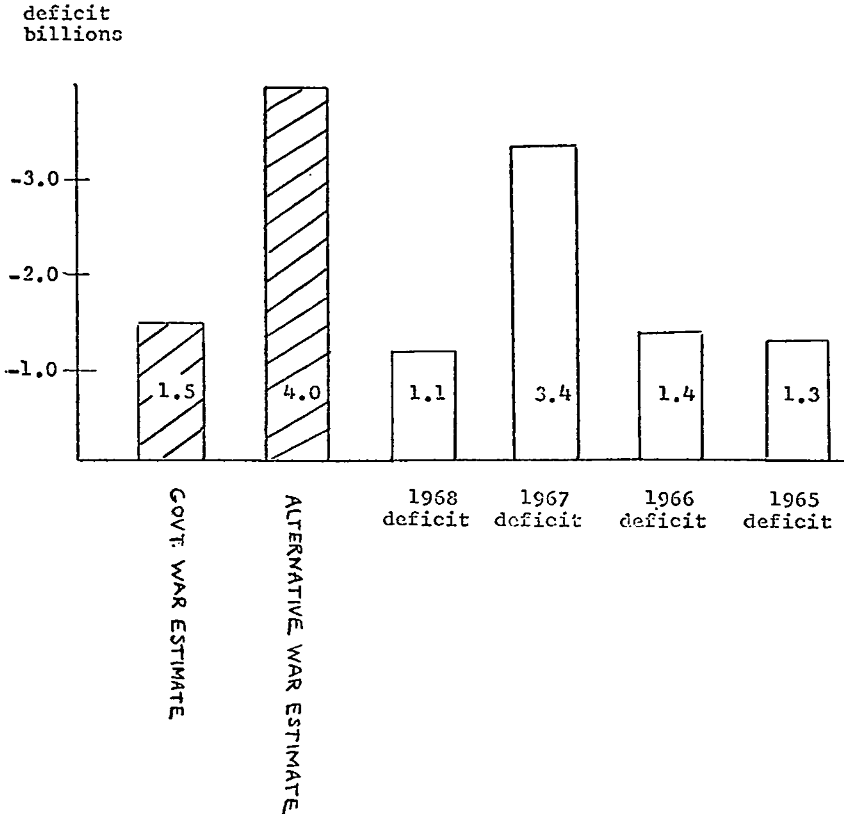
[Billions of dollars]

	1958	1964	1965	Actual 1966	Predicted 1966
Total industrial nations exports, less intra-EEC, intra-EFTA trade	54.6	85.26	91.39	102.51	
Total U.S. exports	17.87	26.63	27.40	30.45	31.74
U.S. percentage share	33.07	31.24	29.98	29.70	30.98

Source: Direction of Trade, International Monetar yFund.

FIGURE I

United States Deficits on a Liquidity Basis and the Payments Effect of the War



Chairman REUSS. Thank you, Mr. Passell.

Secretary Moot, I take it from the summary figures on table III of your testimony that, during fiscal year 1968, our total defense balance-of-payments expenditures abroad were $4.5 billion. Is that right?

Mr. MOOT. Gross expenditures were $4.5 billion.

Chairman REUSS. Now, in trying to sort that out, I come up with approximately $1.5 billion for the war in Southeast Asia, $1.5 billion for Europe, and $1.5 billion for all the rest of the world—that is, this hemisphere, Africa, the rest of Asia and so on. Do you want to correct those "boxcar" figures in any way? I think they are about right.

Mr. MOOT. Table II, in my prepared statement, provides a breakout of our expenditures by major area. About $1.6 billion of our expenditures are in Western Europe and, as I indicated in my statement, about $1.6 billion of our total expenditures in fiscal year 1968 were related to the conflict in Southeast Asia.

Chairman REUSS. Roughly, that is about it. And you say that this amount is going to be larger in the current fiscal year, fiscal 1969?

Mr. MOOT. Yes sir. We expect that our expenditures will increase in fiscal year 1969.

Chairman REUSS. Looking at our expenditures in Western Europe, which you have said are on the order of $1.6 billion, and I notice the expenditures in the Federal Republic of Germany comprise $887 million of that in fiscal 1968, what reciprocal aid are we currently getting from the NATO countries on that whopping balance-of-payments deficit which we incur as part of our mutual security operation? I realize that in the past there have been some buying of bonds by the Federal Republic, which just postpones the evil date since the bonds have to be repaid in 4 years. There have also been some military purchases, but what does it come to currently in fiscal 1969 at the moment?

Mr. MOOT. Insofar as the Federal Republic of Germany is concerned, Mr. Chairman, the fiscal year 1969 arrangements provide for $725 million, primarily in financial arrangements, which do not, of course, have the long-range or the long-term advantage or beneficial effect, but are heavily in our interest to keep the balance of payments ——

Chairman REUSS. Excuse me, is that current? That sounds like the one we had in effect last year. Have they agreed to buy any more of our bonds?

Mr. MOOT. It is very close to the one that was in effect last year. The one that expires this June 30 is composed of: Deutsche Bundesbank and commercial bank purchases of U.S. securities and FRG military purchases through commercial channels—the total of which is $725 million. It is comparable to the previous agreement of $500 million in securities purchases and about $100 million in military purchases through commercial channels.

Chairman REUSS. How is that $725 million broken down among those three components?

Mr. MOOT. It is $500 million, $125 million, and $100 million.

Chairman REUSS. For respectively?

Mr. MOOT. The Bundesbank purchase of U.S. securities is the $500 million.

Chairman REUSS. That is a loan?

Mr. MOOT. Yes, sir; these are financial arrangements. I haven't yet touched upon the military sales piece. These are financial arrangements that I am talking about.

Chairman REUSS. The whole $725 million?

Mr. MOOT. With the one exception that there is $100 million of commercial procurement in the $725 million. There is $500 million and $125 million of financial arrangements, and $100 million in commercial procurement. The total of our receipts in fiscal year 1968 is $1,239 million as shown on our tables. During the past few years more than half our receipts have come from Western Europe. While I can provide data, by country, to the committee, and I will do so if the committee desires. I would prefer not to put them in the open record.

Chairman REUSS. All right, if you would provide those on the arrangement made.

Mr. MOOT. I will.

[Classified data was at this point provided to the subcommittee.]

Chairman REUSS. Do we currently have an agreement with Germany for this fiscal year for the purchase of U.S. military supplies?

Mr. MOOT. Well, we have——

Chairman REUSS. We had one, but I had the impression that they had said no more, they could buy it cheaper elsewhere.

Mr. MOOT. We have open, unfilled orders which are being filled. We have current discussions going on for additional orders as well as other arrangements.

Chairman REUSS. The open, unfilled orders, those are from past arrangements. We shouldn't count them twice, should we?

Mr. MOOT. That is right. They will provide for future deliveries. The current discussions, which will be going on for the next several months, are looking to arrangements which will become effective on July 1, 1969.

Chairman REUSS. Well, now, for the current fiscal year, fiscal 1969, I had the impression that the arrangement with the Federal Republic of Germany for the offset purchases of American goods ran out in about May of last year, just before the end of the fiscal year. I, therefore, put it to you that as of now, there is no German offset whatever. We are negotiating, but meanwhile, the year goes on.

Mr. MOOT. Yes, sir. Subject to my correcting the record, I was not here last May. Therefore, subject to my correcting the record from my own understanding, Mr. Chairman, the 1968 arrangement did run out last June, but a new 1-year arrangement was made for fiscal year 1969, which is basically the arrangement we have been discussing, primarily financial in nature.

Chairman REUSS. But in terms of offset purchases, zero?

Mr. MOOT. May I check, sir?

Chairman REUSS. Yes.

Mr. MOOT. You will recall in the $725 million——

Chairman REUSS. There was $100 million of so-called commercial——

Mr. MOOT. There was $100 million, and in FRG military purchases through commercial channels that is the extent of our current agreement in terms of new receipts for military procurement.

Chairman REUSS. These are purchase from what, private American munition manufacturers?

Mr. MOOT. Yes, sir.

Chairman REUSS. So in terms of the U.S. Government, offset in zero in this fiscal year, 1969?

Mr. MOOT. Yes, sir; in terms of purchases of military equipment directly through the Department of Defense. You do appreciate that there are current discussions leading toward an arrangement which will become effective on July 1, 1969. And as I indicated in my prepared statement, we are working with other agencies to improve the extent and nature of arrangements to offset the foreign exchange costs of our forces overseas.

Chairman REUSS. Why has not the Pentagon ever done what the Joint Economic Committee has urged it to do, which is to go to the NATO countries, particularly West German, Italy, Belgium, and the Netherlands, all of which have profited enormously through gains in their international reserves, by reason of our sending hundreds of thou-

sands of American troops over there to participate in their protection—why has not the Pentagon at least asked the receivers—wealthy European countries—to please give us a check for the balance-of-payments costs, which come to one billion and a half? Why should we weaken our national security and run dollar crises every few months which threaten to bring us to our knees, without even asking the people we are supposedly helping, who have never had it so good, to write us a check?

Mr. MOOT. Mr. Chairman, I can't give you a firsthand answer to that question. I have read the record and I know your position very well. I do know that your position has been considered very carefully. I do know that the three departments involved in the negotiations—namely, State, Treasury, and Defense—are considering the views of this committee and are making what, in their judgment, is the approach which will achieve the best feasible return and still honor, of course, our international commitments.

Chairman REUSS. I can't help but interject that fiscal year 1969 is more than half over and our return is zero—not a mark, not a franc, a lira, a guilder. It would seem to me that we are not pursuing this "poker game" with much vigor.

Mr. MOOT. I would like to assure you from my own personal knowledge that Secretary Clifford has, himself, on several occasions, at ministerial meetings made the point most emphatically that we do need to change our arrangements, we do need to get a better distribution of the total cost, and he has in public stated the congressional opinion that we do need to have a more equitable sharing of the burdens of our common defense. I assure you that the people doing the negotiating are very serious about trying to improve this situation.

Chairman REUSS. Mr. Passell, the burden of your thesis here this morning was that instead of the $1.5 billion, approximately, of balance-of-payments costs estimated by the Pentagon for our Southeastern Asian military operations, in fact, the actual costs come, in your judgment, to something like double or more than double that—something on the order of $4 billion. Is that correct?

Mr. PASSELL. That is correct.

Chairman REUSS. Have you applied a similar analysis to the other two one-thirds of the Pentagon's total balance-of-payments estimates?

Mr. PASSELL. No; I have not. I think there are substantial analytical problems in apply the Vietnam analysis to other military programs. It doesn't seem appropriate to treat our basic strategic military expenditures in the same fashion as temporary Vietnam expenditures. However, I do believe that an estimate could be made which would include indirect effects of military spending and that this estimate would be larger than the current Pentagon estimate.

Chairman REUSS. Well, the two ingredients you used in upgrading the Pentagon's estimate from a billion and a half to $4 billion were, first, you said that, obviously, a military operation of that size required us to chew up more imported materials and you tried to factor those in.

Mr. PASSELL. Yes.

Chairman REUSS. And secondly, you said that a military operation of that size put burdens on American industry which, by raising prices and by making them refuse export orders, lowered our export total.

Mr. PASSELL. Correct.

Chairman REUSS. Why don't both of those factors apply to the European and, indeed, to the all-other element in our Pentagon spending abroad, too?

Mr. PASSELL. One of the assumptions of the analysis was that, in the case of Vietnam, we are chewing up approximately $16 billion in materials. Moreover, we assumed that in the absence of the war this $16 billion in Federal funds would not be reallocated to other uses. The resources freed under such circumstances would relieve some of the strains on the economy without producing much unemployment.

The materials cost of total military procurement may range as high as $30 to $40 billion. The failure to reallocate these funds, should non-Vietnam military expenditures be terminated, would result in substantial unemployment and idle industrial capacity. Therefore, this parallel assumption would not be realistic.

Another approach would be possible. Defense expenditures, unlike consumer expenditures, are concentrated in certain industries. Defense expenditures put burdens on specific industries which require the importation of material. I would expect that the appropriate analytical technique would be to compare defense expenditures with alternative ordinary civilian expenditures, and the comparison would reveal substantial net payments costs.

Mr. MOOT. Mr. Chairman?

Chairman REUSS. Mr. Moot.

Mr. MOOT. Could I mention, and I am sure that Mr. Passell's statement makes this clear, but I would like to point out that our $1.6 billion of cost is not comparable, of course, to his $4 billion.

Chairman REUSS. He makes that clear. Indeed, his figure, his component for your $1.6 billion comes out just about where you did.

However, our $1.6 billion is merely that portion of our $4.5 billion gross military expenditures which is related to Southeast Asia conflict in fiscal year 1968. What do you think of his technique?

Mr. MOOT. We have read it and it is a difficult subject on which to come to a definitive conclusion. If it would be all right with you, I would like to mention a couple of points now, and then add to the record our analysis of their article.

Chairman REUSS. At this point in the record, without objection, we will be glad to receive that.

(The analysis referred to follows*:)

IMPACT OF THE VIETNAM CONFLICT ON THE U.S. BALANCE OF PAYMENTS

There is no question that intensification of hostilities in Vietnam has had an additional adverse impact on the U.S. balance of payments since mid-1965. At the same time, the magnitude of the total impact is unclear, primarily because of the difficulty in accurately estimating indirect effects. Some attempts have been made recently to look more carefully into this area. In the article referred to earlier, Messrs. Dudley and Passell estimate that the Vietnam war adversely affected the U.S. balance of payments by $4,010 million in CY 1967, assuming capital flows remain unchanged and " * * * expenditures for consumption, investment and government purposes other than for the war would have been identical with those that actually occurred." [1]

---

*Mr. Passell's subsequent submission, responding to the analysis, appears on p. 126, following the Defense Department analysis.

[1] Dudley and P. Passell, "The War in Vietnam and the United States Balance of Payments," *The Review of Economics and Statistics* (November 1968), page 437.

The preceding assumptions are basic to the derivation of the estimates in the article; however, had there been no Vietnam conflict, many things could have been different. Indeed it is entirely possible civilian expenditures would have been at different levels under a peacetime situation or the composition of the Federal budget would have changed, thus indicating different spending levels both for defense and non-defense programs. While it is recognized, of course, that without a well defined set of assumptions, it would be difficult to conduct an analysis of this type, it is questionable whether one could realistically expect that expenditure patterns or capital flows would not have been different had there been no Vietnam conflict.

Past efforts to judge the total impact of Vietnam on our payments position indicate that estimates for direct expenditures are far more reliable than estimates of the indirect effects. This point also was expressed in testimony by Dr. Fritz Machlup, Professor of Economics and International Finance, Princeton University, before the Joint Economic Committee in February 1968 when he noted:

"We have figures for direct expenditures. That we do know. But we do not have the figures for the indirect effects for all that the military expenditures abroad and the defense expenditures at home do to other accounts of the balance of payments. These indirect effects we can guess, but we cannot know them." [2]

The estimate suggested by Dudley and Passell of $4,010 million is composed of $1,600 million in net direct expenditures, $1,290 million in the import content of domestically produced war materials and $1,120 million resulting from the diversion of current production of tradable commodities from civilian uses (including exports) into military uses.

Direct net expenditures as estimated by Dudley and Passell are calculated from the 1964–1967 change in the U.S. current account balance plus changes in government loans and government holdings of non-reserve currencies for Asian and African countries (excluding Japan) and for the same period, the change in U.S. military expenditures in Japan as reported in the *Survey of Current Business*. With this approach the authors estimate CY 1967 net direct expenditures at $1,600 million and note further that this figure corresponds quite closely to the estimate of $1,500 million discussed in the U.S. Treasury Department document *Maintaining the Strength of the United States Dollars in A Strong Free World Economy*, published in January 1968.

Despite similar magnitudes, these two estimates represent different definitions of direct balance of payments expenditures for Vietnam. The $1,500 million estimate differs from that of the authors because it includes only increases in Deparment of Defense gross expenditures entering the balance of payments as a result of the buildup in Southeast Asia.[3] The authors, on the other hand, include other categories of oversea spending such as foreign aid, loans or currency holdings with Asia and Africa. These non-military expenditures appear difficult to relate directly to the level of U.S. military spending for Southeast Asia. For example, "loans and other long-term assets" as reported in the *Survey of Current Business* for the Asian and African countries include loans under PL–480 to such countries as Indian and Pakistan, which are not necessarily determined by changes in the level of U.S. military spending for Vietnam. In this respect, it would appear to be more reasonable to assume that in the absence of hostilities in Southeast Asia, economic aid might have been increased.

Another distinction between the two estimates of direct foreign expenditures is that Dudley and Passell undertake a larger and far more difficult task in an attempt to measure the impact of military expenditures on the U.S. current account. They simply calculate this, as noted above, by computing the change in the U.S. current account with Asia and Africa (plus the change in U.S. military expenditures in Japan) from 1964 to 1967. In this way, the authors assume they can account for increased U.S. exports to those areas that are induced by war-related foreign exchange expenditures (oftentimes referred to as the feedback effect). The net change in the current account during this period, however,

[2] Hearings before the Joint Economic Committee, Congress of the United States, February 16, 19, 20, 21, 1968, Part 2, page 449.

[3] For example, on page 82 of the U.S. Treasury Department document entitled *Maintaining the Strength of the United States Dollar in a Strong Free World Economy*, issued in January 1968, it was stated: "The direct balance of payments costs attributable to our security efforts in Southeast Asia began to increase in 1965. By calendar year 1967 the increase totaled $1.5 billion per annum (excluding indirect effects)."

was also influenced by factors not generally attributable to U.S. military spending for Southeast Asia. For example, as noted in the *Economic Report of the President* for the year 1967, the Middle East crisis and its aftermath also had some adverse effects on our current account. To the extent that non-southeast Asia factors changed our current account levels with Asia and Africa then, of course, it would be misleading to assume all changes in the current account level relate to Vietnam spending.

A further distinction between the two procedures for estimating direct foreign expenditures is that the Government estimate of $1,500 million includes estimated expenditures for defense procurement made in areas outside Southeast Asia, but related to the Vietnam conflict. Such data are excluded in the Dudley-Passell estimate; however, it is recognized that the *Survey of Current Business* would not separately identify such information.

As noted above, there are various interpretations possible even in computing direct balance of payments expenditures related to Vietnam; yet, the estimating problems become far more complex when considering the indirect effects of Vietnam spending on our payments position. Much depends on the assumptions and methodology used to measure the multitude of interrelated transactions that take place, some of which may relate to Vietnam spending and others which may not.

Dudley and Passell have suggested that $1,290 million was added to our balance of payments deficits due to the import content of war materials produced in the U.S. This is calculated by taking the difference between FY 1965 expenditures and FY 1968 appropriations for Defense Department procurement of goods and services (adjusted for price increases) and estimating the import content of these expenditures using the Department of Commerce 1958 Interindustry I–O matrix.

Aside from the problem of comparing FY 1965 budget expenditures to FY 1968 appropriations and the question of updating the 1958 Commerce Department's import content factors (which are acknowledged in the article), there is a further reservation in that the budget numbers incorporated in the Interindustry I–O matrix by the authors reflect both spending in the U.S. for defense items as well as defense spending overseas. In order to avoid the problem of double counting, it would be necessary to deduct that amount spent overseas from the budget numbers cited in the I–O matrix.

The remaining indirect component in the Dudley-Passell estimate attempts to measure the amount of trade lost due to domestic inflationary pressures and the diversion of production resources as a result of Vietnam spending. The authors estimate a $1,120 million impact for this category by calculating the difference between the expected loss in the U.S. share of world trade in 1966 given no Vietnam spending and that loss which actually occurred. The authors use an estimating equation to develop the "expected decline" in U.S. export shares without the Vietnam conflict. This equation in effect rests essentially on the view that the U.S. percentage share of industrial countries exports is determined by changes in the real GNP of Britain, EEC and Japan, and Canada. To adjust for possible non-military factors which could reduce the U.S. market share, internal trade in the EEC and the EFTA was subtracted. However. there may be still other factors since 1965 not accounted for in the article which could have affected the U.S. share position. Certain goods in which the U.S. competitive advantage is large are not freely admitted to some foreign market. They are subject to quotas, unusually stringent health and technical standards, equalization levies and other special import taxes. Such restrictions, of course, also limit U.S. exports.

Aside from certain technical questions concerning the statistical significance of the variables used in the estimating equation, we do not feel these estimates of the changes in U.S. export share, especially on the aggregate level, can give very definitive answers. To determine whether the losses in U.S. shares are a general loss of competitiveness or due to special circumstances affecting the demand for particular products would require more detailed study.

Experience indicates that attempts to estimate indirect effects generally result in a very broad range of estimates. While Dudley and Passell suggest a total impact of $4,010 million, different approaches lead to estimates considerably smaller, while still allowing for indirect effects both in the U.S. and overseas. In essence, estimates are dependent on the assumptions that are used.

(Mr. Passell's reply follows:)

REPLY TO DEFENSE DEPARTMENT COMMENTS ON THE IMPACT OF THE VIETNAM CONFLICT ON THE UNITED STATES BALANCE OF PAYMENTS

A number of points in our article and my testimony can be reexamined with reference to Defense Department comments:

(1) Our estimate of the balance of payments effects of the Vietnam War is based on the assumption that expenditures for consumption, investment and government purposes other than for the War would have been identical with those that actually occurred. In this context, War expenditures total approximately $16 billion since military pay, domestic food and housing costs, and dependent allowances are excluded.

We cannot know what aggregate demand would have been in the absence of the War. We chose to assume that civilian disposable income would have been the same. Thus the average annual rate of growth of GNP would have been 4% rather than 5%. In view of widespread current concern about inflation and the overheating of the economy, our assumed level of moderate restraint on growth seems appropriate.

(2) Our calculation of the direct effects of Vietnam expenditures was designed to avoid the pitfalls of looking at only gross military expenditures in Southeast Asia. Some military expenditures return to the United States in the form of induced imports. On the other hand, non-military expenditures which are a direct result of American participation in the War are not included in gross military expenditures figures. For example, some foreign exchange is expended in AID projects within Vietnam.

The use of changes in the total U.S. balance of payments position with Southeast Asia nets out all of these effects and would provide a reasonable estimate of the direct payments cost of the War. Because U.S. regional balance of payments statistics for Southeast Asia are not readily available, we used net changes in the balance of payments with all of Africa and Asia as a proxy.

Since a large portion of gross expenditures and capital flows with Asia and Africa are unrelated to the War, the accuracy of our method is dependent on the absence of major shifts in payments flows in that part of the area outside Vietnam. The Defense Department notes that the Middle East crisis in 1967 had adverse effect on our balance of payments. Some net negative effect may have resulted, but the *Economic Report of the President* (February, 1968, p. 171) considers the effect to have been "not of great magnitude." The *Economic Report* mentions no other special factors would bias the accuracy of our estimate.

(3) The $1,290 million estimated import content of Vietnam War materials is based upon an Input-Output breakdown of net changes between FY 1965 Defense expenditures and FY 1968 appropriations. The use of FY 1968 appropriations from the *Appendix to the Budget of the United States* rather than expenditures is not likely to bias downward our calculations, since aggregate Defense expenditures were not appreciably lower than appropriations.

The Defense Department is correct, however, in arguing that a small amount of double counting results from the assumption that the entire $16 billion change in net expenditures for Vietnam was made in the United States. On the most extreme assumption that the entire $1,475 million 1964–67 change in gross Vietnam military payments flows (*Survey of Current Business*, March, 1968, pp. 32–33, line 16) was spent on items listed in our I–O breakdown, we can estimate an *upper limit* on the size of this double counting.

The $1,475 million represents 9.1% of the $16,200 million total. Double counting may thus have increased our $1,290 million estimate by no more than 9.1%, $117 million.

(4) The Defense Department points out that certain United States exports or potential exports are reduced by protective trade restrictions abroad. This is quite correct, but there has been no increase in the stringency of these restrictions during the Vietnam War period. We know of no major trade barriers which reduced the United States competitive position since 1964.

There remains within the analysis the difficult problem of separating specific Vietnam-induced effects on trade competiveness from unrelated inflation. As we make clear in our article, our current high rate of inflation is probably tied to the economy's extremely high level of aggregate demand and the removal of at least 500,000 men from the civilian labor force. Under our assumptions, the U.S. growth rate would have been less rapid and of course, the non-military labor force would have been larger.

Moreover, as Senator Proxmire pointed out during the hearings, our technique is extremely conservative in accounting for induced imports. The use of the U.S. share in total world trade as a measure of trade position neglects part of the effects of rapidly increasing imports during the War years.

Our estimates by their very nature depend upon the assumptions used and contain a margin of error. We believe that since the assumptions are cautious and the possible estimation errors are not large that the broad conclusions of the paper are reliable.

Mr. MOOT. My general approach to this question of the total Southeast Asian cost goes something like this:

The $1.5 billion, which is the amount of gross U.S. defense expenditures overseas in calendar year 1967 related to the conflict should be reduced somewhat to reflect feedback effect.

Chairman REUSS. If I may interrupt, you have heard Mr. Gaud describe, I think perfectly permissibly, a respending effect.

Mr. MOOT. That is right, sir.

Chairman REUSS. And I suppose, in justice to you, I have to concede that some of this comes back, too.

Mr. MOOT. We really don't know, this feedback effect, with precision, although studies indicate it may be as high as 40 percent or more. And, of course, it varies widely by area. If we assume a 40-percent feedback, the $1.5 billion would then be, on a net basis, approximately $900 million. We also recognize there are indirect effects on our balance of payments, principally in terms of additional imports brought about by Vietnam spending. Thus, if you consider both direct and indirect effects, the total balance-of-payments impact of the Southeast Asia conflict is, of course, higher than $1.5 billion. However, at this point, we would roughly estimate this impact lower than has been estimated by Mr. Passell, perhaps within the 2 to 3 billion range rather than 4 billion or above.

Chairman REUSS. It is a fact, is it not, that since we commenced large military operations in Southeast Asia in 1965 the foreign exchange reserves of the Saigon government have more than doubled?

Mr. MOOT. I believe that is right, sir. On the other hand, their investments in this country, their purchases from this country, of course, have sharply increased too.

Chairman REUSS. Whether the cost of our military operations abroad are on the order of $4.5 billion in fiscal 1968 which the Pentagon estimates, or whether they are on the order of the $7 billion-plus that Mr. Passell estimates, it is a fact, is it not, that on either of these two estimates, our military expenditures abroad are solely and singly responsible for deficits considerably larger than our overall net balance-of-payments deficit?

Mr. MOOT. There is no answer but yes, Mr. Chairman, when you compare our gross expenditures with the deficit, but I would qualify it by saying that there other pieces. For example, travel expenditures approximate the same impact.

Chairman REUSS. That is correct. You can pick out any deficit item and compare it with the total. I was simply doing it for your own operation.

Mr. Moorhead?

Representative MOORHEAD. Mr. Gaud, concerning the net effect of AID on the balance of payments, if we eliminated the AID program, to what degree would our exports be decreased, in your opinion? Can you give us an estimate on that?

Mr. GAUD. If we stopped our AID program altogether?

Representative MOORHEAD. Yes. I am certainly not suggesting this. I am just trying to get an idea. My point is that I think that our exports—both present and future—are increased considerably by our AID program. I can appreciate the difficulty in calculating this effect, but what would your best estimate be?

Mr. GAUD. It is a terribly hard thing to measure, of course, as you say, sir. And there are several elements in it. One, as a result of past AID programs we have, we have increased exports to countries that have improved their standards of living and their foreign exchange earnings. This is a process that is going on all the time. We have tried to estimate the amount of additional commercial exports each year to aid-receiving countries that results from that part of their economic growth due to our AID program. We estimate the additional amount that they buy in this country with their own funds—and it is a crude estimate—is roughly $75 million a year.

More important, of course, is that AID spends about $1 billion of U.S. commodities for export.

We finance, for example, about one-third of all the steel that is exported from the United States, about two-thirds of the fertilizer, and quite a lot of the machinery. For a great many commodities, our expenditures account for a very substantial amount of U.S. exports. I don't know if that is an answer to your question or not.

Representative MOORHEAD. I think it is. I think it would be helpful if you would supply this for the record, because I believe that our total exports are considerably increased because of the AID program and the fact that it is a positive net contribution to our balance-of-trade account should be more widely recognized. Even if you could provide us with estimates of the impact for specific commodities, it would give us some idea of the order of magnitude of the total impact.

Mr. GAUD. Well, yes, I could give you, for example, some figures on exports: $145 million worth of fertilizers exported under AID the first 9 months of 1968; $7 million worth of pesticides and agricultural chemical specialties; $25 million of medicinals and pharmaceuticals; about $7 million of DDT.

Now, we have also run a calculation to try to figure out what the cuts in the AID budget for fiscal year 1969 would mean in terms of U.S. exports. Again, let me stress that these figures are rough. The cut in the President's budget in fiscal year 1969 was a little over a billion dollars. We figure that this is going to mean a reduction in U.S. exports of fertilizer of from $100 to $125 million; fuels, $25 to $35 million; chemicals, $60 to $75 million; iron and steel mill products, $35 to $50 million; nonferrous metals and products, $25 to $35 million; pulp and paper, $15 to $25 million; machinery and equipment, $130 to $150 million; motor vehicles, engines, and parts, $70 to $80 million; railroad equipment, $15 to $20 million; rubber and rubber products, $10 to $15 million; all others, about $100 million. That we estimate is the real result of the cut this last year. Now, if we eliminated the program completely, the reductions would be much larger.

Representative MOORHEAD. However, they would not go down 100 percent, but a substantial part of these exports and future markets would be eliminated——

Mr. GAUD. That is correct.

Representative MOORHEAD. Because these countries couldn't afford to make these purchases.

Mr. GAUD. That is correct. Several hundred million dollars—I can't give you a figure off the top of my head—of the AID funds pay for salaries of technicians, contributions to the U.N. and the like, but the great bulk of our funds does go for commodities for export.

Representative MOORHEAD. At one point to answer my question, you used the figure of $75 million. I wonder if that is the same $75 million that appears on table III?

Mr. GAUD. Yes, sir.

Representative MOORHEAD. I notice that that figure of $75 million is constant from 1965 through 1968. Is that because the estimate is an educated guesstimate?

Mr. GAUD. I call it a "ball park" figure. You are dead right.

Representative MOORHEAD. Mr. Gaud, this may be one of your last appearances in your present capacity. I don't know what the new administration's or your plans are——

Mr. GAUD. I am resigning on the 20th of January.

Representative MOORHEAD. I wonder if you could give us your thoughts on some of the international foreign aid agencies? I think of the International Development Association, the Inter-American Development Bank. Would you say to the Congress, as it looks to the future, that, as far as economic aid is concerned, we should try to keep the great percentage of our aid as a bilateral arrangement, or should we work more toward the multilateral agencies? I think this is one of the crucial decisions that will be facing us over the next 4 years.

Mr. GAUD. Mr. Moorhead, first of all, and I know you are not suggesting this, I would like to say that this business of bilateral and multilateral aid is not an either/or question.

Representative MOORHEAD. Yes; I agree. I mean where should our emphasis be placed in the next 4 years?

Mr. GAUD. Yes. The need for aid is much greater than the supply of aid today. I think there is a place in the aid firmament both for bilateral and for multilateral programs.

They both serve useful purposes. However, I personally would move toward multilateral aid as fast as I could, assuming two things: one, the existence of multilateral agencies that will do a good job and make effective use of aid; two, the willingness of other aid donors to go along on a multilateral basis.

Now, we would like to go, I think, much faster in the direction of multilateral aid today than we really can. The Japanese, the Germans, the French, the Italians are not really very enthusiastic about increasing the proportion of their aid which goes through multilateral agencies. We can't go multilateral unilaterally. Until we can get them with us, we can't do much more than we are doing. I think the Congress very strongly holds the view—and I don't disagree with it—that there ought to be a limit on the size of the U.S. contribution to these agencies; 40 percent is a popular figure, as for IDA, for example. I don't believe the Congress would go along with increasing that to 60 or 70 percent, and I don't think they should go along with it. If we did, I don't think these agencies would be multilateral any more.

So I think we have to face the real problem of getting these other aid donors to buy the idea that multilateral aid should be increased.

The other point that I think is important is the ability of the multilateral aid agencies to carry out their programs effectively. IDA, I have no question about, except that the World Bank and IDA do very little in the way of technical assistance. They are moving in that direction. They do not make program, that is nonproject, loans as we do. I don't see, myself, how you can devise a sensible program for many countries—India, Pakistan, Turkey, Korea, Brazil, Colombia, Chile, for example—without program aid.

Representative MOORHEAD. Could you expound on that?

Mr. GAUD. Yes; the World Bank in the past, and the United States many years ago, gave aid largely for specific capital projects. They didn't give assistance as AID now does in the shape of raw materials, commodities, and spare parts to keep an existing industrial plant going. In other words, the distinction is between building a new fertilizer factory in India and supplying the components and the raw materials so that the existing fertilizer factories in India can stay in production. Now, very few of the multilateral agencies today give that kind of aid. Moreover, apart from the U.N. agencies, they don't do much in the way of technical assistance. So, as I see it, they have to broaden their outlook before they can do the whole job. I think Mr. McNamara is moving toward this as fast as he possibly can.

But going on from the World Bank and IDA, the Asian Development Bank is young. I have high hopes for it. The African Development Bank is getting off the ground also.

Representative MOORHEAD. The African Development Bank, does it have outside-of-Africa capital in it?

Mr. GAUD. No; it does not, but the head of the bank is eager to get contributions from non-African nations for a soft loan fund, the equivalent for Africa of the IDA soft loan window of the World Bank. So that institution is pretty much in its infancy.

The Inter-American Development Bank, of course, is an established institution. It is my own view that it has had less success in imposing self-help conditions on its aid than I would like to see.

The United Nations is another source, particularly for technical and pre-investment assistance. I have some question as to the efficacy of some of their programs. I think in some cases—not all—individual U.N. agencies work in a country without adequate coordination, not necessarily directing their programs at the same priorities. They have problems of hiring people—God knows we all do in this business—it is the toughest thing in technical assistance to get enough good people. But their problems are complicated by their concern for hiring people on a geographical basis. The U.N. Development Program is improving coordination and screening, but it still has a way to go.

So I would say if we are going to talk about increasing the amount of our aid that goes through multilateral institutions, we ought to make a real effort to increase the effectiveness of those institutions. We must not lose sight of that.

Now, coming a little closer to home, if you are interested in multilateral aid's effect on the balance of payments, this presents some real problems, it seems to me. I, for one, do not believe in imposing the restrictions on our contributions to these multilateral institutions that we impose on our bilateral aid programs. If we do that and the Germans and the British do that, and the French do that, and the Italians

do that, and the Japanese do that, before you get through the poor old multilateral institution isn't going to be able to move.

I believe multilateral institutions have to be able to engage in worldwide procurement. So to the extent that you move to multilateral aid, to the extent that you adopt the principle of worldwide procurement, which I believe to be sound, we are not going to be able to tie our aid, as we have tied our bilateral aid program, and there will be an increased effect on the balance of payments.

Representative MOORHEAD. Thank you very much, Mr. Gaud. I think this has been a most helpful discussion.

I think I have taken up all of my time, Mr. Chairman. So I will yield.

Chairman REUSS. Senator Proxmire?

Senator PROXMIRE. Well, gentlemen, it is a real pleasure to have a chance to see you. I am very sorry, Mr. Gaud, that you have resigned, because I think you have done a marvelous job in a position in which you get nothing but blame. Those who agree with you and support you are silent and those who disagree are anything but silent. It is one of those jobs like Secretary of State and Secretary of Agriculture in which you just can't win. I think you have done a splendid job. We owe you a real debt.

Mr. GAUD. Thank you, sir.

Senator PROXMIRE. Mr. Moot, I am very happy that our distinguished, illustrious new Secretary of Defense has seen fit to reappoint you. You were a fine SBA Administrator. Of course, we worked with you in the Senate Banking Subcommittee on Small Business.

Mr. MOOT. Thank you, sir.

Senator PROXMIRE. I know what a fine job you have done here, and it is good to see that continuity, because we certainly need it.

Mr. MOOT. Thank you very much, Senator.

Senator PROXMIRE. I would like to ask Mr. Moot if, in view of the fact that we are more than half way through fiscal 1969, you can give us any estimates of the balance-of-payments situation to complete this table, table I, for the impact of the balance of payments by your definition in the present fiscal year? Are those available at all? Can you just tell us whether it is up or down from what it was?

Mr. MOOT. Well, I think the best way to answer that, Senator, is to say that the calendar year expenditure figure, if we were looking at calendar year 1968, we would be not much above the fiscal year 1968 level. For fiscal year 1969 ending next June 30, as I stated earlier, we expect our expenditures will be higher than in fiscal year 1968 but we anticipate a further slackening in the rate of growth.

Senator PROXMIRE. So that whereas we have had a deteriorating situation in the military, it has been more and more adverse in its impact on the balance of payments, you feel that has been arrested and that on the basis of the past, last 6 months of calendar year 1968, it has gotten no worse and you don't expect it to get much worse in the coming 6 months. Of course, we can't tell what's going to happen in our military policy, but on the assumption that it does not change.

Mr. MOOT. With the budget as it will be explained this week by the President and others, I would say that we are sort of plateauing out in terms of looking forward beyond fiscal year 1969 and it all depends upon the military situation.

Senator PROXMIRE. Why did you have this serious adverse change in the last, in fiscal 1968? It seemed to me the escalation was primarily, at least the manpower escalation, going from 100,000 to 500,000, most of that I thought was in fiscal 1967. Isn't that correct? If it is, I can't understand why it was almost a billion worse the next year.

Mr. MOOT. There are two things, Senator. One, of course, was the increase in expenditures and the second was a reduction in receipts so it was roughly about half and half. About half of that billion dollar increase in our net adverse balance took place because of decreased receipts and half because of increased expenditures.

Now, the statement last March of the President, of course, did announce a further incremental increase of our overseas personnel in Southeast Asia.

Senator PROXMIRE. It had been modest compared to what it had been before.

Mr. MOOT. Yes.

Senator PROXMIRE. This committee requested and received from the Defense Department defense economic indicators about the middle of last year. Since we have gotten those, I have gotten the impression that the impact, the stimulating and expansionary and inflating impact on the economy was diminishing—not simply stable, but diminishing. It would seem to me that it might be helpful if there were hard figures, if the balance-of-payments figures could be added to those defense economic indicators. It seems to me they are not in there.

Mr. MOOT. They are not in there, that is right, sir.

Senator PROXMIRE. Would it be practical to include them?

Mr. MOOT. Yes, if we can work it out. As you know, Commerce now publishes the Defense Indicators, but we work very closely together.

Senator PROXMIRE. I am sure it would be very helpful to us and I am sure the whole business and academic community.

Mr. MOOT. I will try to see that this is done.

Senator PROXMIRE. I wonder, Mr. Passell, if you agree with Mr. Gaud that the AID actually improves our balance-of-payments position—last year, it apparently did—and that the coming years will improve it even more?

Mr. PASSELL. The reason the direct impact is so small is because the aid is tied. Unfortunately tied aid may make indirect demands on the economy leading to net payments losses.

Senator PROXMIRE. So it is possible if you applied the analysis that you applied to Defense expenditures to foreign aid expenditures, you might find that the total overall effect might be negative in the balance of payments?

Mr. PASSELL. I would say "Yes." Another conceptual problem also arises here. The repayment of old foreign aid loans contributes to minimizing the net effect of aid on the balance of payments.

Senator PROXMIRE. Have you looked at this to try to give any kind of estimation of the effect of that?

Mr. PASSELL. No, I have not.

Senator PROXMIRE. It seems to me Mr. Gaud has made such a telling point. If we could accept completely and if the economic profession could accept his analysis, it ought to be shouted from the house-

tops. It seems to me that 99 out of 100 people feel that the balance-of-payments problem is largely caused by the foreign aid giveaway programs. My own expectation is that about 90 percent of the economists, while they don't think it is nearly as serious as the military program, think it is negative. You are telling us that, in your view, it probably is negative indirectly, but the dimension of the negative effect you can't estimate.

Mr. PASSELL. Correct. I would also mention that I expect its effect is less adverse than Defense expenditures per dollar spent, because aid expenditures are less concentrated in heavily burdened sectors of the economy.

Senator PROXMIRE. There is $7 billion by your estimate for military. If foreign aid impact is negative, it is perhaps negative in the area of half a billion dollars or a billion dollars.

Mr. PASSELL. Yes.

Senator PROXMIRE. I want to ask Mr. Gaud to answer, but before I do that, you seemed to omit from your analysis—maybe you didn't—the effect of the military program on increasing our imports by stimulating the economy, by providing higher pressure for higher wages and so forth. For example, one estimate we had was just the escalation in Vietnam resulted in a million direct jobs and 2 additional million indirect jobs. When you have that, you obviously have a stimulation that results in a substantial increase in imports.

Mr. PASSELL. That is quite correct, and indeed, the analysis only partially covers those imports.

Senator PROXMIRE. Looking at the imports in the manufacturing area and so forth, rather than the imports resulting from the consumer, who has more money, going out and buying more and, therefore, increasing our imports, our whole experience has been that, as the economy gets closer and closer to full employment and prices rise, our imports increase greatly.

Mr. PASSELL. Yes; especially capital goods imports during recent years.

Senator PROXMIRE. So it's a conservative estimate in that sense.

Mr. PASSELL. Yes; that is one of the conservative assumptions.

Senator PROXMIRE. Mr. Gaud, do you have a reply to the estimate by Mr. Passell that if you consider the indirect effects of your program, it probably has an adverse effect on balance of payments?

Mr. GAUD. There are a couple of points that I think might be worth bringing up.

On the first question that Mr. Passell raises about the impact of great expansion in the economy on limiting exports and stimulating imports, he builds this, and quite rightly as far as the Defense Department is concerned, by starting from the $16 billion increase in defense production as a result of the Vietnam war. Now, there hasn't been any comparable increase in expenditures under the AID program in the United States. If you look at table I attached to my statement, as far back as 1965, expenditures in the United States were about $1.7 billion. Expenditures today are about $1.9 billion. So that there hasn't been a big increase as a result of the AID program. Even with tying, there hasn't been a big increase in our commodity procurement figure over the last half dozen years. AID expenditures have been more or less stable rather than on a big upscale.

Second, as far as his point on foreign components in the goods that we ship overseas is concerned, we have a regulation which permits only a 10-percent foreign component in anything that we buy under the AID program. We do our best to enforce that, and I think we are fairly successful. So I don't think the element of foreign componentry amounts to very much in our AID program.

Senator PROXMIRE. What you are saying is it may be true that it has some negative effect, but it is quite modest?

Mr. GAUD. I think so, but also let me be quite candid about it. As Mr. Passell pointed out, we reached the conclusion that there is no net adverse effect only by taking into account payments of interest and amortization on loans that had been made. We don't claim that apart from that the AID program benefits the balance of payments in the short run. I would claim vociferously that it benefits the balance of payments in the long run, in the sense that it creates markets for American goods.

Senator PROXMIRE. This was a very well-balanced analysis of yours and very persuasive. There was one element I thought might be missing. You pointed out rightly that we improve our markets by the AID programs by building the economies. But do we also create competition in these areas? It's obvious that we did with the Marshall program, and you say so. We developed our own competitors. We knew we were doing it and we should have done it. It was a great success.

Mr. GAUD. Yes.

Senator PROXMIRE. I suppose we would do that to a much lesser extent with the present programs heavily concentrated in the developing countries.

Mr. GAUD. My feeling—and I think this feeling is shared by the rest of us in the business—is that the capacity for the growth of markets in the underdeveloped countries is such that there will still be plenty of room for us. Regardless of how fast they can build up their own industry, the demand is going to grow faster than their industry will grow. Certainly if you look at countries such as Taiwan, Iran, Israel, and the others which have graduated from aid and which have shown tremendous strength in building up their own economies, their total imports have grown and their imports from us have grown. This has been the record to date.

Senator PROXMIRE. Let me ask you, you spoke, and I certainly favor in principle enthusiastically, of multilateral aid. I have been for that for a long, long time. However, the heart of the advances we have made recently in reducing the effect or limiting the effect, in your case perhaps, on the balance-of-payments program has been to tie aid. Can you tie multilateral aid?

Mr. GAUD. Well, it is being tried this year with IDA, if we ever make that contribution to IDA. As you know, the agreement that was reached among the various countries and the World Bank last year was that the United States, because of its balance-of-payments position, would be put at the end of the queue. For the next 3 years, our funds would be spent only in the United States and not elsewhere. That isn't full tying. It is a step in the direction of tying. But I doubt very much if you could go very far in that direction and still leave IDA in a position to use its funds properly.

Senator PROXMIRE. It seems to contradict the whole purpose of the multilateral program.

Mr. GAUD. It does to me. I think it is dead wrong in principle and I doubt that it would be workable.

Senator PROXMIRE. Let me ask each of you gentlemen one more question, you and Mr. Moot.

What is the cost, the additional cost to the American taxpayer, of this part of our balance-of-payments program—tying aid? How much less would it cost if we didn't tie it; in other words, if we bought it where we could get it cheapest, wherever in the world we could get it for the lowest cost?

Mr. GAUD. I haven't got a figure on that.

Senator PROXMIRE. Can you give us some kind of idea?

Mr. GAUD. We reckon very roughly that it is a matter of 10 to 20 percent.

Senator PROXMIRE. Ten to twenty percent. That means in AID, what is it, $2 billion——

Mr. GAUD. Call it expenditures of $1.9 billion.

Senator PROXMIRE. That would mean $190, $200 million additional cost?

Mr. GAUD. Yes. Perhaps I would put it a little differently. When Congress appropriates $1.9 billion for the AID program, the aid-receiving countries get perhaps $100 to $250 million less good out of it than would be the case if we didn't tie.

Senator PROXMIRE. On the basis of testimony both of Mr. Moot and Mr. Passell, I would say this is another cost of the Vietnam war, because the Vietnam war puts us in a position where we have to tie our aid. The same would be true even if you accept the lower estimates.

Mr. GAUD. Well, you may be right. It is the cost of our present balance-of-payments situation; yes, sir. Whether that is due to the Vietnam war is another question.

Senator PROXMIRE. It is one of the big elements, and today it seems it is the biggest.

Mr. GAUD. It is an important element, no doubt about that.

Senator PROXMIRE. Mr. Moot?

Mr. MOOT. As I stated in our statement, Senator, the additional budgetary cost that we have been accounting for under our 50-percent procurement-differential policy amounts to about 22 percent for our procurement for use overseas, which means that the added budgetary cost has been about $75 or $80 million for this policy since 1961.

Senator PROXMIRE. How do you arrive at so low a figure? Twenty-two percent of our—you see, in Mr. Gaud's case, we applied the 10 to 20 percent of the total overall AID expenditures of $1.9 billion. In your case, you are applying a much lower figure, apparently.

Mr. MOOT. Well, I think that is right, Senator. I believe that I didn't give a complete answer. But I will attempt to find out, because there are thresholds above which there is permission to buy directly overseas without attempting to return procurements to the United States. If I may just check with the staff.

The staff estimates that our added fiscal 1968 budgetary costs for our balance-of-payments programs would be on the order of $100 million. But with your permission, I would like to amplify this.

Senator PROXMIRE. I wish you would, because frankly, I would like to know all the assumptions on which this is based. My own reaction is it must be a great deal higher than that. I don't understand why it wouldn't be in the area of several billion dollars. The reason I say that is, because, if we bought all of the hardware that we need for Vietnam and we need for Europe and elsewhere for the lowest cost, whether we bought it in Germany or bought it in Japan or wherever, if you say you would make a 22-percent saving in doing that, our overall procurement is $43 billion, isn't it, in that area?

Mr. MOOT. I assume that your $43 billion refers to the defense indicator series on the fourth quarter fiscal year 1968 annual rate of prime contract awards for work performed in the United States. And, if so, it is correct. I believe, however, this number greatly overstates the potential for buying overseas in the absence of our balance-of-payments procurement guidelines. It is, of course, difficult to tell what the lowest cost would be. But again, with your permission, I will make the assumptions and submit a statement for the record.

(The information referred to follows:)

ADDITIONAL BUDGETARY COSTS ASSOCIATED WITH THE DEPARTMENT OF DEFENSE BALANCE OF PAYMENTS PROCUREMENT PROGRAMS

Under the Department of Defense balance of payments program, budgetary costs have been incurred by policies which authorize the use of an evaluation factor to be added to price competitive bids offering foreign products. The objective of such action is the saving of foreign exchange in procurement for use in the U.S. and in procurement for use overseas.

These policies are outlined in general terms in the prepared statement by Assistant Secretary Moot. The staff estimate provided during the hearing that added budgetary costs of these policies were on the order of $100 million in FY 1968 was based on (1) an evaluation and extrapolation of data on procurements returned to the U.S. contained in reporting systems in effect in prior years for procurements for use overseas and procurements for use in the U.S., (2) information drawn from overseas petroleum procurement "return" programs and (3) data related to use of revised construction procedures for overseas construction programs. It is recognized that there may be other nonquantifiable impacts. For example, data on procurements for use in the U.S. "returned" to U.S. sources generally can reflect only those cases where foreign source bids were received. However, since Department of Defense has specified in its procurement regulations for a number of years that an alternative 50% balance of payments evaluation factor would be utilized, it could be expected that foreign concerns would submit a bid only where they believed they could still be the low bidder after the evaluation factor was applied. There is no way of "reconducting" past procurement transactions to determine where foreign bids would have occurred if only a 6%–12% evaluation factor had been used or to permit an evaluation of costs and savings in cases where foreign bids were not received. On the other hand, Department of Defense regulations generally require that the validity of the requirement be reconfirmed before payment of premium costs. While there have been cases where requirements were eliminated or deferred at field levels, data are not available on these cases. In addition, it is difficult to assess quantitatively the impact of the general emphasis on reducing balance of payments expenditures as it led to actions such as termination of contracts overseas, with the requirement being absorbed within the organic capability of the military department, with both budgetary and balance of payments savings.

While in some respects Department of Defense use of procurement evaluation factors can have the same effect as AID "tying" policies, there can be no precise comparison between these policies. Unlike AID, the Department of Defense programs have not operated against most of the total procurement program of the Department of Defense nor against a base period where the bulk of procurements had been made from overseas sources. Therefore, an evaluation based on the application of the historical percentage differentials experienced under any portion of the Department of Defense balance of payments program to the en-

tire procurement program of the Department of Defense is considered inappropriate.

In considering the Department of Defense programs, a number of factors must be noted: (1) there are limitations on the Department of Defense use of budgetary premiums, i.e., in most cases a decision generally has been made to procure offshore if the differential is above 50%, (2) there are exceptions which permit procurement overseas *without* application of price differentials, e.g., utilities and communications services, (3) the differentials are applicable only where there is U.S. and foreign price competition for the item or service being procured and, considering the large annual dollar volume of purchasing which is not conducted on a "price competitive" basis, the potential for the application of budgetary premiums is a relatively small portion of total Department of Defense procurements of equipment, materials and supplies and (4) procurements by Department of Defense are primarily for use by the U.S. military services and, as such, the procurements involved in many cases are of a specialized and unique nature rather than being items generally available on the commercial markets in the U.S. and in foreign countries.

It has been the long-standing policy of the U.S. to support U.S. military forces around the world with supplies and equipment manufactured in the U.S. This policy is based on such Congressional enactments as the Buy American Act and the Berry Amendment to the Defense Appropriations Act (see, for example, Section 523 of PL 90-580, the Defense Department Appropriations Act for the fiscal year ending June 30, 1969). In furtherance of these national policies and in support of a program of national defense which requires the maintenance of active research, engineering, development and production capabilities in the U.S., proposals for Defense purchases of military items generally have been solicited from U.S. firms. Because of the past substantial investment in research, development and engineering, U.S. firms generally are in a position to respond effectively to proposals on major items of defense procurement of advanced weapons systems and for continuing support of these systems. Therefore, while there has been a clear association in recent years between the balance of payments programs and the continued active support for a high level of use of domestic supplies and services to meet Department of Defense requirements, the emphasis on support of U.S. military activities by items manufactured in the United States is not, per se, a balance of payments policy. There was such an emphasis prior to the institution of Department of Defense balance of payments procurement guidelines and this emphasis could be expected to continue irrespective of the status of the U.S. balance of payments. In this respect, the Department of Defense has indicated that procurement guidelines involving the use of differentials will be continued in effect only so long as is required by the U.S. balance of payments situation.

Senator PROXMIRE. Could I just ask Mr. Passell, do you have any observation on that?

Mr. PASSELL. No; I don't. I would think the Defense Department's estimate is probably correct.

Chairman REUSS. Mr. Moot, listed in our traditional balance-of-payments accounts are the receipts from U.S. military sales which, according to your table III, have been running at more than $1 billion a year for every fiscal year from 1963 onward. What are these military commodities which we have been selling? I take it that they are not junk. These are things that people want?

Mr. MOOT. Yes, sir.

Chairman REUSS. Why is it that the U.S. Government takes credit for sales of equipment of this sort? What would be an example? Fighter planes?

Mr. MOOT. You mean that we are selling overseas?

Chairman REUSS. Yes.

Mr. MOOT. Yes, sir; it is a good——

Chairman REUSS. Why does the Government credit? Doesn't it just act as a go-between or broker between the American manufacturer and the foreign purchaser?

Mr. Moot. We are attempting wherever it is possible to move exactly in that direction. However, I'm sure you realize that the countries concerned, in many cases, prefer government-to-government arrangements and by going through the Department of Defense they have a single point of contact.

Chairman Reuss. Almost all of the equipment is privately manufactured, isn't it? Some, perhaps, comes from U.S. arsenals, but the majority, I take it, is privately manufactured.

Mr. Moot. Yes. It generally is manufactured in the private sector.

Chairman Reuss. This brings me to my point. Have not we, the United States, for reasons of some mystical symmetry—I do not know why—gotten ourselves into the position of being worldwide crooks and Sir Basil Zaharoffs and purveyors of instruments of death? What's so wonderful about knocking ourselves out selling the products of the U.S. private munitions industry? Why do we not try to offset our various governmental deficits, of which our Pentagon-caused foreign military expenditure is the leading example, by appointing somebody to try to sell American goods that do not kill people? We mine coal in the Appalachians cheaper than they do in the Ruhr and we can deliver our coals at the Ruhr mine head cheaper than it can be mined there. Yet I do not find the Department of Commerce designated by the President as our No. 1 coal salesman.

And wheat is a commodity we produce very economically. I do not find that wheat is the subject of these agreements. And you can go down the list of American nonmilitary goods, yet nobody much tries to sell them as an offset. Who was it who put the Pentagon in as exclusive proprietor of this act? It seems to me it has produced a very unfortunately skewed effect, builds up the American munitions industry to an unhealthy level, gives us a bad image over the world, and upon occasion explodes in our face, as when India and Pakistan or Peru and Equador or other recipients of American-bought military goods fire them at each other.

Mr. Moot. I would like to add that it isn't just because of the balance-of-payments problem that we sell military equipment to friendly nations. It isn't just to encourage receipts to the United States that we have a foreign military sales program. There is a broader question.

First of all, a very basic tenet of our foreign policy is mutual security and these sales further this objective.

Chairman Reuss. To the extent that it supplies friendly allies or not too atrocious a government with arms, there is something to be said for it independently, but that certainly is not the whole rationale of our arms program. The Pentagon for the past 5 years has been pounding its chest about the marvelous good it does to our balance of payments. I do not see why this should be a Pentagon specialty.

Mr. Moot. As I indicated earlier, there are really three objectives in our military sales program. One is to promote the defensive strength of our allies consistent with our political and economic objectives; second is to promote the concept of cooperative logistics with our allies. We are better off if we have common equipment, common vehicles, common parts and logistics support with our allies during any combat or emergency situation. The third, of course, is the balance of payments.

Chairman REUSS. Well, it is this third point where I think we have unnecessarily draped ourselves in the vestments of Zaharoff to our great detriment. How did this come about?

Mr. MOOT. Well, I think it is fairly obvious that a good share of the major arms developments in the free world—that is, using advanced military technology have occurred in the United States and therefore, advanced military equipment has been available in the United States. And I think our allies have looked to the United States for such support.

There is no doubt that we are trying to move in the direction of private financial arrangements rather than public sector financial arrangements. On the other hand, I would feel that we would try to keep standard the total equipment of our allies to the extent that we can.

Chairman REUSS. All of that I think makes excellent sense. It is when, however, we go much beyond it and act as an arms salesman without regard to whether it is really part of a concerted national defense picture that I think we have misplaced our emphasis and maybe cost ourselves something. For all I know, we would have been better off trying to sell efficiently dug coals and efficiently cultivated wheat rather than rather inflated arms goods abroad.

I would hope, just to conclude this discussion, that you would take the first opportunity that presents itself to you to have the Pentagon suggest to other elements in the Government that this sell-American program be broadened and not made exclusively a military venture.

Mr. MOOT. I will do that, Mr. Chairman. I would like to add, however, as I indicated in my prepared statement that decisions to sell military equipment are made only after a determination that it is in the best overall U.S. national interest to make the sale.

Chairman REUSS. Mr. Moorhead, did you have some questions?

Representative MOORHEAD. Very briefly, Mr. Chairman.

Mr. Moot, you stated in your testimony that, following the seizure of the *Pueblo* in early 1968, it was necessary to take a number of steps that increased balance-of-payments costs in the Far East. Could you tell us what those steps were and could you tell us also if steps have now been taken to reverse that process or will they be taken shortly?

Mr. MOOT. Well, I think the situation has stabilized, Congressman Moorhead. We did initiate several actions to strengthen, both with construction and with equipment, our forces in South Korea. As I recall, our increased expenditures overseas will be somewhat over $80 million, including $60 million in construction. Most of these expenditures will, of course, take place during fiscal year 1969 and 1970.

Representative MOORHEAD. How many men do we currently have in Europe, and the second part is, if we reduced that number of men by one-half, would we reduce the balance-of-payments effect by one-half or one-third or one-quarter or by what factor?

Mr. MOOT. Well, in terms of our military personnel, we currently have—may I just check to see if I am going to skirt into classified material?

Representative MOORHEAD. Surely.

Mr. MOOT. Worldwide, we have overseas ashore close to 1.1 million military personnel. Our Western European portion of that is a shade under 300,000.

To answer the second part of your question, worldwide expenditures by our military and civilian personnel and dependents in fiscal year 1968 were, as is shown on table I attached to my statement, a billion and a half dollars. Of course, in Europe, the ratio of dependents in much greater than anywhere else overseas. I think it is fair to say that as you proportionately decrease the overseas personnel, you proportionately decrease individual spending by personnel provided nonappropriated fund facilities are also reduced. Other expenditures would not decrease proportionately since some of our expenditures are not directly related to support of personnel. Therefore, total expenditures would not be reduced proportionately. Savings are, of course, greatest when personnel reductions are accompanied by closing of facilities.

Representative MOORHEAD. May I say, Mr. Moot, that I share some of the feeling of the chairman of this committee that if we can't get our balance-of-payments costs offset by our wealthy allies, we should consider a reduction of our forces in Europe.

I have no further questions, Mr. Chairman.

Chairman REUSS. Thank you very much, gentlemen, for your excellent testimony. We appreciate your coming here.

The subcommittee will now stand in adjournment until 10 o'clock tomorrow morning when, in this place, at 10 o'clock and 2 o'clock we will hear various governmental witnesses and witnesses from the private sector on private capital exports.

We now stand adjourned.

(Whereupon, at 12 noon, the subcommittee adjourned, to reconvene Wednesday, January 15, 1969, at 10 a.m.)

A REVIEW OF BALANCE OF PAYMENTS POLICIES

WEDNESDAY, JANUARY 15, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND
PAYMENTS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on International Exchange and Payments met, pursuant to recess, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss, Moorhead, and Brock; and Senator Proxmire.

Also present: John R. Stark, executive director, and John R. Karlik, economist.

Chairman REUSS. Good morning.

The third session of the hearings of the Subcommittee on International Exchange and Payments will be in order. We are privileged this morning to hear and interrogate in a session that will focus on private capital exports, Federal Reserve System Governor Andrew F. Brimmer; Under Secretary of the Treasury Frederick L. Deming; Mr. Charles E. Fiero, Director, Office of Foreign Direct Investments, Department of Commerce; and Mr. Gesualdo Costanzo, executive vice president of the First National City Bank of New York.

You are all most welcome, gentlemen. You all have prepared papers to the subcommittee, with appendixes in some cases. Without objection, they will all be admitted into and made part of the record. We would like to ask you then to proceed orally in any way you please. It is my hope that the witnesses can confine their oral presentation to around 15 minutes, or as much longer as is necessary, in order that the subcommittee may have an opportunity for full questioning and that we may, hopefully, get through by lunchtime.

Mr. Fiero, would you proceed first?

STATEMENT OF CHARLES E. FIERO, DIRECTOR, OFFICE OF FOREIGN DIRECT INVESTMENTS, U.S. DEPARTMENT OF COMMERCE

Mr. FIERO. Thank you, Mr. Chairman, for this opportunity to participate in your review of the U.S. balance-of-payments policy over the past 4 years.

At your suggestion, my statement this morning will deal with certain aspects of the foreign direct investment restraints, which have been a significant component of balance-of-payments programs since 1965. My comments will include a brief review of the evolution of the

capital restraint programs, an appraisal of their effects on the foreign expansion of U.S. business, a response to major criticisms of the present mandatory program, an estimate of the consequences of discontinuing the mandatory program in early 1969, and, finally, my recommendations.

Before turning to a review of the evolution of the programs, however, I believe it would be useful to define precisely the term "foreign direct investment." As I will use it throughout my remarks, it is different from the capital account item as reported in the balance-of-payments accounts.

Foreign direct investment refers to transactions between U.S. persons—"direct investors"—and foreign business, whether incorporated or unincorporated, in which they own or acquire a 10 percent or greater interest.

It consists of three elements. The first is earnings retained abroad by incorporated affiliates of U.S. direct investors. The second is net transfers of capital between the direct investor and its foreign affiliate; that is, outflows from the direct investor to the affiliates less inflows from the affiliates to the direct investor. The third is the use of proceeds of long term foreign borrowing by direct investors. In computing foreign direct investment, proceeds of long term foreign borrowing by direct investors used for foreign investment are deducted from retained earnings and net transfers of capital so that the resulting figure will include only capital transfers from U.S. sources.

I would like also to direct your attention to the charts and tables I have submitted with my statement. These should be helpful in illustrating the interrelationships among foreign plant and equipment expenditures, foreign direct investment and the use of proceeds of foreign borrowing by direct investors for foreign investment. The figures presented in these charts and tables, and in the larger charts before you, exclude direct investment in Canada, which was exempted in March 1968 from the mandatory foreign direct investment program.

The data must be accepted with caution. The transactions underlying the figures are complex and may involve substantial reporting inconsistencies and errors. There is often a timelag of many months involved in accurate reporting of international transactions. Thus, in some cases the figures are projections and subject to the uncertainty that accompanies attempts to estimate what has not yet actually been recorded. I have tried to allow for these imperfections and believe that the figures used here are the best we can provide at the moment. I should also add that most of the figures were obtained from reports to the Office of Foreign Direct Investments and do not necessarily match data published by other Government sources.

A. Evolution of the Capital Restraints Programs

Restraints on the use of U.S. capital to finance the growth of foreign investment by American business were first introduced in February 1965, as part of a broad presidential program to prevent further deterioration in the U.S. balance of payments. In that year, under the guidance of the Department of Commerce, major American companies were requested to limit voluntarily the rate of expansion of their foreign direct investment in certain developed countries. The

acceptable rate of expansion for each participating company's foreign direct investment was a set percentage of its actual direct investment during the base period years 1962–1964.

This voluntary program of capital restraints remained in effect from 1965 through 1967. During that time, the participating companies succeeded as a group in holding foreign direct investment below the targeted ceilings, even though the ceilings were gradually lowered during those years due to continuing balance-of-payments problems.

By mid-December 1967, however, it became perfectly clear that existing programs to defend the dollar were not adequate and that further and decisive action was essential to halt the growing U.S. payments deficit which, during the last quarter of 1967, reached an annual rate of $7 billion—on a liquidity basis. Accordingly, on January 1, 1968, President Johnson announced a series of new measures designed to reduce our 1968 balance-of-payments deficit by $3 billion from the $3.6 billion deficit, on a liquidity basis, incurred in 1967.

The introduction of mandatory controls over foreign direct investment was an important part of the overall 1968 balance-of-payments program. While the voluntary program had been instrumental in holding the level of foreign direct investment to approximately $4 billion in 1965, $3.9 billion in 1966, and $3.7 billion in 1967 (see chart 1 and table 1, pp. 152 and 155), the Office of Foreign Direct Investments was assigned the much more difficult task of reducing such investment by $1 billion in 1968, or to approximately $2.7 billion.

The mandatory program broadened both the company and geographic coverage of the voluntary program. Under the mandatory program, restrictions are applied on a schedular basis. Foreign countries are classified into three groups, schedules A, B, and C, with separate limits on direct investment in each schedule. Generally, our regulations authorize investment quotas based upon the direct investor's 1965–66 foreign direct investment experience. These quotas are most restrictive in schedule C, basically Western Europe, and most liberal in schedule A, the less developed countries. There is a $200,000 worldwide investment quota for direct investors with limited foreign investment history.

I would like to stress one fact. The mandatory program is aimed at reducing the impact of foreign direct investment on the U.S. balance of payments, not foreign investment as such. A direct investor is not limited in increasing his investments overseas if the source of financing is long-term foreign debt or debt contracted by foreign affiliates.

B. Effects of the Programs on Foreign Expansion of U.S. Business

American business continued to expand its foreign operations at a swift pace during the years of the voluntary program. Excluding Canada, foreign plant and equipment expenditures increased from $4.6 billion in 1964 to $5.6 billion in 1965, $6.3 billion in 1966, and $7 billion in 1967. (See chart 1, and table 1.) American business also continued to expand its foreign operations through acquisitions of existing foreign companies, the amount of such acquisitions averaging approximately $500 million per year during the same 3 years.

With foreign plant and equipment expenditures rising rapidly at the same time that foreign direct investment was declining, U.S. companies turned increasingly to foreign financial markets to finance such expenditures and to provide needed growth in working capital.

During the 3-year period ending December 31, 1967, about $1.9 billion in long-term funds was borrowed abroad for direct investment purposes by U.S. companies participating in the voluntary program. Approximately $1.4 billion of this amount was actually used to finance foreign investment. (See chart 2, p. 153.) In addition, an estimated $2 billion of foreign indebtedness was incurred during this period by overseas affiliates of the participating companies, including subsidiaries organized solely to raise money for foreign investment purposes. Other funds for foreign expansion were derived from the rising depreciation cash flow of foreign affiliates.

It is clear that this use of foreign borrowing was a major factor enabling American business to achieve the balance-of-payments goals under the voluntary program. Not only were net capital outflows from U.S. sources reduced, but remitted income was increased. Inflows from U.S. direct investment—including dividends, branch profits, interest, royalties, and fees—exceeded net capital outflows by approximately $800 million in 1965, $1.6 billion in 1966, and $1.9 billion in 1967. (See table 2, p. 155.)

It is impossible to determine with any precision the amount of foreign direct investment that would have been made during the period 1965 through 1967 in the absence of capital restraints. It seems likely, however, that the net reduction in foreign direct investment achieved over the 3 years of the voluntary program was more than $2 billion.

Surveys of projected foreign plant and equipment expenditures suggested a substantial increase for 1968. This was confirmed 6 months after introduction of the mandatory program in the June survey, which indicated a rise of $600 million to a 1968 total of $7.6 billion. With a $1 billion reduction in foreign direct investment required by the mandatory program in 1968, it was clear that U.S. companies and their foreign affiliates would have to utilize over $2 billion of additional foreign borrowing in 1968 to finance foreign plant and equipment expenditures as well as foreign acquisitions and additions to working capital.

The sharp increase in overseas borrowing by U.S. companies during 1968, particularly during the first 6 months, was therefore largely in response to the introduction of the mandatory program. During the first half of 1968, American companies marketed over $1.4 billion in long-term debentures in the European capital markets, including close to $1.2 billion of convertibles. In the same period, U.S. direct investors or their foreign affiliates arranged additional credit facilities in excess of $1.5 billion. Over $2 billion in long-term debentures were marketed during the 11 months ending November 30, 1968, including over $1.5 billion of convertibles. Other foreign credits also increased substantially during the 11-month period.

We do not yet have direct investment data for the fourth quarter of 1968. Figures for the first three quarters, at an annual rate, suggest that foreign direct investment by American companies in 1968 totaled about 2.5 billion, a reduction of $1.2 billion from 1967. This improvement resulted primarily from the use by U.S. companies or their do-

mestic finance subsidiaries of $1.6 billion of foreign-borrowed funds to finance foreign investment in 1968, as well as a substantial increase, perhaps exceeding $1 billion in borrowing by foreign affiliates.

Actual fourth-quarter figures could cause the estimated 1968 results to vary substantially. In a December survey by our office, selected major direct investors projected a significant increase in the last quarter in their use of proceeds of foreign borrowing. If these projections prove accurate, the use of foreign-borrowed funds by U.S. companies and their domestic finance subsidiaries to finance foreign investment could total $2 billion, rather than the $1.6 billion suggested by the 9-month data. Foreign direct investment for 1968 might, therefore, be as low as $2.1 billion, a reduction of $1.6 billion from 1967. It is not clear at this time, however, to what extent such a rise in the use of proceeds from foreign borrowing in the fourth quarter merely reflects financial shifts unrelated to the immediate direct investment needs of U.S. companies.

A number of factors may have been responsible for such fourth quarter transactions. Growing concern about possible realinement of currencies clearly resulted in sizable and unprojected hedging actions. Another factor may have been the sharp increase in domestic money costs during the closing weeks of the year. This development together with the prospect of extremely tight domestic credit conditions, may have induced many companies to return to the United States funds borrowed abroad earlier in 1968 and not required for 1968 foreign investment. The credit situation here may also have prompted corporate treasurers to create an extra margin of safety against unforeseen yearend fluctuations by utilizing proceeds of foreign borrowings to pay down intercompany accounts.

Our preliminary analysis suggests that the fourth quarter money movements may be of a temporary nature. Companies bringing their direct investment below mandatory quotas are permitted to carry unused quotas forward for use in 1969, and this would appear to be their intent.

It is difficult to estimate what amount of foreign borrowing would have been undertaken in 1968 in the absence of a restraint program. It seems probable that a major portion of the foreign borrowing was induced by the mandatory program; foreign direct investment could therefore have exceeded $4.5 billion without the program, at least $2 billion more than the presently estimated 1968 direct investment before considering the effects of fourth quarter transactions.

Absent any program in 1968, it would appear that foreign direct investment would have exceeded $4.5 billion, at least $2 billion more than estimated 1968 direct investment. In addition, there could have been a significant outflow of short-term liquid funds seeking higher foreign deposit rates had there been no limits imposed upon liquid foreign balances under the mandatory program.

C. Major Criticisms of the Mandatory Program

Next, I would like to comment on the major criticisms of the mandatory program.

Some critics maintain that the program has diminished the growth of U.S. overseas expansion. I do not believe this contention is supported by the evidence. Current estimates suggest that foreign plant

and equipment expenditures, excluding Canada, will increase in 1968 by nearly 8 percent. This is not much different from the percentage projected by companies in December 1967 before the introduction of the mandatory program. By comparison, plant and equipment expenditures in Canada, which was exempted from direct investment controls in March of last year, are projected to decline slightly in 1968.

Other critics charge that the program has adversely affected U.S. exports. There are, of course, many factors affecting U.S. export performance, and any influence of the controls cannot easily be isolated. However, there is no indication of any significant export offset. The fact that U.S. direct investors and their foreign affiliates borrowed more abroad has not caused a shift away from U.S. procurement, except in a few isolated cases. On a seasonally adjusted basis, U.S. nonmilitary merchandise exports for the first three quarters of 1968 rose 9 percent over the same period of 1967. To put this increase in perspective, nonmilitary exports for 1967 rose by only 4 percent over 1966.

Exports by U.S. companies to their foreign affiliates are also estimated to have risen substantially in 1968. Increases in export credit extended by direct investors to their affiliates during the calendar year are treated as capital transfers under the mandatory program and are therefore subject to the investment quotas. Exports to nonaffiliates are not regulated by our Office.

This conclusion is supported by results of a special survey made by our Office in July 1968 in response to the concern expressed by some critics that the growth of intercompany exports to foreign affiliates for resale might be restrained. All direct investors with investment quotas inadequate to finance such exports were invited to apply to us for relief. Only 75 companies actually applied for relief, which was granted in the amount of approximately $90 million.

We are also aware of complaints that the mandatory program has hindered investment in less developed countries. These appear to be unfounded. Investment quotas available under the program for use in less developed countries in 1968, together with additional relief granted without refinancing conditions, exceeded $1.6 billion, an amount roughly 50 percent higher than the level of actual direct investment in these countries in 1967. It is difficult to know to what extent businessmen will use their quotas in 1968. To a large extent, this will depend upon factors unrelated to the foreign direct investment program. Figures for the first three quarters do indicate, however, that total foreign investment by U.S. companies in less developed countries in 1968, including the use of foreign-borrowed funds, will increase over the 1967 total.

Another criticism of the program centers on the use of foreign borrowing as a means of attaining short-term balance-of-payments improvement. Repayment of foreign borrowing used by U.S. companies and their foreign affiliates to finance foreign investments in recent years will, of course, result in reduced direct investment income or increased capital outflows in the future. In this sense, current balance-of-payments gains may have been made at the expense of future balance-of-payments reductions. However, the controls programs were designed to achieve such temporary gains in order to provide time for

working out more fundamental improvements in our balance-of-payments position. In the interim, utilization of foreign borrowing as a substitute for U.S. capital outflows has improved the Nation's international liquidity position. What might otherwise have been liquid indebtedness of the U.S. banking system or the U.S. Government has been lessened or transformed into long-term foreign indebtedness of the business community, which is well able to sustain it from the receipts of foreign affiliates. Our international position during this time was apparently unable to sustain the alternative—100-percent financing a foreign direct investment from the United States.

Moreover, many U.S. companies will not repay the whole of their indebtedness to foreigners on maturity. Instead, they may be expected to refinance some portion of that indebtedness in the now greatly expanded international capital market. In the case of convertible debentures, a significant amount will no doubt eventually be held by foreign bondholders in the form of the underlying equity securities. In short, there is no certainty that current foreign borrowings are entirely at the expense of future gains.

Two other criticisms sometimes levied against the program also deserve comment. It has been argued that foreigners' purchases of convertible bonds may go hand in hand with selloffs of U.S. equities or that such purchases have the effect of reducing the amount of U.S. equities foreigners would otherwise have acquired. Any offsets to foreign purchases of convertible bonds, however, certainly did not dominate in the aggregate. Net purchases of U.S. equities by foreigners expanded dramatically this year and may have surpassed $2 billion. (See chart 3, p. 154.)

It has also been argued that any improvement in the capital account achieved by the restraint programs is offset by a deterioration in the current account, mainly the trade balance, through the automatic mechanism of price and income changes at home and abroad. This is a serious theoretical charge. We have not seen evidence of export offsets associated with the program in 1968. Moreover, recurrent international financial crises should provide ample evidence that the adjustment process is slow and far from automatic. Because of this, governments muts take compensatory action. There is little assurance that the adjustment process functions so well that higher capital outflows would have been quickly offset by an enlarged current account surplus. If adjustment does not take place promptly, something else in the system may crack. It is at least plausible to suggest that I would not be here in my present capacity if there were not a very real danger from slow adjustment. Governmental policies here and abroad can hinder or reinforce this process. Even assuming that adjustment is relatively rapid during periods of stable international monetary conditions, there is no assurance that such is the case in more critical times. During a period of historically high foreign expansion by U.S. business, the voluntary and mandatory programs have helped international financial stability by reducing what otherwise might have been unsustainable additional outflows from U.S. sources.

With the dollar serving as the world's major reserve and transactions and investment currency, I would have serious reservations about testing the validity of this yet unproved theory.

It is interesting that neither the President's decision to try to bring the balance of payments close to equilibrium, nor the clear declaration that an emergency situation existed in late 1967 evoked major criticism. However, some critics now argue that the emergency has passed and that we should consequently abolish the mandatory direct investment program.

D. Effects of Discontinuing the Mandatory Program in Early 1969

Early in December, I suggested that the balance-of-payments risk of removing the mandatory controls early in 1969 could be as much as $3 to $4 billion. Among the factors considered in arriving at this estimate were the following:

First, U.S. companies projected last June that their foreign plant and equipment expenditures in 1969 would approach $8 billion, up from an estimated $7.6 billion in 1968. It seems reasonable to assume that acquisitions of existing foreign ventures will continue and that working capital requirements will expand significantly as sales rise. In addition, there are growing amortization requirements from the foreign indebtedness previously incurred by U.S. companies and their foreign affiliates. While internal cash flow generated by depreciation will also increase in 1969, there is no reason to anticipate a decreasing need for supplementary funds this year.

Should U.S. companies, in the absence of controls and faced with the rising debt-equity ratios of their overseas affiliates, reduce substantially their use of foreign-borrowed funds in 1969, U.S. foreign direct investment could readily expand to $4.5 billion—$2 billion above the projected level for 1968. Even at the $4.5 billion level, we would anticipate substantial use of foreign borrowing.

Second, since 1965, increasing restraint on the retention of earnings abroad and transfers of capital from the United States has caused U.S. companies and their foreign affiliates to utilize substantially more foreign debt than would have been the case without the foreign direct investment programs. As I stated before, we have no way to measure program-induced borrowing, but it could be as much as $5 billion. U.S. companies and their domestic finance subsidiaries probably borrowed and utilized over $3 billion for overseas expansion through December 31, 1968. The amount of program-induced borrowings which have already been utilized by overseas affiliates—and which are still outstanding—may now total over $2 billion.

Though a substantial amount of such foreign indebtedness was raised in the international capital markets and is not likely to refinanced in the near future, the large amount of borrowings from foreign banks and other sources, which now probably exceeds $2 billion, could readily be refinanced from the United States. In addition, we believe that U.S. companies and their domestic finance subsidiaries now hold well over $1 billion in unused proceeds of foreign borrowing which are available for immediate foreign investment.

It is likely that a substantial portion of this $1 billion is held by direct investors as a contingency fund for future investment possibilities. Based upon past experience, we expect that a significant portion of such proceeds will remain unemployed at the end of 1969, whether or not the program is continued.

Taking these factors into account and recognizing that the current high level of domestic interest rates, if continued, would moderate such refinancing, U.S. outflows to refinance the debt backlog could be over $1 billion in 1969.

There is also the possibility of some further erosion from arbitrage activity in convertible bonds and early redemptions of foreign bond debt. However, the balance-of-payments impact is not likely to be large in 1969. There is the additional possibility that U.S. companies would purchase their outstanding debentures in the secondary market for retirement. We have identified 16 issues of Eurobonds presently outstanding which contain call or redemption rights exercisable in 1969. Arbitrage activity in the convertibles during 1968 amounted to only $20 million. With a large number of the convertible bonds issued in 1968 becoming subject to conversion in 1969, such activity may be expected to increase.

Third, the controls programs have reduced the liquidities of foreign affiliates, inducing greater use of short-term foreign borrowing for day-to-day requirements. If the mandatory controls were removed, U.S. companies would tend to restore these liquidities through longer intercompany trade terms, increased advances, and higher retained earnings.

In addition, the amount of liquid foreign balances which direct investors, including both U.S. parent companies and their domestic subsidiaries, may retain abroad is presently restricted by the mandatory program to the holder's 1965–66 level. Free of these restrictions, companies would probably replenish their liquid balances from the United States. The resulting outflow could be large if deposit rate differentials remain high, or if the business community doubted that the balance of payments would be sustainable without the controls and reacted in fear of their reinstatement.

Admittedly, these adverse effects which I have described would be considerably moderated if domestic credit remained tight and the difference between money costs in the United States and foreign countries remained small. For example, there was evidence in the fourth quarter of 1968 that some U.S. companies raised funds abroad for domestic purposes. Thus, it appears that so long as U.S. rates remain high and confidence in the dollar is maintained, the risk of a massive increase in outflows is diminished. Domestic economic policy, however, cannot be constrained by tight credit and high rates for balance-of-payments purposes should conditions at home call for relaxation. Without controls, however, such a relaxation presents the risk of substantially larger capital outflows.

E. Recommendations

Considering the magnitude of the potential adverse effects, I believe it would be unwise to discontinue the mandatory program at this time. I strongly recommend, however, that the program be liberalized at a pace consistent with fundamental improvements in other balance-of-payments accounts. The framework for such a liberalization is contained in the modifications of the program proposed by the outgoing administration for 1969.

Within the balance-of-payments leeway then thought to be available, the 1969 direct investment program was designed to respond to the most serious hardships imposed upon companies by the program in 1968.

First, the 1969 program, as published earlier in proposed form, increased the direct investment target for 1969 by $250 million. This modification reflected the principle that, as a minimum, investment quotas should be expanded with growth in foreign direct investment income.

Second, the minimum permitted investment level was raised to $300,000. The increase implemented our intention that the minimum level of investment be increased as rapidly as possible to ease the burden of controls upon many smaller companies. Third, the 1969 program incorporated a basic shift to earnings as the basis for determining growth in foreign direct investment quotas. This gave effect to our belief that the base period quotas involved too many inequities to be the sole basis for determining investment quotas.

The statement announcing the 1969 program also confirmed the need to be responsive to intercompany export growth, special industry problems, development projects in less developed countries, and repatriation hardships.

Another modification was the introduction of alternative investment quotas based upon 1968 earnings. This change acknowledges that the 1965–66 base period method of computing investment quotas must be supplemented by other criteria in a continuing program. Finally, the minimum permitted investment level was increased to $300,000 to ease the burden of controls upon many smaller companies.

The most important of the substantive changes in the proposed 1969 program is the shift to earnings as the basis for determining growth in foreign direct investment quotas. This shift was made through the introduction of two new investment quotas, the incremental earnings quota—actually added to the regulations in 1968—and the 20-percent earnings quota. The 20-percent earnings quota established the right under the program to make foreign direct investment, in each scheduled area, in an amount equal to 20 percent of 1968 earnings.

Many companies admittedly will not benefit from this new earnings quota at the 20-percent level in 1969. It is important to realize, however, that the balance-of-payments cost of the 20-percent earnings quota is over $200 million. Even this modest percentage will benefit a number of companies.

The incremental earnings quota provided every company with the right to make foreign direct investment commencing in 1970 in an amount not less than 40 percent of the worldwide growth in its earnings over the 1966–67 level. This was not intended to suggest that the controls program would extend into 1970. Rather, it was designed to

be responsive to the planning problems of companies, particularly with respect to the contracting of foreign debt.

The two earnings quotas introduce a philosophy of growth based upon performance. They benefit the newcomer as well as the established investor. They provide a basis for the forward planning so vital to the investment process, and enable more intelligent debt scheduling to coincide with growth in earnings. Ultimately, they are more consistent with the real world of business.

I further recommend that future leeway under the program be allocated on an earnings basis, raising the quotas of those companies which are low in relation to their foreign earnings as rapidly as balance-of-payments circumstances permit. This can be accomplished by raising the quota percentages. As the percentages rise, they will gradually overtake the existing base period quotas and thereby insure that those companies making the largest earnings contribution to our balance of payments are recognized and, indeed, encouraged.

Finally, I would recommend that the minimum level of permitted investment be increased to reduce the number of companies burdened by the controls. We are presently attempting to assess the probable cost of an increase in this minimal level to $500,000.

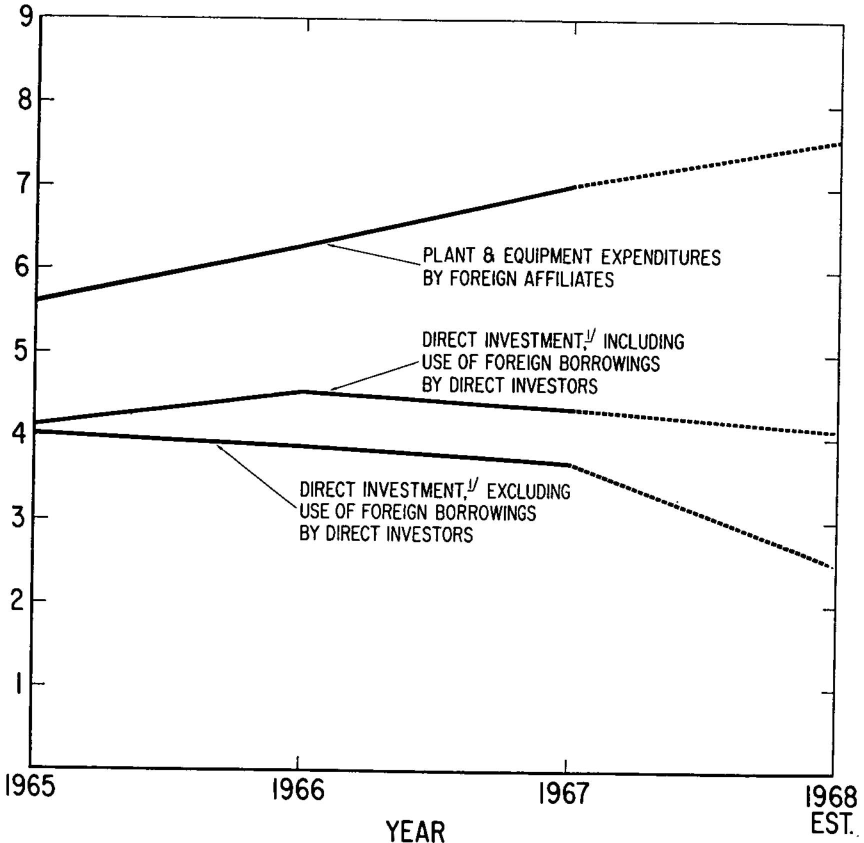
There are many other ways in which the program could be modified, each of which has a balance-of-payments cost of some amount. I would recommend that future balance-of-payments flexibility be used first to expand the optional earnings quota and to raise the minimum level of permitted investment. Other changes may be considered once these have been raised to more realistic levels.

Conclusion

The mandatory program, like the voluntary program which preceded it, has depended to a large extent upon the extraordinary cooperation of the business community. This cooperation has been forthcoming under the assumption that the controls programs would be temporary and that every effort would be made to obtain fundamental improvement in other balance-of-payments accounts. The rapid development of European capital markets made it possible for business to carry on its plans without interruption, notwithstanding increasing limitations on their freedom to employ U.S. funds. Nevertheless, there has been a mortgaging of future balance-of-payments gains and a considerable imposition upon the freedom of action of the business sector. It is imperative that we achieve the fundamental balance-of-payments improvements which will enable early phasing out of capital restraints.

(Charts and tables follow.)

CHART 1
FOREIGN DIRECT INVESTMENT (EXCLUDING CANADA) BY U.S. COMPANIES

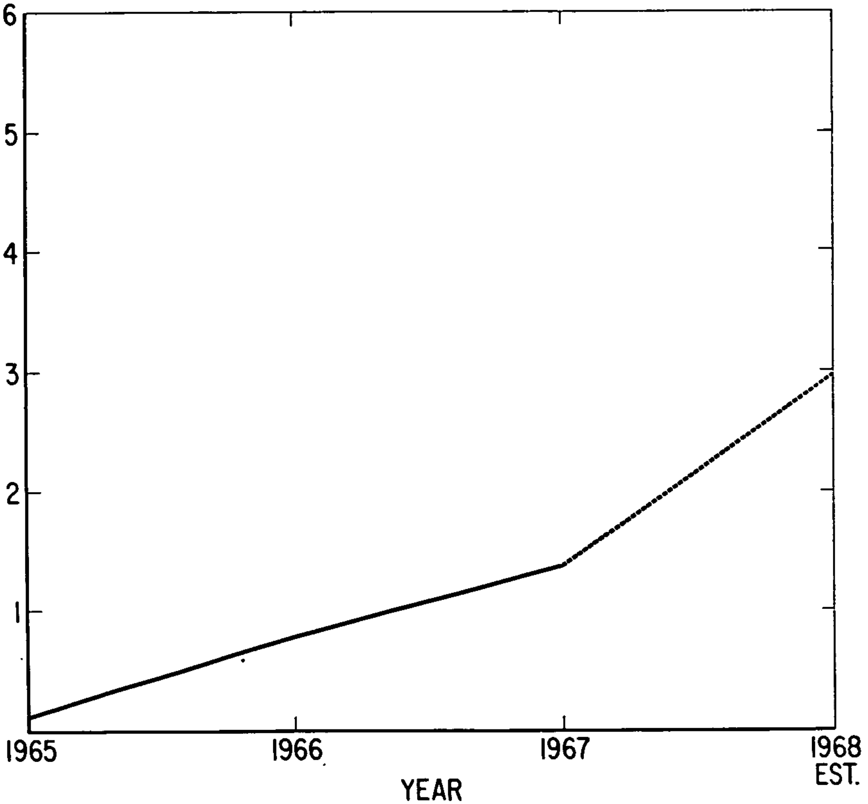


[1] RETAINED EARNINGS PLUS NET CAPITAL TRANSFERS

SOURCES: OFDI FORMS FDI-101 AND FDI-102, 3rd QUARTER; OBE, SURVEY OF CURRENT BUSINESS

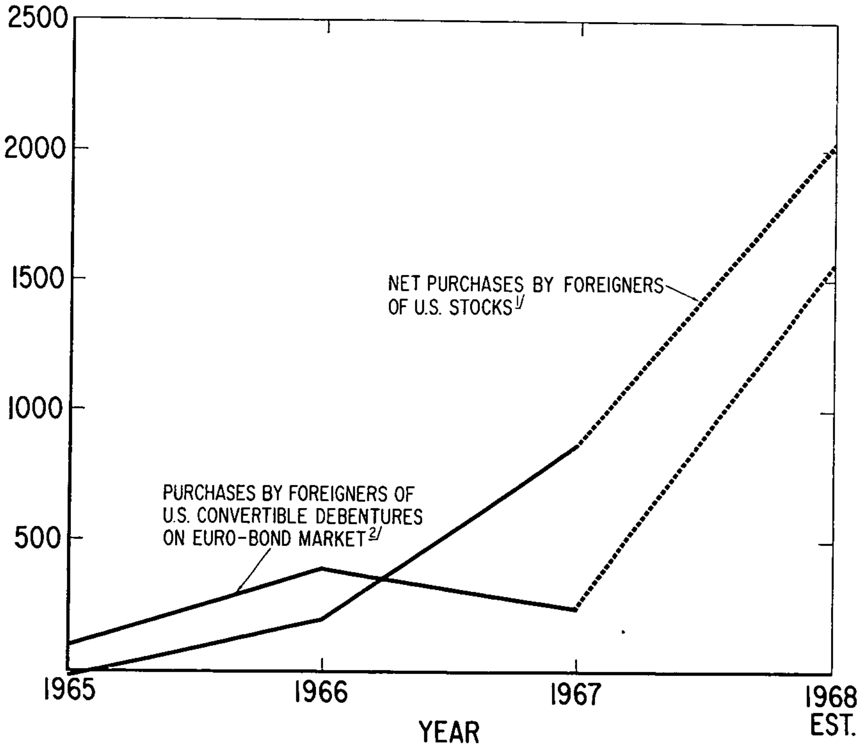
CHART 2
USE BY DIRECT INVESTORS OF LONG-TERM FOREIGN BORROWING FOR DIRECT INVESTMENT AT YEAR-END

BILLIONS OF DOLLARS



SOURCE: OFDI

CHART 3
PURCHASES BY FOREIGNERS OF U.S. CORPORATE STOCKS AND CONVERTIBLE DEBENTURES ISSUED ABROAD



1/ EXCLUDES NET SALES BY UNITED KINGDOM RESIDENTS, 1965-67, TO APPROXIMATE U.K. GOVERNMENT PORTFOLIO LIQUIDATIONS

2/ ISSUED BY U.S. AND FOREIGN FINANCING SUBSIDIARIES

SOURCE: U.S. TREASURY DEPARTMENT, TREASURY BULLETIN (DEC, 1968) AND GENERAL FINANCIAL PRESS

TABLE 1.—FOREIGN DIRECT INVESTMENT (EXCLUDING CANADA)

[Millions of dollars]

	1965	1966	1967	1968 [2]
Retained earnings [1]	(1,006)	(1,076)	(898)	(1,300)
Net transfers of capital [3]	(3,122)	(3,471)	(3,401)	(2,800)
Use by direct investor of foreign borrowed long-term funds	108	659	595	1,600
Direct investment excluding use by direct investor of foreign borrowing	(4,020)	(3,888)	(3,704)	(2,500)
Memorandum item:				
Plant and equipment expenditures abroad	5,595	6,282	7,037	[4] 7,600

[1] Not consistently on calendar year basis owing to 60-day dividend election provision in the OFDI regulations.
[2] First 3 quarters at annual rates. The 1968 data as reported by a panel of companies have been expanded to universe size by the ratios of panel companies' allowable investment quotas to those of all direct investors.
[3] Differs from similar line in table 2 by adjustments for interschedular transfers.
[4] Estimated by comparing percentage change between 1967 and 1968 estimates made in June of current year and adjusting the actual 1967 figure by the percentage.

Source: OFDI, except plant and equipment figures, which are from the "Survey of Current Business" for September 1968.

TABLE 2.—RECEIPTS AND OUTFLOWS FROM FOREIGN DIRECT INVESTMENT (EXCLUDING CANADA)

[Millions of dollars]

	1965	1966	1967	1968 [2]
Receipts (dividends,[1] branch profits, interest, royalties, etc.)	3,734	4,294	4,675	4,800
Net transfers of capital to incorporated and unincorporated affiliated foreign nationals	(3,006)	(3,345)	(3,384)	(2,800)
Use by direct investor of foreign borrowed long-term funds	108	659	595	1,600
Net total	836	1,608	1,886	3,600

[1] Not consistenly on calendar year basis owing to the 60-day dividend election provision in the OFDI regulations which provides that companies receiving approval may count dividends received in the first 60 days of 1 year as if they were received in the last quarter of the preceding year.
[2] First 3 quarters at annual rates. The 1968 data as reported by a panel of companies have been expanded to universe size by the ratio of panel companies' allowable investment quotas to those of all direct investors.

Source: OFDI.

Chairman REUSS. Thank you very much, Mr. Fiero.

Governor Brimmer, will you proceed?

STATEMENT OF HON. ANDREW F. BRIMMER, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BRIMMER. Thank you, Mr. Chairman.

I welcome the opportunity to appear in behalf of the Board to testify on the voluntary foreign credit restraint of credit program. Since this program is going into its fifth year, I prepared a report of the program in some detail. I would be grateful to you, Mr. Chairman, for permitting this to be included in the record as part of my statement. (See p. 163.)

Chairman REUSS. Without objection, it will be so included.

PRESENT STRUCTURE OF THE PROGRAM FOR FINANCIAL INSTITUTIONS

Mr. BRIMMER. Thank you.

The present program is based on guidelines revised on December 23, 1968. These guidelines continued the 1968 program essentially unchanged. I would like to talk first, about the bank program and, secondly, about the program for nonbank financial institutions.

The revised guidelines for banks, issued last December 23, continued the program initiated in February 1965. They were designed to restrain the rate of growth in credit extended by U.S. banks to foreign borrowers. This is done by requesting each bank individually to hold the level of assets covered by the program to a given percentage of the amount of such assets it held on December 31, 1964. The target ceiling for 1969 generally is 103 percent of the 1964 base figure, or a ceiling related to a specific percentage of total assets, whichever is larger.

Each bank, while staying within its ceiling, is to give an absolute priority to extending credits for financing U.S. exports and to providing credits to developing countries.

Banks are requested to refrain from making new term loans—that is, new loans of more than 1 year maturity—to the developed countries of continental Western Europe, except for the purpose of financing U.S. exports. Furthermore, they are to reduce their ceilings on each reporting date by the amount of repayments in the preceding month of loans to such countries outstanding on December 30, 1967. Short-term loans to developed countries of continental Western Europe are to be held to 60 percent of the level existing at the end of 1967.

Credits to Canadians are exempt from the guidelines administered by the Federal Reserve in exactly the same way that they are exempt from the Commerce program and other aspects of the U.S. balance-of-payments restraints.

The objectives of the nonbank program are the same as those for the bank program. The guidelines for nonbank financial institutions have been conformed as closely as possible to those for the banks, with allowances for differences in methods of operation.

About 90 percent, or about $12 billion, of the total loans and related foreign assets of nonbank financial institutions are excluded from the guideline ceiling. The bulk of this exclusion, roughly $10 billion, is accounted for by investments in Canada. The remaining $2 billion of the exclusion is accounted for by bonds of international institutions and long-term investments in the developing countries and in Japan. The 1969 guidelines request that the nonbank institutions hold the level of assets covered by the guidelines to 95 percent of the amount of covered assets held on December 31, 1967.

The nonbank guidelines follow the bank guidelines with respect to priorities and with respect to restrictions on loans to developed countries of continental Western Europe and exemptions for Canadians.

Principal Changes in Programs Since 1965

The objectives of the program for financial institutions and the means of achieving them have remained unchanged since it was established in 1965. In each year, as it became apparent that the programs would have to be continued, the financial institutions could count on operating under a program structured about the same as the earlier ones.

This has been possible largely because the program has been based, not on detailed regulations, but on guiding principles. Under the "guidelines," the management of each financial institution can operate

with a minimum of governmental supervision or interference in decisions of the management of the banks or of the other financial institutions.

Another important fact is that the program remains voluntary. In Executive Order 11387, issued on January 1, 1968, the President authorized the Department of Commerce to issue regulations governing the foreign direct investment of nonfinancial firms. The Executive order gave discretionary authority to the Board to regulate the international transactions of financial institutions. When revised foreign credit restraint guidelines were issued on January 1, 1968, the Board announced that, in view of the strong cooperation received from the financial institutions throughout the life of the program, it did not intend to invoke the mandatory provision of the Executive order. To date, it has had no reason to change its position in this respect. The Federal Reserve Board's program remains voluntary.

Those changes that have been made in the foreign credit restraint programs over the last 4 years were designed to assure that priority credit requirements could be met and to maximize the flexibility open to the institutions within the overall ceilings.

Several changes have been aimed at reducing the inequities inherent in a program of restraints. I will say more about them in a moment. The guidelines for 1966 and 1967 permitted banks with small base figures—that is, small values of their foreign assets abroad—to add at dollar amounts to their bases in calculating their ceilings. In most cases this alternative formula resulted in a ceiling higher than the formula based on the stated percentage of outstanding credits on the base dates. The initial guidelines for 1968 provided that reporting banks whose target ceilings—109 percent of the 1964 base—were less than 2 percent of their total assets as of December 31, 1966, could use the latter figure as their ceilings. This so-called 2-percent formula had to be modified when a more restrictive program was announced on January 1, 1968, but the principle of providing an alternative based on total assets is still in effect.

Another change was an upward revision in the target ceiling in 1966. This 1966 ceiling was maintained in 1967. This 1966 change was made because the Board was satisfied that the financial institutions were making every effort to reduce their foreign activities, and because the Board wanted to make absolutely certain that there was ample room within the ceiling to meet requirements for priority credits.

A major change was made in the guidelines issued on January 1, 1968. For the first time, they requested an outright reduction in the target ceilings of banks and other financial institutions. The reduction requested during 1968 amounted to $400 million for the banks and $100 million for the nonbank financial institutions below the level of covered assets outstanding on December 31, 1967.

I might say, Mr. Chairman, that life insurance companies account for the bulk of the foreign assets held by these nonbank institutions.

Additional emphasis was also given to priority credits to the less-developed countries in order to prevent these reductions from bearing unduly on them.

Finally, as a result of a difficult financial situation that developed in Canada early in 1968, the U.S. Government agreed to exempt that

country from the Federal Reserve, as well as the Department of Commerce, balance-of-payments programs after February 29, 1968. Canada was therefore effectively exempted from the Federal Reserve guidelines. This exemption had a larger impact on the operations of nonbank financial institutions than on those of the banks.

IMPACTS OF THE PROGRAMS ON THE BALANCE OF PAYMENTS

The committee will recall that the present programs were introduced in early 1965, after the increase of bank lending to foreigners rose to $2.5 billion in 1964, more than double the average annual increase during the immediately preceding 3 years. This surge of bank lending abroad was due to several factors. The imposition of the interest equalization tax, effective in mid-1963, led to the subsequent substitution of bank financing for financing that had been done in the U.S. capital market. But there is also some evidence which suggests that a large amount of anticipatory borrowing occurred to avoid governmental controls which were generally expected by the financial community as the balance-of-payments situation worsened in 1964.

In the 10 months following the announcement of the foreign credit restraint program, covered assets of banks increased by ony $170 million. Although this figure is not exactly comparable to changes in bank claims as reported for balance-of-payments statistics, this sharp decline in the rate of increase, compared with 1964, more than accounted for the total statistical improvement in the balance of payments in 1965.

Nonbank financial institutions reduced their covered assets by $200 million during 1965. The reduction included a 50-percent decline in holdings of liquid funds abroad.

In this instance, we are fairly sure that the program had a major impact on movements of bank capital. Many banks found themselves over the target when the program was announced, and many had binding commitments that had to be honored. Their efforts to get under the target ceiling under these circumstances, involving in some cases the selling of foreign assets abroad, undoubtedly was the major reason for the reduction in the rate of growth in bank lending that year.

Beginning about the fourth quarter of 1965, monetary conditions in the United States began to tighten and remained tight during 1966. The limited availability of funds to meet domestic loan requirements reduced the interest of the banks in making foreign loans; indeed, during 1966, the banks through their foreign branches, pulled in a sizable amount of Eurodollars for use in the domestic market. At the same time, a rise in interest rates in the United States relative to rates abroad reduced the attractiveness of the U.S. capital market for foreign borrowers. A reduced level of economic activity in Western Europe also had an impact on foreign demand for credit here.

Covered assets of the banks declined by about $150 million in 1966; this swing from an increase to a decline in assets improved the U.S. payments balance by approximately $300 million. Market forces were predominant during this period although the foreign credit restraint program undoubtedly had some effect in individual instances.

The committee will recall that monetary conditions eased in 1967 in the United States. In that year, the banks recorded an outflow of

about $370 million. This swing from an inflow, in 1966, to an outflow in 1967, contributed $500 million to the deterioration of the balance of payments. On the other hand, banks in the aggregate maintained a substantial leeway under their ceilings during the year, so we cannot say with certainty that the foreign credit restraint program exercised a severe check on lending abroad.

From the start, the programs have taken care to avoid adverse effects on export financing and the extension of loans to the developing countries. Both are "priority areas" in the guidelines. I will comment briefly at this point on the experience of the developing countries under the program.

Helping the developing countries meet their capital needs has been an important national objective for many years. It was recognized early in our formulation of U.S. balance-of-payments measures that there would be no point in reducing the outflow of capital in the private sector if that cutback merely resulted in a larger outflow from the United States through the public sector. This is the reason for the high priority accorded in the guidelines to credits to the less developed countries. It was also the reason, as I mentioned earlier, for designing the restrictive program for 1968 in such a way as to minimize the impact on the developing countries.

To date, there is every indication that the banks are observing the priority. In almost 4 years since the inauguration of the restraint program—through October 1968—the foreign claims of banks have been reduced by $170 million. But over the same period, claims on the developing countries have increased by $1.4 billion, almost half of which consisted of long-term loans which are so important to economic development.

Impact of the Program in 1968 and Prospects for 1969

We have now reached a point where we can begin to assess the performance of the financial institutions under the revised program announced in the President's New Year's Day message of 1968—although we have data on the banks only through November 1968, and on the nonbank financial institutions through the third quarter of 1968.

The committee will recall that the program was designed to secure a reduction in holdings of banks' covered assets by $400 million during that year. As of November 30, 1968, they had reduced their covered assets by $673 million, or by $273 million more than the objective for the year. If this proves to be the position at the end of the year, the change in bank lending between 1967 and 1968 will have contributed about $1 billion to the year-to-year improvement in the U.S. overall payments position.

By September 30, 1968, the nonbank financial institutions had reduced their holdings of covered assets by $192 million; this compared with a suggested reduction of $100 million. The actual reduction was achieved despite the exclusion of Canadian assets from the target ceiling on February 29, 1968. Canadian assets are by far the largest part of the foreign portfolio of the lending institutions; they account for about 70 percent of total foreign assets and about 80 percent of assets not covered by the guidelines.

What are the prospects under the guidelines for 1969? The banks on November 30, 1968, had a leeway under the ceiling effective on that date of about $580 million. From this we may subtract $55 million representing the last increment of a reduction in the ceiling related to short-term credits in developed countries of continental Western Europe and perhaps $10 million reflecting repayments of term loans to those countries during December. The ceiling had been reduced by a total of $370 million through November by these provisions of the guidelines.

Again assuming no major changes occurred during December, we are left with a leeway at the beginning of 1969 of about $525 million. We estimate that the ceiling may be reduced during 1969 by a further $100 to $200 million. If this happens, it will leave a potential further expansion within the guidelines of roughly $300 to $400 million. This is not an exceptionally large amount in comparison with leeways which have existed in the past. Whether it would be significant depends upon developments in other areas of the balance of payments and upon the course of our domestic economy, monetary policy, and so on.

Balance-of-Payments Developments in the Absence of Program

Mr. Chairman, I have reached a point in this statement where it is difficult to cope with a question raised by the committee. You have asked what would have happened to the balance of payments in the absence of the foreign credit restraint program. I have an opinion. While I'm perfectly prepared to express it, I must stress that it rests more on logic than on hard statistical evidence.

From what I have already said, it may be concluded that the major impact of the program occurred in 1965, when the outflow of bank capital was reduced sharply. The changes in bank credits to foreigners in the period 1966–68 to a large degree appeared to be responses to market forces operating on the banks. However, it is undoubtedly true that, in individual cases, banks would have undertaken a greater volume of foreign loans in the absence of the program, and therefore the balance of payments would have been worse. Moreover, the reduction in credit outstanding to contiental Europe in 1968—the area that has had a persistent balance-of-payments surplus—is certainly attributable to the program. Also, the shift in credits toward developing countries since 1964, at least in part, must be related to the program.

In a broader sense, world trade has continued to grow since the beginning of the program, and the international monetary system, despite some rough spots along the way, has been successful in financing the increase in trade. We know that confidence, upon which the international monetary system ultimately depends, can be easily shaken. The Federal Reserve's foreign credit restraint program, by providing some insurance against sudden large capital outflows from U.S. financial institutions, has contributed to the stability of the international monetary system.

Problems and Issues Relating to the Programs

We have recognized all along that this program, as well as other programs, has involved some problems. The Board has been increasingly concerned about the incidental impact of this program upon the

competitive position of the banks. Basing the program upon a situation prevailing at a particular date tended to "freeze" the competitive situation. While this was not desirable, it was not easily avoidable and was acceptable for a temporary program. However, as the program has been carried forward, possible distortions in competitive positions and, more basically, in the allocation of resources become more and more important.

There were 16 banks in the United States on the base date with foreign assets of $100 million or more; these banks held 82 percent of assets covered by the program. By June 30, 1966, the proportion had increased to 84 percent; presently it is back down to 82 percent. The program has not increased the concentration of foreign assets in these banks; yet, it is probable that in the absence of the program the concentration would have been reduced.

In this connection, we must take into account the fact that most of the larger banks have branches abroad. Insofar as these banks were constrained by the program from making loans at the head offices, they were in a position to make such loans at the branches. Loans by foreign branches are exempted from the program. All but one of the group of 16 banks to which I referred above have branches abroad.

As we might expect, U.S. banks that have been willing and able to establish branches abroad generally have gained some competitive advantage in the international field over those U.S. banks that have not done so. This advantage may, in some cases, have been enhanced by the ability of those overseas branches, consistantly with the guidelines, to make loans to foreigners.

I mentioned this so-called 2-percent rule, and I would like to comment on why we would favor that. The provisions of the 2-percent rule in the initial guidelines for 1968, published in November 1967, was an attempt to ameliorate the situation of banks with relatively small international operations. The provision applied to about one-half of the reporting banks, mostly banks with small bases—but many of which are quite large overall—located in the interior of the country. These banks are primarily interested in being able to handle the export business of their regular customers, some of which they complain they are losing to the banks which are big and well established in the international field. For this reason, the additions to the ceilings, about $600 million in the aggregate, were earmarked for priority credits only.

This additional leeway for banks with smaller credits to foreigners had to be curtailed to $200 million under the program announced on January 1, 1968. They did not in fact use this additional leeway.

A major issue since the beginning of the program has been the treatment of export credits. Many people, both inside and outside government, have argued that all export credits should be exempted from the guidelines on the ground that otherwise the possible loss of exports would cost us on current account whatever we might gain on capital account. I do want to stress that we are speaking here of credits to foreigners for financing U.S. exports. The program does not affect credits to American producers and exporters to finance U.S. exports.

We have kept the matter of export credits to foreigners under continuing review. We are convinced that in every year since 1965 the target ceiling has provided room for any reasonable expansion in export financing by the banking system as a whole.

One indication that this is true has been the behavior of exports since the program was initiated. On an annual average basis, exports have increased at a rate of about 7 percent per year since 1964. In 1964 when foreign lending by U.S. banks increased by $2.5 billion, exports increased by $3.2 billion. On the other hand, exports went up by $3 billion in 1966 while bank foreign lending declined by $250 billion. There does not seem to be an obvious link between exports and foreign lending by banks.

Further, the banking system over the life of the program consistently has remained substantially below the suggested target ceiling. There may have been some cases in which individual banks were hampered in granting export credits, but it seems obvious that sufficient financing has been available within the banking system as a whole.

A Treasury survey of export financing availability conducted in 1966 produced only 20 out of 758 respondents who said that the credit restraint program was an obstacle to their efforts to secure export financing. A more recent survey by the Office of Foreign Direct Investment, dealing with a somewhat narrower matter, showed that only a minor amount of additional ceiling would be requested by U.S. firms to finance exports to foreign affiliates.

There are also reasons for believing an exemption would be disadvantageous. Indeed, it might jeopardize the program and give no clear benefit to the balance of payments.

First, it is very difficult to determine whether a credit is essential to an export; that is, whether the export would be lost in the absence of the credit. If the export would be made in any event, the granting of the credit merely deprives us of the advantage of a "cash sale" and, in the short run, worsens the balance of payments.

Second, an exemption of any type of credit creates an incentive to conform foreign credits to the definition of the credit exempted. We see a danger that the exempted export credits would rise at a much faster rate than would exports, with adverse effects on the balance of payments.

Finally, a flat exemption would leave the program "open ended." We could no longer be sure that total bank foreign lending would remain within the specified limits.

For these reasons, the Board has not been convinced that there should be a complete or otherwise broad exemption for export credits to foreigners.

PROJECTED REVIEW OF PROGRAM

In the press release accompanying the announcement of the revised guidelines on December 23, 1968, the Board stated its intention to review the program early in 1969 to determine whether additional flexibility for financing U.S. exports might be provided in the guidelines. With this in mind, and as the Board member to whom the responsibility to administer the program has been delegated, I have scheduled a series of five regional meetings around the country, beginning with a meeting in Chicago on January 22, and following through on January 28 in Atlanta, February 20 in San Francisco, February 21 in Dallas, and in New York on February 26. Participating in these regional meetings will be the banks and other institutions reporting under the pro-

gram. There will also be representatives of the Federal Reserve Banks. I hope that these meetings will provide information that will be helpful to the Board in evaluating the effectiveness of the guidelines, particularly with respect to the financing of U.S. exports of goods and services.

To focus the discussions, each reporting institution has been given a list of questions dealing primarily with its experience in financing exports under the guidelines for the past 4 years. The questions are specific. They deal with matters such as the extent and manner that the guidelines may have affected export financing, bank procedures in processing export loans, problems in identifying bona fide export loans, and the importance of export loans in the total foreign asset portfolio of the reporting institutions.

Specific information, based on experience of indivdual institutions, is what we need in evaluating the guidelines. Since some bankers and other participants may be reluctant to discuss matters in detail among competitors, we are suggesting that they may supply answers in writing if they care to do so.

At this moment, Mr. Chairman, I would prefer not to comment as to whether the foreign credit restraint program should be modified. While the regional discussions I am planning to have will be directed primarily to the question of export financing, they will not be restricted to that. I want to complete these discussions and study the information gained very carefully before I make any recommendaions to the Board as to whether the program should be continued in its present form or modified in some way.

(The appendix to Mr. Brimmer's statement follows:)

APPENDIX

A Progress Report on the Federal Reserve Foreign Credit Restraint Programs

THE PROGRAM FOR BANKS, 1965–1969

In February 1965 the President requested the voluntary cooperation of U.S. financial institutions and non-financial corporations in solving the problem of the persistent deficit in the U.S. balance of payments. The Board of Governors was asked to administer a program for financial institutions, and on March 3, 1965, issued guidelines for banks and nonbank financial institutions.

The major objective of the program for banks was to reduce, but not to eliminate the banks' foreign lending. This was to be done without endangering other important national objectives, such as the financing of exports of U.S. goods and services, and meeting the credit needs of the developing countries.

The guidelines issued on March 3, 1965, requested the banks to hold loans and other foreign assets covered by the program to 105 per cent of the amount of credits outstanding on the base date of December 31, 1964. Since the amount of "covered" assets approximated $10 billion, this formula would have permitted an increase of about $500 million in 1965.

While the program applied to all banks, only banks with total foreign assets of $500,000 or more were requested to report to the Federal Reserve Banks. The number of reporting banks has varied closely around 150 since the beginning of the program.

During 1965 the reporting banks increased their holdings of covered assets by $168 million, as compared with an increase in total foreign assets of $2.5 billion in 1964. At the end of the year, the banks were $321 million below the target ceiling effective on that date.

In December 1965 the Board announced revised guidelines for banks for 1966 which increased the target ceiling to 109 per cent of the end-1964 base, or by about $430 million. The room for additional expansion, the Board said, was

allowed because the Board believed that the additional leeway would be used only to meet priority credit requirements and because it wished to make certain that such requirements could be met. Because the additional leeway was added to an existing leeway of more than $300 million, the Board requested that the banks use the additional ceiling provided at a rate of not more than 1 per cent of the base figures per quarter during 1966; i.e., the target ceiling was set at 106, 107, 108, and 109 per cent by quarters.

The guidelines for 1966 also contained the first provisions to reduce the inequities inherent in a program that is based upon a particular point in time. Banks with bases between $500,000 and $5 million were permitted to adopt ceilings of base plus $450,000 ($225,000 in each calendar half-year) even though in most cases that amount exceeded 109 per cent of their end-1964 base.

Bank holdings of covered assets declined by $156 million during 1966, bringing the total down to about the amount outstanding on the base date. The leeway available on December 31, 1966, was $911 million.

The bank program for 1967, announced in December 1966, was essentially unchanged from the 1966 program. The ceiling remained at 109 per cent of the December 1964 base. Since the banks had a large leeway available at the time the program was announced ($1.2 billion as of October 31, 1966) the banks again were asked to phase any increase in their foreign lending during 1967, this time at a rate of not more than 20 per cent of the leeway on October 31, 1967, in each quarter, cumulative, beginning with the fourth quarter of 1966.

The provision for banks with small bases was modified by raising the maximum base for these "special" ceilings to $10 million, and the amount of the ceiling to base plus $900,000.

The first step in the direction of a geographical focus, other than the priority for developing countries, was taken in 1967 when the banks were asked to use no more than 10 per cent of their available leeway to increase nonexport credits to developed countries. The related reporting requirement was dropped on February 2, 1967, because the banks found it difficult to identify export credits, particularly in the short maturities. However, the banks were asked to continue to conform as closely as possible to the spirit of the request.

Bank foreign assets covered by the program increased by $370 million in 1967, but the banks ended the year with a net leeway for further expansion of $1.2 million, half of which reflected an increase in the ceiling under the revised guidelines for 1968 described below.

Revised guidelines for banks for 1968 were issued by the Board in November 1967, to be effective as of the date of issue. The ceiling was in general retained at 109 per cent of the end-1964 base. However, in a major move to overcome the inequitable effects of the program already referred to, the guidelines provided that banks whose foreign assets on October 31, 1967, were $500,000 or more could take as a ceiling for 1968 their 1967 ceilings or 2 per cent of total assets as of December 31, 1966, whichever figure was larger. The amount by which the ceiling calculated on this basis exceeded the 1967 ceiling was to be used only for priority credits.

This provision added about $600 million to the aggregate ceiling. Again, the size of the leeway available led to a request by the Board that any expansion of foreign lending during the last quarter of 1967 and in 1968 be limited to not more than 20 per cent of the leeway, cumulative, in each calendar quarter, beginning with the fourth quarter of 1967.

The geographical emphasis introduced into the 1967 program was given sharper focus by a provision in the guidelines which requested that banks not increase nonexport credits to developed countries of continental Western Europe above the amount outstanding on October 31, 1967. These countries were singled out because to a large extent their balance of payments surpluses corrsponded to our deficit, and because they were in the best position to meet their own credit needs.

A reappraisal of the U.S. balance of payments results for 1967 in December of that year led to the announcement by the President on January 1, 1968, of a more restrictive balance-of-payments program. The bank program announced in November 1967 was replaced by revised guidelines which for the first time requested an outright reduction in the level of foreign assets outstanding (in the amount of $400 million) as compared with the earlier objective of restraining the rate of increase in such assets. The reduction was accomplished by reducing the ceiling to 103 per cent of the end-1964 base or, for the banks electing the "2 per cent" calculation, to the 1967 ceiling plus one-third of the difference between that

amount and 2 per cent of total assets as of December 31, 1966. As was true in the earlier guidelines for 1968, any amount over the 1967 ceiling was to be used only for priority credits. These measures immediately reduced the ceiling for 1968 by $960 million.

The guidelines provided that the ceiling would be further reduced during 1968 by measures relating to bank foreign lending to developed countries of continental Western Europe. The banks were requested to make no new term loans to those countries (including renewals of term loans outstanding) except to finance U.S. exports, and to reduce their ceilings on each reporting date by the amount of repayments received during the preceding month of such loans outstanding on December 31, 1967. The banks also were asked to reduce their ceilings over the year by 40 per cent of the amount of short-term credits to developed countries of continental Western Europe outstanding on December 31, 1967. The reduction in the ceiling was to take place at 10 percentage points in each quarter; the banks were expected to reduce their short-term credits outstanding to those countries at about the same rate.

There was one major change in the January 1, 1968, guidelines during the year. On March 1, 1968, because of a difficult financial situation that had developed in that country early in the year, Canada was exempted from all of the U.S. balance-of-payments programs. Changes in foreign assets held by financial institutions in Canada after February 29, 1968, were excluded from the target ceilings.

There are data on the performance of the reporting banks under the January 1, 1968, guidelines only through November 30, 1968. On that date the banks had reduced their holdings of covered assets by $673 million below the level outstanding on December 31, 1967, of by 273 million more than the objective for the year. The banks on November 30, 1968, actually were $300 million below the 1964 base figure and had a net leeway for further expansion of $581 million.

On December 23, 1968, the President accepted recommendations of the Cabinet Committee on the Balance of Payments that the balance-of-payments programs be carried forward in 1969 in substantially the same form as those for 1968. On the same date the Board announced revised guidelines for financial institutions which essentially were unchanged from 1968. The target ceiling for banks remains the same as that provided for in the January 1, 1968, guidelines. The provisions relating to treatment of term loans outstanding to developed countries of continental Western Europe are retained, and are expected to result in a further reduction in the ceiling by $100 to $200 million during 1969. Short-term credits to those countries are to be held at the level requested for 1968, that is, 60 per cent of the amount outstanding on December 31, 1967.

The bank guidelines for 1969 contain one change, largely technical in nature. Under the 1968 guidelines equity investments by banks in developed countries of continental Western Europe were treated in the same way as term loans: that is, the banks were requested not to make such investments. Under the guidelines for 1969, banks may make equity investments in developed countries of continental Western Europe within their overall ceiling.

Finally, the bank guidelines from the beginning have provided that banks with no previous experience in foreign lending may request from their Federal Reserve banks special ceilings for the purpose of making priority loans or investments. Thirty-seven special ceilings have been granted since 1965 in an aggregate amount of $69 million.

PROGRAM FOR NONBANK FINANCIAL INSTITUTIONS, 1965–1969

Since the Board had only limited information on the extent to which nonbank financial institutions were engaged in foreign lending and investment, the program announced in February 1965 included tentative guidelines for such institutions. The guidelines were comparable to those for banks, but with allowances for differences in methods of operation. The guidelines suggested that liquid funds held abroad, other than minimum working balances, should be limited to the end-1964 level and reduced, in a gradual and orderly manner, to the December 31, 1963, level. Loans and investments with maturities of five years or less were to be held to 105 per cent of the amount of such loans and investments outstanding on December 31, 1964. The priorities suggested in the bank guidelines also were suggested to nonbank financial institutions.

First reports under the tentative guidelines revealed an unexpectedly large amount of foreign assets held by nonbank financial institutions—12 billion, or about the same amount as total foreign claims held by banks. Revised guidelines were issued in June 1965; the principal change was to expand the coverage of

the 105 per cent ceiling to loans and investments with maturities up to ten years and to suggest that substantial restraint be exercised in acquiring long-term assets (those whose maturities placed them outside the guideline ceiling) in developed countries other than Canada, Japan, and the United Kingdom. On December 31, 1965, long-term investments for which a ceiling was not suggested accounted for almost 90 per cent of total foreign investments held by nonbank financial institutions.

During the first year of the program, the reporting nonbank financial institutions increased total holdings of foreign assets by about $700 million—from $12.2 billion on December 31, 1964, to $12.9 billion on December 31, 1965. However, foreign assets for which a target ceiling was suggested by the guidelines declined from $1.7 billion to $1.5 billion during the same period.

The guidelines for nonbank financial institutions were revised in December 1965, again with the idea of conforming them as closely as possible to the bank guidelines. The target ceiling for loans and investments with maturities of ten years or less was increased to 109 per cent of the end-1964 base; the increase was to be used at a rate of 1 per cent of the base figure in each quarter. Again no ceiling was suggested for long-term loans and investments in the priority categories. However, lending institutions were requested to limit the total of credits and investments in developed countries other than Canada and Japan to 105 per cent of the total of such assets held on September 30, 1965. Within the ceiling, nonbank financial institutions also were asked to avoid any increase in long-term investments in the developed countries of continental Western Europe.

Total foreign assets held by the nonbank financial institutions showed almost no change during 1966. Long-term investments in Canada rose by about $400 million, but holdings of most other assets declined.

The guidelines for 1967, which became effective in the fourth quarter of 1966, simplified the nonbank program by combining assets covered under separate guidelines in the earlier programs into one category of "covered" assets. Covered assets included liquid funds and loans and investments with maturities of ten years or less, and long-term and equity investments in developed countries other than Canada and Japan (except equity securities acquired after September 30, 1965 in U.S. markets from U.S. investors). Covered assets as thus defined totaled $1.9 billion on December 31, 1966, as compared with a total of $2.4 billion for the same types of assets on December 31, 1965.

The 1967 guidelines asked nonbank financial institutions to hold the totals of these covered assets to 105 per cent of the adjusted base figure, (essentially holdings of covered assets on September 30, 1966). The priorities for export credits and credits to developing countries were continued. In addition, lending institutions were asked to limit nonexport loans and investments to developed countries of continental Western Europe to the fullest extent practicable, and in any event to a level not to exceed the amount of such assets held on September 30, 1966.

Nonbank financial institutions reporting at the end of 1967 increased their holdings of total foreign assets by $910 million during the year; of this amount $585 million represented increases in long-term credits and equity investments in Canada and Japan. Covered assets remained relatively unchanged at $1.9 billion; however, adjustments to the base date figures reduced the ceiling by about $130 million, leaving the lending institutions in the aggregate over the target ceiling by $94 million at the end of 1967.

Initial guidelines for 1968 issued in November 1967 increased the target ceiling for covered assets to 109 per cent of adjusted base date holdings. Reporting requirements were eased by providing that financial institutions holding covered assets of $500,000 or more, or total foreign assets of $5 million or more, were expected to report. Previously, lending institutions with total foreign assets of $500,000 or more had been requested to report. The new provision reduced the number of reporters from about 570 to 340 institutions. The group of institutions exempted from reporting held only nominal amounts of covered assets and about $400 million of noncovered assets.

The restrictive program announced on January 1, 1968, reduced the ceiling for covered assets to 95 per cent of adjusted base date holdings (now defined as covered assets held on December 31, 1967). Lending institutions were asked to reduce holdings of liquid funds abroad to zero during 1968, except for minimum working balances. Institutions were expected to refrain from making new investments to developed countries of continental Western Europe, in either debt or equity form, except to finance U.S. exports.

As of March 1, 1968, all Canadian loans and investments formerly subject to the ceiling (money market instruments and short- and medium-term credits) were excluded from the ceiling and from the definition of covered assets.

Performance of the nonbank financial institutions as a group under the January 1, 1968, guidelines has been satisfactory. The guidelines had requested a reduction in covered assets of at least $100 million. On September 30, 1968 (latest data available), covered assets had been reduced by $192 million from the December 31, 1967, level.

Total holdings of foreign assets of reporting nonbank financial institutions increased by almost $350 million during the first three quarters of 1968 to $14.1 billion. Almost the entire amount of the increase reflected increased investments in Canada.

The importance of Canadian assets in the portfolios of nonbank financial institutions is emphasized by the fact that Canadian investments on September 30, 1968, both short- and long-term, accounted for 70 per cent of total foreign assets held by nonbank financial institutions and 80 per cent of the assets not covered by the guidelines.

Guidelines for nonbank financial institutions issued on December 23, 1968, continued the ceiling for covered assets at 95 per cent of adjusted base date holdings for 1969. Lending institutions that had not succeeded in reaching this ceiling during 1968 are requested to increase their efforts to do so.

STATISTICAL NOTE

Bank holdings of short- and long-term claims on foreigners are published by the Treasury Department and the Federal Reserve on the basis of data collected from the banks on Treasury Department foreign exchange reporting forms. These data are not comparable with the data reported to the Federal Reserve Banks under the foreign credit restraint program, since some institutions and accounts covered by the Treasury Department forms are not included in the foreign credit restraint program, and vice versa. For example, U.S. agencies and branches of foreign banks report to the Treasury Department but not to the Federal Reserve under the program. Foreign assets reported by banks to the Treasury but not covered by Federal Reserve guidelines include foreign assets held for account of customers, loans guaranteed or participated in by the Export-Import Bank (and, since December 23, 1968, by the Department of Defense), and, since February 29, 1968, loans to residents of Canada. Assets reported to the Federal Reserve and not to the Treasury Department include foreign long-term securities held for own account and investments in foreign subsidiaries and branches.

FOREIGN CREDITS OF U.S. BANKS

[Dollar amounts in millions]

	1964 Dec.	1965 Dec.	1966 Dec.	1967 Dec.	1968 Mar.	1968 June	1968 Sept.	1968 Oct.	1968 Nov.
Number of reporting banks	154	161	148	151	153	153	154	157	153
Target ceiling		$9,973	$10,407	$11,069	$9,984	$9,886	$9,785	$9,784	$9,773
Total foreign credits subject to ceiling [1]	$9,484	9,652	9,496	9,865	9,396	9,203	9,156	9,249	9,192
Change from previous date		+168	−156	+369	−469	−193	−47	+93	−57
Net leeway for further expansion		321	911	1,204	588	683	629	535	581
Total foreign credits held for own account [2]	9,719	9.958	9,844	10,202	9,731	9,721	9,649	9,761	9,711
Change from previous date		+239	−114	+358	−471	−10	−72	+112	−50

[1] Total foreign assets reported on Treasury Foreign Exchange Forms B-2 and B-3 minus (1) amounts held for accounts of customers, (2) loans guaranteed or participated in by the Export-Import Bank or insured by the FCIA, and (3) beginning Mar. 1, 1968, changes after Feb. 29, 1968, in claims on residents of Canada held for own account; plus foreign assets held for own account but not reported on forms B-2 and B-3.

[2] Total foreign assets reported on Treasury Foreign Exchange Forms B-2 and B-3 plus foreign assets not reported on those forms. minus amounts held for account of customers.

FOREIGN ASSETS OF U.S. NONBANK FINANCIAL INSTITUTIONS AND NONPROFIT ORGANIZATIONS

[Dollars in millions]

	Holdings end of September 1968	Change from June 1968		Change from December 1967	
		Amount	Percent	Amount	Percent
ASSETS SUBJECT TO GUIDELINE					
Deposits and money market instr., foreign countries except Canada	$26	−$7	−21.1	−$30	−54.1
Short and intermediate credits, foreign countries except Canada [1]	258	−9	−3.5	−37	−12.7
Long-term investments "other" developed countries: [2]					
Investment in financial businesses [3]	97	4	4.1	−4	−4.4
Investment in nonfinancial business [3]	6	(4)	6.8	−3	−32.9
Long-term bonds and credits	634	−9	−1.4	−25	−3.8
Stocks [5]	463	−17	−3.5	−92	−16.6
Total holdings of assets subject to guideline	1,483	−37	−2.5	−192	−11.5
Adjusted base-date holdings [6]	1,604	−9	−.6	(7)	(7)
Target ceiling [8]	1,524	−9	−.6	(7)	(7)
ASSETS NOT SUBJECT TO GUIDELINE					
Investments in Canada:					
Deposits and money market instruments	93	−31	−25.3	−22	−19.0
Short- and intermediate-term credits [1]	151	9	6.3	16	12.3
Investment in financial businesses [3]	590	−4	−.7	13	2.3
Investment in nonfinancial businesses [3]	44	(4)	.6	1	2.2
Long-term bonds and credits	7,943	93	1.2	365	4.8
Stocks	1,335	4	.3	−46	−3.3
Bonds of international institutions, all maturities	1,042	33	3.2	63	6.5
Long-term investments in the developing countries and in Japan:					
Investment in financial businesses [3]	25	(4)	−.5	12	98.9
Investment in nonfinancial businesses [3]	9	1	17.1	2	32.3
Long-term bonds and credits	824	11	1.3	80	10.7
Stocks	231	9	4.3	9	4.2
Stocks, "other" developed countries [9]	338	1	.4	44	14.9
Total holdings of assets not subject to guideline	12,624	125	1.0	538	4.5
Memo: total holdings of all foreign assets	14,107	88	.6	346	2.5

[1] Bonds and credits with final maturities of 10 years or less at date of acquisition.
[2] Developed countries other than Canada and Japan.
[3] Net investment in foreign branches, subsidiaries, or affiliates in which the U.S. institution has an ownership interest of 10 percent or more.
[4] Less than $500,000.
[5] Except those acquired after Sept. 30, 1965 in U.S. markets from U.S. investors.
[6] Dec. 31, 1967 holdings of assets subject to guideline, less carrying value of equities included therein but since sold, plus proceeds of such sales to foreigners.
[7] Not applicable.
[8] Adjusted base-date holdings, times 95 percent.
[9] If acquired after Sept. 30, 1965 in U.S. markets from U.S. investors.

Chairman Reuss. Thank you very much, Governor Brimmer. Secretary Deming?

STATEMENT OF HON. FREDERICK L. DEMING, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. Deming. Mr. Chairman, members of the committee, I have a supplemental statement, Mr. Chairman, which I will present for the record and my main statement which I shall read. With your permission, I will work from both of them in this presentation.

Representative Reuss. The record will include all that you present, Secretary Deming.

Mr. Deming. As the President noted last night, in 1968 the United States had a surplus in its balance of payments on both the liquidity

and the official settlements basis. On the liquidity basis, the surplus was the first since 1957—around $150 million on the preliminary figures we have. On the official settlements basis, the 1968 surplus, again on preliminary figures, was about $1.7 billion. The data on official settlements goes back only to 1960; we had a small surplus of about $300 million in 1966; every other year from 1960 through 1967 for which we have records, we had deficits.

The 1968 total is preliminary but I think it is fairly firm. The final is not likely to be more than $200 or $300 million different either way, up or down, from the preliminary. That may be quite a difference from pure fourth quarter figures—which are the ones that are preliminary—but not much for the year.

Also, in 1968, we restored our full position in the International Monetary Fund—$6,450 million. Our gold tranche of $1,290 million is, of course, virtually automatically available, should we need it. In addition, in 1968 the Federal Reserve swap lines were enlarged—to a total of $10.5 billion and, at yearend, our drawings on our swap partners were less than $450 million, down from a peak of $1.8 billion in December 1967.

To round out the international financial picture for 1968, I want to note three other achievements.

In March, the two-tier gold system was established and has worked well. After suffering severe losses of gold reserves in late 1967 and early 1968, the drain of monetary gold into private hands was stopped. Since the end of March, U.S. gold holdings have increased net by $188 million. Also in March, the archaic gold cover requirement for Federal Reserve notes was removed, thus freeing up all of the U.S. gold stock for international monetary purposes.

Also in March, final agreement was reached on a plan for a new international reserve asset—the Special Drawing Rights, or SDR. As of January 10, 1969, 29 countries with 47.54 percent of the weighted votes have ratified the proposed amendment to the Fund's articles of agreement. When 67 countries, with 80 percent of the weighted votes, take this ratification action, and when countries with 75 percent of the vote deposit their certificates of participation with the Fund, the new machinery will be in place. I am confident that this will occur in the very near future. Activation of the new facility will, of course, come later—but, I hope, fairly soon—after a collective decision on amount.

Finally, the international monetary system weathered a series of financial storms in 1968. International monetary cooperation successfully met the challenges it faced last year. Undoubtedly the system can and will be improved over time, but it should not be overlooked that it has worked well and has contributed greatly to world economic growth and the growth of world trade.

Just a year ago, Secretary Fowler released the U.S. Treasury Department report entitled "Maintaining the Strength of the U.S. Dollar in a Strong Free World Economy." [1] That report gave the history of the U.S. balance-of-payments position, described various programs that had been undertaken to resolve our balance-of-payments problem, and described in detail President Johnson's January 1 balance-of-payments

---

[1] Available from Superintendent of Documents, U.S. Government Printing Office, Washington, D.C.

action program. Last month, Secretary Fowler released a supplement to that report entitled "A 1968 Progress Report," which was based on the results of the first three quarters of this year. It described the progress we had made in 1968 and the actions still required.

The Progress Report also repeated the text of the January 1 message and printed an exchange of letters between President Johnson and Secretary Fowler announcing the 1969 balance-of-payments program, as recommended by the Cabinet Committee on the Balance of Payments and approved by the President. The Cabinet Committee laid down the following principles, which they believed should govern the program in 1969.

1. A stable economy and the restoration of a healthy U.S. trade surplus should be the primary objective for 1969.

2. Initiatives pursued in 1968 to assure fairness to U.S. trade in world markets should culminate in 1969 in cooperative action by the United States and our trading partners.

3. The Department of Commerce should intensify efforts to expand commercial exports generally and in conjunction with foreign assistance, and the Agency for International Development should continue measures to assure additionality and to minimize substitutions in foreign assistance.

4. Consistent with our security commitments, the Nation in 1969 should continue to minimize its net military deficit by reducing those expenditures whenever conditions permit and by neutralizing them through cooperative action by our allies.

5. The mandatory and temporary foreign direct investment program, as announced in modified form by the Secretary of Commerce on November 15, 1968, should be maintained.

6. The Federal Reserve voluntary foreign credit restraint program should be maintained with present ceilings on foreign lending from the United States, but in the coming year attention should be given to possible modifications to encourage further the promotion and financing of exports by the commercial banking system.

7. The interest equalization tax, which expires July 31, 1969, should be extended with the existing authority to vary the rate from 1½ percent down to zero, depending on circumstances.

8. A 5-year program is needed to narrow the travel deficit through promotion of foreign travel in the United States by both public and private action.

Against this background, I would like to analyze in some detail the history and the anatomy of the U.S. balance of payments. For this purpose, I have had constructed two tables, table 1 and table II, which present the U.S. balance of payments from 1941 through 1967 in a different and, I believe, somewhat more useful analytical form than the conventional current account-capital account presentation. This analytical form, which in broad outline is not unique is, I believe, particularly useful from the viewpoint of policy formulation.

The two fundamental differences between the analytical models given in tables I and II and the conventional presentations are (1) the income on our foreign investment and the outpayments on foreign investment in the United States are taken out of the traditional "services" account, which is a current account item, and put into the "net private capital" account; and, (2) the figures on U.S. Government re-

ceipts and payments, both current account transactions and net U.S. Government grants and loans, are consolidated in two accounts, which I call Government grants and capital, including income and military sales and expenditures. There is one major exception to this second consolidation. Outpayments of interest on foreign holdings of U.S. Government securities are included in the capital account, which I call, consequently without complete accuracy; net private capital. I will give the rationale for this inclusion later on.

Table I shows the detail, consolidated into the accounts noted, for the overall balance of payments. Table II shows the detail for the net private capital account, as I define it. Table I balances to the familiar liquidity balance measurement but also shows, for the period after 1960, the official settlements measure. Data on this measure, as I have noted, is not available before 1960, which is the major practical reason for balancing the table to the liquidity measure.

Now, let me explain the specific accounts briefly. Column 1, merchandise balance, is the familiar trade balance—the difference between exports and imports. It excludes sales and purchases on military account. Exports financed by U.S. economic grants and loans are included.

Column 2, service balance, is quite different from the conventional account on services. It includes outflows and inflows—and thus the net—on transportation, on travel, and on miscellaneous services account, the latter both private and Government, plus pensions and remittances—also both Government and private. It might have been more consistent to have stripped out from this account Government payments and receipts for miscellaneous services and payments of Government pensions to those living abroad. In 1950, the net of these was about $200 million; in 1967, it was about $800 million. The reason for leaving these items in the services balance was partly because of the work involved but mainly because the services were miscellaneous and the pensions, a major portion, are not susceptible to policy action anyway. The services balance does *not* include any *income* receipts or payments on investment; as noted, these are included in the net private capital account. Nor does it include any military or Government aid and loan transactions. These are included in the military and Government accounts.

Column 3 is merely the sum of columns 1 and 2.

Column 4, Government grants and capital, including income, includes both disbursements and repayments on loans and grants—in other words, it is net. The account also includes interest and other income on Government loans and investments. It does *not* include foreign investments in U.S. Government securities or payments of interest on such securities. These are included in the net private capital account. Prior to 1946, the data on the Government account include military grants.

Column 5, military sales and expenditures, is basically the foreign exchange costs of our military operations abroad, less receipts on sales of military goods and services. Before 1952, the series is a pure expenditure series; from 1953 to 1959, inclusive, it is expenditures minus deliveries of military goods and services; from 1959 on, it is expenditures minus cash receipts on military exports. From 1966 on, a separate column, 6, indicates military "neutralization," which is essen-

25-765—69——12

tially financial transactions designed to offset the foreign exchange costs of our military expenditures undertaken in the common defense, but is not directly connected with foreign purchase of military goods and services from the United States.[1]

Column 7 is the net private capital account; column 8, the liquidity balance; column 9, the official settlements balance.

Table II shows a breakdown of the net private capital account in table I. As can be seen, it includes capital outflows from the United States on direct investment, column 10, and on other account (except Government), column 11. It also includes income receipts on our private foreign investments and this column, 12, includes receipts of fees and royalties from our direct investments abroad. Column 13 merely nets columns 10, 11, and 12. Net foreign investment inflow is shown as column 14. Income we pay to foreigners on their investments in the United States is shown in column 15. That series includes payments by both U.S. private and public sectors, and a word of explanation should be given right here about this series.

Income payments to foreigners is a composite of three separate payments. First is the dividends and interest earned on private investments in the United States by foreigners. Such foreign investment is mainly portfolio investment, but there is substantial direct investment here also. Second is interest and dividends earned on investments in the United States by public institutions or governments. It is important to recognize that there are public or governmental investments—both direct and portfolio—in the private U.S. economy. Some of these investments are in real estate; most are in the form of interest-earning deposits in U.S. banks. Neither of these types of investment are new developments, although foreign central bank investments in U.S. bank certificates of deposit or time deposits have been extended both in amount and maturity in recent years, as interest rates in the United States have risen. Third is the interest payments made on foreign holdings—both public and private—of U.S. Government securities.

In connection with this third category, it is important to recognize two facts. First, the United States has financed much of its deficits over the past 18 years by increasing its liabilities both to official and private holders of dollars. As the primary reserve and vehicle currency of the free world, this has been a natural development. These dollars, of course, are held because of confidence in the U.S. economy, because there are major money and capital markets here which make it easy to buy and sell securities—particularly Government securities—and because investments in dollar securities earn a return. The rise in the volume of income payments to foreigners reflects in no small degree the rise in U.S. dollar liabilities to foreigners—both public and private.

Second, included in those payments are interest payments on the special types of U.S. securities held by official foreign accounts, such as Roosa bonds and the nonliquid securities sold to neutralize military foreign exchange costs. The only real difference between these latter and any other U.S. Government security is their nonliquidity, so that

---

[1] Technically, military neutralization did not begin until 1967 when financial transactions for that purpose were specifically linked to our military expenditures in particular countries. I have included transactions done in 1966 and 1967, not then specifically counted as military neutralization but of the same type, only for purposes of comparability in this presentation.

they are counted technically—in the liquidity balance concept—as capital inflow. From the interest cost point of view, there is little, if any, difference between them and any other Government security. I shall come back to this point later on in the analysis.

Finally, column 16, errors and omissions, is included in the net private capital account. Most analysts regard it as mainly an unrecorded capital item. Column 17 is the same as column 7, net private capital in table I.

Now, let us move to analysis of the figures as shown. You will note from the tables that I have grouped certain series of years and computed averages for those years. The first three groupings cover a period of 17 years—World War II, the immediate postwar, and the 1950–57 periods. Note that the United States was in deficit on the liquidity basis—and, if we had figures, I am sure it would show similar deficits on the official settlements basis—in 11 of the 17 years. The average annual deficit for the entire period was $563 million. And the United States financed its whole deficit in the 17 years—some $9.6 billion—by an increase in liquid dollar liabilities, about $7.7 billion to official holders and about $4.7 billion to private holders—which adds up to more than the deficit. The difference came in our gold holdings which, on December 31, 1957, were up $862 million from the end of 1940, and an improvement in our IMF position of nearly $2 billion.

Let us look at the individual accounts. The trade balance was in very substantial surplus until 1950—reflecting two basic facts. One, we were the arsenal of democracy in World War II and, in the immediate postwar years, we had the only major industrial plant that was not damaged by war. It is not much of an oversimplification to say that we had most of the goods and most of the money in the free world. When you look at the Government grants and capital account, you can see that we gave or loaned the rest of the world money and, with it, they bought our goods. If you look at foreign investment in table II, you can see that foreigners also sold off investments in the United States to get funds to buy badly needed goods and services. And, finally, even though they did not have much gold, they sold us gold and held dollars in preference—the dollars earned income.

We ran big surpluses on services account in the war years and were roughly in balance on that account in the immediate postwar years. The foreign exchange costs of our military operations overseas were not all that high, and we had pluses on net capital account from our earnings on previous investment and from errors and omissions, which probably reflected mostly capital inflow to the United States for safety reasons.

Between 1950 and 1958, the world was being rebuilt—in large part due to our help. We were able to cut back considerably on Government grants and capital, but our military expenditures rose as we stopped formal occupation of former enemy countries but still maintained troops there and elsewhere, without covering their foreign exchange costs. Our services account went into deficit as travel and transportation account worsened—but the deficit was not too great. And our net private capital account improved somewhat. Income on our foreign investment continued to rise, and it was not until the very end of the period that our capital outflow increased sharply. Foreign investment, while not large, did flow into the United States and, inclusive of

the inflow on errors and omissions, exceeded income payments to foreigners.

The big loser in this period was the trade account. Except for 1956 and 1957, it was substantially smaller than in the war or immediate postwar years. Partly, that was due to recovery and industriay modernization and availability of goods from sources other than the United States; partly, it reflected sharper cost increases here than elsewhere and deterioration in our competitive position; partly, it reflected our willingness to suffer trade disadvantages not connected with costs; partly, it reflected reduction in our loan and grant programs.

But, even with all of these developments, our deficits were not particularly large or disturbing. Statistically, they averaged no more than in the war years, and we financed them mainly with increased dollar liabilities to foreigners. Our gold stock at the end of 1957 was $1.7 billion below the balance at the end of 1949, but we still had considerably more gold than at the end of 1941.

The real facts of the matter were that at no time between 1941 and 1958 was the United States in deficit in any meaningful sense. We saw our net reserve position deteriorate, but we could afford it and, indeed, it was good for the world. The dollar was better than gold, and most foreigners preferred it. In essence we acted with responsibility and with altruism and with enlightened selfishness. It was good for the world and it was good for us.

In 1957, due primarily to the Suez crisis and the oil situation, we had a balance-of-payments surplus of $578 million. That was to be the last until 1968. Our trade and service surplus was $5.4 billion; our Government and military deficit was $5.2 billion, and we still had a small net capital inflow.

After 1957, the picture changes radically. By 1958, Western Europe and—Japan had recovered from World War II—as noted, due in large part to U.S. policy—their currencies were basically convertible and their industrial plant strong and competitive. The United States no longer had most of the goods and most of the money, but both we and the industrial world continued to act as though that still were the case. We continued to tolerate disadvantages to our trade and to encourage our people to travel and buy abroad. We continued to pick up most of the foreign exchange and budgetary check for the common defense of the free world. And, to compound our difficulties, sluggishness in the American economy and the investment opportunities in the expanding world economy brought an ever-increasing flow of private capital out of the United States.

The rest of the world had grown used to increases in their international reserves and did not wish to see that process arrested. At the same time, they began—inconsistently but nonetheless actually—to get nervous and displeased about the continuing and increasing American deficits. They expressed this nervousness and displeasure by converting a large part of the dollar increases in their reserves into gold from the American gold stock.

In the 10 years, 1958–67, the U.S. balance-of-payments deficits cumulated to almost $28 billion, or $2.8 billion per year on the average—4½ times the average annual deficit of the previous 17 years. In financing that deficit, the United States increased its dollar liabilities to private and public holders by over $17 billion. But we also saw our gold

stock drop by almost $11 billion. Part of that decline was due to the gold rushes of late 1960 and early 1961 and late 1967. But most of it was a fairly steady attrition resulting from the need to finance our deficit.

In a very real sense, the balance-of-payments adjustment problem—both for the world and for the United States—in the 1958–67 period can be characterize as a struggle, both intellectual and real, to get the surplus countries of Western Europe to recognize that chronic surpluses were bad and to get the United States to recognize that chronic deficits were bad. For far too long, we continued to say three things: (*a*) our deficit was good for the world; (*b*) it really was not very important anyway; and (*c*) at the same time we apologized for being in deficit. For far too long, Western Europe continued to say; (*a*) the United States should correct its deficit; (*b*) Europe had no responsibility for taking compensating action; and (*c*) proper demand management in the United States would do the whole job.

In the past couple of years, however, real progress has been made on both sides in recognizing not only the oversimplification of the above propositions but the basic responsibilities which lay on both sides. Most helpful in arriving at this better and more appropriate position have been the regular discussions in the OECD, especially in its Working Party 3, and in the Group of Ten, as it considered the need for a new type of international reserve asset.

Now let us return to the analysis—this time of the 1958–67 period. As can be seen from the tables, I have grouped the 1958–67 years into four subperiods: 1958–60; 1961–64; 1965–66; and 1967.

Note that the trade balance in 1958–60 averaged just about the same as in 1950–57, and then improved strikingly in 1961–64. Note also that, while the trade balance deteriorated significantly from 1964 through 1967, it was still a respectable and a real surplus.

Much of the good performance on the trade account in the 1960–65 years was due to the good performance of the American economy from a cost viewpoint. The economy was running at less than optimum level during much of this period, but it was growing and cost stability was being maintained. As Vietnam began to put pressure on resources, however, higher cost trends began to develop. Failure to arrest these trends, I believe, has been the basic factor in the deterioration of the trade balance. While we can never know for certain, my own judgment is that failure to enact the Revenue and Expenditure Control Act of 1968 in the summer of 1967, when it was introduced, was the major factor in our deteriorating trade balance in 1968. That weakness was compounded by the strikes or threatened strikes in steel, copper, and the docks. The threat, culminating in the reality, of the current dock strike probably is responsible for temporarily arresting the recovery of our trade balance that was evident this fall.

The services balance also shows steady deterioration throughout the period, being arrested only a bit in 1964. From 1957, when the services balance showed a deficit of $674 million, to 1967, when it was in deficit by $2,592 million, there was a deterioration of almost $2 billion. The travel deficit worsened by a billion; the transportation deficit, part of which reflects tourism, worsened by $700 million; the pensions and remittances deficit worsened by $600 million. These were offset in only a minor way by improvement in our miscellaneous services surplus.

So we see that the average combined trade and services account improved by $2 billion from 1958–60 to 1961–64, despite some deterioration in the services account; dropped by $1.4 billion in the 1965–66 period, as the trade balance declined and the services balance worsened further; and dropped another $1.4 billion in 1967, reflecting the same developments but with more accent on a sharply increased tourist deficit.

The Government grants and capital account in1958–60 was slightly less in deficit than it had been in 1950–57. The deficit widened in 1961–64; widened slightly further in 1965–66; and was sharply higher in 1967 and 1968. In large measure, the early increase in the 1960's were due to increased aid and, in the late 1960's to increased lending by the Export-Import Bank.

It should be noted that this account represents little financial drain. It mostly finances U.S. exports which might not take place without U.S. Government grants and loans. Much of the financing is tied to purchase of U.S. goods and services. Included in these totals are Export-Import Bank loans.

The military account deficit in 1958–60 was up significantly from the average of the previous 8 years. Then, by a combination of military offset sales and reductions in costs, that account deficit was reduced substantially in 1961–64. The sharp rise after 1965 reflects almost entirely the direct foreign exchange costs of Vietnam. Beginning in 1966, we began to seek financial neutralization of the foreign exchange costs of our military expenditures abroad. In 1968, we more than doubled that neutralization of 1966 and 1967.

A major point to stress in explaining changes in the U.S. balance of payments after 1957 is the capital account. Table II shows the developments in the components of that account.

Direct investment outflow rose sharply in 1956 and 1957, fell back in 1958–60, and then more than doubled by 1966. Other private capital outflow, mainly borrowings by foreigners in our markets and bank lending abroad, also began to rise sharply in 1956–57 and increased fairly steadily until 1964, when it peaked at more than $4 billion. These accounts show two significant things.

First, direct investment—even in balance-of-payments terms—was not cut back absolutely by the voluntary program in 1965 and 1966 but was reduced somewhat in 1967 under a continuation of the voluntary program and not reduced much further in 1968 under the mandatory program. What my arrangement of the data does not show—but Mr. Fiero's statement does—is that the overall foreign exchange costs of direct investment were reduced quite significantly. The reduction is reflected, however, in large part in column 14, where part of the foreign investment inflow reflects foreign financing, through purchases of American corporate bonds, of U.S. direct investment abroad. In point of fact, neither the voluntary or mandatory programs ever were designed to curtail gross U.S. investment overseas—but to shift the financing abroad and thus lessen the foreign exchange drain. In fact, the programs have succeeded. As Mr. Fiero points out, gross U.S. investment overseas has risen each year, with the 1968 increase expected to be 8 percent.

The second point is that other investment outflow dropped very sharply after 1964, due in part to extension of the interest equalization

tax to bank loans, in part to the Federal Reserve program and in part to the Commerce program on direct investment. The improvement in this account from 1964 to 1965 was almost $4 billion. Of this the banks accounted for about $2.5 billion as their short-term loans to foreigners went from a net outflow of $1.5 billion in 1964 to a net inflow of $300 million in 1965.

Some part of this very large improvement obviously was not sustainable and in 1966 the net outflow on other capital increased by $450 million, due mainly to a reversal of flows in the corporate account. In 1967, there was a sharp deterioration in this account due to three factors:

1. Americans increased their purchases of new issues of foreign securities by over $400 million between 1966 and 1967. Part of the increased purchases were issues of international organizations, such as the World Bank; part represented sales of bonds by the Government of Israel following the outbreak of hostilities in June of 1967; and part reflected an increase in new Canadian issues.

2. There was a reversal in 1967 of U.S. liquidation of foreign security holdings, a process that had been going on since the IET was put into effect in 1963. Net U.S. purchases of outstanding foreign securities in 1967 exceeded $100 million, compared with liquidation of about $325 million in the preceding year. The reversal in late 1966 of the long downward trend in major foreign stock markets probably played a role in the resumption of U.S. purchases.

3. The easier reserve position of U.S. commercial banks in 1967 resulted in a very marked rise—$660 million—in their short-term credits to foreigners, although the great majority of banks remained within their ceilings under the voluntary credit restraint program. The bulk of the increase in 1967 credits went to Japan, which had reduced its short-term U.S. banking obligations in the previous year.

In 1968, some of these losses were recouped, primarily because the banks again reduced their foreign loans under a tighter Federal Reserve program.

Income on our foreign investment, including fees and royalties, rose very sharply throughout the period, proving two things. One, the restraint programs certainly did not kill the goose that laid the golden eggs, and two, in general this source of earnings is a powerful and growing help to our payments balance.

Now, note that the combination of restraint on outflow and growing earnings turned the net on U.S. capital (column 13) from a fairly large negative in 1964 to a very large positive in 1965 and following years.

Net foreign investment inflow was modest throughout the 15 years from 1950 to 1965. Beginning in 1966, it increased sharply and continued to increase in 1967. It more than doubled from 1967 to 1968. I have noted that part of this development really represents foreign financing of direct U.S. investment abroad. Sales of U.S. corporate debt securities mostly for this purpose totaled about $550 million, in both 1966 and 1967, and, in 1968, are estimated at $2 billion.

A large part of the improvement, however, reflected a real movement into U.S. equities, which began to escalate in late 1967 and continued throughout 1968. It may have been strengthened by the unrest in Europe in the late spring of 1968, but it was well underway

before that time. I believe that part—probably a major part—of the credit goes to the Foreign Investors Tax Act and the concerted movement of American financial houses to attract foreign portfolio investment. A recent article in U.S. News & World Report comments on this increase in purchase of U.S. equities, either direct or through mutual funds.

Finally, some portion, but not a large one, reflects a shift in central bank or government investments in U.S. bank certificates of deposit from shorter to longer maturities. The increase in 1966 in such certificates was about $350 million; in 1967 was about $500 million; and in 1968 is estimated at $200 million. For the most part, these shifts reflect interest rate considerations but, in some measure—particularly from Asian sources—they reflect the desire to help neutralize our increased military costs in Southeast Asia. These investments are separate from those I show in the military neutralization column. The difference is both in form and in explicit understanding with regard to neutralization of military expenditures.

I have already commented on column 15, income payments to foreigners. The sharp and steady rise reflects—as to be expected—the rise in foreign investment in the United States and the rise in U.S. liquid dollar liabilities to foreigners, both public and private.

Now what lessons can be learned from this detailed analysis? In my judgment they are the following:

1. It is vital that we improve performance on the trade account. In doing so these points are important:

(*a*) The economy must not be allowed to overheat. A sustainable rate of growth is desirable but a growth rate that strains resources, puts upward pressure on prices and costs, renders us less competitive, and sucks in imports in extraordinary volume is not desirable—either domesitcally or internationally. It is not desirable—either domestically or internationally—to deflate the economy substantially below its capacity.

(*b*) Every effort must be made to avoid crippling strikes in key industries that lead to lessened exports and increased imports. It takes a long time to recover from the effects of such developments.

(*c*) We need to engage more heavily in export promotion and continue to improve our export financing machinery.

(*d*) We must move strongly toward ameliorating the trade disadvantages which are built into the existing system. These include both nontariff barriers and border tax-export rebate systems.

2. It is vital that we continue to push toward further reductions in the net foreign exchange costs of our military expenditures incurred in the common defense of the free world. We have done a good deal in this area; we must move to more sustainable programs and to greater amounts. In this connection, it is important to note:

(*a*) At the last meeting of NATO Ministers in November 1968, the following language was in the communique:

> They (the Ministers) also acknowledged that the solidarity of the Alliance can be strengthened by cooperation between members to alleviate burdens arising from balance of payments deficits resulting specifically from military expenditures for the collective defense.

It is now necessary to work out the implementing details.

(*b*) After Vietnam, it will be important to capture the potential foreign exchange savings through better burden sharing of mutual defense costs in the Far East.

(*c*) There is nothing inherenlty wrong in the military neutralization program—offsetting foreign exchange costs through financial transactions that represent capital inflow to the United States. Fundamentally, it costs the United States no more to pay interest on nonliquid military neutralization securities than on any other U.S. Government securities in which foreign governments invest their reserves. Nevertheless, foreign governments do not wish to lock up too great a quantity of their reserves in nonliquid securities so that the potential for such transactions is not infinite. But, more importantly, it is better practice to reduce the net foreign exchange costs of military expenditures through host country purchases of military goods and services from the United States or direct assumptions of some of the foreign exchange costs we bear and which accrue to those countries.

3. It is vital that we continue to stimulate foreign investment inflow into the United States. This is a perfectly sound method to aid our payment balance. Both direct and portfolio investment by foreigners in the United States is useful and helpful.

4. For the time being it is essential that we continue to restrain capital outflows from the United States.

5. We must stimulate more foreign travel to the United States.

In summary, let me point out these facts:

1. Even if we succeed in stimulating travel to the United States, it is unlikely that we can do more than to hold the deficit in service account, as I define it, to something like its level in 1967 and 1968. As a high income country, our people will travel abroad. Simple demand management policy—even perfect demand management policy—will not cut this outflow. So we will have to run fast in promoting foreign travel here just to stay in the same place—a substantial deficit. Here a 5-percent ticket tax with the proceeds going to finance a well-coordinated tourism program is highly important.

2. Government grants and capital help finance exports and are important in helping develop the less developed countries of the world. We should increase our level of foreign aid, but do so in a way that protects us when we are in balance-of-payments deficit and in a way that helps assure additionality of commercial exports. But it is unlikely that the gross drain—as shown in column 4 will decline. It is likely to rise—and it should rise.

3. Military expenditures are not susceptible to demand management. We have to seek political cooperation to reduce their net foreign exchange drain.

4. If we assume a service outflow of $2.5 billion, a Government capital outflow of $3.5 billion, and a net military outflow of only $1 billion, we need a $7 billion trade surplus just to balance these outflows and this leaves nothing for private capital export. To the extent we export capital net we need a bigger trade surplus.

5. It thus is highly important that we attract capital inflow here—to offset gross capital outflow that cannot be covered by the trade account.

I might summarize my remarks at this point by saying that I believe the corrective or adjustment process in our balance of payments will

have to occur to a significant extent in the capital accounts and not only in our current account items. I also believe this process will necessarily involve more policy coordination among the major countries, not only on general adjustment measures but on specific ones as well.

General measures, working through changes in incomes and prices, here and abroad, simply do not have sufficient effect on military, foreign aid and, perhaps, some other types of transactions; and any effect they do have is likely to be diffused rather than concentrated among the countries most involved in such transactions.

As I said last September at the annual meeting of the National Association of Business Economists:

". . . the adjustment process is complex—and, consequently, the attainment of successful adjustment has to involve both surplus and deficit countries and a whole range of policies and policy instruments. Proper fiscal and monetary policies are of key importance in successful adjustment—but other policies, at least for the United States, and, I believe, for others, as well, are of high importance also.

Some types of transactions are primarily responsive to domestic fiscal and monetary policies; other are less so. Still others are influenced primarily by past economic policies and developments. Some reflect policy decisions of an essentially noneconomic nature.

I believe this situation will continue; and that in addition to whatever balance-of-payments adjustment we achieve through general measures, we will also have to rely on some specific measures for achieving external balance. Not only are general measures ineffective for certain important types of U.S. transactions abroad; their use beyond a certain degree to influence transactions where they are effective may run into conflict with the achievement of one or more other major national objectives, such as full employment and steady economic growth.

Let me now mention two points on which you asked me to comment.

The proposed temporary tax on travel expenditures plus a proposed 5-percent ticket tax on international flights was designed to achieve an immediate balance-of-payments saving by inducing travelers to moderate their expenditures while abroad and, at the same time, provide budget funds for financing over the next 5 years greatly stepped-up promotion campaigns for foreign travel to the United States.

The Congress did not accept the proposed taxes—the restrictive aspect of the proposal; but by not providing an alternative source of financing for the medium-term promotion campaign, it has left efforts to reduce our tourist deficit in suspension.

I do not know what views the new administration might have on this matter, but my own judgment, if I were continuing in office, would be to press Congress hard for more adequate funds for promoting foreign tourism to the United States; and, if this required additional financing because of overall budget considerations, renew the

request for a 5-percent ticket tax on international flights—the same rate that has applied to domestic flights for years.

The second matter is the interest equalization tax which went into effect in July 1963 as a means of stemming the rapidly rising outflow of U.S. portfolio capital to other advanced countries. Foreign borrowers, by and large, were seeking medium- and long-term funds here not because of any shortage of dollar exchange in their own countries, but because they could borrow here more cheaply for their domestic working capital needs than they could borrow in their own markets. The U.S. market was, in effect, playing a role which the domestic money and capital markets of other advanced countries should have filled; and this was costing our balance of payments heavily.

The tax was certainly effective in stemming the portfolio outflow at which it was initially directed, and in early 1965 when it was applied to long-term bank loans, it reinforced the operation of the banks' voluntary restraint program by screening out those foreign borrowers unwilling to pay the additional 1 percent per annum which the tax involved.

Only about $120 million of foreign issues subject to the interest equalization tax have been floated in the United States in the 5½ years since the tax took effect. Countries subject to the tax—including Japan which has a limited exemption—sold $356 million of issues here in 1962 and almost $700 million, at an annual rate, in the first half of 1963. Last year, as far as our data now show, they sold only $3 million here. Hence, without regard to any trend growth in their issues here, our balance of payments last year benefited by a gross amount of around $700 million. With allowance for some trend growth, the amount would be even larger.

The net benefit, of course, is less than this, for part of the potential outflow in the form of portfolio investment abroad was undoubtedly diverted into other forms of lending abroad. But we do not think the net benefit for our balance of payments was much less than the gross benefit for the following reasons.

As noted above, a large part of the pre-July 1963 outflow was essentially for domestic working capital use in the countries of the borrowers. After the interest equalization tax took effect, they turned to their local or third country markets and stimulated a growth in the size of these markets (mostly in Europe) which was greatly abetted by the efforts of U.S. investment bankers who had lost a considerable amount of their foreign business in the United States.

By the time the voluntary and mandatory restraint programs came along, the European markets were able to respond not only to the growing demand of many foreign borrowers outside the United States but also the large demand of U.S. direct investors who were induced by the FDIP to finance their direct investments through such borrowing. The international securities market, outside the United States, has grown from around $500 million in 1963 to around $5 billion in 1968—a tenfold increase in 5 years.

This is an example of a temporary restrictive measure generating a useful long-term effect. But how temporary is the interest equalization tax? It was passed initially for 2 years; and it has been renewed twice. The last renewal added an administrative flexibility feature to the tax, designed in part to aid in phasing the tax out.

In my judgment, the tax should be extended and the flexible authority retained.

The same point applies to extension of the interest equalization tax legislation. I do not think it should be allowed to lapse until our balance-of-payments progress on other fronts is sufficiently assured to avoid any likely need for renewal of the tax. The tax has served and continues to serve a useful function in restraining capital outflows; and it has done this with no observed adverse effect on private long-term capital inflows which have occurred at an unprecedented rate in the last year and a half.

This completes my comments on the second example of a specific balance-of-payments measure, one which Congress has supported.

In conclusion, a solution of the balance-of-payments problem remains among the Nation's top priorities. Progress toward a solution is being made on major sectors other than trade and tourism; and the elements for a gradual improvement in these accounts are at hand in the measures which we have designed.

With a determination to end inflation, the continuation of certain specific balance-of-payments measures and responsible action by the surplus countries, I can foresee a successful end to our efforts.

It is true that relative interest rates here and abroad, in December, favored foreign corporate borrowing here by only about a half percent—well under the 1.25-percent interest equalization tax per annum cost to a potential foreign borrower. Relative interest rates, however, provided a stronger incentive to foreign goverments to borrow here rather than abroad. Also, the relative rate situation has been affected by the unusually liquid conditions in certain European credit markets—namely in Germany and Italy—and by the tight conditions here. It is not clear how long this situation will last. If we had reduced the interest equalization tax rate to a per annum effective cost of, say, a half percent a year, there might have been a surge of foreign issues on this market in anticipation that the interest equalization tax rate would be raised.

In short, a reduction of the rate seems useful only when there is a clear prospect that the reduction will not have to be temporary.

TABLE I.—U.S. BALANCE OF PAYMENTS

[In millions of dollars]

	Merchandise balance	Services balance	Balance on goods and services	Government grants and capital including income	Military sales and expenditures [1]	Military neutralization	Net private capital [2]	Liquidity balance	Official settlement balance
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1941	1,927	84	2,011	[3] −1,314	−162		584	[4] 1,119	(5)
1942	5,688	1,290	6,978	[3] −6,507	−953		277	[4] −205	(5)
1943	10,516	1,762	12,278	[3] −12,835	−1,763		341	[4] −1,979	(5)
1944	11,926	1,800	13,726	[3] −14,060	−1,982		457	[4] −1,859	(5)
1945	7,228	318	7,546	[3] −7,544	−2,434		−305	[4] −2,737	(5)
Average 1941–45	7,457	1,051	8,508	[3] −8,452	−1,459		271	[4] −1,132	(5)
1946	6,634	331	6,965	−5,272	−493		207	993	(5)
1947	10,036	286	10,322	−6,055	−455		398	4,210	(5)
1948	5,630	−165	5,465	−4,816	−799		967	817	(5)
1949	5,270	−303	4,967	−5,551	−621		1,341	136	(5)
Average 1946–49	6,893	37	6,930	−5,424	−592		625	1,539	(5)
1950	1,009	−537	472	−3,531	−576		146	−3,489	(5)
1951	2,921	−57	2,864	−2,993	−1,270		1,391	−8	(5)
1952	2,481	−309	2,172	−2,176	−2,054		852	−1,206	(5)
1953	1,291	−703	588	−1,803	−2,423		1,454	−2,184	(5)
1954	2,445	−733	1,712	−1,282	−2,460		489	−1,541	(5)
1955	2,753	−753	2,000	−1,937	−2,701		1,396	−1,242	(5)
1956	4,575	−833	3,742	−2,168	−2,788		241	−973	(5)
1957	6,099	−674	5,425	−2,369	−2,841		363	578	(5)
Average 1950–57	2,947	−575	2,372	−2,282	−2,139		792	−1,257	(5)
Average 1941–57	5,202	47	5,249	−4,836	−1,575		599	−563	(5)
1958	3,312	−1,138	2,174	−2,280	−3,135		−124	−3,365	(5)
1959	985	−1,411	−426	−1,637	−2,805		998	−3,870	(5)
1960	4,743	−1,405	3,338	−2,446	−2,768		−2,022	−3,901	−3,403
Average 1958–60	3,013	−1,318	1,695	−2,121	−2,903		−383	−3,712	(5)
1961	5,422	−1,491	3,931	−2,423	−2,599		−1,279	−2,371	−1,347
1962	4,387	−1,623	2,764	−2,569	−1,966		−435	−2,204	−2,702
1963	5,057	−1,818	3,239	−3,106	−1,967		−838	−2,670	−2,011
1964	6,649	−1,695	4,954	−3,133	−1,889		−2,735	−2,800	−1,564
Average 1961–64	5,379	−1,657	3,722	−2,808	−2,105		−1,322	−2,511	−1,906
1965	4,728	−1,828	2,900	−2,895	−1,865		525	−1,335	−1,289
1966	3,635	−1,872	1,763	−3,086	−2,808	743	2,035	−1,357	266
Average 1965–66	4,182	−1,850	2,332	−2,991	−2,337	372	1,280	−1,346	−512
1967	3,477	−2,592	885	−3,697	−3,317	734	1,823	−3,571	−3,405
Average 1958–67	4,240	−1,687	2,552	−2,727	−2,512	[6] 148	−205	−2,744	[7] −1,546

[1] Figures through 1952 are expenditures only; those for 1953–59 are net of "transfers" (i.e. deliveries) on military sales; those beginning 1960 are net of cash receipts from military-sales contracts.

[2] Including private payments and receipts, and Government payments, of investment income; includes also long-term capital inflows from foreign governments not related to military sales or military neutralization.

[3] Includes military grants, which not separately available before 1946.

[4] Earlier series which may not be precisely comparable with data for 1946 on.

[5] Not available.

[6] Averaged over 10 years in order to cross-add to "liquidi " balance, although such transactions began only in 1966.

[7] Average for 1960–67.

TABLE II.—U.S. BALANCE OF PAYMENTS: DETAIL OF COL. 7, TABLE I

[Dollars in million]

	Outflows on direct investment (10)	Other private capital outflow (11)	Income receipts (12)	Net of cols. 10–12 (13)	Foreign investment inflow [2] (14)	Income payment to foreigner [3] (15)	Errors and omissions (16)	Net private capital cols. 13–16 (17)
1941	$47	$40	$535	$622	−$327	−$187	−$476	$584
1942	19	12	496	527	−34	−158	−8	277
1943	98	−70	497	525	−63	155	34	341
1944	71	−147	556	480	175	−161	−37	457
1945	−100	−450	572	22	−104	−231	8	−305
Average 1941–45	27	−123	531	435	−81	−178	95	271
1946	−230	−183	815	402	−615	−212	218	−207
1947	−749	−238	1,113	126	−432	−245	949	398
1948	−721	−185	1,321	415	−361	−280	1,193	367
1949	−660	107	1,397	344	44	−333	786	1,341
Average 1946–49	−590	−125	1,162	447	−341	−268	787	625
1950	−621	−644	1,610	345	181	−369	−11	146
1951	−508	−540	1,813	765	540	−414	500	1,391
1952	−852	−308	1,754	594	52	−421	627	852
1953	−735	352	1,786	1,403	146	−461	366	1,454
1954	−667	−955	2,091	469	249	−420	191	489
1955	−323	−432	2,328	1,073	297	−489	515	1,396
1956	−1,951	−1,120	2,697	−374	615	−568	568	241
1957	−2,442	−1,135	2,850	−727	545	−639	1,184	363
Average 1950–57	−1,075	−598	2,110	444	328	−473	493	792
Average 1941–57	−637	−347	1,425	442	50	−338	445	599
1958	−1,181	−1,755	2,784	−152	186	−669	511	−124
1959	−1,372	−1,003	3,042	667	736	−828	423	998
1960	−1,674	−2,204	3,404	−474	407	−1,063	−892	−2,022
Average 1958–60	−1,409	−1,654	3,077	14	443	−853	14	−383
1961	−1,598	−2,582	4,024	−156	731	−1,007	−847	1,279
1962	−1,654	−1,772	4,528	1,102	570	−1,110	−997	−435
1963	−1,976	−2,483	4,811	352	379	−1,325	−244	−838
1964	−2,328	−4,250	5,686	−892	473	−1,456	−860	−2,735
Average 1961–64	−1,889	−2,772	4,762	102	538	−1,225	−737	−1,322
1965	−3,468	−326	6.308	2,154	55	−1,729	−315	525
1966	−3,623	−793	C,589	2,273	2,044	−2,074	−210	2.033
Average 1965–66	−3,546	−560	6.499	2,394	1,050	−1,902	−263	1,280
1967	−3,020	−2,630	7,374	1,724	2,924	−2,293	−532	1,823
Average 1958–67	−2,189	−1,980	4,865	696	851	−1,355	−396	−205

[1] Including fees and royalties from direct investment and excluding Government investment income.
[2] Includes long-term inflows from foreign governments not related to military sales or military neutralization.
[3] Includes U.S. Government payments of investment income.

Mr. Chairman, in the supplemental statement which I herewith submit I do an analysis of 1968 compared with 1964 and 1967. I have a couple of additional comments to add at the conclusion of that analysis.

(Supplemental statement of Mr. Deming follows:)

SUPPLEMENTAL STATEMENT OF UNDER SECRETARY FREDERICK L. DEMING

Mr. Chairman and Members of the committee, I am now able to give you preliminary figures for 1968. The organization of the data is the same as appears in Tables I and II of my full statement.

1968 U.S. balance of payments

[Estimated in millions]

TABLE I

1.	Merchandise balance	$500
2.	Services balance	—2,315
3.	Balance on goods and services	—1,815
4.	Government grants and capital including income	—3,640
5.	Military sales and expenses	—3,600
6.	Military neutralization	1,512
7.	Net private capital	7,700
8.	Liquidity balance	150
9.	Official settlement balance	1,700

TABLE II

10.	Outflow on direct investment	—3,000
11.	Other private capital outflow	—1,850
12.	Income receipts	8,300
13.	Net, columns 10 to 12	3,450
14.	Foreign investment inflow	6,950
15.	Income payments to foreigner	—2,800
16.	Errors and omissions	100
17.	Net private capital columns 13 to 16	7,700

In 1968, the United States had a surplus in its balance of payments on both the liquidity and the official settlements basis. On the liquidity basis, the surplus was the first since 1957—around $150 million on the preliminary figures we have. On the official settlements basis, the 1968 surplus, again on preliminary figures. was about $1.7 billion. The data on official settlements goes back only to 1960; we had a small surplus of about $300 million in 1966; every other year from 1960 through 1967, for which we had records, we had deficits.

The 1968 total is preliminary but I think is fairly firm. The final is not likely to be more than $200 or $300 million different either way, up or down, from the preliminary. That may be quite a difference from pure fourth quarter figures—which are the ones that are preliminary—but not much for the year.

The real uncertainties lie in the figures given for the specific accounts. Trade figures are reasonably firm, for we get monthly data on these and they represent essentially 11-month data extrapolated for the year. The military account and the neutralization account are fairly firm; Government grants and capital is a highly preliminary estimate. The net private capital item is really the balancing item, and its components in Table II are all most preliminary estimates. We have reasonably good current figures on foreign purchases of U.S. stocks and bonds, and on U.S. bank lending abroad. But the capital flows of the past two months leave many of the figures for the individual capital accounts in a high state of uncertainty.

To sum up, we are reasonably certain of the total for the liquidity balance; less certain, but not too much so, of the figures for the official settlements balance and the components of Table I and not at all certain of the component figures in Table II. Nevertheless, I think it useful to present the figures.

With these 1968 figures, I can carry the analysis a step further by comparing 1968 with 1964 and 1967.

The trade performance in 1968 was very poor. The final figure seems likely to show a miserable $500 million surplus, down $3 billion from last year's respectable but relatively poor showing, and down more than $6 billion from the 1964 level. I have already noted that the major factor in the decline was the overheated U.S. economy and that delay in passage of the tax bill probably cost us dearly in the trade balance. The primary element in the worsening of our trade balance was the expansion of imports. The trade balance also was affected adversely, as noted earlier, by actual or threatened strikes. Perhaps a quarter of the deterioration from 1967 to 1968 reflected that factor.

The Services Balance in 1968 showed some improvement from 1967, which had been especially adverse because of the attraction of Expo 67 in Canada. Obviously, the basic trend in this account is adverse. Relative to 1964, the 1968 Services account deteriorated $500 million.

Thus the Balance on Goods and Services which had been strongly positive in 1964, and still positive in 1967, turned strongly negative in 1968. This was clearly the worst feature of the 1968 performance.

The adverse balance on Government Grants and Capital actually improved a bit from 1967 to 1968, reflecting hard Government efforts to reduce outflows on this account. Relative to 1964, such outlays were higher by $500 million—due in large part to much heavier financing of non-military goods and services exports by the Export-Import Bank. This financing, of course, strengthened our export position.

Military expenditures, net of military sales rose $1.7 billion from 1964 to 1968 and were up $300 million from 1967 to 1968. But with the concentrated effort to neutralize these foreign exchange costs—reflected in the doubling of such arrangements from 1967 to 1968—the 1968 figure net of such neutralization was within $200 million of the 1964 outflow and $500 million better than in 1967.

The real swing came in the Capital accounts. The net of capital outflows from the U.S. and the income inflows, including fees and royalties, on our foreign investment was a positive $3.5 billion in 1968—double what it was in 1967 and almost $4.5 billion better than it was in 1964. And these figures do not reflect the real cutback in financial flows on direct investment account due to American business borrowing abroad. That, as noted, is included in Foreign Capital Inflow. The favorable result in this area was a product of ever growing earnings on our foreign investments and restraint on the foreign exchange costs of our foreign investment.

Foreign capital inflows in 1968 apparently reached close to $7 billion and outpayments of income to foreigners on their investments here were about $2.8 billion. The capital inflows in 1968 were $6.5 billion larger than in 1964 and $4 billion larger than in 1967. Income payments to foreigners were $1.3 billion more than in 1964 and $500 million more than in 1967.

The inflow in 1968 represented purchases of American equities of close to $2 billion, purchases of American corporate debt instruments of about the same amount, special receipts from foreign governments other than military neutralization of about $1.5 billion, and direct investments plus foreign commercial credits to U.S. borrowers of about $1.5 billion.

Finally, errors and omissions seem to have turned positive for the first time since 1959.

Pulling all this detail together, we can see that 1968 relative to 1964 showed a deterioration of $7.5 billion in the combination of trade, service and Government expenditures, and an improvement of $10.6 billion in the capital account for a net improvement on the liquidity balance measure of $3.1 billion. Relative to 1967, the comparable figures are a deterioration in trade and service of $2.8 billion, an improvement in Government account of $700 million and an improvement in capital account of $6.1 billion for a net gain on the liquidity basis of $3.9 billion.

In my formal statement, I cited several conclusions which I distilled from the detailed analysis of the 1941–67 data on balance of payments. None of those conclusions are changed from analysis of the preliminary 1968 data. Nevertheless, I have some additional comments to make as a result of that analysis.

1. The 1968 balance of payments result reflected mainly a strong balance of payments program, the Action Program announced by the President on January 1. Those parts of the program that were put into effect—the mandatory direct investment program, the strengthened Federal Reserve program, and the drive to reduce the foreign exchange costs of Government—including military expenditures overseas—worked very well.

2. Failure to enact promptly what the President called the first order of business—the Revenue and Expenditure Control Act of 1968, cost our trade account heavily. So did the strikes or threatened strikes.

3. We also got no help from removal of trade disadvantages or deliberate actions—e.g., Kennedy Round acceleration by our trading partners—on our trade problem.

4. While tourism was not as big a drain in 1968 as in 1967, that was due to special factors. We have a good long-range plan to attract foreign tourists here. We have no financing for that plan.

5. Most of the capital inflow that occurred in 1968 was solid and the result of deliberate policy or deliberate attempt to secure it. Some—equally solid—may have reflected unrest and uncertainty in Europe and realization that even an overheated U.S. economy was an attractive place to invest.

6. There is no reason not to expect continuation of the favorable capital position. Earnings on our foreign investments should continue to increase; investment in American equities should continue substantial—especially if the economy comes into better balance; borrowings by American corporations overseas should continue, if needed.

7. Thus, our balance of payments position in 1968 is not "fragile" or "unsound." Whether we should balance in other years in this way is, of course, another question. My answer is that such a balance is not really good for the world.

8. Thus, I want to restress the conclusion in my formal statement. We need to improve the trade balance; we need to drive even harder to offset military foreign exchange costs. We need to begin effective action to hold the Services deficit in bounds. And we need to continue to attract foreign capital. If we do these things, we can free up our own capital outflows.

9. This is the real road to both a solid and a responsible balance of payments equilibrium.

Chairman Reuss. Thank you, Secretary Deming. Mr. Costanzo?

STATEMENT OF G. A. COSTANZO, EXECUTIVE VICE PRESIDENT, FIRST NATIONAL CITY BANK

Mr. Costanzo. Mr. Chairman, I appreciate the opportunity to present my personal views regarding existing controls over capital exports from the United States. It is my recommendation that steps should be taken to terminate these controls during 1969. Capital controls, instead of being temporary as they were supposed to be, have proliferated. They have become self-perpetuating, despite their questionable usefulness. They have turned attention away from the underlying causes of our payments problem and lulled us into a false sense of purpose.

When a control program has been in effect for some time, those responsible for its administration are understandably reluctant to terminate it. They are quick to point out dangers and to urge a policy of wait and see. Controls, they suggest, must be retained until the underlying imbalance is corrected.

I have participated personally in terminating exchange control in several countries. That experience taught me one lesson. The only way to end exchange controls is to end them, backing up that action with appropriate policies to eliminate the cause of payments imbalance. As long as the controls are in place, they remain a reason for not taking the necessary internal measures.

Postwar experience has demonstrated the failure of trade and exchange controls to correct balance of payments disequilibria. It has shown that a balance-of-payments deficit cannot be corrected if the growth in Central Bank assets—and thereby in the money supply—is

allowed to exceed the growth in the country's productive potential, taking into consideration price developments in other countries.

These programs, beginning with the interest equalization tax, were all proposed and implemented on the basis that they were temporary. If they are indeed temporary, their success should be measured in terms of their early termination.

Mr. Chairman, in support of these conclusions, I submit the following observations:

The improvement in the private capital account of our balance of payments has exceeded even the optimistic expectations held a year ago. This is true not mainly because of controls but for other reasons. The overseas outlays of U.S. companies have risen more slowly, and foreigners have greatly increased their purchases of U.S. equities.

Excluding funds borrowed abroad by American corporations, the flow of capital from the United States into direct investments abroad in the first 9 months of 1968 was about $2.8 billion, at an annual rate. This is substantially less than the peak level of $3.4 billion in all of 1965. Much of the reduction was in the flow of direct investment funds to continental Europe, where the main thrust of our capital controls program has been directed.

Undoubtedly a part of this reduction was the result of the controls. But the decline must also be regarded as a natural rebound from the large outflows of 1964 and early 1965 which were induced by anticipation of controls. Furthermore, the lure of an exceptionally attractive return on investment in Europe has diminished. According to the Department of Commerce, the average rate of return on manufacturing investment by U.S. companies in Europe has declined from 13.9 percent in 1964 to 9.5 percent in 1967. Another factor has been the cooling toward American investment in certain European countries.

While developments in one year are not necessarily indicative of a trend, the fact is that plant and equipment expenditures by foreign affiliates of U.S. companies in Europe increased only 5 percent in 1968 and 12 percent in 1967, in contrast to 23 percent in 1966 and 21 percent in 1965.

I should point out, too, that the return flow of income from U.S. direct investment totaled $6.1 billion at an annual rate during the first 9 months of 1968, or $2.8 billion higher than the total of new funds flowing abroad.

If one looks at the entire balance of payments and not just at the private capital account, there is to my mind a serious question whether our capital controls have had any important effect on the overall balance. The controls have increased the demand for dollars abroad for short-term borrowing and for capital investment. This demand has been met by answering increases in the supply of dollars in the Eurodollar and Eurocapital markets. The additional dollars have come in part from the United States. In other words, there have been outflows of funds which would not have occurred if the additional demand for dollars abroad had not been artificially created by our own controls. Our capital controls have distorted money flows, but they have not stopped them.

The interest-equalization tax no longer has any important effect on capital flows. If it was ever useful, its usefulness has been outlived. In-

terest rates today are about in line with those abroad if not a little higher. There is no rate inducement to foreign borrowers to enter the New York market. Also, the well-developed Eurobond market and Eurodollar market are in some respects more attractive to borrowers than the U.S. market. For example, issues need not be registered with a securities and exchange commission. Yields on long-term corporate bonds in the U.S. market are at 7 percent, slightly higher than in the German market. Yields on Eurodollar issues denominated in German marks stand at about 6¾ percent. In mid-1963, when the tax went into effect, United States and German yields were 4¼ and 6 percent, respectively.

At the very least, the interest-equalization tax should be allowed to expire as it is now scheduled to, on July 31 of this year.

Most discouraging of all, is that the time which the capital controls were ostensibly to provide, to find a basic solution to our balance-of-payments problems, has not been well used. Indeed, as capital controls proliferated, our monetary and fiscal policies became increasingly inflationary, canceling out even the alleged gains of the controls. In practical effect, controls have reduced rather than increased the relative priority of the balance of payments in our national policy.

Last year the administration's balance-of-payments strategy called for more stringent, mandatory controls over capital flows and an improvement in the $3.5 billion merchandise trade surplus of the previous year. Controls were tightened, but the trade surplus, far from improving, disappeared—allowing for AID-financed exports. Imports were sucked in by an overheated economy, offsetting much of the gains in the capital account. And I might add that some observers last year predicted this would happen.

If restraint over capital is now being justified on the grounds that it is necessary because of the deterioration in our trade account, then I would say again that the controls have become self-perpetuating. They have strayed far from their original intent.

Your committee has heard testimony that elimination of capital controls is dangerous because there would be a prompt and major outflow of capital from the United States to refinance the foreign debit amassed by the U.S. corporations which have borrowed overseas since 1965. Of course, such an argument makes the controls self-perpetuating. The programs have created a large overhang of overseas indebtedness, therefore the programs must be continued.

I submit that this is far less of a problem than has been suggested. Under present conditions, it is doubtful that U.S. companies would move large amounts of funds abroad to refinance overseas debts. Such a move today would, in many cases, replace money borrowed abroad in the last few years at lower rates with money borrowed here at today's very high rates. So far as debt in the form of bonds or convertible debentures is concerned, most of the issues have call-protection provisions which restrict the borrower's ability to refinance.

The argument that a major outflow of funds would follow termination of controls seems to overlook the substantial changes in the world's capital and money markets, since these programs were initiated. In 1964, the Eurodollar market was about $8 billion. Last year it amounted to something over $20 billion. In the last year before the interest-equalization tax was applied in 1963, foreign borrowings—excluding

Canadian borrowings—in the New York market amounted to $0.8 billion. Last year, foreign subsidiaries of U.S. corporations raised $2 billion through the sale of new issues in the Eurobond market and another $1 billion was raised by other borrowers.

It is clear that borrowers, both American and foreign, now have access to a well-developed long-term market abroad, largely denominated in dollars. Is it reasonable to expect these large markets to shrink away if the U.S. controls are eliminated? Yet, that is what the argument implies.

In this connection, it is relevant to note that U.S. banks have not used all the leeway available under the restraint programs. Given monetary conditions in the U.S. markets and the growing availability of Eurodollar funds, foreign branches of U.S. banks have made loans outside the United States that would otherwise have been made by their head offices. By the end of September, they had reduced their foreign claims by over $700 million below the amount outstanding at the end of 1967 or by $300 million more than the Federal Reserve had requested for all of 1968.

What reality there is to the danger of a massive outflow of capital if controls were removed could be dealt with a voluntary understanding with major borrowers that they would spread any refinancing of foreign indebtedness over a reasonable period.

I have personally presided over the dismantling of trade and exchange controls under circumstances more difficult than our situation today—in Greece in 1953, Paraguay in 1956, Bolivia in 1957, Argentina in 1958, Venezuela in 1959, and Ecuador in 1960. In each case I heard essentially the same arguments presented here today as to why controls could not be eliminated. In all the countries I mentioned, complex systems of trade and exchange control, multiple exchange rates, and price controls were terminated in one fell swoop. Simultaneously, domestic financial stabilization programs were adopted.

The main ingredient of these stabilization programs was a quantitative ceiling on central bank credit to the Government and private sectors, in order to hold down the growth in money supply to a rate compatible with the real growth in the economy. There were also, of course, tax increases and far-reaching economies in Government spending to enable the Government to live within the ceiling on central bank borrowing. The programs were successful and the experiences are fully documented in the records of the International Monetary Fund. Similar experiences are those of Germany, Italy, and Belgium in the early postwar years, France in 1958, Spain in 1959, and in more recent years, Taiwan and Korea.

I realize that none of these situations is fully comparable with our own. I recognize the dominant position of the United States in the world economy and the repercussions of changes in the level of economic activity in the United States on the whole free world.

I also recognize the special problems created by the lower ratio of international transactions to gross national product in the United States as compared with the countries I have mentioned. These differences of degree which complicate the solution of our problem. But there is no escape from the hard reality that the world will not go on indefinitely financing our deficits. Sooner or later we must take measures to redirect a greater flow of resources from domestic to external use.

Mr. Chairman, the United States has run a large balance-of-payments deficit for more than a decade.

Unfortunately, the figures that were just quoted here by Mr. Deming make that statement not completely accurate at this point. It was a surprise. I did not realize 1968 was going to show a surplus.

During 5 of the last 10 years we have had some form of capital export control. Yet no end to the deficity is in sight. To my mind this is proof enough that exchange controls are not the answer to balance-of-payments deficits. Postwar financial history amply demonstrates the futility of trying to cope with balance-of-payments disequilibrium with controls. Such measures postpone the day of reckoning. But the longer the period of procrasintation, the more painful and protracted the adjustment.

There are only two ways I know of to correct the balance-of-payments deficit. Both involve redirecting the flow of resources from domestic to foreign use. If the imbalance has not been permitted to get too far out of hand, equilibrium can be restored through restrictive monetary policy without provoking intolerable unemployment, and this, in my opinion, is the case of the United States today.

If disequilibrium has gone too far, then devaluation of the currency is required to achieve the required transfer of resources without severe unemployment.

With the Federal budget for calendar year 1969 in the best shape in a number of years, we have a real opportunity to attack the balance-of-payments problem at its roots—by a judicious slowdown of the expansion of Federal Reserve Credit, so administered as to avoid creating havoc in the financial markets.

Mr. Chairman, to summarize, my personal views of the question before this committee today are:

1. The existing controls over U.S. capital exports—that is, the interest equalization tax, foreign direct investment controls and bank and financial institution guidelines, should be terminated during 1969, and

2. We should look to fiscal and above all to monetary policy for a solution to our balance-of-payments problem as well as problems of domestic inflation. After all, inflation and balance-of-payments deficits are but two manifestations of a single malady.

Thank you, Mr. Chairman.

Chairman Reuss. Thank you, Mr. Costanzo.

Secretary Deming, congratulations on your apparent 1968 payments surplus, of which I guess the hero is the capital account. It is a nice graduation present for you and well deserved.

Would it be your opinion that the foot dragging in connection with the ratification of the special drawing rights amendment to the IMF articles of agreement could well now cease? Since part of the delay was due to the old business about the U.S. balance-of-payments deficit, and now that there is not one for the moment, will things be better?

Mr. Deming. I think, Mr. Chairman, that it will have more to do with activation. I do not think there has been any deliberate foot dragging at all in the ratification process. I think it has just been what you might call legislative processes—the length of time it takes to get actions through. I believe we should have the full activation relatively soon.

Chairman REUSS. Regarding activation, though, there was the French and German reservation that complete or substantial improvement in our payments account had to be obtained. The 1968 performance, however transitory it may be in fact, is a rather complete answer to that reservation; is it not?

Mr. DEMING. That is correct, Mr. Chairman. As I say, I think that has to do more with the activation than with the ratification. I have detected no hostility in any quarter to the plan.

Chairman REUSS. But it should have a lot to do with the activation; should it not?

Mr. DEMING. That is right.

Chairman REUSS. In a favorable way?

Mr. DEMING. That is right.

Chairman REUSS. Mr. Fiero, the President's Advisory Committee on Foreign Assistance Programs, chaired by President James Perkins of Cornell, recently recommended that the United States should liberalize our restrictions on direct corporate investment in the less developed countries. Why is that not a perfectly sensible recommendation, and why would it not be a good idea to make a permanent exemption for, less-developed country direct capital investment? The more the merrier, really. The more there is, the less foreign aid we have to contribute.

Mr. FIERO. Mr. Chairman, the available quotas under the program in the less developed countries have been very high.

Chairman REUSS. I realize that, but if they are very high, why have them at all. If nobody bumps against the ceiling, then it serves no purpose. If people do bump against the ceiling, it serves a counterproductive purpose. Do we really want to restrict investment in the less developed area?

Mr. FIERO. It is difficult for us to estimate the cost to our balance of payments of eliminating the less developed countries from the program altogether. Borrowing by direct investors, alone, to finance investents in the less developed countries may have exceeded $250 million during this past year. This would be mainly borrowing in the European capital markets undertaken in lieu of exporting U.S. capital. In addition, affiliates in the less developed countries also increased the amount of their foreign borrowing.

We expect investment in the less developed countries to increase significantly in 1969. While some companies will achieve this by taking advantage of their relatively high investment quotas, others will, if the program continues, have to borrow a portion of their capital requirements abroad. One might guess—and this is only a guess, because until we have the companies' estimates we will not know—that the balance-of-payments cost of eliminating schedule A from the program could be on the order of half a billion dollars.

Chairman REUSS. Like what?

Mr. FIERO. One-half a billion dollars, $500 million, sir.

Chairman REUSS. If we completely took off the ceiling on investment in less developed areas?

Mr. FIERO. Yes, sir.

Chairman REUSS. Initially. But what about the export factor?

Mr. FIERO. There will, of course, be export offsets, but such offsets will occur if the financing is done abroad as well.

A large part of the 1969 investment is associated with the oil and other extractive industries and will go ahead whether or not there are restrictions upon investment in less developed countries. It has already been scheduled—planned long in advance—and in fact will take place. It will be financed abroad if the program continues and will not be financed abroad if the program is discontinued.

I do not mean to imply it will be financed in the less developed countries themselves. By and large, the funds will come out of the international capital market.

Chairman REUSS. I have a little difficulty with your point that the present restrictions are not in fact going to inhibit any direct investment in the less developed countries and the point that if we took off the controls, something like half a billion dollars in outflow could be expected.

Mr. FIERO. As I said, sir, it is hard for me to give you a precise number at this moment, because we do not have projections of what companies intend to do for 1969 on an individual basis. We know only what they projected in June 1968 regarding plant and equipment expenditures.

Nor do we yet have results for the fourth quarter. But we do know that U.S. direct investors, in order to finance a somewhat lesser level of investment activity in 1968, expended roughly $250 million, perhaps somewhat more, of proceeds of long-term foreign borrowing in schedule A during 1968.

With the expansion anticipated in the less developed countries in 1969, it seems very likely that a larger portion will have to be financed from the proceeds of foreign borrowing, unless, of course, schedule A were exempted. This is likely because the companies which apparently will expand significantly in 1969 are in the major extractive industries. Their projected investment needs are far in excess of their investment quotas in the less developed countries.

Chairman REUSS. Well, what are the prospects for exempting U.S. investment in the less developed areas completely except for the extractive industries. That seems to be where the big push would occur.

I am interested in getting rid of as much bureaucratic interference with the process of investment as we can, and it seems to me this is one area where you could lift the ceiling without explosive effects.

Mr. FIERO. Mr. Chairman, I think that there is good support for your point if the extractive industries were separately controlled. Whether one could discriminate against a specific sector of U.S. business in a specific area of the world, I do not know. I would have serious reservations about that.

But perhaps the same purpose could be achieved through some action on the minimum permitted investment level as it applies to the less developed countries.

In this connection, we have had an exchange of letters with AID in which we noted that our internal policy during the past year has been relatively flexible insofar as developmental projects in less developed countries are concerned. Our internal committees were authorized to go above the minimum permitted investment level for such projects. For example, when this level was $200,000, they had general authority to go up to $500,000 for developmental projects.

This year, we have informed AID that with the minimum level being increased to $300,000, we would be prepared to approve capital outflows for developmental projects in less developed countries on a specifically authorized basis for amounts considerably in excess of $500,000. The only proviso has been that if a company has substantial foreign borrowing capacity and sizable unused proceeds of such borrowings, we would require that they use such borrowed funds or borrowing capacity.

Chairman REUSS. Well, I leave you with the thought that I believe it is important that there be some indication that the autarchic trend of our capital controls is indeed temporary. I cannot think of any better area in which to start lifting the ceiling than in certain areas, at least, of investment in the less developed countries.

Senator Proxmire?

Senator PROXMIRE. Mr. Deming, I must say that I have a little different view, apparently, than you or the chairman may have on the kind of graduation present you are getting. As I look at these figures, I think it is kind of like getting a graduation present to put you in the front line of combat in Vietnam.

These figures that you have in this table show a very depressing deterioration of our trade balance, our balance on goods and services. You go back in your table to 1941. The guess of the staff is that with the exception of the small deficit in 1959, you might have to go to the 19th century to find a time when we had any deficit, and perhaps never before anything this bad.

This seems to me to be the fundamental crux of our balance of payments. These other things are very important, too, but this balance on goods and services is something we have always counted on. The fact that our balance of goods and services is negative to the tune of $1.8 billion is a fact that strikes me as very shocking.

Then when we go on and find that the only reason we really have the bare liquidity balance of $150 million and a more substantial one in official settlements is because we had this remarkable improvement in the net private capital flow of $7.7 billion. Now, that does seem to me to be something that we would have to regard as probably temporary.

And I notice in your assumptions, you seem to feel we will be fortunate if that balances out even with no plus or minus over the long pull.

Mr. DEMING. Senator, I have no quarrel with what you are saying at all. I'm trying to make two points here: one, the United States can, as it did in 1968, balance its payments position by an infusion of foreign capital. I do not think, and I said so in the statement, that this is a good posture for the United States to be in.

Senator PROXMIRE. Well, you say the United States can if it—this is not a matter of our own volition and planning. This is something that happened beyond our control, was it not, largely?

Mr. DEMING. It goes beyond that, because the program for 1968, announced last January 1, was really in two parts. The first part was general, and it concerned demand management. It was the tax bill, the avoidance of strikes, threatened strikes in industries, and so forth.

The second part of the program was in five pieces.

Senator PROXMIRE. Let us start with the first part of the program. Secretary Dillon came before the Ways and Means Committee of the

House in February 1964 and said we need a tax cut because the tax cut will help us greatly to get the inflow of foreign capital. It will make American capital more attractive, people will invest in American stocks and bonds. Now you are saying the opposite—that a tax hike is bringing foreign capital to the United States.

We cannot have it both ways. This time, as we increase taxes, I can see how this could affect indirectly, perhaps, our trade account, although it does not seem to have helped very much in that regard. But I cannot, for the life of me, see how it will make American capital more attractive if we increase taxes.

Mr. Deming. There are two points. First, the American economy was overheated. Some restrictive action, in this case fiscal restraint, was necessary to bring the level of economic growth down to a more sustainable rate.

Senator Proxmire. But all the arguments were that this is going to help us on the trade account because it will reduce our imports.

Mr. Deming. That is right, but we did not get it into effect until midyear. The economy was already running pretty hot at that time. The impact of the tax measure was not as quick as some had forecast it to be.

Senator Proxmire. That is a masterpiece of understatement. It has had no effect at all so far that we can see. Maybe in the last few weeks, there are some few indications. But they are awfully tentative.

Mr. Deming. I think it is beginning to have some effect, Senator. But what I am really driving at is that more appropriate demand management in the economy should have resulted in a lower volume of imports moving into this country. This overheated economy just sucked imports in generally all across the line.

In addition to that, there were some special factors.

Senator Proxmire. It did not work that way. Maybe it will, but so far overall, at least, the one area where the tax increase was supposed to give us an assist, the trade account, we have had a disastrous, unprecedented fall in our advantage. I do not say that the tax increase had much to do with it. It did not. I do not think it affected it either way so far.

Mr. Deming. We had a somewhat better trade performance in the second half of the year than in the first half. Not much, obviously, because this is a miserable result. All I am saying here is that on the trade account, it quite obviously went to pieces. I think the major factor was an overheated economy, supplemented by some other factors, the strikes or threatened strikes in steel and copper and on the docks.

It is awfully hard to compute the effect of these things with any precision. Actually, we lost last year something like $3 billion in the trade account. While there is nothing very precise about the relationship, when the gross national product grows at a rate of more than 6 percent, you get a far more than proportionate increase in imports. If it grows at a rate less than 6 percent, you do not get quite as strong an import effect.

I have said and I think it is the key point, that we need to improve our trade account quite substantially. We need to do that by proper demand management. We need to do that by removing some of the trade disadvantages under which we suffer and under which we

gladly suffered when we were in a strong position. And we need to promote and finance more exports.

Senator PROXMIRE. You are setting a goal and I know that toward the conclusion of your statement, you say you realize that this was not necessarily something you could attain, but you are just showing what a serious problem we have. When you said we would have to have a $7 billion merchandise balance, something we have never attained, we came somewhat close to it in 1964 with 6.6, but this is 'way above the average. To go up that far from being down now with only a $500 million merchandise balance——

Mr. DEMING. Yes, you have got to.

Senator PROXMIRE. It seems to me to be superoptimistic.

Mr. DEMING. It is not attainable next year by any means. But you have to work awfully hard in the account. Let me summarize.

Let me look at the capital account first, because I think the total picture will come into focus better. If you separate the capital account into two pieces, U.S. investment outflow and U.S. income on that investment on the one side and foreign investment into the United States and the payments we make on that foreign investment on the other side, we had last year a $3.5 billion surplus on our own side. That is, the earnings exceeded the outflow by $3.5 billion. On the foreign side, a $4 billion surplus resulted because the inflow exceeded the earnings payments that we had to make.

Now, separate is differently so that you just count outflow from the United States against inflow from abroad. We sent about $5 billion outside the country and took about $7 billion into the country—just the investment flow, not counting income. We earned on our investment $8 billion and we paid out about $2.5 billion on the investment input here.

Any way you put this together, we had a net surplus of over $7 billion on the capital account.

Now, if we can improve the trade account, and if we can successfully, as I think we should, neutralize our military expenditures—either by reduction of them or by host country assumption of costs, or by purchases of military goods and services from the United States or by financial neutralization, and if we can hold our services account deficit, which is going to be roughly at least $2.5 billion, given the form in which I cast the services account; if you can do these things, then you do not have to depend as much on foreign capital inflow and you can, in a net sense, be less dependent on the whole capital account.

Senator PROXMIRE. I agree with all that. Of course, the difficulties are the "if" is very, very big on improving our trade position, because there are some fundamentals here that we have to recognize.

Mr. DEMING. No, Senator.

Senator PROXMIRE. This is a fairly steady deterioration. It is true, this last year was exceptional. I am sure we will not have this disastrous adverse balance of trade we had last year in goods and services.

However, we do have a situation where Europe and Japan are rebuilt now. They are going to maintain a certain competitive productivity advantage, perhaps. At least, we have to be very aware of it, very concerned about it.

It is also true in some countries that are regarded as underdeveloped that they are also making some progress in this direction. But as I say,

to get back to a $7 billion surplus may be unrealistic, and to accept that as a steady diet and count on it is going to be a lot harder.

On the other hand, you look at the private capital account and here I think you can see you do have exceptional situations. The French crisis, a number of other things that developed last year, made it a very, very extraordinary year that is not going to repeat itself in that area. My own feeling is that our balance-of-payments problem is more serious right now in the outlook than it has ever been.

Mr. DEMING. I think in one sense, I would agree with you on this when you focus on the trade account. We quite obviously have to improve that account. I do not think that one can look forward to the point where you can improve that trade account so quickly that you can cease dependence on foreign capital coming into this country. But if you can, and it is a very modest level, if you can push the trade account back to $4 billion, you can be $3.5 billion less dependent on foreign capital inflow, or you can increase capital outflow from the United States by that same amount. I am just pushing the numbers around to illustrate the possibilities.

Senator PROXMIRE. It would be that much dependent—you said yourself the assumption you make is that we should expect a washout on the capital account. I think that is very optimistic. The tendency has been for us to invest abroad for many, many reasons. The opportunities have been good. Maybe it would be a washout, maybe that would be good.

I would like to ask Mr. Costanzo, who made the only direct attack on our investment control program, and I think he expressed a view that is widely shared in the business and the banking community—I found this again and again and again, that the people who talked to me in the business community seemed to want an end to this program.

Did you answer, or try to answer the chairman's question about how much would the balance of payments be affected, say, during the first year of termination of the program, in your view?

Mr. COSTANZO. Senator Proxmire; I did not try to answer that directly, for this reason: that is that I basically do not agree with this approach to the problem. The idea that the balance of payments consists of independent transactions and you can improve it by increases or decreases in specific accounts is fallacious—all of these items are very much interrelated. All of these transactions are the result of market forces, many markets operating all over the world.

I do not say eliminate controls and stop there. I say eliminate controls and then concentrate on the root of the problem, which I say is basically demand management.

My position is that if we have the appropriate monetary and fiscal policies and if we stop the excessive monetary expansion of the last 10 years—and I want to say a word on that——

Senator PROXMIRE. I agree with you and I think a lot of people agree with you in many ways, and I think everybody at the table would agree those are the fundamental ways to attack it. What I am asking is this: we have this immediate problem now on our balance of payments. Mr. Fiero indicated that in his judgment, we would be minus $3 to $4 billion if we terminated the investment control program.

Is that correct?

Mr. FIERO. Senator, the $3 to $4 billion is what I consider to be the potential outflow under certain conditions. I did qualify my presentation by noting that the circumstances of the last 3 or 4 months, particularly the tightening of credit in the United States, would substantially moderate any potential outflows. My only point was, should economic conditions here require some easing of the credit restraints and the very tight policy that the Federal Reserve Board started to follow in the latter part of the year, we could see an outflow of that magnitude.

Senator PROXMIRE. This committee had very persuasive testimony by a professor from North Carolina—I cannot think of his name, but he is an expert in this area. You gentlemen probably all know him. He said that in his view, any successful restriction in American investment abroad could be effective for a year or two, but within, I think he said 30 months, you would begin to lose any advantages because the payback, he indicated, was within 2.5 years from investment abroad.

So it is a very short-term effort. If we are going to rely on it, it seems to me it is going to have an adverse effect on our balance of payments rather swiftly, and we can only rely on it, therefore, on the assumption that the balance-of-payments deficit is temporary—temporary in the sense of being only a year or two.

Mr. FIERO. I think, Senator, that the gentleman you refer to is Professor Behrman.

Senator PROXMIRE. That is right, Jack Behrman.

Mr. FIERO. He has come up with a thesis to challenge a previous thesis, which suggested that the payback period was considerably longer. I am not sure of the relative merits of the two. I do think, however, that the shorter payback period is considerably exaggerated. Perhaps the longer period is not as great as someone suggested.

But more significantly, I think we should challenge the basic assumption that we have experienced a reduction in the level of foreign expansion by U.S. companies because of controls. I do not think we have seen that in 1968. Furthermore, I do not think we will see a significant reduction in 1968 because of controls.

Senator PROXMIRE. You make a very, very strong case that the reduction is far less than is ordinarily estimated. You make the point that the reduction is not anything to speak of because they borrow abroad and invest.

Some would say this is too difficult and awkward, and if they cannot finance through internal sources, which so much business does, they are not going to do it.

Mr. FIERO. I think that the proof of the pudding may be found in the companies' own estimates of foreign plant and equipment expenditures. They submitted estimates for 1968 back in December of 1967, just prior to the announcement of the mandatory program. Revised estimates were submitted again in June, 1968, after the much more restrictive mandatory program had been in effect for 6 months. The June figures did not indicate any material difference in their plans for 1968. The Department of Commerce is now preparing revised estimates for 1969, based upon information submitted by companies in December. It will be interesting to see how they compare with 1969 estimates submitted last June.

We are also in the process of getting estimates from companies as to their foreign direct investment plans for 1969. We will be in a better position, we think, to give you a judgment as to the year 1969 in the course of the next month or so.

I think the other point that has to be made here is that U.S. companies during the past year borrowed or arranged to borrow overseas considerably in excess of $5 billion. Money was readily available. Many companies which early in the year expressed concern about raising funds abroad found, after exploring, that it wasn't that difficult or expensive. In fact, they have been terribly ingenious and have discovered all sorts of foreign sources that no one anticipated as recently as 6 or 7 months ago.

So I think the case for saying that there has been or will be any substantial cutback in overseas expansion plans, at least in 1969, is not a very good one. There will obviously be a few companies discouraged by controls. Others may postpone projects. But, in the aggregate, I would not think the amounts involved would be substantial. The postponed projects would probably tend to be of the more marginal and slow payout variety.

Senator PROXMIRE. Your chart indicates that the trend line which had been up through 1966 began to go down and went down through 1967 and 1968 for direct investment, including the use of foreign borrowers, by direct investors. Of course, expenditures increased, but that may be something else.

Mr. FIERO. Yes; I think that is an interesting question. That line turn down mainly because foreign affiliates financed more of their investment needs from foreign sources, so that less direct investment was needed to finance their expansion abroad. It is interesting to note, though, that while plant and equipment expenditures abroad by foreign affiliates have continued to rise, the rate of increase has moderated. I think I would prefer the thesis developed by a number of people that the reduction in the rate of profit opportunities overseas has in itself caused some slowdown in the rate of foreign expansion. In fact, I would go even further. If the rate of return from foreign investments continues in downward trend, the pressure on our balance of payments flowing from foreign direct investment could subside materially, particularly in view of the growing amount of internally generated cash from depreciation.

Senator PROXMIRE. Do you have an answer to that, Mr. Costanzo?

Mr. CONSTANZO. Yes; on that particular point, as I think has been indicated, the rate of plant and equipment expenditure overseas has declined a great deal since 1964 and 1965.

Profitability is declining in Europe.

The other point I want to make again is, we have a huge Eurodollar and capital market in existence now. That market will continue to be here. If controls were lifted I do not believe that all of a sudden, you are going to have massive refinancing and large capital outflows. The interest rate structure has now changed considerably—money is today cheaper in Europe than in the United States.

If the Fed goes on following the kind of policies they have been following since the first of December, there is not going to be money for that kind of financing available in the United States.

Senator PROXMIRE. This gets me to my final question. We have, after all, now the highest interest rates we have had in my memory, and I think in the memory of people who are even older than I am. We all think they are unusual. We hope they will fall, and sharply; and part of the reason for our fiscal effort is to bring those rates down.

At least part of the effort is, we have this extraordinary reward for capital now in very, very high-interest rates.

You say in your statement that the balance-of-payments deficit cannot be corrected if the growth in central bank assets—and thereby in the money supply—is allowed to exceed the growth in the country's productive potential, taking into account price developments in other countries.

Of course, the emphasis you made on monetary policy as extremely interesting and in the long run, perhaps this is the fundamental way.

I noticed in your very last statement, that we should look to fiscal and above all the monetary policy for a solution to our balance-of-payments problem, as well as problems of domestic inflation—what you are saying is that if we follow a policy that is restrained and restrains an over-heated economy through monetary policy, it is going to have the effect of encouraging the proper kind of capital inflow here.

Mr. COSTANZO. That is right.

Senator PROXMIRE. It is also going to have the effect of encouraging our investors abroad to use capital markets abroad if they can get an advantage in doing so, and that this is the natural way to do it rather than rely on controls.

Mr. COSTANZO. Yes.

Senator PROXMIRE. Mr. Brimmer, as a Federal Reserve Governor, what is your reaction to that? I would like to get Mr. Deming's, too, because he is the monetary expert in the Treasury.

We are fortunate in having two of the money managers of the Nation before us.

Mr. BRIMMER. Thank you, Senator.

The basic view Mr. Costanzo has expressed is admirable. His timing, however, is indefinite. Therefore, I find his proposition not essentially operational over the next year.

Senator PROXMIRE. Do you agree with his principle that we have made a mistake or we do make a mistake when we increase the money supply more rapidly than the growth in the gross national product at a time when the economy is highly heated, if not overheated?

Mr. BRIMMER. I would agree that any kind of expansionary policy, whether fiscal or monetary, which leads to excessive claims on real resources is a mistake. The origin of that mistake is not in the growth of money supply, but in the generation of the excess demand in mid-1965, and the failure of the overall combination of stabilization policies to offset that growth. Putting it rather succinctly, with the increase in demand for real resources on the part of the Government from mid-1965 on, we should have increased the taxes.

Much of what we are talking about here, as Mr. Deming stressed, is simply a tracking through.

Senator PROXMIRE. You have to have both, though. We have the increasing taxes. Concurrent with the increase in taxes, we had an easing of monetary policy. We had a situation where we had a slowdown of the growth in money supply in the third quarter that was consistent

with the growth in the economy. I understand in the fourth quarter, we have had a further growth.

But while we are awaiting your report—there has been the preliminary indication of natural growth.

Mr. BRIMMER. I don't put much emphasis on these month-to-month fluctuations and month-to-month supply of money growth. I would take a much longer view. I am interested in seeing the outcome of our report to you, myself. I know it will be coming to you soon.

But I would not like to be distracted for a moment, if you do not mind, sir, from the basic point which Mr. Costanzo raised and which is shared widely. That is, there is some configuration of interest rates in this country which, essentially, taken alone, would be sufficient to bring about and sustain an equilibrium in the U.S. balance of payments. We can achieve that configuration of interest rates without, as I believe he said, and I do not wish to debate him—without causing havoc in the United States.

Senator PROXMIRE. Is that configuration higher or lower than now?

Mr. BRIMMER. In the long run, I would expect that configuration of interest rates to be lower than it is now if we could provide backup with fiscal policy and other reinforcements. But in that kind of situation, I have no expectation whatsoever that relying primarily on monetary policy, we could achieve or sustain this equilibrium with the structure of interest rates——

Senator PROXMIRE. Are you asking for lower if the fiscal program of $7 billion for 1969 is adequate?

Mr. BRIMMER. I have not seen the budget.

Senator PROXMIRE. We have an overheated economy. It seems to me fiscal policy is restraining if you have a $3 billion surplus; somewhat restraining. Would you want a bigger surplus than that to make monetary policy operate?

Mr. BRIMMER. I would not want to say whether a $3 billion surplus in fiscal 1970 is sufficient, because it would depend on the strain of aggregate demand in the economy. We may need a larger one if aggregate demand exceeds the rate of growth in real resources.

Senator PROXMIRE. Also in the last year, fiscal 1969, we had this fantastic turnaround, from a $25 billion deficit to a $2 billion surplus. If you gentlemen who manage our money supply say we have to rely on further fiscal restraint, it would seem to me you are asking for a lot. It seems to me that now it is the turn of the monetary policy to do its job.

Mr. BRIMMER. I would certainly welcome a return from financing of a debt of some $17 or $18 billion of the capital market, which is due in fiscal 1968, and Mr. Deming has his figures on what he expects to demand in the market in fiscal 1969, so I would not comment on that. But certainly something of that sort would be helpful in creating conditions under which the scope of monetary policy would be increased. But that is a different issue. It is still a relatively shorter range view. And I do not think anyone is talking about achieving the kind of equilibrium the U.S. balance of payments is sustaining, relying somewhat heavily on the growth of our current account for a genuinely sustainable trade surplus.

No one, as I recall, is suggesting that that can be achieved over the next 12 months—18 months, a much longer range view. That is why

I am less sanguine than Mr. Costanzo is about the ability to permit access. I think we ought to talk about it this way: to permit open access to the American capital markets of foreigners and complete freedom of capital outflows generated by U.S. citizens without any kind of innovation or inhibition whatsoever over the near term.

If someone in this committee hearing is able to provide an acceptable explanation of what can be in fact done over the near term, I am ready to hear it. I am not sure it can be so done.

Senator PROXMIRE. I would like to ask Mr. Deming to comment.

Mr. DEMING. Senator, I think Governor Brimmer has made the point which I would make, that the important thing is to have proper demand management—proper fiscal and monetary management—whatever that turns out to be. I agree with you, there is not much more possibility now of increasing taxes to restrain the economy, so the weight falls on the monetary side. There is, as in the Revenue Expenditure and Control Act of 1968, the expenditure control tool which is an additional contribution to demand management policy.

I know how difficult that is, also, but the important thing, from my point of view, is to get the economy into a more sustainable rate of growth rather than this very high rate of growth.

Now, Mr. Costanzo's point is that monetary policy can operate in this country to maintain a sort of interest rate equalization, if you like, between the United States and the developed world. And if the rate structure is in reasonable balance you will not have the attraction to American foreign investment going overseas to such a great degree. You will not distort the movement of capital if you are in more proper rate balance. That is something I agree with.

It does not follow that you have to have an interest rate structure that is as high as the present interest rate structure for this balance to be achieved.

I do think, finally, to sum this point up, that with the tremendous demands for capital in the world, in the United States and in the rest of the developed world and in the underdeveloped world, I cannot foresee a return to a low-interest-rate structure, an interest-rate structure as low as we had in the 1950's. I just do not think that is in the cards for the foreseeable future.

But from my point of view, while it is absolutely vital to have proper demand management in the United States to get our payments into balance, what I do not agree to is that this will do the whole job.

I fail to see how you can run the U.S. economy at a level which will generate enough of an export surplus to offset some of the other foreign exchange costs that we have in an extraordinary degree and which other countries do not have in the same degree. Even using fiscal and monetary policy to achieve the most perfect demand management is not going to do anything about the deficit we have in the military account.

That is a political and not an economic problem. We need to work separately on that. I am not any more in favor of segmentizing balance-of-payments policies than Mr. Costanzo is, but on this point, it is important to segmentize, because those military expenditures are important and because you cannot push the trade surplus up high enough to offset the military expenditures plus other costs.

I also do not think fiscal or monetary policy or demand management policy has much effect on tourism. There we have to have a policy to hold that deficit in bounds. I am not talking about reducing it, just holding it in bounds so it does not grow larger. That requires, I think, promotion, financing, getting a lot more tourists into this country. I do not see anything inconsistent with economic freedom in managing that part of the balance of payments specially so as to handle that problem.

Once you do that and run a proper economy, I think you can have a higher trade surplus and not depend quite so much on attracting foreign capital. I think Mr. Fiero's point is well taken on this. When you look at that column on return—Mr. Costanzo referred to this also—return from dividends, fees, royalties, et cetera, in 1964 it was $5.7 billion. In 1968, it was $8.2 billion. It has grown $2.5 billion.

We can look forward, I think, with reasonable confidence, assuming the rest of the world runs its economies reasonably well, to an increase in earnings on foreign investment. We can look forward, I think, with reasonable confidence to an increase in the growth of American investment overseas.

The Commerce Department program, Mr. Fiero stressed, never was designed to stop that growth. It was designed to shift the financing. In that, it has been extraordinarily successful.

I do not feel quite as strongly as Mr. Fiero does that this has mortgaged our future.

You have to come back to special effort on at least two segments of the balance of payments, on the military side and on the private capital side, in order to get enough breathing room to build up the trade balance. But you are still going to have to depend, in my judgment, on a fairly high gross flow of foreign capital into the United States which will permit a higher gross flow of capital from the United States abroad.

There is not much question but that we are a financial intermediary. Perhaps not quite so much as Charlie Kingleberger puts it.

Chairman Reuss. Thank you, Mr. Deming.

Mr. Moorhead?

Representative Moorhead. Thank you, Mr. Chairman.

Mr. Deming, in your testimony, you spoke about the possibility of improving the international monetary system, although you gave it high marks, indicating that it is a system that is working pretty well. It certainly appears to me to be to the contrary, that we are dealing with an obsolete jalopy that is going at Cadillac speed down the road and that only the most talented of mechanics, of which you are one, can keep it going.

Do you share any of my feeling along these lines?

Mr. Deming. Mr. Moorhead, I do not feel that the international monetary system is perfect. I do not put it in quite the terms you do, that it is a jalopy going at Cadillac speed down the road. Certainly, there are things that can be done to improve it. I think one of them is in process.

That is the creation of a new international reserve asset. This I think will help stabilize the system.

I think various proposals that have been suggested for improvement in the international monetary system ought to be looked at. They

may not turn out to be as good as one might expect them to be, but they are worth studying. I think perhaps the monetary authorities have been a little too casual in not exploring some of these things a little more. But I have seen progress on what you might call the basic adjustment process front over the past several years—a far greater understanding of the necessity to work cooperatively in this field, and a far greater understanding that most surplus countries have to take responsible action.

We did find some responsible action, perhaps not as much as one would like, but some responsible action on the part of the European countries which approved the program we announced last January and tried to take some positive expansionary actions in their own economies.

What we are looking for were some other things in addition to this, some removal of the trade disadvantages that we have suffered.

In some of these things, we are making some gains also, and we need to push harder on that front.

The German Government recently took an action to reduce its border tax adjustment barriers. Implicity, this indicates that such practices had produced some impact on trade balance both in Germany and its trading partners. The German action is designed to moderate its trade surplus and help the countries that were not in trade surplus. I think this is another area that might be well explored in the implementing of the adjustment process.

Back in 1966, Working Party Three of the OECD turned out a report on the adjustment process. It is an excellent report and it is full of what I think are perfectly sound principles. What we really need to do is work on the implementation of some of these principles a little more than we have, in which case, you may find that the international monetary system, with the SDR added to it, does not need quite as much tinkering with as some people have suggested.

Representative MOORHEAD. You mention cooperation. I was in France in late November, I was pleased to find that the French were urging upon me the importance of international financial cooperation. I think that might have been a little change in attitude.

Mr. Secretary, while we have you here, there are proposals being made for increased flexibility in the system along the line of widening of the bands and the crawling pegs and things like that. Can you give us any of your advice and opinion on moving in this direction?

I quite agree with you, we do not want to jump into something radical and new. I just do not think that that would work. I tend to think we should move in this direction.

Mr. DEMING. Mr. Moorhead, I think there has been an ever-growing level of interest in exploring certain of these proposals. So far, it has been confined pretty much to academic circles. I was at a meeting in England, I guess a month ago, where there was a group of businessmen and financial men as well as academicians who were expressing some interest in this.

Understandably, with the system that, despite some difficulties in 1968—difficulties that stemmed, I think, as much as anything from factors that did not have much to do with the international monetary system—is not perfect, it is reasonable to begin to look at the system and suggested changes from an operational point of view. Whether

the suggested changes will prove to have anything much in them or not, I do not know, but I do not think it is any longer possible to put your head in the sand and say you cannot study anything.

Basically, we need a fixed rate system. Whether we have any flexibility in that fixed rate system is another question. I do not think freely fluctuating rates are any solution whatsoever to our problem. I think you cannot go that way. But a little more flexibility in a fixed rate system may be useful.

I might mention as an aside that people no longer call it a crawling peg. That seems to have some invidious connotations. It is now called dynamic parity.

Representative MOORHEAD. Indeed, it would be a lot easier to vote for dynamic parity than a crawling peg.

Mr. Secretary, I also think your presentation of the balance-of-payments figures is very helpful. It points up with greater clarity where the changes have come.

Let me see if the theory I have you would agree with. I think that a useful analogy can be made by comparing the balance of payments to the balance sheet and the income sheet of a corporation. It would seem to me that your figures would show that in previous years, our income statement was in pretty good shape, but that we were investing in long-term, and the liability side of our balance sheet was short, so we are in a balance sheet bind.

The foreign investment control program, particularly when it was rigidly enforced, beginning just a year ago, has just about reversed the process.

Mr. DEMING. That is correct.

Representative MOORHEAD. The most dramatic swing, of course, was on current account. We have gone from an average balance on goods and services from $2.5 billion-plus, to the figures you gave us today for 1968, minus $1.8 billion, a tremendous swing. But when you look at the balance sheet figures, what has happened contrary to General de Gaulle's recent statements, instead of our going out and buying up Europe, we have turned the thing around and they are coming in and buying up the United States.

Mr. DEMING. Part of the United States.

Representative MOORHEAD. I have been doing a little bit of exaggerating. But it did shift from an average of −.2 in your column 7 for the period 1958–67, to +7.7, and those two things, to me, are the most dramatic reversals.

Mr. DEMING. That is right.

Representative MOORHEAD. Mr. Fiero, contrary to your testimony, it has also been argued that any improvement in the capital account achieved by restraint programs is offset by a deterioration in the current account. If anything shows up in these dramatic figures that Secretary Deming has presented, it is a very strong indication that this may be the result of your strong capital restrictions.

Mr. FIERO. Mr. Moorhead, I think that is very difficult to relate the deterioration in our trade account over the past 18 months to capital controls. The main problem with our trade account has been the alarming growth in imports. It is possible that our failure to export more capital in recent years has made more funds available domestically, thus adding to the inflationary pressures in the United States. How-

ever, I would doubt that capital controls have been a significant factor influencing domestic inflation.

More significantly, I think that even supporters of this thesis would admit that there can be a considerable time delay in the adjustment process for this is not a perfect world and authorities may intervene to achieve other purposes, thereby frequently upsetting in one way or another, the working of the process.

The thesis is unproven. If it is correct, obviously, it will require some reassessment.

But I do not think that the dramatic increase in our exports which took place in this past year as against the increase over 1966–67, particularly when you eliminate the agricultural sector, would tend to support it.

Representative MOORHEAD. Governor Brimmer, since you are going to be the strongest force on deciding whether we liberalize bank credit controls where exports are concerned, I wonder if you would care to comment?

Mr. BRIMMER. I would like very much to comment on that, Mr. Moorhead, and I would like to take up where Mr. Fiero has left off.

As I looked at the question of the interrelationship between a given amount of bank credit and the growth of the U.S. exports, I find myself doubting even more strongly than I did initially that the effects of the restraint programs have been adverse with respect to export financing. You may recall I said that one of the activities we shall be engaged in over the next month or so is an examination of this question. Until we get the results of that examination, I would have to reserve judgment.

I would like to share with the committee something I find particularly dramatic in terms of a restraint program. Let us take a look at the annual rate of growth of exports over the last few years, leaving aside 1964, which all of us admit was extraordinary. In 1965, total exports grew 3.6 percent; in 1966, 11.5; in 1967, 4.5 percent; and in January to November of last year, they were 9.2 percent on an annual basis.

Now let us break off the exports to Western Europe, excluding the United Kingdom, which comes close to the conception in our guidelines of developed countries of continental Western Europe. Again, leaving aside 1964, in 1965, exports grew 4.3 percent; in 1966, 6.8 percent; in 1967, there was a zero; in the first 11 months of 1968, the U.S. exports to continental Western Europe grew by 10.3 percent.

If we try to unravel these data, the thing that strikes me is this, that it is the relative demand for U.S. goods abroad—in other words, the economic development in our principal market—that has a great influence on our ability to sell in these markets.

There was a slowdown of the rate of growth in Western Europe, especially Germany in 1966–67—notice our exports to that economy did not grow at all in 1967. In 1968, the impact on the foreign credit restraint program undoubtedly was severe in Western Europe—after all, we called for the repayment of term loans and the reduction from the ceiling, and the banks could make no loans to Western Europe except for exports. Yet in that period, exports to that end rose by 10.3 percent.

I find it difficult to conclude on the basis of this that bank financing had an adverse effect.

Now, there is one other point I would like to make which I cannot document with data at this point. That is that we should recall that the great bulk, perhaps the vast majority, of U.S. exports is financed not by financial institutions, but by American producers, who finance either through trade credit or some other way.

I think we should be on guard against concluding that we require a dollar of U.S. bank financing or financing by insurance companies to move $1 of U.S. exports. This is not true.

So I share with Mr. Fiero the conclusion that we ought to be cautious in trying to make this kind of linkage.

Representative MOORHEAD. Governor, I'm almost convinced. My concern is when you try to clamp down one area of a basic problem you create impacts in other areas and sometimes these impacts are inequitable and damaging in the long run.

I would agree with Mr. Costanzo that as soon as possible, we should move toward freedom so we do not distort anything. That is really what I was urging.

One final note, Secretary Deming. You were talking about the military expenditures and how we should cut those back or have them offset for balance-of-payments purposes. One of the things I understood you to say was the purchase of bonds. It would seem to me that if we were equating between the balance sheet and the income sheet, the military expenditures, once they are spent, are gone and you have nothing to show for it, and if you offset them with an investment, it is not a fair standoff, although it does make the book look a little bit better.

But fundamentally, if we are dealing in true economic terms, it is not the way to balance them out. Would you agree with me?

Mr. DEMING. Yes. I said that some place in the statement, Mr. Moorhead. I think it is far sounder to balance this off with some assumption by the host country of expenditures by the nonhost country so you neutralize the balance-of-payments costs. Also, it is sounder to do it through foreign expenditure for military goods in this country than it is to balance it through financial transactions.

Where it is not possible to do either of those first two or a whole variety of other things, it is better, in my judgment, to balance it with financial neutralization than not to balance it.

Representative MOORHEAD. Then we are in accord, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman REUSS. I have just one final question. In Mr. Costanzo's statement, he referred to the likelihood that some of the controls on foreign investment by U.S. corporations had been evaded by an additional outflow of funds from the United States to the Eurodollar market. Of course, that would rob Peter to pay Paul, if true.

What can you say, Mr. Fiero, about it?

Mr. FIERO. Mr. Chairman, we have not seen any evidence of this, at least insofar as companies that are reporting to us. In fact, their liquid foreign balances held abroad, as opposed to proceeds of foreign borrowing awaiting investment, have remained remarkably steady throughout the year. So if it took place, and I do not know what supporting evidence Mr. Costanzo has for this, it must have taken place from other sectors of the economy.

Chairman REUSS. Suppose I wrote a check on my bank in Washington and deposited it in a bank on the Continent. How does that show up in our accounts? In the first place, that is caught, I take it, by our accounting system.

Mr. FIERO. This is a U.S. outflow of funds and increases the foreign liquid claims on the United States. So it has the effect of hurting our balance of payments. To a large extent, these funds end up in the holdings of foreign monetary authorities and are generally very short term. However, foreign authorities have admittedly been placing more and more dollars into the foreign banking system.

Chairman REUSS. What can you say to this, Mr. Costanzo?

Mr. COSTANZO. Yes, Mr. Chairman. I do not mean to imply by that statement that there is evasion. What you have here is increasing pressures on the Eurodollar market which is resulting in higher Eurodollar rates. This is bound to affect the flow of funds between Europe and the United States. Without the Eurodollar bond issues we might have had even larger foreign investments in the U.S. securities market and, hence, a larger capital inflow to the benefits of our balance of payments.

Chairman REUSS. Has it, in fact? Has there been an increase in transfer of U.S. domestic balances to Eurodollar balances in the year or two?

Mr. COSTANZO. It is difficult to measure that in a period when we have been running a balance-of-payments deficit which, in essence, has been feeding the dollars into the Eurodollar market throug the central banks.

The whole market has been growing, so it is very difficult to segregate the impact of these particular factors.

But I still feel, just on the logic of the situation, that these market forces are bound to suck funds into Europe that otherwise would not have been—simply because of the demand that has been created for funds over there and the higher interest rates which have resulted.

Chairman REUSS. Eurodollar deposits in private hands have increased in the past year, have they not?

Mr. COSTANZO. Yes, there has been an increase. Eurodollars have increased from about $8 billion in 1964 to $20 billion last year, and I think the increase over the last year was something like from $16 to $20 billion.

Chairman REUSS. Well, I would say Mr. Costanzo may have a point there. One wonders how much of that $4 billion increase in Eurodollars holdings was an attempt by American holders of balances in this country to take advantage of the fact that a lot of American companies were making floatations in Europe.

Mr. FIERO. I would like to make two additional points, Mr. Chairman, if I might.

First of all, the marketplace has expanded, if for no other reason than the U.S. companies which have borrowed abroad have generated very substantial balances which they have tended to keep abroad until such time as they have need to employ them.

But those balances which are borrowed abroad are not the kind I think Mr. Costanzo is referring to. Under our program, we have limits on the amount of balances that arise other than from borrowing abroad. Direct investors report to us regularly as to their holdings. The data we have indicate that companies participating in the man-

datory program have not taken measures to increase their short-term liquid balances abroad or to flow funds out from the United States to take advantage of higher interest rates.

Chairman REUSS. Well, wasn't there a $4 billion increase in Eurodollar holdings last year?

Mr. FIERO. Yes. This could be explained by several factors. One factor is the rate structures there. We may have actually seen some local currency funds—marks, perhaps francs, perhaps lira—move into dollars. This would result in drains on a few of the surplus currencies while the dollar marketplace expanded. In fact, I think that this has been one of the major factors responsible.

Another factor, of course, is the long-term foreign borrowing by U.S. companies, which has been very substantial during the last year. Such funds flow, to a considerable extent, from other currencies, but they tend to be held in short-term Eurodollars pending their utilization by U.S. companies for foreign investment purposes. This alone could easily have resulted in an expansion of the Eurodollar market by over a billion dollars.

Others have used the Eurobond market as well and it is reasonable to believe that many such users also increased their short-term deposits in dollars. I would sincerely question whether U.S. companies as a group, certainly those reporting to us, placed surplus domestic liquidities overseas.

Chairman REUSS. Mr. Deming is late for an appointment, and we would be delighted to excuse him so that he is not any later.

Mr. DEMING. Thank you.

Chairman REUSS. Thank you so much, Mr. Secretary.

Representative MOORHEAD. I want to commend all of the witnesses before any of them leave. I think this has been a most helpful hearing. I think you, as chairman, should be commended for bringing to us such brilliant witnesses.

Thank you, Mr. Chairman.

Chairman REUSS. Thank you, Mr. Moorhead.

You have spoken, Mr. Fiero, about corporate transactions. What about individual transactions? What about individual transactions which are not covered by your controls? As far as I can see, large sums of individual holdings may in the last year or two have gone overseas and thense into the purchase of flotations overseas by U.S. corporations.

To the extent that that is what happened, the whole exercise was in vain because we have the same capital outflow that we would have had had the direct investment been made.

Mr. FIERO. Mr. Chairman, of course, this would be in direct violation of the interest equalization tax which does place restrictions upon the purchase by U.S. citizens of certain bonds issued by U.S. companies in the European marketplace.

We do not have any statistics which would disclose to us in the Office of Foreign Direct Investments what individuals in the United States may have done. I do not know whether the Federal Reserve Board would have any data that would throw any light on this particular issue.

Mr. BRIMMER. May I, Mr. Chairman?

First of all, as Mr. Fiero said, since the bond issues by American subsidiaries abroad are issued by foreigners, they are subject to the IET, and Treasury data would show the volume of such transactions subject to that tax.

I am sorry Mr. Deming left before he could comment on this.

Mr. Chairman, more generally the question concerns the growth of funds in the Eurodollar market. The sources from which they could arrive are, of course, many. The deposits on the books of U.S. branches abroad would be one indication of the way in which this could arise.

At one time, I was concerned as to whether the U.S. banks would use their foreign branches, especially in London, in effect to intercept funds which normally would come to the United States to put them on the books of their London branches, and thus to keep them available in the Eurodollar market. I was surprised to see that, at least as late as 1968, there had been no evidence of this.

The rate of growth in the liabilities to foreigners owed by the head offices of U.S. banks had not slowed down at all.

So I would not conclude that the use of Eurodollars necessarily implies the acceleration of the outflow of funds from the United States.

With respect to the bank program, the banks, as we have said earlier, reduced their net long-term loans, and by the end of 1968, they were required to reduce their short-term loans to 60 percent of the amount outstanding at the end of 1967. Let me rush to say that the development and performance of the Eurodollar market—up to now we cannot identify the principal sources, at a good level of detail anyway—of the sources of the funds coming into the markets. We do know that the central banks play a large role in it.

As you know, some of the central banks received large inflows of funds, especially during this disturbance in the Middle East during June. That did put some funds back into the market, but we cannot specify it.

Chairman Reuss. I am baffled by the reference to the interest equalization tax here. The case I put is an American with an account in an American bank who writes a check for $1,000 on an American bank, deposits that in dollars in a bank in France or Switzerland or Germany, and a month later, writes a check on that continental bank overseas for a thousand dollars in order to purchase a thousand dollars' worth of bonds floated by an American company that wants to put up a plant in Belgium and is raising the money locally.

Is that covered by the interest equalization tax?

Mr. Fiero. Yes, Mr. Chairman, it is, provided that the U.S. corporation floating the bond is deemed to be formed or availed of for the principal purpose of obtaining funds for foreign investment. Most of the Eurobond financing in recent years has been accomplished through foreign offerings of debentures by U.S. corporations which are special finance subsidiaries of other major U.S. corporations. These finance subsidiaries operate in such a way as to derive 80 percent or more of their income from foreign sources. When first offering such debentures, these subsidiaries obtain rulings from the Internal Revenue Service that they are formed or availed of for the purpose of obtaining funds for foreign affiliates. Therefore, if a U.S. citizen were to purchase such debentures, either at the time of original issue or in the

secondary market, he would be required to pay the tax, unless exempted for some reason. The amount of this tax can be quite substantial.

Chairman REUSS. On a 6-percent bond bought at par for $1,000, what would the tax on that be?

Mr. FIERO. The amount of the tax varies according to the period remaining to maturity of the debt obligation purchased. The top rate of the tax for a remaining maturity of 28½ years or more, is 18.75 percent. Therefore, the tax on a 6-percent bond purchased at par for $1,000 and having a 29-year maturity would be $187.50. The average maturity of the Eurobond offerings in 1968 is probably about 15 years. The interest equalization tax on the purchase of a debenture having a 15-year maturity is about 13 percent of actual value, or approximately $130 per thousand.

With your permission, Mr. Chairman, I would like to refer to an article that might shed some light on that question posed here. It appears in the Morgan Guaranty Trust Co.'s "World Financial Markets," dated December 27, 1968, in which they attempt to analyze the increase in the Eurodollar market this past year.

They refer, first, to the tremendous cash holdings of the U.S. companies arising out of them marketing of Eurobonds. They go on to say that there are several other important factors responsible for the rapid expansion of the short-term Eurodollar market during 1968.

One has been the increase in dollar deposits by overseas sterling area countries, presumably reflecting efforts by such countries to diversify their officials reserves. This was a significant factor.

In addition, there was a considerable expansion of dollar deposits of banks in Britain originating from Western European countries, notably France, Belgium, Italy, and Switzerland. These are attributed, in part, to the flight from French francs and the improvement in the Italian balance of payments which resulted in large dollar holdings by the Italian banks.

The flow of dollars originating from Switzerland may be due to the channeling of officially held dollars into the Eurodollar market and to placements by the Bank of International Settlements. It also reflects large placements with banks in Britain and elsewhere by the Swiss commercial and private banks.

We have seen an extraordinary movement of money during the past year, reflecting the uncertainty in the international markets. Such funds tend to move to the strongest currencies. But the banking systems in those countries cannot employ all the funds they receive and they have therefore tended to move them into the international market, frequently in the form of dollar deposits.

Chairman REUSS. Thank you very much.

In view of the lateness of the hour, we will now declare this hearing adjourned, to be reconvened at 2 o'clock in this room. We appreciate your cooperation.

Thank you so much.

(Whereupon, at 1:10 p.m., the hearing recessed, to reconvene at 2 p.m., in the same room, this same day.)

AFTERNOON SESSION

Chairman REUSS. Good afternoon.

The final session of the Joint Economic Committee's Subcommittee on International Exchange and Payments will be in order.

We are very pleased to have here with us as our last witness Dr. N. R. Danielian, president, International Economic Policy Association, and with him his son and associate Mr. Ronald Danielian.

I first want to say that the report on our balance of payments 2 years ago, I believe, by the International Economic Policy Association, has been a very fundamental document in our whole study over the years of the balance of payments and its recent updating has been most helpful, too.

Mr. Danielian, you have a lengthy statement with very comprehensive attachments, all of which will be admitted into the record. I would now like to ask you to proceed in your own way, either by reading it or, because it is lengthy, if these are parts which you can compress, suit yourself on it.

STATEMENT OF DR. N. R. DANIELIAN, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION; ACCOMPANIED BY RONALD L. DANIELIAN

Mr. DANIELIAN. Mr. Chairman, I shall be glad to abide by the pleasure of the Chair. If it is possible to print the document as if the whole had been read in full——

Representative REUSS. It will be printed in its entirety.

Dr. DANIELIAN. I would like to emphasize certain portions of it in view of the fact that the trade aspect and the tourist and direct investment controls have been emphasized in this morning's discussion; perhaps comments on those areas would be quite appropriate.

Mr. Chairman, it is a privilege to appear before this committee to discuss the balance-of-payments problems of the United States. As early as 1960 our organization warned appropriate committees of the Congress that unless the United States got control of the deficits in the international accounts, we would lose our freedom of action and initiative in the world.

In 1966 we published a volume, "The United States Balance of Payments: An Appraisal of U.S. Economic Strategy." We have recently updated this book in an addendum entitled, "The United States Balance of Payments: A Reappraisal, 1968," which has been mailed to each member of your committee. In these publications we have made detailed recommendations on how to correct the payments deficit.

I must say in all fairness that in the past 4 years the administration has shown a growing awareness of the seriousness of the problem; and the U.S. Treasury officials in particular, have shown a great versatility in sitting on the lid of an explosive international financial situation, a position, I am sure, which they have not enjoyed.

In spite of all these efforts, however, the international payments accounts of the United States continue to be in a precarious situation.

Although the balance-of-payments statistics look good for 1968, the underlying factors in current account receipts and expenditures have not improved, and the betterment in the statistics has come about my

capital account transactions which may or may not be recurrent. I shall, in this paper, briefly touch upon the more important components of these accounts and make some further recommendations.

Balance of Payments

Our total liabilities as of the end of September 1968 had climbed from a 1958 figure of $16.8 to $33.6 billion. At the same time, our gold reserves with which to pay these obligations had dropped from $20.6 billion at yearend 1958 to $10.9 billion as of November 30, 1968.

In 1967 the United States suffered its worst balance-of-payments deficit on a liquidity basis since 1960. The deficit was $3.6 billion, which included approximately $1 billion of special transactions, bringing the actual deficit closer to a $4.5 to $4.6 billion range. In response to this hemorrhage of dollars, the President, on January 1, 1968, announced a comprehensive program to stem the outflow by $3 billion, of which $2.5 billion was to be made up in the private sector and only $500 million in the Government sector: $1 billion from a cutback on private investments; $500 million from a cutback on bank loans to foreigners; $500 million from the tourist account; and $500 million from an increase in exports.

The first three quarters 1968 figures now indicate that the private investment sector will make its $1 billion savings goal; the banking sector has achieved its target of $500 million savings. The travel sector alone has gained $209 million net (on an annual basis) over 1967. It is too early to give an accurate breakdown of the transportation sector; however, the total transportation sector has lost only $10 million over 1967.

However, the U.S. trade balance slid from $3.47 billion in 1967 to $432 million in 1968 (first three quarters on an annual basis), a loss of over $3 billion. Our true commercial balance (trade excluding Government-financed exports), which indicates the foreign exchange earnings of our trade account, is in deficit by $3.1 billion. And Government expenditures abroad have increased. It is the deterioration in these accounts which will make it hard for a real and substantial improvement in the U.S. balance of payments.

Table 1 is a consolidated statement of the private and Government sectors in the U.S. balance of payments. This represents the closest breakdown that we can make using the Department of Commerce's balance-of-payments statistics as presented in the Survey of Current Business. It indicates the real deficit (the deficit excluding certain special or transitory transactions). There was a substantial overall improvement in the balance of payments during the first 6 months of 1968, but the three quarters figures indicate that the deficits were still high for the year. The total Government sector has increased its outflows over 1967 and the total private sector has increased its inflows (earnings). On the basis of these 9-month figures, we would be inclined to estimate that the true U.S. deficit will range from $3.5 to $4 billion for 1968, excluding temporary and nonrecurrent items. This is, of course, a saving from the true deficit of $4.5 to $4.6 billion in 1967, but it is still unacceptably high.

By the Government's measurement, the preliminary 1968 three quarter figures indicate that the liquidity deficit will be about $1.1 to

$1.2 billion on an annual basis, allowing for more than $1.9 billion worth of special transactions (on an annual basis). These special transactions include the sale of U.S. Government offset bonds to official foreign agencies and commercial banks.

Let us now consider the major areas within the U.S. balance of payments that affect the deficit in either a positive or negative way. These are the balance of trade, tourism, direct investment controls, and military and foreign aid expenditures.

TRADE

I think the most serious deterioration has taken place in the trade account; the U.S. net trade position has deteriorated consistently since 1964, when we had a surplus of $6.6 billion. From that height it has slid to a mere $432 million in 1968—first three quarters on an annual basis. The true commercial surplus—trade excluding aid-financed exports—which shows the actual foreign exchange earnings of our trade account, dropped from $3.6 billion surplus in 1964 to a $3.1 billion deficit in 1968—a drop of $6.7 billion in 5 years.

The case is not that our exports have stagnated, but rather that imports have risen more sharply than our exports. While our imports rose by 22.3 percent between 1967 and 1968, our commercial exports rose by only 11 percent. There has been a structural change in our commodity import-export relationship leading to a loss of our proportionate share of world trade. Chart I shows this decline in our share of world trade starting in 1957, well before the high inflation rates and near capacity production levels of the latter 1960's.

Table 2 shows the U.S. merchandise balance and percentage increase in exports and imports from 1965 to 1968 by major trading areas. Between 1967 and 1968, the following areas accounted for a $2.9 billion decrease in our trade balance:[1]

United Kingdom, $309 million; European Economic Community, $918 million; Canada, $972 million; and Japan, $700 million. An additional loss of $438 million on net balance is attributable to "other countries in Asia and Africa."

Within the total merchandise trade sector, agriculture used to account for 25 to 30 percent of our exports. In 1965 it accounted for 24 percent; in 1966, 23.8 percent; in 1967, 21.1 percent; and in 1968, 19.4 percent—first three quarters on an annual basis. Agricultural products are the items in which the United States is most competitive. From 1960 to 1966 there was a steady rise in our exports in this sector. Since 1966, however, agricultural exports have been declining.

There are recent indications that the international grains arrangement has further jeopardized the U.S. position in agricultural exports. Under Secretary of Agriculture John Schnittker admitted in the beginning of August 1968 that certain flaws in the IGA may be permitting other producers to undercut established minimum prices in certain grades of wheat.

According to the U.S. Department of Agriculture, agriculture's yearly contribution to the balance of payments in the 4 preceding years averaged $1 billion. The Department concluded that in view of net

---

[1] 1968 first three-quarter figures projected on an annual basis.

trade deficits in nonagricultural trade in 1967, the overall balance-of-payments deficit and potential drain on gold stocks were minimized by the good agricultural performance.[2]

Past agricultural contributions no longer are reason for optimism, however, for future improvement in the agricultural trade account will require reversal of current trends. Agricultural exports in 1967 declined 7 percent from their 1966 peak, and 1968 data are not expected to reflect any significant change; 1969 projections are not optimistic either. Despite the many predictions for world food shortages, there is increasing evidence that the decline in U.S. agricultural export opportunities reflects serious structural changes in world agriculture. These changes are being reflected in reallocation of productive resources in world agriculture, with the result that U.S. products are being displaced by foreign production.

A recent OECD report[3] documents the development of surpluses in many of our traditional export markets, especially the European Common Market. The OECD projects worldwide surplus production of temperate zone products, but fears that solutions to these problems will be inhibited by economic nationalism directed toward whole or partial self-sufficiency.

The U.S. Department of Agriculture recently confirmed the serious implications of these developments in wheat, traditionally our leading agricultural export commodity.

At least for the current year, the world not only has more than enough wheat for its needs, but the grain is so adequately distributed that trade expansion is not expected.[4]

The prospects for our trade account, in general, do not look good. As recommendations in this area which I feel would help this account earn more, I suggest the following:

1. The United States should seek the elimination of nontariff barries to our trade such as variable levies and border tax adjustments and quotas in other countries. What profit is there in negotiating sweeping tariff cuts in the Kennedy round only to find that the Europeans and the Japanese have devised other means of protecting their markets?

2. Consideration should be given to revision or withdrawal at the earlier possible date from the international grains arrangement so that the United States may compete in world markets on the basis of its comparative advantage in the cost of producing wheat. What sense does it make to adhere to artificially high world wheat prices when other producers, who have an oversupply this season, find ways of selling below the established minimums?

3. We should provide export incentives, while unfair border taxes are negotiated, to American exporters. One method could possibly take the form of an international trading corporation, for export purposes only, with a tax advantages; for example 14 points less than the normal corporate tax level.

4. Consideration should be given to opening up East-West trade in consumer and agricultural products. To enable the United States

---

[2] "U.S. Agriculture and the Balance of Payments, 1960–67," Economic Research Service, U.S. Department of Agriculture. ERS–Foreign 224.

[3] "Agricultural Projections for 1975 and 1985; Production and Consumption of Major Foodstuffs in Europe. North America. Japan, and Oceania," Organization for Economic Cooperation and Development (Paris 1968).

[4] "Wheat Situation," U.S. Department of Agriculture, November 1968.

to secure its share of hard currency earnings in agricultural trade with the Soviet Union and Eastern Europe, the cargo preference requirements as they apply to commercial agricultural exports should be removed.

Mr. Chairman, I would like to add a fifth point, and I have made this recommendation before:

5. The GATT agreement should be subject to renegotiation. The GATT agreements were negotiated in 1948, when the primary concern of the Western World was the rehabilitation of Western Europe, and many provisions of that agreement were written with that in mind. I think since conditions have changed, certain aspects of that agreement should be reconsidered.

Chairman Reuss. Do you have reference there to the provisions of GATT with respect to tax rebates?

Mr. Danielian. The provisions with respect to tax rebates, yes, certainly, and perhaps also the provisions relating to balance-of-payments consideration so that the provisions could be put into effect in a more orderly fashion. At the present time, as you know, on balance-of-payments grounds, members can establish quotas. Everyone agrees that quotas are not the desirable way to control international trade, and therefore, perhaps border tax adjustments should be substituted instead of quotas as a balance-of-payment relief measure.

I think there may be other aspects to give greater prominence to reciprocity, instead of merely across-the-board most-favored-nation arrangements. You see, when a country like Japan excludes everybody's products, it is abiding in some respects with provisions of GATT because everybody is excluded and everybody has a most-favored-nation treatment, but that does not help our trade relations with the country.

I feel that greater emphasis should be placed upon negotiation with trading blocs, say the Common Market and the United States, on the basis of reciprocity.

But this gets us into some rather controversial areas, and these are my own personal views; they do not represent an organization viewpoint. But I feel that it is time that GATT should be looked at very hard with a view to shaping it to our present requirements.

Direct Investment Controls

The direct investment controls announced on January 1, 1968, have admittedly benefited our balance-of-payment accounts by $1 billion, but they are, in my opinion, detrimental to the balance of payments in the long run. Investments are being curtailed, and earnings are being forced back to the United States. By the structuring of the controls to include reinvested earnings as an outflow and, therefore, under restriction, the internal cash flows and working capital of the U.S. direct investor are being cut back.

Corporations have been forced to rely on foreign borrowings. Approximately $1.6 billion has been borrowed through security issues during the first three quarters of 1968 and a $2- to $2.5-billion total for 1968 is a possibility. Another $300 million or so in long-term funds have been borrowed through the foreign banking sector. With cash flows restricted, it will become increasingly difficult for the U.S. direct

investor to keep up his traditional rate of return, for the cost of doing business will rise.

The $1 billion savings target will probably be met mostly from repatriation of income and reduction in liquid foreign balances. No accurate figures are available to indicate to what extent reinvested earnings have been curtailed, but income on foreign investments is up $442 million for the first three quarters of 1968 over the same period in 1967.

It is an undisputed fact that U.S. investments abroad have earned more for the United States by way of repatriated income—with or without royalities and fees included—than the amounts of direct outflows. What we are doing in our controls program is restricting our earning capacity abroad, forcing repatriation of income, substituting borrowed money for it, and calling it a saving.

In much the same way, restrictions on short term bank loans to foreigners only deny the United States the interest from these loans. If they are short term, the principal will be repaid with income in the form of interest. If you cut these short-term loans, you have given up the income thereon.

As abhorrent as these controls are to individual businessmen, they have shown great forbearance and willing compliance with the regulations. I want to put my case against controls on national interest grounds. It is simply not possible to improve our earning capacity abroad, to do all the things we are called upon to do, as a nation, by borrowing either on Government account, to keep our troops abroad, or on private account, diminishing the equity income of our investments. Nor can we maintain the credit of this country by borrowing short, and lending long or spending on current consumption.

I would recommend the elimination of the investment controls before they irrevocably hurt our earning capacity. Each year the controls remain, corporations are forced to increase their debt burden to increase investments. As debt increases, it becomes harder to eliminate the controls for fear of massive outflows to pay off the outstanding obligations. This period of high interest rates in the United States is the ideal time to start to eliminate the controls.

I do not believe the finance ministers and central bankers in Europe have the same resistance to U.S. direct investments now as they had in 1967. Belgium and Spain, and Ireland, too, have officially pleaded with the U.S. Government to take off these controls and France in its present condition has come to appreciate the benefits of U.S. financial and technological input. Great Britain welcomes United States investments. What we are confronted with primarily are the attitudes in the Netherlands, West Germany, and Switzerland. I should imagine that in the context of our total relations with the Dutch and the Germans we should be able to come to an amicable understanding with them. That leaves the Swiss bankers who, I do not believe, can alone start a run on the U.S. Treasury.

However, to eliminate even the remote possibility of a flight of capital from the United States or a massive repayment of foreign debts with U.S. funds, the new administration may wish to establish a transitional period during which a voluntary program of restraint may be instituted, primarily with respect to direct outflows from the United

States to such Western European countries as favor them. This may be accomplished, for example, by the following method:

1. Abolition of all schedules with respect to reinvested earnings and repatriation of income. I am referring to the Department of Commerce schedules A, B, and C, concerning investment in the less developed countries, the developed countries, and Western Europe. A direct investor could be required to repatriate a minimum amount either at a reasonable percentage or the average of a base period such as 1964–66. Earnings should be calculated on a consolidated basis with no restrictions on the use of retained earnings.

2. Abolition of schedules A and B, but the retention of schedule C, for such continental European countries as desire them, only with respect to direct outflow of capital, subject to the following conditions:

(*a*) A temporary voluntary limit on outflows based upon the average of 1964–65, or such period as may be appropriate in individual cases.

(*b*) Temporarily, no direct outflows to be permitted to schedule C countries, as narrowly defined, based upon a year-end to year-end basis, to prevent any danger of massive transfer of capital.

(*c*) Investors with no base may be given either a flat allowance or be subject to special consideration.

(*d*) Complete freedom to acquire equity and debt obligations of affiliated foreign nationals in exchange for intangibles such as know-how and industrial property rights or tangibles such as machinery.

(*e*) Freedom to issue and sell abroad equity securities of U.S. companies for the purpose of construction of new plants, expansion of existing plants, and acquisition of existing facilities.

(*f*) An incentive in the form of increases in allowable capital exports or retained earnings, based upon proof of improvement in total balance-of-payments contributions of each enterprise, including imports and exports by a specified percentage per year, such as 5 or 10 percent; some proportion of the improvement may be added to the allowable limit of capital exports or retained earnings on a discretionary basis.

We have, Mr. Chairman, estimated the effect of the suggestions, and whereas we estimate that complete abolition of the controls immediately might increase capital outflows by a billion dollars, and this was a question that was asked this morning—of Mr. Deming, I believe—the institution of this voluntary program that we are advocating, will not cause any large increase of outflows over and above the present Government program. In fact, it compares favorably with the mandatory controls that the Department of Commerce has established. A comparison is given in tables 5 and 6 in the appendix.

These guidelines could be the first in a number of steps to the eventual elimination of all controls at the proper time. Our calculations show that these voluntary guidelines would save as much, if not more, than the present Government program while eliminating some of the cumbersome and arbitrary rules now in force.

Tables 3 and 4 are provided as background information on U.S. direct investment abroad and the present Government program. Tables 5 and 6 give our evaluation of the balance-of-payments effects of the Government program compared with our proposal as stated above.

In comparing lines 7 and 8 of table 5 with table 6, it can be seen that our proposal would have resulted in $100 to $900 million less outflows over the 4 year range (including Canada) than the present Government program. We feel that as a transition step, this phased approach would still give substantial leeway to corporate finance officers—more so than the present OFDI program—and, at the same time, affect the balance of payments in a positive way.

I also feel that as an aid to the balance of payments, an incentive program allowing repatriation of income over and above the 1964–67 historical level, free of U.S. tax liabilities, for a specifically limited period, should be encouraged to see what results may be achieved. Excess funds may flow back into the United States as a direct result of this.

Tourism

I would like to turn to tourism. This is a matter in which the chairman has taken great interest, and I hope he will retain his interest, because I believe very deeply that there are great opportunities here for increasing the earnings of the United States in this account.

Preliminary indications of travel expenditures alone indicate that the net deficit on this account in 1968 will be $209 million lower than in 1967. This is compared with the $500 million target that the President's objectives called for a year ago January.

We oppose restrictions on the freedom of Americans to travel. Travel abroad is in essence import of services. We do not see the logic of singling out this particular form of imports for taxation or any other kind of limitation. In fact, we are inclined to believe that freedom of individuals should carry a higher scale of priority than, say, price of goods.

On the other hand, there are many activities of a positive nature that can be undertaken to offset the so-called tourist gap in our balance of payments. I do not see why the selling of services to foreign travelers in the United States has not received the same emphasis as exporting goods.

In fact, if one were to assess the potentialities of the two efforts I, for one, have believed for a long time that the United States has much to offer in this area of great attraction and interest to peoples of other lands. Whereas, one may not be able to tell the difference between the services obtained from a transistor radio or TV made in the United States, Japan, or Germany, I am sure everyone will recognize that the Metropolitan Opera in New York, or the city of Washington, or the Grand Canyon, are unique and can only be appreciated by a personal visit.

Very valuable work has been done in this area by the U.S. Travel Service of the Department of Commerce and by the national and international air, rail, and bus carriers in reducing rates for inbound foreign travelers, but much more can be done and I want to enumerate some of these possibilities.

First and foremost, we would like to renew the recommendation made in our book on the balance of payments in 1966 that the Congress appropriate, and the Treasury Department implement, a program of issuing coupons to incoming tourists for, say, a 20-percent discount on tourist services purchased in the United States. The administrative problems are not so difficult as they may appear.

25-765—69——15

The most important work would be to encourage incremental travel to the United States which would have to limit this privilege to particular classes of travelers who would not otherwise be able to come to this country. The problems on this side are minimal. These coupons could be easily redeemable either at the local post offices or in payment of taxes to the Federal Government.

Second, the U.S. Travel Service budget should be increased substantially, up to $10 million immediately, and ultimately to $15 million, and the position of the Director of the U.S. Travel Service should be enhanced to that of Assistant Secretary of Commerce for Tourism.

In the third place, a new function has to be created here in the United States, the lack of which has made travel by foreigners in the United States a very difficult and trying experience. This function one might call the "reception industry." As you well know, organized group travel to Europe, for instance, is facilitated by agencies in each country which provide assistance in every aspect of travel, including reception at the airport, interpretative services, facilitating clearance through customs, transportation into town and handling of baggage, sightseeing guides, et cetera. This is an expensive function in the United States and as of now it is almost nonexistent.

I suggest, therefore, that sufficient funds be provided to the U.S. Travel Service to initiate this service. Perhaps it may be possible to persuade some private foundations, with the cooperation of the Internal Revenue Service, to fund pilot projects in this area until it is well developed so that we are better able to judge whether the costs could be absorbed in the total cost of the tourist package. This may, in fact, become ultimately a major source of employment for able and linguistically inclined college students.

We are all aware of the fact that the services in many of our national parks are now overcrowded and inadequate, and if we are to provide package tours for foreign travelers in the United States, it would be necessary to expand these facilities. I recommend, therefore, that the Congress give sympathetic consideration to the programs of the Department of the Interior in this field.

Attention should be given also to the growing restrictions on travel by the citizens of many countries and since tourism to the United States is a sale of services, this area of restriction against our export of services should receive a high priority in the diplomatic representations of the State Department.

Finally, I recommend strongly that this committee hold a special set of hearings and invite the transportation, travel and hotel industries to come forward with their own specific recommendations on how to expand foreign travel in the United States.

I hope that the chairman of this committee will maintain his constructive interest in this field.

MILITARY EXPENDITURES

The net deficit on military expenditures, after deducting military hardware sales, has been more than $2 billion every year from 1958 to 1967. Table 7 shows these balances. In 1968 (first three quarters on an annual basis) the next deficit on military transactions will be in the neighborhood of $3.1 billion. With our commitments in Southeast Asia,

our troop concentration in Western Europe, and constant threats such as the Czechoslovakian situation, it is hard to see any diminution in our foreign exchange losses in this account. Considering our balance-of-payments problems, it is essential to the maintenance of free world security that our allies share in the burden of defense expenditures in Europe. Selling interest-bearing bonds to offset military expenditure is not a proper "sharing" of costs. It will only aggravate our balance-of-payments situation in coming years.

In my recent travels in Europe I have found much support in business and governmental circles that the European governments should pay for a larger portion of their defense costs. There has been no logical explanation why the U.S. Government has failed to accomplish this result.

I believe that the following recommendations in this area should be adopted to ameliorate the adverse balance of-payments effect of our defense expenditures.

1. The United States should insist that the foreign exchange costs of maintaining U.S. forces in Western Europe be borne by the respective countries through budgetary appropriations. As a minimum, these countries should be required to purchase U.S. products in the equivalence of our military expenditures, over and above a historical base.

2. If the European countries do not feel that they should pay part of the costs of our defensive deployments, in a sense denying the seriousness of the threat to their security, we should be prepared to reduce conventional forces while maintaining our fire power.

3. Our expenditures in Asian countries, such as Japan, the Philippines, the Republic of China, Thailand, and South Korea, and our other Asian military endeavors, should be arranged in such a fashion as to increase procurement by those countries in the United States. The situation in this countries is different from Western Europe. They do not have a gross national product that can support a major security effort. Therefore, our military costs in that area should be offset as nearly as possible by equivalent transfers of real resources. This would require payment in blocked dollars in American banks, acceptable for U.S. procurement under specific administrative arrangements, assuring additionality of imports from the United States over a base period. This could result in savings of as much as $2 billion.[1] The trade statistics previously cited indicate that we are far from achieving this result. In fact, we have gone into reverse gear.

FOREIGN AID

From 1965 to 1967, the estimated exchange costs of our foreign aid amounted to an average of $727 million. In 1968, the first three quarter figures on an annual basis indicate that the exchange costs will decline by $127 million to approximately $600 million. In my view, there is no need for even this much foreign exchange loss in our aid program, if 100 percent additionality were practiced. A survey of this problem in certain South American countries undertaken last August indicates that we are far from achieving this result. I would recommend the fol-

---

[1] International Economic Policy Association, "The United States Balance of Payments: A Reappraisal, 1968," December 1968.

lowing as a means to assure that there will be no exchange losses in this account:

1. The foreign aid program should be reoriented from a program loan basis or a line of credit basis, to providing only U.S. goods and services for individually approved incremental development projects.

2. There should be a greater degree of international sharing of aid. Table 8 indicates that the United States gives the lowest combination of favorable interest rates and maturity periods. In addition, other countries of the world, such as France, count as aid the normal interest-bearing loans extended to their former colonies.

3. If it becomes necessary to give low-interest, long-maturity, program loans for balance of payments, import assistance, or debt repayment, then such loans should be given for that expressed purpose by a consortium of the developed countries, on equal terms and on a proportionate basis. I see no reason for our providing 40- or 50-year loans at low interest rates and other members of a consortium providing 6- or 7-year loans at a 6-percent interest rate.

SUMMATION

In summation, Mr. Chairman, the U.S. balance-of-payments deficit is still dangerously high. The Government account is responsible for the deficit, while the private account is just not able to provide enough surplus to pay for the difference. A combined program that would actively promote exports, insisting on reciprocity of treatment, encourage tourism to the United States, reduce Government expenditures by reallocating military expenditures and foreign aid, and decontrol private investments, will do more to eliminate the balance-of-payments deficits than the present Government programs.

ALTERNATIVES

There is a tendency in this country to look for a simple panacea to correct the imbalances in our international accounts. Of course, the surest cure would be to withdraw our military presence from the Far East as well as Europe, but that is not a simple or feasible proposition in the light of world conditions.

For quite a while, curtailment of U.S. investments abroad had its strong advocates, but we have found that it doesn't really cure our balance-of-payments deficits.

There are those who advocate floating exchange rates as if that alone will bring our international accounts into balance by increasing exports and diminishing imports. Since our balance-of-payments deficits are primarily due to governmental expenditures abroad, a devaluation of the dollar in terms of other currencies will merely increase the costs of our efforts abroad without improving our balance of payments.

Furthermore, one must assume a corresponding increase in commercial exports as a result of depreciation of the dollar in relation to other currencies. Where is there in this world a country which will voluntarily allow us to obtain such an advantage? The only prospects are the Netherlands and West Germany, with their balance-of-payments surpluses but any revaluation of their currency would have minimal effects on U.S. trade, what with their other restrictions such as variable levies on U.S. agricultural exports. It is far better that

they take on a larger share of our troop costs than tamper with exchange rates.

Then there is a school of thought that the problem is one of liquidity and you can increase liquidity by increasing the price of gold, on the one hand, or by creating special drawing rights as a means of international payments. However, since the rest of the world has much of the gold, an increase in the price of gold will merely obligate the United States to buy it back at a higher price, giving capital gains to other countries for which we must be willing to give goods, services, investments, or other property. An increase in the price of gold will not provide us enough resources to make it possible to continue funding our deficits.

The special drawing rights, desirable for the expansion of liquidity in the long run, will not supply us even a fifth of the costs of our troops in Europe per year, even if creditor countries should permit us to use them for that purpose.

There is also a proposal to curtail total demand by fiscal and monetary measures by slowing down the rate of growth. There is here a confusion between the rate of growth and the rate of inflation. If these measures are taken for the purpose of curbing inflation, then, of course, they should have the blessing of everyone who believes that money is a store of value, a measure of contractual obligations between borrowers and lenders—and that includes our bank depositors, savings bank account holders, beneficiaries of insurance and pension plans, and everybody else who holds a fixed-dollar asset for future payment—a medium of exchange which must have reliability in order to lubricate the wheels of commerce, domestically as well as internationally.

There is in these functions of money a good enough reason to prevent the erosion of value as a result of inflation. Maintenance of the value of the dollar by curbing inflation should therefore have the highest priority in economic policy.

However, if it is hoped to redress the balance-of-payments deficits by sufficient depression of income or prices domestically to affect a part, probably a small part, of our imports, and possibly a small part of our exports—though that is more problematical—one must consider very carefully the cost of such an approach in terms of the total economy.

An analysis of the types of commodities entering into imports and exports and the areas of the world involved in the deteriorating trade position of the United States would seem to indicate that more can be accomplished in earning income abroad through a well-organized and aggressive negotiating stance in those areas, such as agriculture, export incentives, value added taxes, East-West trade, sharing of mutual defense and foreign aid costs, and a long-range investment program which, in time, would bring sufficient income to obviate the necessity of trade restrictions.

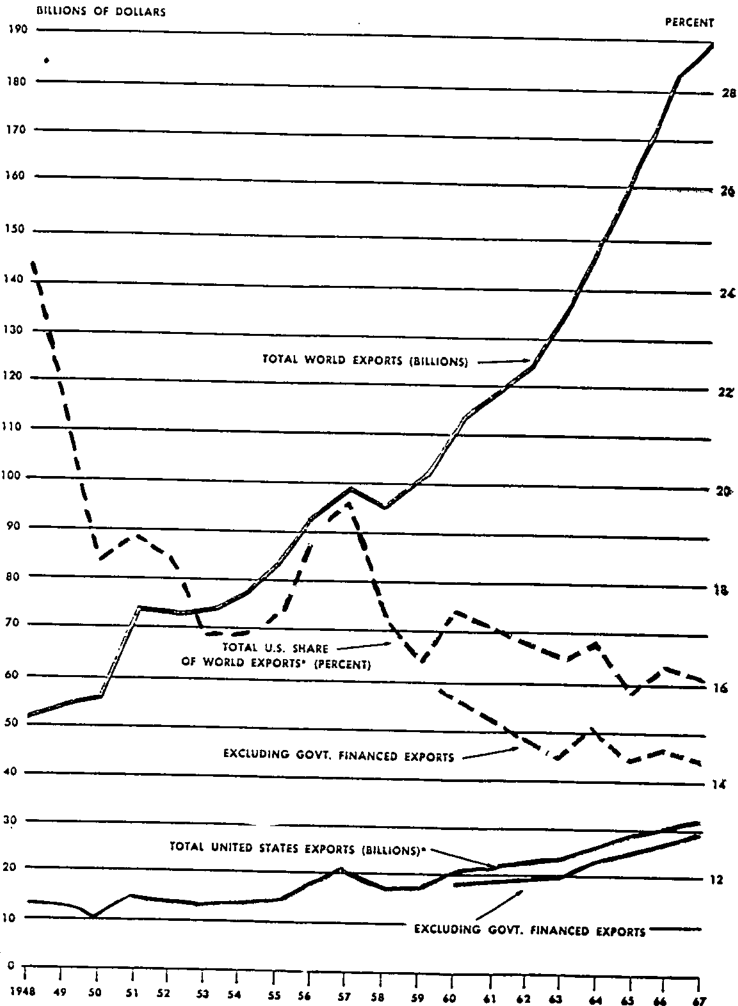
We should not be concerned in the long run with deficits in our balance of trade or tourism, because a capital exporting country, if it is to receive income on its investments abroad, must expect, when these investments are matured, to import more goods and services than it exports. This, after all, will increase the consumable wealth of the United States.

It is only because of the tremendous magnitude of the U.S. Government's involvement abroad, with its attendant costs, that we have a balance-of-payments deficit and monetary crisis. The transfer of re-

sources required by these programs has not been, and apparently cannot be, accomplished by the automatic workings of the international pricing and foreign exchange mechanisms.

The answer, I am afraid, is not in changing the mechanism or in some other painless alternative. It must be found in a strong diplomatic effort, at the highest levels, to persuade other countries to accept more of our goods, more of our investments, and more of our burdens.

(Chart and tables submitted by Mr. Danielian follow:)



* Merchandise excluding military.

SOURCE: U.S. Department of Commerce, BALANCE OF PAYMENTS STATISTICAL SUPPLEMENT (rev. ed.) 1963. SURVEY OF CURRENT BUSINESS, June 1967, U.S. Government Printing Office and International Monetary Fund, INTERNATIONAL FINANCIAL STATISTICS 1968 issues.

TABLE 1.—PRIVATE AND GOVERNMENT SECTORS IN THE U.S. BALANCE OF PAYMENTS, 1962–68

[In billions of dollars]

	1962		1963		1964		1965		1966		1967		1968 [1]		1968 [2]	
	Private	Government	Private	Government	Private	Government	Private	Government	Private	Government	Private	Government	Private	Government	Private	Government
Exports	18.1	2.5	19.2	2.9	22.3	3.0	23.3	3.0	26.0	3.2	26.9	3.5	29.4	3.7	29.9	3.5
Income on investments	4.1	.5	4.2	.5	5.0	.5	5.0	.5	5.7	.6	6.2	.6	6.5	.7	6.8	.8
Other service receipts	4.4	.2	4.7	.2	5.2	.3	5.6	.3	6.5	.3	6.9	.3	7.0	.4	7.3	.4
Long-term capital inflows	.4		.3		.1		−.2		2.2		2.3		4.9		5.1	
Repayments to U.S. Government [3]		1.3		1.3		1.3		1.5		1.6		2.2		2.6		2.6
Government liabilities [4]		.6		.4		.5		.2		.1		(5)		.2		−.2
Total receipts	27.0	5.1	28.4	5.3	32.6	5.6	33.7	5.5	40.4	5.8	42.3	6.6	47.8	7.2	49.1	7.1
Imports	−16.2		−17.0		−18.6		−21.5		−25.5		−27.0		−32.1		−33.0	
Services	−5.6	−1.0	−6.2	−1.1	−6.6	−1.3	−7.2	−1.4	−8.2	−1.5	−9.2	−1.7	−9.0	−1.7	−9.7	−1.8
Private long-term investments	−2.9		−3.7		−4.4		−4.5		−3.8		−4.3		−3.4		−4.0	
Military cash outflows		−3.1		−3.0		−2.9		−2.9		−3.7		−4.3		−4.5		−4.5
Government grants and loans		−4.3		−4.6		−4.3		−4.2		−4.7		−5.2		−5.8		−5.5
Total payments	−24.6	−8.4	−26.9	−8.7	−29.6	−8.5	−33.2	−8.5	−37.5	−9.9	−40.5	−11.2	−44.5	−12.0	−46.7	−11.8
Basic position	2.4	−3.3	1.5	−3.4	3.0	−2.9	.5	−3.0	2.9	−4.1	1.8	−4.6	3.3	−4.8	2.4	−4.7
Short-term capital outflows	−.5		−.8		−2.1		.8		−.4		−1.2		−.5		−1.3	
Unrecorded outflows	−1.0		−.2		−.9		−.3		−.2		−.5		−.3		−.3	
Balance	.9	−3.3	.5	−3.4		−2.9	1.0	−3.0	2.3	−4.1	.1	−4.6	2.5	−4.8	.8	−4.7

[1] First 2 quarters at annual rate.
[2] First 3 quarters at annual rate.
[3] Excludes debt prepayments of $680,000,000 in 1962; $326,000,000 in 1963; $123,000,000 in 1964; $221,000,000 in 1965; $429,000,000 in 1966; and $6,000,000 in 1967. Includes military sales.
[4] Excludes sale of medium-term Government securities to foreign governments which totaled $469,000,000 in 1967.
[5] Less than $100,000.

Note: Private exports equals value of all merchandise exports excluding military, minus expenditures by U.S. Government on merchandise ($3,523,000,000 in 1967). Government exports equals U.S. Government expenditures on U.S. merchandise ($3,523,000,000 in 1967).

Source: U.S. Department of Commerce, "Survey of Current Business," June 1968, pp. 29 and 39, September 1968, U.S. Government Printing Office.

TABLE 2.—U.S. MERCHANDISE TRADE BALANCE EXCLUDING MILITARY IN MILLIONS OF DOLLARS AND PERCENTAGE INCREASE IN EXPORTS AND IMPORTS, 1965–68[1]

	United Kingdom				European Economic Community (EEC)				Other Western Europe			
	1965	1966	1967	1968	1965	1966	1967	1968	1965	1966	1967	1968
Net trade balance	+$214	−$24	+$159	−$150	(2)	+$1,296	+$1,080	+$100	(2)	+$644	+$396	+$345
Exports	$1,628	$1,756	$1,864	$1,926	(2)	$5,404	$5,506	$5.989	(2)	$2,419	$2,297	$2,541
Rise in exports (percent)		7.9	6.1	3.3			1.9	8.8			−5.0	10.6
Imports	−$1,414	−$1,780	−$1,705	−$2,076	(2)	−$4,108	−$4,488	−$5,889	(2)	$1,775	−$1,901	−$2,196
Rise in imports (percent)		20.9	−4.2	21.8			9.3	31.2			7.1	5.5

	Canada				Latin America and other Western Hemisphere				Japan			
	1965	1966	1967	1968	1965	1966	1967	1968	1965	1966	1967	1968
Net trade balance	+$642	+$511	+$84	−$888	−$122	+$34	+$13	+$18	−$388	−$633	−$344	−$1,044
Exports	$5,460	$6,552	$7,095	$7,550	$4,234	$4,719	$4,669	$5,200	$2,051	$2,340	$2,673	$2,900
Rise in exports (percent)		20.0	7.7	6.4		11.5	−1.1	11.5		14.1	14.2	8.5
Imports	−$4,818	−$6,041	−$7,011	−$8,438	−$4,356	−$4,685	−$4,656	−$5,182	−$2,439	−$2,973	−$3,017	−$3,944
Rise in imports (percent)		25.4	16.1	20.4		7.5	−0.6	11.3		21.9	1.5	30.7

25-765—69—16

	Eastern Europe				Australia, New Zealand and South Africa				Other Countries in Asia and Africa			
	1965	1966	1967	1968	1965	1966	1967	1968	1965	1966	1967	1968
Net trade balance	+$7	+$21	+$19	−$5	+$623	+$337	+$468	+$471	+$1,400	+$1,589	+$1,826	+$1,388
Exports	$147	$200	$199	$209	$1,258	$1,141	$1,274	$1,413	$4,198	$4,645	$4,891	$5,153
Rise in exports (percent)		36.0	−0.5	5.0		−9.3	11.7	10.9		10.6	5.3	5.4
Imports	−$140	−$179	−$180	−$214	−$635	−$804	−$806	−$942	−$2,789	−$3,056	−$3,065	−$3,765
Rise in imports (percent)		27.8	0.6	18.8		26.6	0.2	16.8		9.2	0.3	22.8

	Total, all areas				Total, all areas, excluding Government financed exports[3]			
	1965	1966	1967	1968	1965	1966	1967	1968
Net trade balance	+$4,728	+$3,635	+$3,477	+$432	+$1,776	+$483	−$46	−$3,100
Exports	$26,244	$29,176	$30,468	$33,452	$23,292	$26,024	$26,945	$29,920
Rise in exports (percent)		11.2	4.4	9.8		11.7	3.5	11.0
Imports	−$21,516	−$25,541	−$26,991	−$33,020	−$21,516	−$25,541	−$26,991	−$33,020
Rise in imports (percent)		18.7	5.7	22.3		18.7	5.7	22.3

[1] 1968 figures are first 3 quarters at an annual rate.
[2] Not available: Up to 1965 the EEC was included in Western Europe; in 1965 the "Survey of Current Business" started to list the EEC separately.
[3] 1968 figures for Government financed exports are first 3 quarters at an annual rate.

Note: Percentages are rounded.

Source: U.S. Department of Commerce, "Survey of Current Business," June and December 1968.

TABLE 3.—U.S. DIRECT INVESTMENT POSITION 1964–67 [1] ACCORDING TO SCHEDULES A, B, C OF FOREIGN DIRECT INVESTMENT REGULATIONS UNDER EXECUTIVE ORDER 11387 AS ORIGINALLY ISSUED

[In millions of dollars]

	Value of investments				Outflows [2]				Reinvested earnings			
	1964	1965	1966	1967	1964	1965	1966	1967	1964	1965	1966	1967
Total, all areas	44,386	49,328	54,711	59,267	2,416	3,468	3,623	3,020	1,431	1,542	1,739	1,578
Schedule A, total	12,320	13,289	14,150	14,891	397	562	474	442	292	387	429	292
Latin America	8,894	9,391	9,826	10,213	143	176	190	191	216	306	302	172
Far East, less Japan	1,182	1,358	1,471	1,665	103	164	55	135	28	9	56	63
Africa, less Libya and Republic of South Africa	816	961	1,085	1,145	54	118	108	88	−1	25	22	5
Other Oceanic [3]	117	134	146	160	−27	9	4	2	15	8	8	13
Other Western Hemisphere [4]	1,311	1,445	1,622	1,708	124	95	117	26	34	39	41	39
Schedule B, total	22,150	24,664	27,393	29,596	760	1,700	1,770	1,296	782	911	901	89
Australia	1,475	1,679	1,923	2,354	125	136	148	324	64	72	92	104
Canada [5]	13,796	15,223	16,999	18,069	239	962	1,135	392	500	540	547	644
Japan	598	675	756	868	78	19	31	33	35	49	49	79
Libya	402	428	389	456	70	21	−43	55	5	5	4	3
Middle East [6]	1,332	1,536	1,669	1,748	42	245	118	150	11	3	14	−14
United Kingdom	4,547	5,123	5,657	6,101	206	317	381	342	167	242	195	81
Schedule C, total	8,029	9,391	11,151	12,448	1,179	1,193	1,448	1,133	279	164	288	221
Common Market	5,426	6,304	7,584	8,405	807	857	1,143	816	100	−3	100	41
Other Europe, less United Kingdom [7]	2,136	2,558	2,967	3,376	355	305	285	284	141	149	140	144
South Africa	467	529	600	667	17	31	20	33	38	18	48	36

	Earnings				Income[8]			
	1964	1965	1966	1967	1964	1965	1966	1967
Total, all areas	5,061	5,460	5,702	6,017	3,670	3,963	4,045	4,518
Schedule A, total	1,419	1,551	1,662	1,638	1,137	1,184	1,234	1,339
Latin America	1,095	1,160	1,267	1,203	895	869	965	1,022
Far East, less Japan	153	168	164	216	117	156	104	147
Africa, less Libya and Republic of South Africa	1	43	23	−1	3	23	4	−5
Other Oceanic	21	20	23	20	6	10	13	7
Other Western Hemisphere[4]	149	160	185	200	116	126	148	168
Schedule B, total	2,825	3,002	3,053	3,275	2,080	2,134	2,233	2,467
Australia	121	126	146	151	52	52	54	50
Canada	1,106	1,209	1,237	1,327	634	703	756	790
Japan	54	91	91	123	30	47	43	46
Libya	258	232	270	292	252	226	266	289
Middle East[6]	813	840	877	1,004	836	836	863	1,018
United Kingdom	473	504	432	378	276	270	251	274
Schedule C, total	724	773	853	889	424	576	554	656
Common Market	398	395	436	448	275	366	321	398
Other Europe, less United Kingdom[7]	239	277	293	313	103	132	157	178
South Africa	87	101	124	128	46	78	71	80

[1] Preliminary.
[2] Includes funds borrowed abroad through security issues and actually used abroad by American direct investors, $52,000,000 in 1965, $445,000,000 in 1966, and $278,000,000 in 1967.
[3] New Zealand is not listed separately; although minimal, it is in this total. (Normally in schedule B.)
[4] Includes Bermuda and Bahamas which are not listed separately. (Normally in schedule B.)
[5] Canada is excluded from OFDI regulations. Therefore, it is necessary to subtract this from total schedule B.
[6] Includes other Middle East countries such as South Yemen. (Normally in schedule A.)
[7] Includes Greece and Turkey which are normally in schedule B.
[8] Royalties and service fees not included.

Note: Totals of all schedules will not equal "Total, all areas" due to "International shipping companies incorporated abroad" being omitted.

Source: U.S. Department of Commerce, Survey of Current Business, September 1966, 1967, and October 1968, Washington, D.C.

TABLE 4.—THEORETICAL LEVELS OF ALLOWED INVESTMENT IN SCHEDULES A, B, C COUNTRIES UNDER EXECUTIVE ORDER 11387

[Dollar amounts in millions]

	Total and average 1965, 1966 investment		Theoretical investment allowed, 1968		Actual 1967 outflows amount
	Total [1]	Average	Percentage average allowed	Amount	
Schedule A total	$1,852	$926.0	110	$1,018.60	$734
Latin America	974	487.0	110	535.70	363
Far East (less Japan)	284	142.0	110	156.20	198
Africa (less Libya, Republic of South Africa)	273	136.5	110	150.15	93
Other oceanic	29	14.5	110	15.95	15
Other Western Hemisphere	292	146.0	110	160.60	65
Schedule B total (excluding Canada)	2,098	1,049.0	65	681.85	1,157
Schedule B total (including Canada)	5,282	2,641.0	65	1,716.65	2,193
Australia	448	224.0	65	145.60	428
Canada	3,184	1,592.0	65	1,034.80	1,036
Japan	148	74.0	65	48.10	112
Libya	−13		65		
Middle East	380	190.0	65	123.50	136
United Kingdom	1,138	569.0	65	369.85	423
Schedule C total	3,093	1,546.5	35	541.27	1,354
Common Market	2,097	1,048.5	35	366.97	857
Other Europe (less United Kingdom)	879	439.5	35	153.82	428
South Africa	117	58.5	35	20.47	69

[1] Includes funds borrowed abroad—$52,000,000 in 1965; $445,000,000 in 1966; and $278,000,000 in 1967. These funds represent funds borrowed abroad and actually used for direct investments. They cannot be broken down by schedules.

Note: All investment outflows shown are calculated as outflows plus reinvested earnings.

Source: Figures computed from figures contained in table 3.

TABLE 5.—EFFECTS OF OFDI CONTROLS ON DIRECT INVESTMENTS,[1] 1964–67

[In millions of dollars]

Line		1964	1965	1966	1967
1	Net U.S. direct investment outflow [2]	2,416.0	3,416.0	3,178.0	2,741.0
	Actual reinvested earnings	1,431.0	1,452.0	1,739.0	1,578.0
	Total, outflows (OFDI basis) [3]	3,847.0	4,958.0	4,917.0	4,319.0
2	110 percent of 1965–66 average allowable outflows for schedule A as per OFDI	1,018.6	1,018.6	1,018.6	1,018.6
3	65 percent of 1965–66 average allowable outflows for schedule B as per OFDI, including Canada	1,716.6	1,716.6	1,716.6	1,716.6
4	65 percent of 1965–66 average allowable outflows for schedule B as per OFDI, excluding Canada	681.9	681.9	681.9	681.9
5	35 percent of 1965–66 average allowable outflows for schedule C as per OFDI	541.3	541.3	541.3	541.3
6	Subtract total funds borrowed abroad and used abroad [4]	−38.0	81.0	625.0	367.0
7	Outflows allowed under OFDI, including Canada, lines 2 plus 3 plus 5 minus 6 equals program effect and total balance-of-payments effect [5]	3,314.5	3,314.5	3,314.5	3,314.5
8	Outflows allowed under OFDI, excluding Canada, lines 2 plus 4 plus 5 minus 6 equals program effect [6]	2,279.8	2,160.8	1,616.8	1,874.8

See attachment for footnotes and source, p. 231.

TABLE 6.—EFFECTS OF NEW IEPA PROPOSAL ON U.S. DIRECT INVESTMENT, 1964-67

[In millions of dollars]

Line		1964	1965	1966	1967
1	Net U.S. direct investment outflows [2]	2,416.0	3,416.0	3,178.0	2,741.0
	Actual reinvested earnings	1,431.0	1,542.0	1,739.0	1,578.0
	Total, net outflows (OFDI basis) [3]	3,847.0	4,958.0	4,917.0	4,319.0
2	Outflows allowed under new IEPA proposal based on average outflows 1964-65 with no outflows allowed in schedule C	1,756.0	1,756.0	1,756.0	1,756.0
3	Outflows allowed under new IEPA proposal, excluding Canada from controls	1,155.5	1,155.5	1,155.5	1,155.5
4	Add reinvested earnings at the residual of average 1964-66 repatriation under our proposal (72 percent against 24 percent)	1,419.9	1,528.8	1,596.6	1,684.8
5	Add reinvested earnings as the residual of average 1964-66 repatriation under our proposal, excluding Canada	949.2	1,020.2	1,071.6	1,125.6
6	Subtract all funds borrowed abroad and used abroad [4]	−38.0	81.0	625.0	367.0
7	Outflows, adjusted, under IEPA new proposal, including Canada, lines 2 plus 4 minus 6 equals program effect and full balance-of-payments effect [5]	3,213.9	3,203.8	2,727.6	3,073.8
8	Outflows, adjusted, under IEPA new proposal, excluding Canada, lines 3 plus 5 minus 6 equals program effect [6]	2,142.7	2,094.7	1,602.1	1,914.1

See attachment for footnotes and source.

ATTACHMENT FOR TABLES 5 AND 6

[1] These are calculated effects of the various proposals on the 1964-67 figures.

[2] These are outflows as listed by the Commerce Department, i.e., direct investment outflows with funds borrowed abroad through security issues and actually used for direct investment—netted out: 1964, not available; 1965, $52,000,000; 1966, $445,000,000; and 1967, $278,000,000.

[3] This figure is provided for comparison only. If represents what the OFDI would consider as outflows.

[4] This represents the sum of funds borrowed and actually used abroad through security transactions plus long-term liabilities—under the assumption that net changes in long-term liabilities of U.S. corporations reflect net proceeds of loans obtained abroad which are immediately transferred to foreign affiliates.

[5] Since all countries throughout the world are included here, this figure represents the IEPA program total net outflows and the total balance-of-payments net outflows for the direct investment sector.

[6] Since Canada is excluded from the calculation of this figure, this represents only the IEPA program total net outflows.

Source for table 5: Calculated from figures contained in table 4.

Source for table 6: U.S. Department of Commerce, "Survey of Current Business," June 1968, p. 29; September 1968, pp. 29 and 31; and October 1968, pp. 25 and 26, Washington, D.C.

TABLE 7.—U.S. MILITARY EXPENDITURES AND SALES, 1958-67

[In millions of dollars]

	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
Expenditures (total)	−3, 435	−3, 107	−3, 087	−2, 998	−3, 105	−2, 961	−2, 876	−2, 945	−3, 735	−4, 340
Continental Western Europe	−1, 485	−1, 362	−1, 351	−1, 291	−1, 423	−1, 327	−1, 311	−1, 304	−1, 388	−1, 401
United Kingdom	−360	−289	−287	−225	−197	−184	−173	−154	−145	−210
Other world	−1, 590	−1, 456	−1, 449	−1, 482	−1, 485	−1, 450	−1, 392	−1, 487	−2, 202	−2, 729
Sales (total)	300	302	335	402	656	657	747	830	829	1, 240
Continental Western Europe	168	173	211	250	521	527	560	460	471	543
United Kingdom	5	8	10	16	18	13	43	56	78	328
Other world	127	121	114	136	117	117	144	314	280	369
Balance (total)	−3, 135	−2, 805	−2, 752	−2, 596	−2, 449	−2, 304	−2, 129	−2, 115	−2, 906	−3, 100
Continental Western Europe	−1, 317	−1, 189	−1, 140	−1, 041	−902	−800	−751	−844	−917	−858
United Kingdom	−355	−281	−277	−209	−179	−171	−130	−98	−67	118
Other world	−1, 463	−1, 335	−1, 335	−1, 346	−1, 368	−1, 333	−1, 248	−1, 173	−1, 922	−2, 360

Source: U.S. Department of Commerce, Balance of Payments Statistical Supplement (revised edition), and Survey of Current Business, June 1968.

TABLE 8.—AVERAGE FINANCIAL TERMS OF OFFICIAL BILATERAL LOAN COMMITMENTS, 1963–66

	Weighted average maturity periods (years)				Weighted average interest rates (percent)			
	1963	1964	1965	1966	1963	1964	1965	1966
Australia								
Austria	20.0	8.8	7.7	6.5	3.0	5.2	5.5	5.7
Belgium	[1]8.7	14.7	10.0	13.9	[1]1.3	2.1	4.8	2.8
Canada	12.5	25.1	30.1	34.3	6.0	4.7	3.8	2.4
Denmark		19.1	13.7	18.7		4.0	5.3	
France	[1](15.0)	[1]15.6	16.6	15.3	[1]4.2	[1]3.2	3.7	3.6
Germany	18.5	18.1	16.9	21.2	4.3	3.9	4.2	3.3
Italy	8.7	9.2	7.3	8.0	6.1	4.3	4.2	3.7
Japan		16.0	12.0	14.1		5.6	4.4	5.2
Netherlands	23.8	24.2	23.9	23.6		3.9	3.5	2.0
Norway		17.0	16.0			4.5	3.0	
Portugal	20.2	16.3	[1]21.5	[1]25.9	3.3	4.1	[1]3.8	[1]3.6
Sweden	20.0	20.0	20.0	20.0	2.0	2.0	2.0	2.0
United Kingdom	21.0	23.9	22.1	23.9	4.8	3.8	3.3	1.0
United States	32.5	33.4	28.0	29.3	2.0	2.5	3.3	3.0
Total DAC countries	[2](24.8)	28.4	22.2	23.5	[2]3.4	3.0	3.6	3.1

[1] Based on gross disbursement data.
[2] Based on incomplete data.

Note: Figures in parentheses ( ) are secretariat estimates.

Source: OECD, "Development Assistance Efforts and Policies," 1966 review, p. 160, 1967 review, p. 76.

Chairman REUSS. Thank you very much, Dr. Danielian, for a most perceptive statement.

Your estimates of the balance-of-payments costs of our foreign aid program contradict rather markedly the estimates made before us yesterday by Administrator Gaud of AID. I do not know whether you were present during his testimony.

Mr. DANIELIAN. Yes; I am aware of it.

Chairman REUSS. If you could address yourself to that discrepancy.

Mr. DANIELIAN. Our figures come from the Department of Commerce Survey of Current Business, and they include the total aid given by the United States, including IDA and the Inter-American Bank, and so on. You will find, if you subtract line 26 from line 1 of the survey of current business, December 1968, page 29, table 5, you will get the outflow of dollars resulting from all foreign aid programs. They do take credit also for repayments, such small repayments as we are receiving now from other countries, for previous loans.

Chairman REUSS. Do your figures give credit to the additional exports produced under the letter of credit procedure, which I believe——

Mr. DANIELIAN. Yes; those are taken into account. These are the net costs as obtained from the Department of Commerce statistics.

Now, the AID agency, as the Defense Department in its presentation yesterday, and as the Treasury Department today, make their own calculations, taking credit for inflows which may appear in other accounts of the balance-of-payments statistics. But actually, the net outflow, according to Department of Commerce statistics, is in the neighborhood of $600 million in 1968 for aid.

Chairman REUSS. That would be subject to whatever offset is obtainable by increased prosperity in the developing countries leading to greater imports from the United States.

Mr. DANIELIAN. Yes; I think there are ancillary economic effects that would not show in the statistics, of course.

Chairman REUSS. Mr. Brock?

Representative BROCK. If we may, I would like to talk a little bit about this international trading corporation that you suggest. Would you just sketch briefly how it might work? Would it be composed of all U.S. exporters involved in a jointly owned operation, or——

Mr. DANIELIAN. No, an individual company would set up an export corporation, taking title to exports at the water's edge, and the profits that accrue to the corporation from the exports. This would be a U.S. corporation, taxable in the United States. Profits accruing to it, instead of being given a 50-percent tax rate, would be given a 35-percent tax rate. The effect of that would be not so much in the net price reductions offered to the customers, because if the rate is calculated, it would come to possibly 1.7 or 2 percent in cost. But it would be in the promotional effort that a company would be inclined to give to that aspect of the business because of the difference in the income tax rate.

Representative BROCK. So each corporation then could set up its own subsidiary, in effect, which would engage only in export trade?

Mr. DANIELIAN. Yes. This would differ from the Western Hemisphere Trade Corp., in that it would not be allowed to invest in property abroad and have a tax advantage there.

Representative BROCK. It would exist only for the purpose of export?

Mr. DANIELIAN. Yes, sir.

Representative BROCK. All right. Now, how does this jibe with existing international agreements? With one of the witnesses we had before us on Monday we were talking about the actual cost of ad valorem and comparable taxes in this country which are not reduced for export goods.

For example, the various manufacturers' taxes. He said that the figure would be somewhere between 2 and 4 percent.

Mr. DANIELIAN. Mr. Surrey; Stanley Surrey?

Representative BROCK. That is right. In light of his statement of the figure of 2 to 4 percent, how do you justify this 2.4-percent tax rate?

Mr. DANIELIAN. But the whole percent would be on the total price of the product.

Representative BROCK. And you figure this is a comparable rate?

Mr. DANIELIAN. No; this is much smaller than that, actually, in terms of price. This is not a reduction of price, this is a reduction of income tax liability.

Representative BROCK. It is an increase in incentive; isn't that what it is?

Mr. DANIELIAN. Yes.

Representative BROCK. Which would make more funds available for promotion and sales and exporting?

Mr. DANIELIAN. I think an allowance or credit or rebate would be greater than this proposition. This proposition is more of an incentive proposition than a reduction in price.

Representative BROCK. I see. That would not come in conflict with the existing international agreements emanating from the GATT——

Mr. DANIELIAN. They are less likely to raise questions about this than they are a direct assault along the lines of the TVA scheme. In other words, if today, we do what Germany did a year ago—increase import duties by 10 percent—and Congress changes the tax system and gives 10 or 11 percent incentive rebate on exports, there would be a tremendous uproar around the world.

Two to four percent, maybe they will not raise so much of an uproar.

On that tax incentive, through this corporation, as I said, if you analyze the arithmetic, it would come to about 1.7- or 2-percent reduction in cost.

Let me give you an example to make it clear: If a company which makes, let us say, 10 cents on the dollar of sale and pays 50 percent of that to the Federal Government because of the 50-percent tax rate, and retains 5 cents on the dollar as net profit, obtains a 14-point reduction in taxes, that would be 1.7 cents more. He will just be making, instead of 5 cents, 6.7 cents.

Representative BROCK. I understand the logic of your case.

Mr. DANIELIAN. Yes; so it is not a tremendous concession in the price of the product, I think, but it will be a great incentive to put more effort into export.

Now, I would not offer this as a substitute or a major realinement of our trade relationship with the Common Market or with Japan in some of these other areas. I would like to see, specifically, a retreat from the international grains arrangement and a rather aggressive reconsideration by representation of the European agricultural policy, because we are being excluded and we simply cannot afford to lose

our agricultural markets in view of the importance in our trade account.

Representative BROCK. I think you are right.

I think you raised another point in balance of payments, and that is the terrific difficulty a representative body such as the Congress has in effecting change in a particular area. When we talk tax incentive for export, that is very appealing to the export industry. It has no appeal whatever to the steel and textile industries, because they are subject to import problems, not export.

I would agree with what you are saying. Theoretically, I think it is a marvelous approach. I think the problem we face in the Congress is that we are going to be under increasing pressure to take rather harsh action in terms of either quotas or border taxes or some impairment device to reduce the impact on the domestic industry of the imports. That is part of the balance-of-payments problem, but it is more of a political problem than a problem of balance of payments.

Mr. DANIELIAN. I am aware of it, and of course, there are serious aberrations taking place in our trade picture. In addition to agriculture, I think steel is another, and automobiles are likely to come up very seriously.

I understand Japan has plans for expansion of auto production of up to 9 million units a year in the next 4 to 5 years. They are going to be looking for markets for them. I understand that registration of automobiles on the west coast from Japanese origin is a very large percentage of total registrations, and that is going to come up.

I think we are going to hear of more problems than we are hearing in the chemical area as time goes on. So we do have a fundamental aberration taking place in our trade relations. But this is a consequence of the fact that we have not changed gears in the last 10 years.

Back in 1960, I gave a statement here on Capitol Hill saying that we are going through a transitional period and we must reevaluate our economic and political policies in this area.

I said that if we adopt instruments of economic policy which do not work, we are going to find ourselves in a very difficult position. If the Defense Department designed and produced a missile and said it is going to fly 5,000 miles and, upon test, you find it only flies 500 miles, you have a bunch of embarrassed generals. But in economic policy, we just seem to adopt one policy after another and if it does work, we either excuse it or forget it and go to another temporary policy.

Now, I think that our trade relationships have to be restructured around the creation of trade blocs. Trade blocs, by their very nature, exclude outsiders and give special favors to insiders. So you have to redefine the concept of a nation under GATT.

What do you mean by a nation? Well, they drafted it so that a trade bloc was considered a nation. But they have it both ways, you see. An individual country is a nation and the group is a nation.

Now, do we redefine the concept of a nation under GATT, or do we redefine the policies that apply to different groups of countries? It seems to me that these trade blocs are tending toward self-sufficiency, and by their very nature they do not seem to accept, really, the international division of labor that is implicit in a free trade economy.

So we cannot continue giving lipservice to policies that are not

working. It seems to me that we simply have to sit down with the EEC and put our cards on the table with regard to trade relations, with regard to balance-of-payments relations, military allocations, and foreign aid, and say, "Fellows, we can afford to keep our troops in here if you buy more grain from us. Or, if you want us to keep our troops here, we cannot afford to buy all these Volkswagens. You have to make a choice?

If you really approach them in that way and say, if you cannot come to an agreement on this, we are going to make some fundamental changes in our policies, it should be possible to talk with reasonable men on the basis of mutual and national interests.

But why we have failed to do this, I just have not been able to understand. I think it has been because our own thinking has been clouded—just as in economics, many people in economic policy are going back to the 1930's, and I belong to that generation, and I know what we went through, and even in banking, I can remember 1929–32, and some of the economic theories I hear now are echoes of that.

In trade policy, we have been thinking in terms of 1945–50 in Western Europe and Japan. We have not really shifted our thinking to the new world that is emerging and the elements of this new world are transferability of resources, technology, know-how, capital, and the emergence of trading blocs which want to be self-sufficient and exclude outsiders. We have to redefine the areas of trade and, through negotiation, reduce trade imbalances.

But what is the quickest way to come to free trade? It is not necessarily a repeating of slogans of the past. You have to have the negotiating power to accomplish it.

Representative BROCK. I fully concur. I think we have the negotiating power today, but if we do not do something about it, I am afraid we will lose that negotiating power. I concur in your statement very strongly.

Thank you, sir.

Chairman REUSS. What I like about your approach, of course, is that you move across the board in the direction of freedom. You say that on trade, we have not yet really backtracked and let us not; in tourism, though, we have flirted with controls: we have not adopted them; let us not. And where we have adopted controls over investment and lending, we should make that the focus of our first attempt at moving back in the direction of freedom.

On the relaxation of investment controls, you have offered an interim or transitional arrangement that you think at least would prevent untoward flights of American capital, which could be discombobulating.

In fact, let me suggest an argument in favor of your of your position that you have not explicitly made. Probably any relaxation of investment controls which we made at this juncture would be in consultation with and at the behest of certain foreign countries—you have pointed out that the Belgians and the Spanish have officially asked us to relax them, that France seems to have withdrawn much of his objection of several years ago.

To the extent that a relaxation of controls on capital investment abroad were made at the behest of foreign countries, if this action did result in somewhat larger short-term capital outflow than we now have, we would be, to some degree, insulated against criticism by for-

eign countries of our deteriorating balance-of-payments position, would we not?

Because we would have removed these controls at their total or partial behest.

Mr. DANIELIAN. Yes; I think so. I am of the impression that in December of 1967, at Basel, they perhaps read the riot act to us that we had to do something immediately, and we did on January 1. Many things have happened in Europe since, and certainly security of dollars is much more appealing to them now than many of their own currencies. So I think that the official as well as popular attitudes have changed. I am sure that through consultation, we will find that there will not be any objection.

Now, that does not mean to say that we are not going to have a problem of increased dollar liabilities. But the answer to that problem is not in this area. The answer to that problem is, again, in earning, let us say, $500 million more in grain exports and sharing the troop costs with the NATO countries for another $800 million.

In that way, you can shore up your balance of payments—and you are not going to accomplish this by tampering with the private economy.

So it seems to me we would be in a strong moral position with these countries if we looked at the controls after consultation with them.

Chairman REUSS. Do you think it would be feasible to lift them with respect to countries that want them lifted and retain them with respect to countries that will not make a representation to us? After all, that is, in effect, what we have done with Canada, Japan, the less-developed countries as it is.

Mr. DANIELIAN. Yes.

Chairman REUSS. And there is something to be said for the position that if France, for example, still does not want the amount of American investment in France that obtained in the recent past, we should respect that.

Mr. DANIELIAN. As you know, Mr. Chairman, I was in Europe in September and October and I looked into this question. I was told by a very high official of the European Community that whereas in the past, France representatives, used to urge their colleagues in various committees of the EEC to agree to a limitation of foreign investments, that particular theme song is now very quiet and there is not the same aggressiveness as there used to be in the past.

I was also informed by a very high banking official in Paris that he does not know of any investment proposal in France that has been rejected in the past several years. As long as the investment proposal fits with the plan of the French Government with respect to location and so on and fits with the general plan for economic development, there has been no rejection of investments in France.

So to answer your first question, of course, if one member of the Common Market, such as Belgium, allows investment, it becomes

difficult for another member to turn his back on the proposal because of intra-EEC competition. But it seems to me I do not see why we should penalize Belgium, which also has problems of reemployment in various depressed areas. If Belgium wants the controls lifted, why not lift them for Belgium and for Spain?

Then let the French and the German Governments take that factor into consideration as to redefining their attitude on the whole proposal.

Representative BROCK. If the gentleman would yield, would that not be a pretty nice way of easing out of this whole control situation on a gradual basis, rather than a total abolition of controls? Would not this soften the blow rather dramatically and still achieve our objective, which I am sure we all want, of trying to get out from under these controls?

Mr. DANIELIAN. Mr. Brock, I may say in our group, there is no one who wants to be responsible for a massive outflow of capital, and there is no one who wants to be responsible for an international financial crisis. Therefore, we are adopting this attitude of gradualism, and our statistical studies indicate that total elimination of controls may mean at least a billion dollars more of outflow on the basis of what existed as an average in the period 1965 to 1967—$1 billion if it is eliminated on the basis of what was happening at that time.

The results may be advantageous to us if this gradual approach is adopted.

Representative BROCK. You might have less of an outflow than is currently taking place?

Mr. DANIELIAN. Yes. I think tables 5 and 6 will indicate that.

Representative BROCK. Thank you.

Chairman REUSS. Did you have any further questions?

Representative BROCK. No.

Chairman REUSS. In conclusion, Dr. Danielian, I think it would be most helpful if you would be good enough, if you could address yourself to Mr. Gaud's testimony, particularly his computation of balance-of-payments costs of foreign aid, particularly with regard to additionality and perhaps append at this point in the record some analysis of the rather sharp discrepancy between your $600 million estimate and his estimate.

Would that be an imposition on you?

Mr. DANIELIAN. Not at all, Mr. Chairman, we shall be glad to do that.

(Mr. Danielian subsequently provided the following letter and tables for the reord:)

INTERNATIONAL ECONOMIC POLICY ASSOCIATION,
Washington, D.C., January 21, 1969.

Hon. HENRY REUSS,
Chairman, Subcommittee on International Exchange and Payments, Joint Economic Committee, U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN REUSS: On January 15, 1969 at the conclusion of my appearance before your Subcommittee on International Exchange and Payments you asked me to address myself to the discrepancy between Mr. Gaud's testimony of January 14, 1969 in reference to the net foreign exchange cost of the aid program and our own estimate. Mr. Gaud estimates 1968 gold or foreign exchange outflows of AID at $178 million. We stated that total U.S. aid outflows are closer to $600 million. You also asked me to focus on additionality.

First of all, with respect to additionality, the AID Agency has made considerable progress over the years in increasing U.S. exports in conjunction with aid. In absolute amounts, the figures indicate that expenditures on U.S. merchandise have risen. Mr. Gaud claims that an examination of the aggregate U.S. commercial exports to aid-receiving countries would show that substitution has been small; therefore, additionality has been high, in the aggregate, 98 percent. As the statistical studies on which this estimate is based are not available to us, we are not able to comment on it. Our observations in South America do not sustain the general conclusion, nor do the statistics pertaining to South East Asia.

Concerning the foreign exchange cost of our aid program, Administrator Gaud is concerned in his tabulations with his own particular agency. Our estimate of the net exchange costs of our foreign assistance refers to our total government grants and loans in the aid field. This would include receipts and/or expenditures for P.L. 480 and the Inter-American Development Bank, including not only the Social Progress Trust Fund but also our 75 percent share in the Fund for Special Operations and our portion of the funding for Ordinary Capital. Our figures also include expenditures under the Export-Import Bank Act, capital subscriptions to international and regional organizations such as IDA and the United Nations Development Fund (excluding the IMF), and principal repayments and interest payments from those various programs.

Our figure, therefore, is in relation to total aid given by the United States as calculated in our balance of payments statistics. Exhibit I and Exhibit II attached hereto show total U.S. aid by category, by program, and by disposition. As can be seen, Line A1 is the total U.S. Government grants and transactions increasing government assets, and Line A26 shows the estimated transactions involving no direct dollar outflow from the United States. This last figure takes into account expenditures on U.S. merchandise and services, and receipts of interest on other U.S. aid loans. In subtracting Line A26 from Line A1 you arrive at the estimated dollar payments to foreign countries and international and regional organizations through U.S. Government grants and transactions increasing government assets, which is Line A34. Our $600 million figure is based on the first three quarters of 1968 projected at an annual rate.

These statistics, as set forth in the enclosed exhibits, are included in the total U.S. balance of payments. Therefore, I feel that there is no real discrepancy between Mr. Gaud's figures and ours because his figure pertains to his organization and our figures are the absolute total of all U.S. aid.

I hope that this adequately answers the questions you posed to me.

Sincerely yours,

N. R. DANIELIAN, *President.*

(Further comment on this subject was later received from AID:)

COMPARISON OF A.I.D. GOLD BUDGET ESTIMATE WITH THOSE GIVEN IN THE TESTIMONY OF N. R. DANIELIAN

A.I.D.'s gold budget data are not directly comparable to those of Mr. Danielian's derived from the *Survey of Current Business*. A.I.D.'s figures are roughly equivalent to net outflows under the Foreign Assistance Act only as defined in the *Survey of Current Business* while Mr. Danielian's are for all non-military programs.

In addition, however, A.I.D.'s gold budget statistics, which are compiled for all government agencies by the Bureau of the Budget, do differ from outflows recorded under the Foreign Assistance Act by the Department of Commerce. The major differences are:

(1) that BOB recognizes expenditures by International Organizations in the United States as legitimate offsets against voluntary contributions by the United States to these organizations, whereas the Department of Commerce does not; and

(2) unlike the Department of Commerce, BOB also recognizes A.I.D.'s use of excess and near-excess currencies as an offset to A.I.D.'s overseas payments. A.I.D.'s estimate $178 million adheres to the BOB conventions.

FEBRUARY 12, 1969.

Chairman REUSS. Thank you.

If there are no further questions, we want to express our appreciation for your great help, as always, to this subcommittee.

The hearings of the Subcommittee on International Exchange and Payments will now stand adjourned.

(Whereupon, at 3:10 o'clock p.m., the subcommittee adjourned.)

[Exhibit tables submitted by Dr. Danielian follow on the next four pages.]

Exhibit I. Survey of Current Business

TABLE 5.—MAJOR U.S. GOVERNMENT TRANSACTIONS

[Millions of dollars]

Line	Transactions	1960	1961	1962	1963	1964	1965	1966	1967 Total	1967 I	1967 II	1967 III	1967 IV	1968 I [1]
A. 1	U.S. Government grants (excluding military) and transactions increasing Government assets, total (table 1, lines 29, 42, and 43, with sign reversed)	3,405	4,053	4,293	4,565	4,281	4,241	4,676	5,191	1,333	1,430	1,144	1,284	1,449
1a	Seasonally adjusted									1,394	1,305	1,226	1,266	1,510
	BY CATEGORY													
2	Grants, net	1,664	1,853	1,919	1,917	1,888	1,808	1,910	1,800	485	509	445	361	387
3	Credits repayable in foreign currencies	525	759	862	726	885	739	354	776	574	100	49	54	408
4	Other foreign currency assets (excluding administrative cash holdings), net	573	220	228	434	49	50	265	−198	−392	131	−32	94	−140
	Receipts from—													
5	Sales of agricultural commodities	1,186	1,133	1,084	1,215	1,312	981	844	740	198	243	137	162	261
6	Interest	69	74	114	147	168	183	181	171	42	50	36	43	44
7	Repayments of principal	22	50	61	92	88	91	119	173	36	84	28	25	37
8	Reverse grants	27	24	15	15	7	2	1	2	(2)	1	1	(2)	1
9	Other sources	41	29	67	70	23	53	17	20	2	16	1	2	2
	Less disbursements for—													
10	Grants in the recipient's currency	179	262	372	393	530	336	387	218	45	76	63	33	54
11	Credits in the recipient's currency	312	490	448	420	648	573	232	679	544	74	28	34	364
12	Other grants and credits	44	59	19	27	23	12	7	7	2	2	1	2	4
13	Other U.S. Government expenditures	238	278	275	265	349	340	270	401	78	109	143	70	62
14	Capital subscriptions to international and regional organizations, excluding IMF	153	172	122	62	112		−101	194	33	42	77	41	38
15	Credits repayable in U.S. dollars	516	1,008	1,146	1,413	1,378	1,715	2,248	2,574	672	639	578	686	735
16	Other assets (including changes in administrative cash holdings), net	−26	41	16	13	−30	−70	(2)	45	−39	9	27	48	20
	BY PROGRAM													
17	Under farm product disposal programs	1,278	1,351	1,503	1,670	1,765	1,484	1,396	1,315	339	428	246	302	391
18	Under Foreign Assistance Acts and related programs	1,657	1,791	1,949	2,172	2,027	2,157	2,274	2,273	685	532	544	512	533
19	Under Export-Import Bank Act	406	822	621	509	337	533	909	1,229	269	337	281	342	400
20	Capital subscriptions to international and regional organizations excluding IMF	153	172	122	62	112		−101	194	33	42	77	41	38
21	Other assistance programs	21	27	111	100	149	153	158	167	42	44	42	40	48
22	Other foreign currency assets acquired (lines A.6 A.7 and A.9)	132	153	243	309	279	327	316	364	80	149	66	70	83
23	Less foreign currencies used by U.S. Government other than for grants or credits (line A.13)	238	278	275	265	349	340	270	401	78	109	143	70	62
24	Advances under Exchange Stabilization Fund agreements net	−5	23	19	26	−30	−18	−8	−27	−1	−24	−1	−1	−1
25	Other (including changes in administrative cash holdings) net	1	−7	−1	−18	−9	−55	2	78	−35	32	32	48	19
	BY DISPOSITION [3]													
26	Estimated transactions involving no direct dollar outflow from the United States	2,280	2,910	3,250	3,752	3,590	3,524	3,942	4,461	1,162	1,247	954	1,098	1,297
27	Expenditures on U.S. merchandise	2,046	2,396	2,503	2,882	3,032	2,952	3,152	3,523	966	933	790	834	934
28	Expenditures on U.S. services [4]	368	497	670	785	690	748	798	750	172	204	191	183	207

25-765—69——17

Line	Item	Col 1	Col 2	Col 3	Col 4	Col 5	Col 6	Col 7	Col 8	Col 9	Col 10	Col 11	Col 12	Col 13
29	Military sales contracts financed by credits (including short term, net)[5] (line B.4)	26	33	13	36	16	90	291	390	99	111	81	100	126
30	U.S. Government credits to repay prior U.S. Government credits[4]	37	71	100	186	151	154	162	178	40	84	29	25	61
31	U.S. Government credits to repay prior U.S. private credits		111	93	34		5	14	104	1	37	30	37	39
32	Increase in claims on U.S. Government associated with Government grants and transactions increasing Government assets (including changes in retained accounts) (line B.7)	41	80	147	94	49	−86	−205	−85	−38	−12	−23	−12	−8
33	Less foreign currencies used by U.S. Government other than for grants or credits (line A.13)	238	278	275	265	349	340	270	401	78	109	143	70	62
34	Estimated dollar payments to foreign countries and international and regional organizations through U.S. Government grants and transactions increasing Government assets	1,125	1,144	1,042	813	691	717	734	731	171	184	190	186	152
B. 1	U.S. Government liabilities associated with specific transactions (table 1, line 56); net increase (+)	26	85	614	443	489	197	129	−16	93	106	−55	−160	−39
1a	Seasonally adjusted									78	140	−102	−132	−54
2	Associated with military sales contracts[6]	−16	4	470	347	233	306	346	64	102	106	−28	−116	−13
2a	Seasonally adjusted									95	147	−67	−111	−20
3	U.S. Government recipts from foreign governments (including principal repayments on credits financing military sales contracts), net of refunds	319	399	1,139	994	987	1,080	927	1,023	347	397	112	167	185
4	Plus military sales contracts financed by U.S. Government credits[7] (line A. 29)	26	33	13	36	16	90	291	390	99	111	81	100	126
5	Less U.S. Government receipts from principal repayments	26	25	26	26	24	34	43	110	16	24	15	55	25
6	Less transfers of goods and services (including transfers financed by credits) (table 1, line 4)	335	402	656	657	747	830	829	1,240	328	377	206	328	299
7	Associated with U.S. Government grants and transactions increasing Government assets (line A. 32)	41	80	147	94	49	−86	−205	−85	−38	−12	−23	−12	−8
7a	Seasonally adjusted									−38	−12	−23	−12	−8
8	Non-interest-bearing securities issued to IDA	58	58	36	13	15	−79	−75	−25	−25				
9	Non-interest-bearing securities issued to IDB		25	100		25		−150						
10	Non-interest-bearing securities issued to U.N. for special programs				43	30	−14	−41	−17	−12		−5		
11	Foreign funds retained in U.S. Government accounts for purchases in the United States			4	36	−15	10	61	−43	−1	−12	−18	−12	−8
12	Other	−17	−2	7	2	−7	−2	(2)	(2)	(2)	(2)	(2)	(2)	(2)
13	Associated with other specific transactions	1	(2)	−3	2	207	−24	−12	5	30	12	−4	−33	−19
13a	Seasonally adjusted									22	5	−12	−10	−27
14	Purchase of Columbia River downstream power rights					204	−30	−30	−30				−30	
15	U.S. Government nonmilitary sales and miscellaneous operations	1	(2)	−3	2	3	6	−4	15	1	15	−2	1	−2
16	Nonmarketable, nonconvertible U.S. Government obligations to be liquidated against U.S. claims							22	20	29	−4	−2	−4	−17
C. 1	Foreign holdings of nonmarketable, nonconvertible medium-term U.S. Government securities not associated with specific transactions (table 1, line 57); net increase (+)			251	−56	−23	−7	−49	469	(2)	(2)	335	135	273
2	Export-Import Bank Portfolio Certificates of Participation				18	−3	−7	−3	19	(2)	(2)	10	10	48
3	U.S. Treasury securities not included elsewhere[8]			251	−74	−20	(2)	−46	450	(2)		325	125	225

[1] Preliminary.
[2] Less than $500,000 (±).
[3] As reported by the operating agencies.
[4] Line A.28 includes foreign currency collected as interest and line A.30 includes foreign currency collected as principal, as recorded in lines A.6 and A.7.
[5] Consists of transfers of military goods and services financed by U.S. Government credits and of advance payments to the Defense Department (on military sales contracts) financed by credits extended to foreigners by U.S. Government agencies.
[6] Transactions under military sales contracts are those in which the Defense Department sells and transfers military goods and services to a foreign purchaser, on a cash or credit basis. The entries for the several categories of transactions related to military sales contracts in this and the other tables are partially estimated from incomplete data.
[7] Consists of transfers of military goods and services financed by U.S. Government credits (include in line B.6) and of increases in Defense Department liabilities (on military sales contracts) which arise from advance payments to the Defense Department financed by credits to foreigners by U.S Government agencies.
[8] Includes securities payable in U.S. dollars and in convertible foreign currencies.

Note: Details may not add to totals because of rounding.

Source: U.S. Department of Commerce, Office of Business Economics.

EXHIBIT II. SURVEY OF CURRENT BUSINESS

TABLE 5.—MAJOR U.S. GOVERNMENT TRANSACTIONS

[In millions of dollars]

Line	Transactions	1967 Total	1967 I	1967 II	1967 III	1967 IV	1968 I	1968 II[1]	1968 III[2]
A. 1	U.S. Government grants (excluding military) and transactions increasing Government assets, total (table 1, lines 29, 42, and 43, with sign reversed)	5,191	1,333	1,430	1,144	1,284	1,419	1,508	1,178
1a	Seasonally adjusted		1,394	1,305	1,226	1,266	1,510	1,384	1,261
	BY CATEGORY								
2	Grants, net	1,800	485	509	445	361	393	469	411
3	Credits repayable in foreign currencies	776	574	100	49	54	383	78	32
4	Other foreign currency assets (excluding administrative cash holdings), net	−198	−392	131	−32	94	−138	71	13
	Receipts from—								
5	Sales of agricultural commodities	740	198	243	137	162	261	170	61
6	Interest	171	42	50	36	43	44	55	50
7	Repayments of principa	173	36	84	28	25	37	31	36
8	Reverse grants	2	(3)	1	1	(3)	1	1	2
9	Other sources	20	2	16	1	2	6	6	10
	Less disbursements for—								
10	Grants in the recipient's currency	218	45	76	63	33	54	52	45
11	Credits in the recipient's currency	679	544	74	28	34	368	53	16
12	Other grants and credits	7	2	2	1	2	2	1	6
13	Other U.S. Government expenditures	401	78	109	143	70	63	86	79
14	Capital subscriptions to international and regional ogranizations, excluding IMF	194	33	42	77	41	38	45	17
15	Credits repayable in U.S. dollars	2,574	672	639	578	686	753	802	735
16	Other assets (including changes in administrative cash holdings), net	45	−39	9	27	48	19	46	−30
	BY PROGRAM								
17	Under farm product disposal programs	1,315	339	428	246	302	406	419	166
18	Under foreign assistance acts and related programs	2,273	685	532	544	512	515	573	583
19	Under Export-Import Bank Act	1,229	269	337	281	342	400	382	305
20	Capital subscriptions to international and regional organizations, excluding IMF	194	33	42	77	41	38	45	17
21	Other assistance programs	167	42	44	42	40	48	48	120
22	Other foreign currency assets acquired (lines A.6, A.7, and A.9)	364	80	149	66	70	88	92	96
23	Less foreign currencies used by U.S. Government other than for grants or credits (line A.13)	401	78	109	143	70	63	86	79
24	Advances under Exchange Stabilization Fund agreements, net	−27	−1	−24	−1	−1	−1	−1	−1
25	Other (including changes in administrative cash holdings), net	78	−35	32	32	48	18	37	−29
	BY DISPOSITION[4]								
26	Estimated transactions involving no direct dollar outflow from the United States	4,461	1,162	1,247	954	1,098	[1]1,323	1,308	1,069
27	Expenditures on U.S. merchandise	3,523	966	933	790	834	[1]949	925	775

28	Expenditures on U.S. services[5]	750	172	204	191	183	[1] 223	224	201
29	Military sales contracts financed by credits (including short term, net)[6] (line B.4)	390	99	111	81	100	115	175	130
30	U.S. Government credits to repay prior U.S. Government credits[5]	178	40	84	29	25	61	31	36
31	U.S. Government credits to repay prior U.S. private credits	104	1	37	30	37	43	24	6
32	Increase in claims on U.S. Government associated with Government grants and transactions increasing Government assets (including changes in retained accounts) (line B.7)	−85	−38	−12	−23	−12	−5	15	(3)
33	Less foreign currencies used by U.S. Government other than for grants or credits (line A.13)	401	78	109	143	70	63	86	79
34	Estimated dollar payments to foreig ncountries and international and regional organizations through U.S. Government grants and transactions increasing Government assets	731	171	184	190	186	[1] 126	199	108
B. 1	U.S. Government liabilities associated with specific transactions (table 1 line 56); net increase (+)	−16	93	106	−55	−160	−46	−44	−27
1a	Seasonally adjusted	-----	78	140	−102	−132	−61	6	−96
2	Associated with military sales contracts[7]	64	102	106	−28	−116	−22	−60	−73
2a	Seasonally adjusted	-----	95	147	−67	−111	−29	−3	−136
3	U.S. Government receipts from foreign governments (including principal repayments on credits financing military sales contracts) net of refunds	1,023	347	397	112	167	185	282	145
4	Plus military sales contracts financed by U.S. Government credits[8] (line A.29)	390	99	111	81	100	115	175	130
5	Less U.S. Government receipts from principal repayments	110	16	24	15	55	24	99	6
6	Less transfers of goods and services (including transfers financed by credits) (table 1 line 4)	1,240	328	377	206	328	299	419	342
7	Associated with U.S. Government grants and transactions increasing Government assets (line A.32)	−85	−38	−12	−23	−12	−5	15	(2)
7a	Seasonally adjusted	-----	−38	−12	−23	−12	−5	15	(3)
8	Non-interest-bearing securities issued to IDA	−25	−25	-----	-----	-----	-----	-----	-----
9	Non-interest-bearing securities issued to IDB	-----	-----	-----	-----	-----	-----	-----	-----
10	Non-interest-bearing securities issued to U.N. for special programs	−17	−12	-----	−5	-----	-----	-----	-----
11	Foreign funds retained in U.S. Government accounts for purchases in the United States	−43	−1	−12	−18	−12	−5	15	(3)
12	Otoer	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)
13	Associated with other specific transactions	5	30	12	−4	−33	−19	1	46
13a	Seasonally adjusted	-----	22	5	−12	−10	−27	−6	38
14	Purchases of Columbia River downstream power rights	−30	-----	-----	-----	−30	-----	-----	-----
15	U.S. Government nonmilitary sales and miscellaneous operations	15	1	15	−2	1	−2	1	49
16	Nonmarketable U.S. Government obligations to be liquidated against U.S. claims	20	29	−4	−2	−4	−17	-----	−2
C. 1	Foreign holdings of nonmarketable medium-term U.S. Government securities payable before maturity only under special conditions, not associated with specific transactions (table 1 line 57); net increase (+)	469	(3)	(3)	335	135	273	772	409
2	Export-Import Bank portfolio certificates of participation	19	(3)	(3)	10	10	48	(3)	-----
3	U.S. Treasury securities not included elsewhere[9]	450	(3)	-----	325	125	225	773	409

[1] Revised.
[2] Preliminary.
[3] Less than $500,000 (±).
[4] The identification of transactions involving direct dollar outflow from the United States is made by the operating agency. Data for 2d and 3d quarters 1968 are based on the extrapolations by OBE.
[5] Line A.28 includes foreign currency collected as interest and line A.30 includes foreign currency collected as principal, as recorded in lines A.6 and A.7.
[6] Consists of transfers of military goods and services financed by U.S. Government credits and of advance payments to the Defense Department (on military sales contracts) financed by credits extended to foreigners by U.S. Government agencies.
[7] Transactions under military sales contracts are those in which the Defense Department sells and transfers military goods and services to a foreign purchaser, on a cash or credit basis. The entries for the several categories of transactions related to military sales contracts in this and the other tables are partially estimated from incomplete data.
[8] Consists of transfers of military goods and services financed by U.S. Government credits (included in line B.6) and of increases in Defense Department liabilities (on military sales contracts) which arise from advance payments to the Defense Department financed by credits to foreigners by U.S. Government agencies.
[9] Includes securities payable in U.S. dollars and in convertible foreign currencies.

Note: Details may not add to totals because of rounding.

Source: U.S. Department of Commerce, Office of Business Economics. Quarterly statistics, 1960–67, for sec. A of table 5 and for table D are presented in "Foreign Grants and Credits by the U.S. Government," issue No. 80. This report also includes a detailed enumeration, by country, of the transactions included in line 45 of table 1 for all quarters 1959–67 and other information for 1965–67 supplementing table 5 and lines 13, 28–29, and 41–45 of table 1. Copies of this report are available free, as long as the supply lasts, by request from the Office of Business Economics (BE-50), U.S. Department of Commerce, Washington, D.C. 20230.

Appendix I

CHILD & WATERS, INC.,
New York, N.Y., January 14, 1969.

Congressman HENRY S. REUSS,
Chairman, Joint International Exchange and Payments Subcommittee, House Office Building, Washington, D.C.

DEAR HENRY: It is my understanding that you are conducting hearings on the balance of payments program as recommended to the new Administration.

I have prepared the attached statement on the possibility of expanding, substantially, the tourism earnings of the United States during the next five years. Perhaps this statement would be useful for inclusion in the report you will prepare as the result of these hearings.

With warm personal regards.

Sincerely,

SOMERSET R. WATERS,
President, Child & Waters, Inc.

TOURISM—A PRACTICAL WAY FOR THE UNITED STATES TO INCREASE ITS FOREIGN EXCHANGE EARNINGS BY $2.2 BILLION ANNUALLY

Within five years the United States could be earning an extra $2.2 billion per year if the U.S. government would follow the example of a number of other governments who have discovered the remarkable potential of tourism as a way to ease balance of payments difficulties.

In 1961 Congress passed the "International Travel Act of 1961." This act called on the government to "develop, plan and carry out a comprehensive program designed to stimulate and encourage travel to the United States" and to "encourage the development of tourist facilities and low cost unit tours and other arrangements within the United States for meeting the requirements of foreign visitors." Unfortunately, Congress has failed to appropriate the funds necessary to carry out the intention of this act.

Despite the meager encouragement on the part of government to the development of America's tourism potential, U.S. earnings from foreign visitors since the passage of the International Travel Act have increased from $0.99 billion in 1961 to $1.88 billion in 1967, an increase of 90%. During this same period exports of merchandise have increased only 40%. Thus, with only minimum encouragement, earnings from tourism have shown a rate of growth of more than double that of merchandise exports.

This year (1968) the United States earned $2 billion from catering to foreign tourists. This is more than earned by any other country in the world. Except for the export of automotive vehicles and parts, which amounted to $2.5 billion in 1967, no other single U.S. export commodity exceeds tourism as an earner of foreign exchange. The aircraft manufacturing industry earned $1.5 billion, exporters of wheat earned $1.2 billion, power generating machinery exports amounted to $1.0 billion, but tourism produced earnings of $1.8 billion in 1967 and could earn $4.2 billion annually within five years if properly stimulated.

An Industry-Government Task Force under the chairmanship of Ambassador Robert M. McKinney has recommended a congressional appropriation of $30 million to launch a comprehensive U.S. program to attract foreign visitors. At the present time the travel development program now administered by the Department of Commerce has a budget of $4.5 million.

A successful program to develop the full potential of America's tourism resources would require new measures to involve the individual states or regions of the U.S. in the promotion of tourism. America is too large and too diverse to be promoted as a single destination.

Many departments of government are involved in the business of developing our tourism resources. The Department of Commerce is charged with overseas promotion; the Department of the Interior has responsibility for administer-

ing parks, outdoor recreation and historic sites; the Department of Transportation is responsible for transport policy; the State Department issues visas. Once a comprehensive program for tourism development is created it may be necessary to establish a small one-man office in the Executive Office of the President to monitor the program and coordinate the activities of the various government agencies.

There is much the travel industry can contribute to the success of such a program if government is ready to provide leadership. The National Association of Travel Organizations has recently been reorganized and strengthened. It has pledged itself to support the government efforts to greatly expand the flow of foreign visitors to the United States.

In summary, the techniques of developing a nation's tourism resources are well known and have proved successful for many countries. The U.S. travel industry stands ready to support a comprehensive government program of travel development. Such a program would require a government appropriation of about $30 million annually for a 5-year period. It can be predicted with considerable confidence that a properly administered tourism development program would, within a 5-year period, increase U.S. foreign exchange earnings by at least $2.2 billion annually.

SCANDINAVIAN AIRLINES SYSTEM, INC.,
OFFICE OF THE PRESIDENT,
New York, January 10, 1969.

Hon. HENRY REUSS,
Chairman, Subcommittee on International Exchange and Payments, Joint Economic Committee, U.S. Congress, Washington, D.C.

MY DEAR MR. REUSS: In view of your Sub-Committee's evaluation of the effectiveness of steps taken by the United States Government to deal with the balance of payments problem, you may wish to have the latest available information on the support being given to the "Visit USA" effort by the European airlines who serve this country.

The enclosed data have been compiled by the European Airlines Research Bureau at Brussels, of which seventeen companies are members. While EARB has no direct representation in this country, I know that these colleague airlines would joint with me as the senior representative in this country in hoping that this material can be included in the record of your hearings as evidence of their understanding of the problem and their desire to assist in a proper solution.

We believe that this material bears directly on the point of your own studies, because it demonstrates the very considerable international support for the United States Government's position that deficits in the American tourist account are best adjusted by constructive steps to increase the flow of tourism to America. In many ways, the catalyst of our efforts to make the Atlantic a two-way street with evenly balanced traffic has been the United States Travel Service, and much of the activity recorded in the enclosed has been carried out in very close cooperation with USTS. The testimony of the Department of Commerce will undoubtedly call to your attention the further fact that two European airlines—Alitalia and SAS—are further contributing directly to the funding of USTS work in their areas.

The single fact that the European airlines are spending at a rate almost $1,000,000 a month to promote travel to the United States may be important to your study. Expenditures of this magnitude are not lightly committed and can be justified only by a strong belief that they will develop a significantly larger volume of traffic to this country. The record of the past several years indicate that the flow of European tourists to America is already growing at a much greater rate than that of American tourists to Europe, and we fully expect that this trend, if properly encouraged, will continue to the point of actual balance. Thus, we are able to say to the Sub-Committee in good conscience that we have staked at least $22,000,000 in 1968–69 on our conviction that the promotion of greater traffic to America is the best and most promising solution to any balance of payments difficulty which may exist in the field of tourism.

Since air travel and tourism are only part of the complex of international commercial and monetary relationships, I am taking the liberty of sending you as well an earlier EARB study of North Atlantic air travel and commerce which may have escaped your notice. The statistics are not completely up-to-date, but we believe that the conclusions remain valid.

Thank you very much for your consideration.

Sincerely yours,

TORE H. NILERT.

(The following brochure was published by the European Airlines Research Bureau, Brussels, Belgium, September 1968:)

EUROPEAN TRAVEL TO U.S.A.

HIGHLIGHTS OF THE 1968 PROMOTION OF EUROPEAN TRAVEL TO THE UNITED STATES BY THE EARB MEMBER AIRLINES

Ten million dollars have been provided by the E.A.R.B. North Atlantic operators for the promotion in 1968 of European travel to the U.S.A. Expenditure budgeted for this purpose in 1969 is expected to reach 12 million U.S. dollars. It may be noted in passing that this total of 22 million dollars for the two years—1968 and 1969—represents a 16 percent increase on the budget provisions originally made for these years and reported in documentation released earlier this year (Press Release and Note G.400 issued in February 1968).

At this stage, fully comprehensive information on the proportion of the 1968 budgets already committed or actually spent is not yet available. For this promotion covers a wide range of activities and is spread over such different periods that it is difficult to draw up the aggregate of the expenses so far incurred. However, latest data available from various carriers indicate that expenditure incurred for this promotion up to June this year, already amounted to between 45-75 percent of the budget provisions made for 1968. Nor can the effectiveness of the airlines' promotional efforts be measured at present with any degree of accuracy. If, in normal circumstances, the impact of specific advertising and publicity is difficult to assess, this is even more so in the present fluctuating situation affected by a number of economic and political factors and events on both sides of the Atlantic which are outside the carriers' control.

It should nevertheless be emphasized that the long term effect and success of the "Visit the U.S.A." campaign launched by the European airlines will depend, to a large extent, on the efficacy of the steps taken in the U.S.A. to make travel in America economically more attractive to Europeans. It is therefore hoped that measures—such as hotel and transport discounts and other facilities—sponsored by the U.S. Authorities and various American organizations concerned with tourism, will be implemented systematically.

The European scheduled airlines have attacked the problem of stimulating the European public's interest in visiting the U.S.A. along a broad front of promotional activity. This is best illustrated by the following summary yet incomplete listing of some specific promotional activities by nine E.A.R.B. North Atlantic operators (representing 74% of the Europe-U.S. traffic carried by E.A.R.B. member airlines).

1. Distribution of publicity material up to June 1968 by nine E.A.R.B. airlines:

72,730 copies of 44 different posters have been circulated.

Over 3,283,000 copies of 226 different folders, brochures and guide books have been distributed, of which 121,000 copies of special discount booklets and directories went to travel agents.

541,000 promotional letters have been addressed to prospective travellers.

Thus, over 3,800,000 copies of various publicity materials ranging from posters to individual letters were put in circulation by nine E.A.R.B. airlines during the first part of 1968.

Large numbers of "U.S. hospitality" and "Discover America Passports" were made available. Five E.A.R.B. carriers alone distributed as many as 309,000 U.S. hospitality cards. In addition 45,000 U.S. hotel guides, 50,000 Holiday Inn passports and 45,000 Discover America buttons were issued.

2. Advertising in newspapers and magazines: Travel to the U.S. has been advertised in 291 newspapers and in 101 magazines reaching out to more than 142 million readers. Of these, newspaper readership accounted for 111 million.

3. Films, radio and television programmes:

42 different films were produced and projected at 217 locations with a total estimated audience of at least 200,000.

There were 196 radio spots and broadcasts and 35 television programmes.

4. Window displays: Over 4,300 window displays were installed at 2,700 points of sale.

5. Special "U.S. Weeks": Special "U.S. Weeks" were organised at 18 different locations.

6. Seminars and educational tours for travel agents:

In total, 122 such seminars have been held and were attended by about 5,000 agents.

In addition, 17 educational tours to the U.S. have taken place with the participation of 328 agents and airline personnel.

7. Tour programmes advertised: The interest and travel motivation of Europeans have been further stimulated by the organisation of 467 different tour programmes, for which a total of 2,760 tours is scheduled.

8. Examples of special airline's campaigns. The following are some typical examples of special campaigns launched by E.A.R.B. airlines:

One special action consisted of a "U.S. holiday tie-in" with a chain of super-markets. This resulted in the exposure of the "Visit the U.S." message at 1,000 retail points of sale and in the distribution of 300,000 leaflets.

The "family fares" programmes have been especially featured in all publicity material, press advertising and promotional letters.

Promotion in newspapers and magazines also took the form of special competitions with "U.S. holiday" prizes.

Special "welcome services" and desks for "transit services" have been introduced by the E.A.R.B. airlines at the U.S. gateways.

503 billboards have been put on display.

The U.S. Travel Service "Americans at home" programme has been featured in the sales literature.

Special "tie-in" campaigns with U.S. air, bus and rail operators and car-hire companies have been launched.

Appendix II

STATEMENT PRESENTED BY ADRIENNE CURTIN ON BEHALF OF THE IRISH INDUSTRIAL DEVELOPMENT AUTHORITY

Mr. Chairman and Members of the Sub-Committee, we appreciate the opportunity of submitting this statement for your consideration.

I. BACKGROUND

Ireland achieved independence less than 50 years ago. In this time, the Irish Government has managed to provide the country with most of the appurtenances of a modern Society; complete electrification, good roads, an excellent educational system including four universities, etc. For the last 15 years, we have directed our efforts towards industrializing in order to create a self-sustaining economy.

II. PROGRAMME FOR IRELAND'S INDUSTRIAL DEVELOPMENT

The population of Ireland is 2,900,000. Because the Irish in the U.S. abound in such large numbers, many American's don't realize the parent country is so tiny; that, in fact, estimates indicate there are more Irish in Philadelphia than in Dublin, more Irish in cities like St. Louis and Milwaukee than in Cork City (Ireland's second largest).

The smallness of the home market dictated that industrialization efforts would have to be directed toward export markets. Such a situation carries with it a built-in obstacle, i.e., most companies wishing to manufacture abroad seek a location within the market they expect to serve.

To overcome this and other difficulties inherent in attracting industry to a small country, the Irish Industrial Development Authority offers a two-point programme for new manufacturing projects:

(1) Outright non-repayable cash grants in amounts varying from ⅓ to ⅔ of the cost of land, buildings and machinery plus loans for part or all of the balance.

(2) Agreement for forego taxes for 10 years on all profits derived from export.

III. OFDI RESTRAINTS AND THEIR EFFECTS ON IRISH INDUSTRIAL DEVELOPMENT PROGRAMS

Prior to FDI Restraints, U.S. manufacturers were already utilizing our cash grants to open in Ireland with a much lower capital outlay than would be possible elsewhere. It would be safe to say that they averaged at least 50% of the investment in the form of grants and local borrowing accounted for a substantial part of the balance. In all cases, these firms were:

(*a*) reaching markets which they could not profitably serve from a U.S. Base.

(*b*) exporting capital equipment, components, and materials from the U.S. into the Irish plant, thus improving a balance of trade already heavily weighted in favor of the United States.

At the start of the OFDI regulations, it should be noted that Ireland's immediate reaction was expressed by the Minister for Industry and Commerce, the Honorable George Colley. He stated that Ireland would offer the fullest coopera-

tion to assist the U.S. balance of payments problem. Such cooperation would be achieved by even more generous administration of grants to the American manufacturer and assurance of Government assistance in obtaining loans locally for the balance.

The effects of the OFDT restraints were several:

(1) Ireland's position as a "developing" or non-industrial country, previously recognized by the U.S. Government for purposes of the 1962 Revenue Act—was reclassified by decree of the Commerce Department and we found ourselves "bed fellows" in Schedule B with Japan, Great Britain, and the oil-rich Middle Eastern States.

(2) The repatriation requirements of Schedule B meant the return to the U.S. of funds not attributable to U.S. investment in the first place and the *taxing in the U.S.* of those funds on which the Irish Government had foregone taxes. This effectively "cut the rug" from under the Irish Development Program, and we believe it did so accidentally; that this tax penalty was an unintended side effect of the OFDI program.

IV. RECOMMENDATION

Since the announced objective of the OFDI restraints was to better the balance of payments by limiting outflow of capital and ensuring certain inflow, we have offered to the Commerce Department a solution which meets that objective as regards inflow. (Note—we again repeat that Ireland's system of grants and loans to U.S. and other manufacturers already solved the outflow question.) The solution is a simple one. Companies in Ireland who are affected by the OFDI repatriation requirements would deposit the required amounts with the Irish banking community. The latter would undertake to transfer these sums under its own name to U.S. Banks, to be left there for an agreed-upon period of time. The Irish Government would oversee the program to ensure adherence. This solution provides the U.S. with the same amount of help for its balance of payments problem without the adverse effects of:

(*a*) placing the Government of Ireland in the position of subsidizing the U.S. Treasury.

(*b*) seriously damaging the efforts of a small country to acquire needed industry—efforts which had just begun to show signs of success in terms of decreased emmigration and increased per capita income.

We would like to point out that this solution would not be an exception to current OFDI practices nor would it apply to Ireland on an "excepted" basis. It could apply to any country wishing to cooperate in the program and where tax forgiveness in that country was being absorbed by the U.S. Treasury. Further, it is fully in keeping with precedents already established by OFDI for particular companies.

V. CONCLUSION

The final cut-off date of our 10 years tax exemption is the fiscal year 1979–80. The question of a solution is therefore an urgent one for Ireland so we are doubly grateful to this Committee for permitting us to place our views on record. We earnestly hope that the Members will consider Ireland's position when making any recommendations on the Balance of Payments question.

STATEMENT BY RICHARD W. LINDHOLM, DEAN, GRADUATE SCHOOL OF MANAGEMENT AND BUSINESS, UNIVERSITY OF OREGON, EUGENE, OREG.

My remarks are aimed at providing a general and brief rebuttal to several points of the statement presented before this Subcommittee on January 13, 1969 by the then assistant Secretary of the Treasury, Stanley S. Surrey. The title of his statement is "A Review of U.S. Balance of Payments Policies." Its analyses consider a number of matters that are not included in this rebuttal. My chief concern is much narrower. I will consider only the portion of the statement dealing with the usefulness of the value added tax (VAT) as a tool to be utilized in setting U.S. Balance of Payments Policies.

The Surrey analysis incorrectly assumes that income taxes to be refunded on exports or charged on imports can be as readily and accurately set as VAT. A moment of reflection is all that is needed to conclude this is nonsense. For example, the profitability of an operation and therefore the tax liability is not known until the end of the accounting period. Also, the portion of the profit to be attributed to a particular sale is difficult to determine even with the most sophisticated accounting procedures. This is not a situation which can be expected to lend itself to accurately setting refunds or border taxes on internationally traded goods.

Consideration of the suitability of the income tax or the taxation of profits as an international trade tool similar in effectiveness to VAT is sufficiently important to justify several more comments.

1. No-profit businesses and businesses operating at a loss would not benefit if rebates on exports were based on profit tax liabilities. (Frequently the firms in this type of profit situation are also the ones most likely to expend that extra effort required to export successfully.)
2. Cooperatives and other agriculturally oriented and low income and profit tax liability enterprises would not be stimulated to increase their export efforts.
3. Our efforts to use direct taxes like indirect taxes would provide a justification for other countries to act in the same fashion. The result would be another rebate and border tax added on to those already used by these nations.

Surrey makes the point in this statement that he has made before, and most recently at the 73rd Annual Congress of American Industry of the National Association of Manufacturers,[1] that VAT is just like a high-rate retail sales tax. I want to attack this blatant misrepresentation in a unique but basic way.

The national income accounts have become a familiar approach to the measurement of a nation's economic activity. These accounts add up to the Gross National Product which is equal to, and the other side of the coin of, Gross National Income. The taxation of income is therefore also the taxation of product, i.e., the

[1] Dec. 6, 1968, New York, N.Y.

sales of goods and services. All taxes paid in a current period must come out of income, which means the income arising from the sale of goods and services must be sufficient to cover all taxes paid. Therefore, of course, all income taxes are really sales taxes as is also VAT.

When VAT is looked at as a tax liability arising at the point of transaction it looks like a sales tax. When VAT is looked at as a tax on the income of all the factors of production (rather than only the income of capital, as profit taxes tend to do) it looks like an income tax.

It does little to increase the understanding of the basic characteristic of VAT to call it either an income tax or a sales tax. It is when VAT is described as a uniform tax on GNP (or GNI) wherever it arises, that the basic characteristic of VAT is identified.

VAT is not a tax that rests heavily on the retail sale as is, of course, true of the conventional retail sales tax used by the states. Our typical 4% retail sales tax is calculated on the retail price of the good. A broom selling for $5 develops a 20 cent tax liability. VAT at the retail level applies only to the markup of the retail dealer. In the example of the broom the markup may be $0.50. A 15% VAT would then develop a tax liability of 7½ cents, some 12½ cents less than a 4% retail sales tax. One must also keep in mind that VAT need not include as a portion of its base the GNP arising in retailing. Prior to last year this was the situation in France, (often considered the mother of VAT, although it was in the 1920's that the tax was first carefully and favorably considered and this took place in the United States and Germany).

It is not my purpose now, although this would be possible, to develop a complete point-by-point refutation of the Surrey position relative to VAT. However, now is the time to point out that more than likely the weakness of Surrey's presentation is most strikingly highlighted by his statement's recognition that Germany, in November, 1968, "reduced the rate of its border adjustments below its domestic tax rate . . ." but his failure to realize this action illustrated a basic strength of VAT. This action was taken because Germany was accumulating large quantities of foreign exchange. Because Germany had a VAT, it was possible for her to make an adjustment helpful to international monetary stability without changing the value of the German mark. If she had not adopted VAT on January 1, 1968, she could not have made this adjustment. One of the advantages of VAT is that it provides a new and useful tool of international economic adjustment. Also it is a tool that operates within definite limits, and therefore cannot be used to wreck international economic relations. The limits are set by the VAT rate a nation is willing to use, and remember VAT is a very broad-based tax and therefore rate changes are not lightly made. One must also keep in mind that Germany, by reducing the VAT border tax rate, was also changing the balance of its budget and this could be done in a manner that would also be helpful in adjusting the international economic imbalance.

Appendix III

STATEMENT SUBMITTED BY THE INSTITUTE OF U.S. TAXATION OF FOREIGN INCOME, INC., NEW YORK, N.Y.

INTRODUCTION

The Institute on U.S. Taxation of Foreign Income, Inc., welcomes this opportunity to present its views regarding certain features of tax legislation and administrative action subsequent to 1962 which we believe have harmed our balance of payments position and to suggest some needed changes.

RECOMMENDATIONS

1. Foreign funds controls

We recommend removal of the Foreign Funds Control of normal overseas business activities. This legislation by Presidential order, directed against "Foreign Direct Investment" misses its aim. U.S. business would not object to or be harmed by legislation designed to control investment in foreign-owned businesses. But what this legislation does is to rigidly, arbitrarily and discriminatively interfere with and control U.S. *business* activities abroad. It is just such U.S. business activities that have provided the U.S. Government with most of the foreign funds it has spent and given away abroad in recent years. Briefly stated, in the years 1950 to 1967 U.S. government programs caused a net outflow of $95.2 billion, whereas private sector operations created a net inflow from abroad of $61.6 billion.

As stated by the head of a large U.S. manufacturing corporation: "Let's face the facts and not kid ourselves into thinking we somehow are going to correct our present balance of payments deficit through exhorting unsophisticated manufacturers to export more and, strangely and illogically, restricting direct investment overseas, an action which defeats its own end."

We have progressed a long way from the days of the trader who sold his goods in foreign ports to the buyer on board or alongside his sailing vessel. To sell successfully large quantities of U.S. manufactured products abroad today requires the employment of substantial capital in the countries where the goods are marketed. Market research, advertising, sales promotion, creating and training an organization, warehousing, assembly and, often, manufacturing may be essential if the U.S. manufacturer is to benefit to the fullest from the potentials of foreign markets for the sales of its products.

2. Tax on imaginary dividends

We recommend removal of the burdens imposed by 1962 tax legislation on overseas business activities of U.S.-owned enterprises. These burdens consist of far more than the amount of taxes actually collected as a result of this well-intentioned but basically unsound legislation. Taxing U.S. corporations on imaginary dividends from their subsidiaries doing business abroad probably has cost business more in unnecessary record-keeping and reporting expenses and losses of potential profits than the amount of taxes collected by the U.S. Treasury on such imaginary dividends. It has led to heavier burdens of foreign taxes on the activities of such overseas business. Worst of all, from the standpoint of our domestic economy and our balance of payments deficits, it has prevented many smaller U.S. manufacturing corporations from exporting their products as they otherwise would be doing if not for this 1962 tax legislation.

3. Inequitable 10(?)% surtax computation

We recommend correction of the statutory computation which imposes a heavier tax on the manufacture of goods in the United States and sale of U.S. goods abroad, than the 10% surtax payable on all other forms of income. This so-called 10% surcharge tax provision is so worded that it now has the effect of collecting an additional tax of more than 10% on income derived from the

manufacture of goods in the United States and from the receipt of foreign income—the very activities the Administration has said it wishes to encourage. The surtax should be neither more nor less than 10% of the amount of U.S. tax that would be payable if there were no surtax.

DISCUSSION

Undesirable effects of foreign funds controls

Although most of the very large, well-established U.S. multinational corporations have gotten through the first year of the F.D.I. foreign funds controls with a minimum of evil effects, even they have been harmed by these controls. They, our economy, and our balance of payments deficit position will suffer increasing harm as long as these controls continue in effect.

The harm being done by these arbitrary, enforced controls has been summarized thus by a U.S. manufacturer: "The Regulations force us to borrow funds we do not need. They oblige us to bring back to the United States an abnormal amount of dollars. They make it more difficult to finance exports through the medium of foreign affiliated companies. They make planning for the future difficult and uncertain."

Perhaps the greatest harm has been done by preventing many other U.S. corporations, especially the smaller manufacturers, undertaking foreign business activities. This is the result of administrative and psychological barriers to overseas business activities, resulting from strict regulatory limitations on the use of funds abroad and on the retention of profits earned abroad which otherwise would be available for expansion and payment of debts.

Only those large corporations which were already committed to substantial overseas activities are in a position to, and, in fact, have been forced to cope with all the complexities of complying with the O.F.D.I. Regulations affecting foreign transactions of every kind. There has been an understandable feeling on the part of those not already involved in these complexities that, despite what the Administration may say, it was determined to place heavier discriminatory burdens on foreign trade and commerce. This is a psychological barrier which has had a deterrent effect on all small (and some large) U.S. businesses and has tended to prevent their entering the international market. This attitude of business is understandable, in view of the series of actions and proposed actions directed against U.S. overseas business: The Treasury's 1962 Revenue Bill (which was far more radical and severe than the measure finally enacted); its three successive so-called "Foreign Investors Tax" Bills (similarly softened before enactment); its Interest Equalization Tax (which, however, in its present form should be of little concern to business); and, finally, the 1968 New Year's Day Foreign Funds Control order of President Johnson. All these bills aimed at international business activities naturally have had a very adverse psychological effect on planning for overseas business of every kind, including the export of U.S. manufactured products.

It is unfortunate that these controls were imposed (not by Congress but by order of the Chief Executive) without consultation with the heads of U.S. corporations having business activities abroad and without thorough analysis of the facts. This is evident, as the government has only now commenced an attempt for the first time to compile all the facts necessary for such an analysis.

Adverse effects of the 1962 Revenue Act

Before 1962 manufacturers could enter the export market in the normal way, without the threat of U.S. taxes on imaginary dividends which they might never receive from their subsidiaries marketing their products abroad. Now they must labor under the threat of U.S. taxes on the profits of their foreign subsidiaries before they have been brought home. Business does not do business abroad without the expectation of bringing its profits home. As a matter of fact, business engages in most overseas activities on the basis of an average pay-out period of less than three years. Its profits generally are subject to

double U.S. taxation when brought home—once when received by the U.S. parent corporation and again when distributed to its shareholders. U.S. stockholders of a U.S. corporation are not taxed on income it earns in the United States until distributed to them as dividends—why should we penalize U.S. stockholders of foreign subsidiaries by taxing them on income earned abroad before its receipt in the United States? Is this any way to encourage exports and the earning of income abroad, when this is just what we need to help our balance of payments?

Discriminatory method of computing the 10 (?) % surcharge tax

Under the present method of computing the so-called 10% surcharge tax, a U.S. manufacturer selling its products through foreign subsidiaries may be required to pay a surcharge amounting to much more than 10% of the tax it would have paid in 1967 on the same amount of income. This results from the effective disallowance of 10% of the investment credit (for additions to plant equipment) and 10% of the foreign tax credit. This discriminates in favor of taxpayers receiving income of other kinds, including those entitled to the 27½% depletion deduction. For example: On $250,000 of corporate income the 1968 tax would amount to $63,500 after an investment credit of $21,000 and a foreign tax credit of $29,000 and before the surtax. The so-called surtax would be, not $6,350, but $11,350, equal to almost 18% of the tax that would be payable if there were no surtax.

This would be at a rate of 80% higher than the 10% surtax payable by a taxpayer having income of any other kind.

This is an unfair and discriminatory penalty on income from manufacturing and on income earned abroad (when actually received or when taxed as an imaginary dividend). The resulting discouragement of foreign trade surely does not help our balance of payments deficit position. Why not compute the 10% surtax based on the amount of U.S. income tax which would be payable if there were no surtax? Why discriminate?

Conclusion

Remove these three handicaps on international trade and commerce and you will soon see such an improvement in our balance of payments picture as will astonish you. We leave to others the question of controls of U.S. government spending and giving away abroad—our recommendations are confined to the positive side of the picture—how to encourage, rather than discourage, overseas activities of U.S. concerns which create foreign income and result in bringing home foreign funds.

There are many steps which could be taken to afford positive encouragement of foreign business activities and thereby help overcome our balance of payments deficits. However, the starting point is to remove the discriminatory burdens on overseas business activities which have been imposed since 1962. Eliminate these handicaps and business will produce more tax revenue for the Treasury and more prosperity for the domestic economy.

Paul D. Seghers,
President, Institute on U.S. Taxation of Foreign Income, Inc.