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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 16, 1972

To Board of Governors

Subject: _____

From Ralph C. Bryant

Projections of the U.S. balance of payments for the remainder of 1972 and for 1973 have again been substantially revised in an adverse direction. These two memos, prepared by John Reynolds, discuss these revisions and some possible implications.

Attachments 2.

cc: Mr. R. Solomon



BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

DATE: August 16, 1972

TO: Chairman Burns

FROM: RALPH C. BRYANT

I believe these two memos warrant
your attention.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 11, 1972

To Mr. Bryant

Subject: Revised Projections of U.S.

From John E. Reynolds

Balance of Payments

CONFIDENTIAL (FR)

At a meeting on August 4, the interagency Balance of Payments Information Committee made very substantial adverse revisions in its projections for 1972 and 1973. Our staff representatives concur in these new projections. But the projected deficit magnitudes have now become so large that the projections seem certain to self-destruct within the next few months. That is to say, the projected magnitudes are most unlikely to be allowed to materialize; several of the assumptions (present exchange rates, existing controls, stable capital flows, willingness of foreign central banks to accumulate billions of additional dollar claims on the United States) are almost certain to prove false.

On the assumptions used, the U.S. deficit on current account and long-term capital transactions would remain at a record \$13 billion annual rate in the second half of 1972 and would subside only to a \$10 billion rate in 1973 (compared to \$5 billion projected for 1973 in the June chart show to the FOMC). (See Table 1.) As these magnitudes gradually become known to the public (through monthly trade figures, shrewd guesses by Morgan Guaranty about the over-all deficit, etc.), it is most unlikely



Table 1. Summary of Balances: 1969-1973e
(In billions of dollars; half-years at seasonally adjusted annual rates)

<u>Period</u>	<u>Merchan- dise trade</u>	<u>Goods and services</u>	<u>Goods, services, & remittances</u>	<u>Current account & long- term capital</u>	<u>Official settlements (excl. SDR allocations)</u>
1969	0.6	1.9	0.6	-3.0	2.7
1970	2.2	3.6	2.1	-3.1	-10.7
1971	-2.7	0.7	-0.8	-9.4	-30.5
1972e	-6.7	-3.7	-5.4	-12.8	?
(1st hf)p	(-7.2)	(-4.7)	(-6.3)	(-12.7)	(-8.9)
(2nd hf)e	(-6.2)	(-2.8)	(-4.5)	(-12.9)	(?)
1973e	-4.5	-1.3	-3.1	-9.9	?
(1st hf)e	(-4.7)	(-1.4)	(-3.1)	(-9.9)	(?)
(2nd hf)e	(-4.3)	(-1.3)	(-3.1)	(-9.9)	(?)

p = Preliminary.

e = Projected, August 4, 1972.

that net inward movements of short-term capital will offset much or any of this basic deficit. So the official settlements deficit is likely to be this large, or larger, which implies huge new accumulations of dollar assets by foreign central banks.

Most of the revisions in the projections have been made in goods and services, these being the items most susceptible to quantitative analysis and projection. The capital account projections remain about as before, but rest, as noted above, on unrealistically favorable assumptions of relative stability.



Goods and services

Compared with the June chart show, the projected balance on goods and services has been revised downward by large amounts. The balance for 1972 has been revised down by \$2.1 billion, to -\$3.7 billion, and that for 1973 has been revised down by \$4.4 billion, from +\$3.1 billion to -\$1.3 billion. (See Table 2.)

Most of the revisions have been made on the import side, in both goods and services. (See Table 3.) Merchandise imports were 2 per cent higher in the second quarter than had been expected as recently as early June (when the latest trade data available were those for April). This seemed to disprove the earlier comforting theory of a temporary spring bulge as a result of an earlier bunching of orders. Also, recent data suggest that the effects of exchange rate changes both in raising import prices and in discouraging import volume are coming more slowly than had earlier been anticipated. Finally, growing petroleum imports have been more explicitly allowed for in the new projections. The result of all these considerations has been an upward revision of 4 to 5 per cent in projections for merchandise imports in the second half of 1972 and throughout 1973. (Even so, the projected ratio of merchandise imports to GNP levels off at 4.7 per cent after early 1972, after having risen sharply for several years.)





Table 2. Goods and Services: Projections for 1972-73
(In billions of dollars)

	Years		Half-years (annual rates)			
	1972	1973	1972-I	1972-II	1973-I	1973-II
<u>Merchandise, ex. military</u>						
Exports	47.8	54.9	46.5	49.1	53.2	56.5
Imports	-54.5	-59.3	-53.8	-55.3	-57.9	-60.8
Balance	-6.7	-4.5	-7.2	-6.2	-4.7	-4.3
(June chart show)	(-5.0)	(-2.4)	(-6.3)	(-3.6)	(-2.6)	(-2.1)
<u>Services and military transactions</u>						
Exports	24.9	27.4	24.0	25.8	26.9	27.8
Imports	-21.9	-24.2	-21.5	-22.4	-23.6	-24.8
Balance	3.0	3.2	2.5	3.4	3.3	3.1
(June chart show)	(3.4)	(5.5)	(2.9)	(3.8)	(5.0)	(5.9)
<u>Goods and services</u>						
Exports	72.7	82.2	70.6	74.8	80.1	84.3
Imports	-76.4	-83.5	-75.3	-77.6	-81.5	-85.6
Balance	-3.7	-1.3	-4.7	-2.8	-1.4	-1.3
(June chart show)	(-1.6)	(3.1)	(-3.4)	(.3)	(2.4)	(3.8)

Note: Data for first half 1972 are actual for trade, preliminary estimates for services.

Table 3. Goods and Services: Revisions of Projections for 1972-73
between June 1972 Chart Show and August 4, 1972
(In billions of dollars)

	Years		Half-years (annual rates)			
	1972	1973	1972-I	1972-II	1973-I	1973-II
<u>Merchandise, ex. military</u>						
Exports	-0.1	+5	-0.3	+0.2	+0.7	+0.4
Imports	-1.7	-2.7	-0.6	-2.8	-2.7	-2.7
Balance	-1.7	-2.1	-0.9	-2.6	-2.0	-2.2
<u>Services and military transactions</u>						
Exports	+0.2	-0.6	-0.1	+0.4	-0.1	-1.1
Imports	-0.6	-1.7	-0.3	-0.8	-1.6	-1.8
Balance	-0.4	-2.3	-0.4	-0.4	-1.7	-2.8
<u>Goods and services</u>						
Exports	+0.1	-0.1	-0.4	+0.6	+0.5	-0.7
Imports	-2.2	-4.4	-0.9	-3.6	-4.3	-4.4
Balance	-2.1	-4.4	-1.3	-3.0	-3.8	-5.1

Projections of imports of services have been revised upward even more sharply, percentagewise, especially for 1973. The revisions reflect both a more explicit allowance than before for anticipated increases in U.S. short-term interest rates, and an upward revision of the volume of liabilities to foreigners on which interest will have to be paid. Also the earlier projection for exports of services in the second half of 1973 has been revised downward to eliminate an anomalous sharp rise in miscellaneous receipts that had crept into the earlier projections.

Comparisons with OECD projections and "aims"

The OECD secretariat, in its Economic Outlook of June 19, 1972 (written largely in May), was even farther off the mark in its estimates for the first half of 1972 than we were at that time. (See Table 4.) It put the trade deficit in that period at an annual rate of \$4.9 billion (compared with an actual \$7.2 billion), and it estimated net earnings on services and remittances at a rate of \$2.1 billion (compared with an actual preliminary rate of only \$0.9 billion).

The balance on goods, services, and remittances (referred to as the balance on "current account" in OECD discussions of balance of payments aims) was projected by the OECD in June at -\$2.0 billion for the year 1972, whereas we now expect it to be -\$5.4 billion, and at an annual rate of only -\$0.6 billion in the first half of 1973, whereas we now foresee a rate of -\$3.1 billion in that period.



Table 4. Current Account Projections Compared, 1972-73
(In billions of dollars)

	Year	Half-years (annual rates)		
	1972	1972-I	1972-II	1973-I
Merchandise exports				
Current projection	47.8	46.5	49.1	53.2
(OECD, June 1972)	(49.7)	(47.7)	(51.6)	(55.2)
Merchandise imports				
Current projection	-54.5	-53.8	-55.3	-57.9
(OECD, June 1972)	(-54.0)	(-52.6)	(-55.3)	(-58.7)
Trade balance				
Current projection	-6.7	-7.2	-6.2	-4.7
(OECD, June 1972)	(-4.3)	(-4.9)	(-3.7)	(-3.5)
Services and remittances, net				
Current projection	1.3	0.9	1.7	1.5
(OECD, June 1972)	(2.3)	(2.1)	(2.5)	(2.9)
Balance on goods, services, and remittances				
Current projection	-5.4	-6.3	-4.5	-3.1
(OECD, June 1972)	(-2.0)	(-2.8)	(-1.2)	(-0.6)

The differences partly reflect different assumptions about the impact of last year's exchange rate changes. The OECD secretariat assumes that such changes will have improved the U.S. balance on current account by roughly \$5 billion at an annual rate in the first half of 1973, whereas we now would expect only a \$4 billion to \$5 billion improvement by the end of 1973, and perhaps only a \$2-3 billion improvement in the first half of that year. Neither party feels very confident about its judgments of this matter, and it is unlikely that the ultimate outcome will ever be measurable.



In OECD discussions last October, the United States suggested that it should aim at a surplus on "current account" (goods, services, and remittances) of about \$9 billion in 1974. The OECD secretariat suggested a minimum of \$6 billion, as a figure that we and the world might be able to live with. In a more recent paper of July 27, 1972 (CPE/WP3(72)14), the secretariat suggests (page 7) that a figure in the \$3 billion to \$6 billion range may actually be achievable in 1974; it asks for discussion as to how satisfactory or unsatisfactory such an outcome might seem, implying that it would leave something to be desired. Our present projections of the "current account" balance, at minus \$5-1/2 billion in 1972 and minus \$3 billion in 1973, suggest that major changes will have to occur in exchange rates or in other parameters (controls?) if a sizable current surplus is in fact to be achieved in 1974, or indeed at any later time.

cc: Mr. R. Solomon
Mr. Partee
Mr. Hersey
Mr. Irvine
Mrs. Junz
Mr. Katz
Mr. Pizer
Mr. Wood
Mr. Roxon
Miss Morisse



CONFIDENTIAL (FR)

John E. Reynolds
August 3, 1972

Widespread Reserve Gains Continue

The balance of payments surpluses abroad that are the counterpart of the huge U.S. deficit are very widely spread among the other countries of the world. This can be roughly demonstrated by a study of changes in official reserve assets, for which data are available for most countries through June of 1972.

Reserve changes

Of the 40 countries that each hold reserve assets of more than \$400 million, all except the United States gained reserves over the year to mid-1972. Eight had reserve gains of more than 100 per cent: Japan and the United Kingdom among industrialized countries; Greece, New Zealand, and Yugoslavia among other developed countries; and Iran, Saudi Arabia, and Israel among less developed countries (see Table 1).

Most of the others had gains of at least 25 per cent. This was true for all industrialized countries except Belgium and Italy, for all the other developed countries without exception, and for the developing countries of the Philippines, Kuwait, Brazil, Libya, Mexico, Lebanon, and Venezuela.

The reserve figures used are in U.S. dollars, and therefore include the effects of the 8.57 per cent revaluation of gold and SDRs as well as the 1972 allocation of new SDRs. Nevertheless, reserve gains of more than 25 per cent in the year are a fairly unmistakable sign of over-all payments surplus.

Widespread reserve gains have persisted for more than a year. Over the two-year period to mid-1972, countries that have increased their reserves by more than 40 per cent include all the industrial countries except Italy and the United States, all other developed countries except South Africa, and eleven less developed countries including the five Middle East petroleum producers, and Israel, the Philippines, Brazil, Mexico, Lebanon, and Venezuela (see Table 2).

For about three-fourths of the 40 countries studied, reserve gains have been even larger in the first half of 1972 than a year earlier. (The IMF data used here show the gold and SDR revaluation as of December, so that it does not affect the comparison of first half years). This is true for all industrialized countries except Japan, Italy, and Norway; for 7 of the 10 other developed countries; and for 10 less developed countries (see Table 3).



Table 1. Countries Ranked by Percentage Reserve Gains
(measured in U.S. dollars) in the Year to Mid-1972

<u>Country</u>	<u>Per cent gain</u>	<u>Country</u>	<u>Per cent gain</u>	<u>Country</u>	<u>Per cent gain</u>
<u>Industrial countries</u>		<u>Other developed countries</u>		<u>Less developed countries</u>	
United Kingdom	113	Yugoslavia (10 mos.)	(144)	Iran (11 mos.)	(158)
Japan	103	Greece	122	Saudi Arabia	106
Denmark	87	New Zealand	114	Israel (10 mos.)	(102)
France	66	Turkey	96	Philippines	55
Sweden	45	Australia	79	^{1/}	
				Kuwait ^e	47
Switzerland	38	Spain (9 mos.)	(54)	Brazil (9 mos.)	(45)
Germany	36	Finland	53	Libya	35
Norway	34	Ireland	29	*Mexico (11 mos.)	(31)
Austria	32	Portugal (11 mos.)	(28)		
Canada	28	South Africa	25	Lebanon (10 mos.)	(31)
				Venezuela	25
Netherlands	25			Thailand	14
Belgium	20			*India (10 mos.)	(14)
Italy	6				
United States	-1			Iraq	13
				Taiwan	7
				Malaysia (10 mos.)	(6)
				Korea (11 mos.)	(0)

* Latest month's data are confidential.

^{1/} Including Government assets which are reported only at irregular intervals and for which interpolated estimates are used.

Source: Based on IMF data.



Table 2. Countries Ranked by Percentage Reserve Gains
(measured in U.S. dollars) in the Two-year Period to Mid-1972

<u>Country</u>	Per cent gain	<u>Country</u>	Per cent gain	<u>Country</u>	Per cent gain
<u>Industrial countries</u>		<u>Other developed countries</u>		<u>Less developed countries</u>	
Japan	288	Turkey	299	Iran (23 mos.)	(210)
United Kingdom	177	New Zealand	229	Saudi Arabia	184
Germany	157	Australia	166	Israel (22 mos.)	(157)
Denmark	132	Greece	165	Philippines	136
Sweden	116	Spain (21 mos.)	(162)	Libya	114
France	111	Yugoslavia (22 mos.)	(103)	Brazil (21 mos.)	(105)
Norway	94	Finland	100	Kuwait ^{1/}	77 ^e
Netherlands	64	Ireland	46	*Mexico (23 mos.)	(65)
Switzerland	63	Portugal (23 mos.)	(44)	Iraq	59
Austria	62	South Africa	-21	Lebanon (22 mos.)	(59)
Belgium	48			Venezuela	52
Canada	43			Malaysia (22 mos.)	(29)
Italy	37			*India (22 mos.)	(15)
United States	-18			Taiwan	14
				Thailand	9
				Korea (23 mos.)	(-3)

* Latest month's data are confidential.

^{1/} Including Government assets which are reported only at irregular intervals and for which interpolated estimates are used.

Source: Based on IMF data.



Table 3. Countries Having Larger Reserve Gains in the
First Half of 1972 than a Year Earlier

<u>Country</u>	<u>Reserve gain (\$m.)</u>		<u>Country</u>	<u>Reserve gain (\$m.)</u>		<u>Country</u>	<u>Reserve gain (\$m.)</u>	
	<u>1st hf</u> <u>1971</u>	<u>1st hf</u> <u>1972</u>		<u>1st hf</u> <u>1971</u>	<u>1st hf</u> <u>1972</u>		<u>1st hf</u> <u>1971</u>	<u>1st hf</u> <u>1972</u>
<u>Industrial countries</u>			<u>Other developed countries</u>			<u>Less developed countries</u>		
Germany	3,086	4,246	Australia	861	1,262	Kuwait ^{1/}	180 ^e	340 ^e
France	695	1,145	South Africa	-158	357	Brazil	249	(331 - 3 mos.)
United Kingdom	793	1,142	Turkey	12	98	Saudi Arabia	284	486
Switzerland	-49	52	Finland	47	89	Israel	89	(350 - 4 mos.)
Canada	173	517				Thailand	18	189
Netherlands	264	592	Greece	21	211			
Belgium	349	371	New Zealand	135	244	*Mexico	134	(196 - 5 mos.)
Austria	128	142	Yugoslavia	40	(242 - 4 mos.)	Iran	104	(187 - 5 mos.)
Sweden	204	284				Taiwan	-60	80
United States	-983	149				Korea	-29	(11 - 5 mos.)
Denmark	-60	64				Philippines	48	81

* Latest month's data are confidential.

^{1/} Including Government assets which are reported only at irregular intervals and for which interpolated estimates are used.

Source: Based on IMF data.



Naturally, the largest reserve gains and payments imbalances in absolute amount have been those of the countries that have the largest international transactions, notably Japan and the main industrial countries of Europe. But the gains of other countries have been surprisingly large, too. Over the past two years, for example, Australia has added \$2.9 billion to its reserves, Spain (in 21 months through March) added \$2.2 billion, Canada \$1.9 billion, Libya \$1.7 billion, Saudi Arabia \$1.3 billion, and Brazil and Kuwait each \$1 billion.

Some implications

Not all of the surpluses reflected in large reserve gains represent fundamental imbalances. Some countries (Yugoslavia, Turkey, Israel, South Africa, the Philippines) are reaping the first fruits of fairly recent devaluations designed to restore earlier reserve losses; and it may be expected that their surpluses will diminish as temporary restraints on imports and on domestic spending are gradually relaxed. The large reserve gains of the United Kingdom have reflected both a huge inflow of short-term capital that has since been reversed, and a large current surplus that has recently been rapidly eroding.

There is room for considerable disagreement as to whether the surpluses of some continental European countries (notably Germany, France, Switzerland, the Netherlands) are likely to persist, or are instead likely to fade away as recent exchange rate changes take effect and as recent huge inflows of short-term capital abate and are reversed. But it seems clear that at least the surpluses of Japan, Australia, and the petroleum-producing countries of Iran, Saudi Arabia, Libya, and Kuwait do represent fundamental and persistent imbalances of the sort that might appropriately be dealt with by exchange rate changes. Since such changes would tend to enhance the surpluses of European countries, some exchange rate adjustments on their part are also likely to be needed. Thus it appears that a fairly general realignment of exchange rates may soon be required.

The difficulties of persuading other industrial countries to acquiesce in such adjustments are well known. Less attention has been paid to the problem of the petroleum-producing countries. It is interesting also to note that two large countries that already permit considerable exchange rate flexibility -- Canada with its floating rate and Brazil with its crawling peg -- continue to manage their rates in such a way as to insure continuing payments surpluses and reserve gains.



One implication of recent widespread reserve increases may be that countries have sought as a matter of policy to increase their reserves substantially, both to remedy what was earlier felt to be a reserve stringency and to preserve a proper proportion between reserves and the rising value of international transactions. If so, this would argue for the creation of a larger amount of new SDRs than has generally been contemplated, as the only alternative to intractable U.S. payments deficits and continued turmoil in foreign exchange markets.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 24, 1972

To Mr. Ralph C. Bryant

Subject: U.S. Merchandise Trade --

From Sujin Shin

July 1972

In July, the U.S. trade deficit was \$7.1 billion at a seasonally adjusted annual rate (balance-of-payments basis), about equal to the deficits recorded in May and June. The levels of both exports and imports rose about equally in July. From February through June exports and imports showed little month-to-month variation. For January-July the trade deficit was \$7.2 billion at an annual rate.

Imports in July were \$54.9 billion at an annual rate (balance-of-payments basis), about 2.2 percent above the June rate. The major increase in imports from June to July was in imports of industrial supplies and materials, continuing the strong upward movement which had begun about April. Arrivals of cars from non-Canadian sources also rose in July but were still below the levels in the first part of the year. These advances were partially offset by relatively small declines in foodstuffs, capital goods, and nonfood consumer goods (other than autos) from the high June levels.

Exports in July were \$47.8 billion at an annual rate (balance-of-payments basis), a rise of 2.4 percent over June. Shipments of agricultural commodities in July advanced further above the already high June level. The major element in the July advance was larger shipments of industrial materials and machinery which had been relatively flat in the last three months. The July rise in exports of these nonagricultural commodities may represent the first sign of exports responding to improved economic conditions abroad. The bulk of the rise in exports from June to July was in shipments to Western Europe. Exports of commercial aircraft declined in July to a very low level.

U.S. Merchandise Trade, Balance of Payments Basis
(billions of dollars, seasonally adjusted annual rates)

	1971	1972					
	<u>Year</u>	<u>IQ</u>	<u>2Q</u>	<u>Apr.</u>	<u>May</u>	<u>June</u>	<u>July</u>
Exports	42.8	47.2	45.9	44.5	46.4	46.7	47.8
Imports	45.5	53.9	53.6	53.3	53.7	53.7	54.9
Balance	-2.7	-6.7	-7.7	-8.7	-7.3	-7.0	-7.1

Note: Details may not add to totals because of rounding.



Table 1

U.S. Merchandise Trade
(billions of dollars, seasonally adjusted annual rates)



	<u>Census Basis</u>			<u>Balance of Payments Basis*</u>		
	<u>Exports</u>	<u>Imports</u>	<u>Balance</u>	<u>Exports</u>	<u>Imports</u>	<u>Balance</u>
1963	22.5	17.2	5.3	22.3	17.0	5.2
1964	25.8	18.7	7.1	25.5	18.6	6.8
1965	26.7	21.5	5.2	26.4	21.5	4.9
1966	29.5	25.6	3.9	29.3	25.5	3.8
1967	31.0	26.9	4.1	30.6	26.8	3.8
1968	34.1	33.2	0.8	33.6	33.0	0.6
1969	37.3	36.0	1.3	36.4	35.8	0.6
1970	42.7	40.0	2.7	42.0	39.8	2.2
1971	43.6	45.5	-1.9	42.8	45.5	-2.7
1968 I	32.1	31.5	0.6	31.8	31.3	0.5
II	33.9	32.6	1.3	33.5	32.5	0.9
III	36.1	34.2	1.9	35.5	34.3	1.3
IV	34.3	34.1	0.2	33.5	33.8	-0.2
1969 I	30.5	30.6	-0.2	30.0	30.3	-0.4
II	39.1	38.4	0.7	37.9	38.3	-0.3
III	39.6	37.3	2.3	38.3	37.1	1.2
IV	40.1	37.8	2.3	39.5	37.5	2.0
1970 I	41.3	38.9	2.4	40.9	38.9	2.0
II	43.2	39.5	3.7	42.3	39.3	2.9
III	43.4	40.1	3.3	42.8	39.9	2.9
IV	43.0	41.3	1.7	41.8	41.1	0.8
1971 I	45.0	43.2	1.8	44.1	42.9	1.2
II	43.9	47.0	-3.1	42.8	46.9	-4.0
III	46.7	47.8	-1.1	45.9	47.8	-1.9
IV	38.9	44.1	-5.2	38.3	44.2	-6.0
1972 I	47.7	53.7	-6.0	47.2	53.9	-6.7
II	46.3	53.7	-7.4	45.9	53.6	-7.7
1971 July	41.9	45.5	-3.6	41.1	45.4	-4.3
August	44.1	47.1	-3.0	43.4	47.1	-3.7
September	54.1	50.9	3.2	53.3	50.9	2.4
October	32.5	42.3	-9.8	31.7	42.3	-10.6
November	37.9	40.5	-2.6	37.3	40.5	-3.2
December	46.3	49.5	-3.2	45.7	49.8	-4.1
1972 January	50.7	54.5	-3.8	50.0	55.2	-5.2
February	45.7	52.8	-7.2	45.5	52.8	-7.3
March	46.7	53.7	-7.0	46.2	53.8	-7.6
April	45.1	53.5	-8.4	44.5	53.3	-8.7
May	47.0	53.6	-6.6	46.4	53.7	-7.3
June	46.9	53.9	-7.1	46.7	53.7	-7.0
July	48.2	54.7	-6.5	47.8	54.9	-7.1

*The monthly balance of payments figures are only rough estimates and are subject to considerable revision.

r = Revised.

Note: Details may not add to totals because of rounding.

Table 2

U.S. Exports of Domestic and Foreign Merchandise
by End-Use Commodity Categories
Including Department of Defense Shipments
(Seasonally adjusted; annual rates)
billions of dollars



	1971	1972					
	Year	1Q	2Q ^{*/}	Apr.	May	June	July
Foods and feeds	6.1	7.0	6.9	6.1	7.1	7.5	7.4
Industrial materials	12.7	13.7	12.5	12.2	12.8	12.5	13.3
Capital goods	15.1	16.5	16.0	15.7	16.1	16.1	16.1
Civilian aircraft	(3.3)	(3.3)	(3.3)	(2.7)	(4.0)	(3.3)	(2.6)
Machinery	(11.6)	(12.9)	(12.5)	(12.5)	(12.4)	(12.5)	(13.1)
Automotive equipment	4.4	4.8	5.0	4.9	5.1	4.9	4.9
To Canada	(3.2)	(3.6)	(3.9)	(3.9)	(4.0)	(3.9)	(4.1)
To other	(1.2)	(1.2)	(1.1)	(1.1)	(1.1)	(1.1)	(1.1)
Consumer goods (non-auto)	2.8	3.3	3.3	3.2	3.3	3.3	3.6
All other	3.0	2.8	3.0	3.3	3.1	2.7	3.3
Total	44.1	48.2	46.9	45.7	47.6	47.3	49.0
Agricultural goods	7.8	9.1	8.5	7.7	8.7	9.1	9.4
Nonagricultural goods	36.4	39.2	38.4	38.0	38.9	38.2	39.6

U.S. General Imports
by End-Use Commodity Categories
(Seasonally adjusted; annual rates)
billions of dollars

	1971	1972					
	Year	1Q	2Q ^{*/}	Apr.	May	June	July
Foods and feeds	6.4	7.3	6.8	6.5	6.9	7.0	6.9
Industrial materials	17.0	18.9	19.2	18.5	19.2	19.9	20.8
Fuels and lubricants	(3.7)	(4.3)	(4.6)	(4.8)	(4.5)	(4.6)	(4.9)
Iron and steel	(2.9)	(2.7)	(2.7)	(2.2)	(2.9)	(2.9)	(3.0)
Capital goods	4.1	5.3	5.4	5.2	5.2	5.7	5.6
Automotive equipment	7.9	8.9	9.4	10.2	9.5	8.5	8.9
From Canada	(4.5)	(5.0)	(5.5)	(6.3)	(4.9)	(5.3)	(5.2)
From other	(3.4)	(3.9)	(4.1)	(4.4)	(4.6)	(3.4)	(3.7)
Consumer goods (non-auto)	8.6	11.5	11.0	11.5	10.4	11.3	11.0
Nondurable goods	(3.3)	(4.2)	(3.8)	(3.9)	(3.6)	(4.0)	(3.9)
Durable goods	(4.7)	(6.5)	(6.4)	(6.9)	(6.0)	(6.5)	(6.2)
Unmfgd. goods	(0.6)	(0.7)	(0.7)	(0.7)	(0.7)	(0.8)	(0.9)
All other	1.6	1.8	1.7	1.8	1.7	1.6	1.6
TOTAL	45.6	53.7	53.7	53.5	53.6	53.9	54.7

Note: (1) Details may not add to totals because the commodity sections were independently adjusted for seasonal variations.
(2) Totals will not correspond to the Census basis totals in Table 1 because Department of Defense Military Grant-Aid shipments are included in exports of domestic and foreign merchandise in Table 2.

* / Preliminary = sum of three months.

Table 3
Imports as Per Cent of GNP
(billions of current dollars)



<u>Annual</u>	<u>GNP</u>	<u>Imports</u> ^{1/}	<u>Percent</u>
1961	520.1	14.52	2.79
1962	560.3	16.22	2.89
1963	590.5	17.01	2.88
1964	632.4	18.65	2.95
1965	684.9	21.50	3.14
1966	749.9	25.46	3.40
1967	793.9	26.82	3.38
1968	864.2	32.96	3.81
1969	930.3	35.80	3.85
1970	976.4	39.80	4.08
1971	1,050.4	45.46	4.33

Half Years at Annual Rates, Seasonally Adjusted

1968			
1H	845.7	31.91	3.77
2H	882.7	34.02	3.85
1969			
1H	915.3	34.29	3.75
2H	945.3	37.30	3.95
1970			
1H	964.9	39.12	4.05
2H	988.0	40.48	4.10
1971			
1H	1,033.2	44.90	4.35
2H	1,067.5	46.02	4.31
1972			
1H	1,124.3 ^r	53.74	4.78

Quarterly at Annual Rates, Seasonally Adjusted

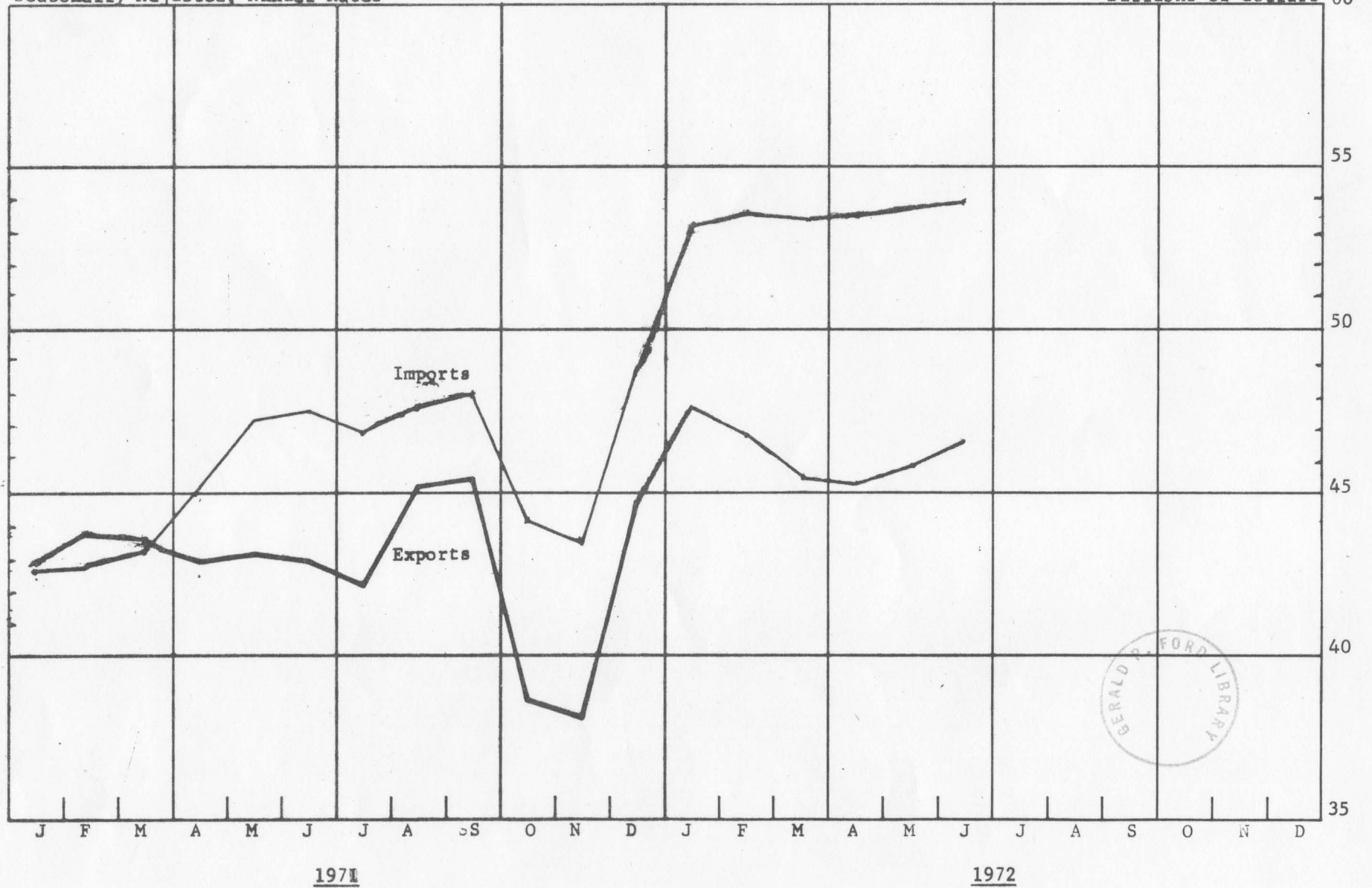
1967			
I	774.4	26.64	3.44
II	784.5	25.86	3.30
III	800.9	26.17	3.27
IV	815.9	28.61	3.51
1968			
I	834.0	31.28	3.75
II	857.4	32.54	3.80
III	875.2	34.27	3.92
IV	890.2	33.76	3.79
1969			
I	907.0	30.30	3.34
II	923.5	38.27	4.14
III	941.7	37.08	3.94
IV	948.9	37.52	3.95
1970			
I	958.0	38.92	4.06
II	971.7	39.32	4.05
III	986.3	39.87	4.04
IV	989.7	41.08	4.15
1971			
I	1,023.4	42.91	4.19
II	1,043.0	46.89	4.50
III	1,056.9	47.80	4.52
IV	1,078.1	44.23	4.10
1972			
I	1,109.1	53.93	4.86
II	1,139.4 ^r	53.55	4.70

^{1/} Balance of payments basis.
r = Revised.

U.S. MERCHANDISE TRADE
Balance of Payments Basis
1-2-1 Moving Averages

Seasonally Adjusted, Annual Rates

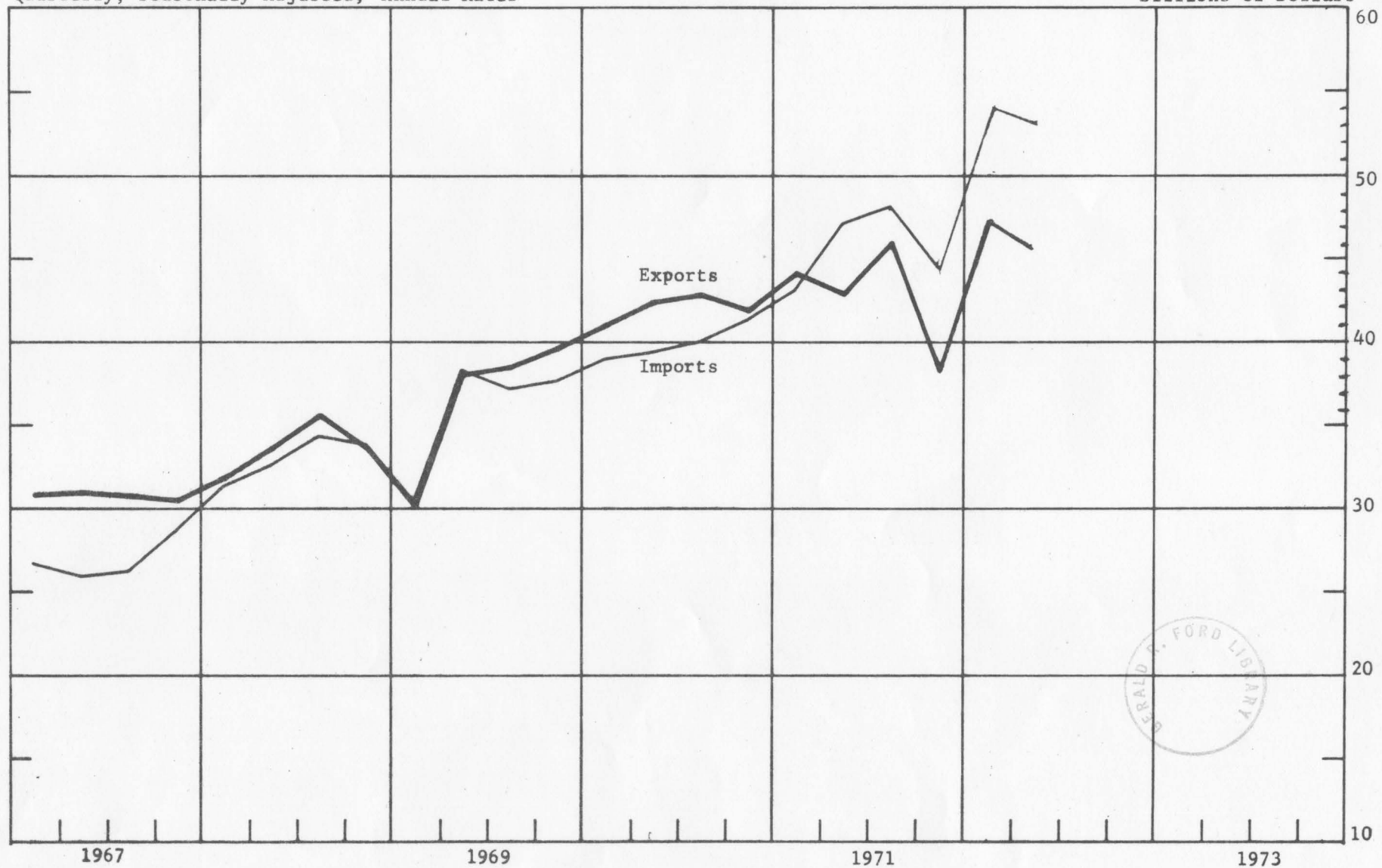
Billions of dollars 60



U.S. MERCHANDISE TRADE
Balance of Payments Basis

Quarterly, Seasonally Adjusted, Annual Rates

Billions of Dollars



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 6, 1972

To Mr. Samuel Pizer

Subject: Revised balance of payments

From Daniel Roxon

estimates for 1972 and 1973.

STRICTLY CONFIDENTIAL (FR)

Revised estimates for 1972 and 1973 of U.S. exports and imports of goods and services and other components making up the "basic" balance of the U.S. balance of payments are shown in the attached tables. The assumptions underlying these estimates are shown in Table 1. A basic assumption was that domestic price and wage controls will be continued throughout 1973.

For 1972 the estimate for goods and services is for an import balance of \$4-3/4 billion. (See Table 2). For 1973 the estimate is for a substantially lower import balance -- about \$2-1/4 billion. The smaller deficit results almost entirely from a reduction on the trade deficit -- from \$6-3/4 billion in 1972 to \$4-1/2 billion in 1973. The net surplus on services is estimated to increase only marginally from 1972 to 1973.

It should be noted that the estimates of exports and imports of goods and services for 1972 and 1973 will differ from those shown in the GNP accounts since the goods and services figures for the second quarter of 1972 shown in the GNP accounts are unrevised and will probably remain so until the next annual revision of the GNP data next July. The estimates shown in the GNP accounts in the periods following the second quarter are linked to this unrevised figure, i.e., the quarter to quarter changes in the estimates on the revised balance of payments.



basis are applied to the unrevised second quarter GNP data. The deficit balance on goods and services on the GNP basis is therefore about \$1 billion less at an annual rate each quarter than the estimates on a balance of payments basis. (See Table).

The "basic" balance -- the sum of current account transactions (including Government grants) and long-term Government and private capital flows -- is estimated to be only slightly lower in 1973 than the very large deficit of \$11-3/4 billion estimated for 1972. In 1971 the "basic" balance was also a large deficit of about \$9-1/2 billion.

Trade: The estimated reduction in the trade deficit in 1972 from 1972 arises from a very strong rise in exports (16 percent) while imports may increase more moderately (10 percent). See Table 4). The trade deficit in the first half of 1973 may still be quite high -- \$5 billion at an annual rate -- but then is estimated to decline to a rate of about \$3 billion in the fourth quarter as exports expand more rapidly than imports. Exports in 1973 may total \$56.3 billion, almost \$8 billion more than in 1972, and substantially larger than earlier estimated. The principal reasons for the new higher projected level of exports are: (1) the fuller recognition of the huge amount of agricultural commodities to be exported next year, (mainly because of the sales to the Soviet Union but also because of larger exports to other countries because of limited supplies in competing foreign suppliers); (2) the expectation of greater deliveries of commercial aircraft, particularly the new DC-10's; (3) a probable increase in



aid to Viet-Nam toward the end of 1973 with the ending of the war. As the estimates for foreign industrial activity are unchanged from those made previously, there is no change in the estimated value of U.S. exports related to this element.

The effect of exchange rate change on exports in 1972 is estimated to be zero and about \$1.3 billion in calendar 1973. By the fourth quarter of 1973 it is estimated that the effect of the exchange rate changes on exports may be about \$2-1/2 billion at an annual rate.

Imports in 1973 are estimated to be about \$61 billion -- \$5-1/2 billion (10 percent) more than in 1972. This is somewhat higher than previous estimates. An important element in raising the value of total imports in 1973 is the anticipated further increase in fuel imports. In 1973 such imports may total about \$6-1/2 billion compared with \$3.7 billion in 1971 and an estimated \$4.7 billion in 1972. The effect of the exchange rate changes on imports may become positive, i.e., reduce imports, in 1973 compared with the negative or "perverse" effect of raising the value of imports in 1972. The exchange rate effect may be to reduce imports by about \$1 billion in calendar 1973 and by a rate of \$2-1/4 billion by the fourth quarter of 1973. Thus the combined positive effects of the change in exchange rates for both exports and imports may be about \$4-1/2 billion at an annual rate in the last quarter of 1973.

Services: The net surplus on services in 1973 is estimated to be about the same as in 1972, i.e., \$2 billion. Military expenditures



abroad may dip only slightly between the two years; shipments of military equipment may rise somewhat. The estimated increase in fees and royalties receipts from direct investment abroad may be largely offset by reduced net income receipts as increased liabilities to foreigners combined with rising domestic interest rates may raise income payments to foreigners. The increase in the net import balance on travel from 1972 to 1973 may be substantially less than the very large increase from 1971 to 1972.

Government grants and credits: The outflow of Government grants and credits in 1973 is estimated to be exceptionally high -- \$5 billion. This compares with a little less than \$4 billion in 1972. The major factors in the \$1 billion increase are: (1) Additional Viet-Nam aid of \$300 million; (2) Increased CCC credits (mainly to the Soviet Union under the grain sale agreement) and P.L. 480 financing, together totaling an increase of \$300 million; (3) Greater Export-Import Bank loans of \$375 million; (4) Increased payments to international institutions (IDA and IDB) of \$200 million. U.S. Government aid and credit outlays have been below \$4 billion in the past 5 years except in 1971 when it totaled nearly \$4-1/2 billion.

Private long-term capital: The net outflow of private long-term capital in 1973 is expected to be moderately larger than in 1972 but considerably below the outflow in 1971. U.S. private long-term capital outflow in 1973 may be somewhat higher than in 1972. Direct investments abroad are estimated to rise in 1973 from the relatively



Mr. Samuel Pizer

-5-

low level estimated for 1972. This increased outflow may be partially offset by a moderate decline in bank claims on foreigners.

The inflow of private foreign long-term capital in 1973 is estimated to be about the same as in 1972. The moderate increase estimated for foreign direct investment in the United States may be just about offset by an estimated reduction in sales of new bond issues abroad by U.S. corporations (to finance their direct investments) from the exceptionally high amounts sold in 1972. Sales of U.S. equities to foreigners in 1973 are estimated to be unchanged from the estimated \$1.7 billion sold in 1972.

(It should be noted that these estimates of capital flows are subject to even greater reservations and caveats than are generally applied to the estimates of exports and imports of goods and services.)

cc: Messrs. Bryant, Gemmill, Hersey, Katz, Norwood, Reynolds, Wood, Siegman, Irvine, Mrs. Junz, Messrs. Henry, Peret, Zeisel, Henderson, and All Economists in Trade, Aid, and Investment Section.



November 6, 1972

Table 1. ASSUMPTIONS USED FOR GOODS & SERVICES PROJECTIONS: 10/27/72

	UNITED STATES					FOREIGN			
	GNP	Deflator 1958 \$	Real GNP	PCE	Change in Business Inventory	Whole- sale Prices (1963=100)	Industrial Production ^{1/} (1963=100)	Wholesale Prices ^{1/2/} (1963=100)	Capacity Pressure ^{3/}
<u>Years:</u>									
1971	1050.4	141.6	741.7	664.9	3.6	120.7	164.6	123.0	11.18
1972	1151.1	145.9	789.0	720.9	4.8	125.1	174.6	128.1	10.98
1973	1264.9	150.4	841.3	789.2	12.0	128.5	187.9	132.4	12.55
<u>Quarters:</u>									
1971 - 4 actual	1078.1	142.9	754.5	680.5	1.7	121.7	167.1	124.5	10.37
1972 - 1 actual	1109.1	144.7	766.5	696.1	.4	123.4	170.0	126.1	10.59
2 actual	1139.4	145.3	783.9	713.4	5.0	124.5	172.8	127.5	10.71
3	1162.2	146.1	795.3	728.1	5.7	125.7	175.9	128.8	11.04
4	1193.6	147.3	810.2	746.1	8.0	126.7	179.5	130.0	11.56
1973 - 1	1224.2	148.7	823.3	764.1	10.0	127.5	182.9	131.1	11.89
2	1253.8	149.8	837.0	782.1	12.0	128.2	186.2	132.0	12.25
3	1279.0	150.9	847.6	797.6	13.0	128.8	189.4	132.9	12.67
4	1302.8	152.0	867.0	813.1	13.0	129.3	193.2	133.7	13.39
<u>Percent change:</u>									
<u>Years:</u>									
1972/71	9.6	3.0	6.4	8.4		3.6	6.1	4.1	
1973/72	9.9	3.1	6.6	9.5		2.7	7.6	3.4	
<u>Qtr. 4/Qtr. 4:</u>									
72/71	10.7	3.1	7.4	9.6		4.1	7.4	4.4	
73/72	9.1	3.2	7.0	9.0		2.1	7.6	2.8	

^{1/} Weighted average.^{2/} Excludes effects of exchange rate changes.^{3/} Measures difference between production capacity and actual production.

November 6, 1972

Table 2. U.S. Balance of Payments - Projected for 1973
billions of dollars, seasonally adjusted

	YEARS			HALF YEARS			
	<u>1971</u>	<u>1972</u>	<u>1973</u>	1972		1973	
				<u>1H</u>	<u>2H</u>	<u>1H</u>	<u>2H</u>
Balance on goods & services	.7	-4.7	-2.2	-2.7	-2.0	-1.4	-.8
Remittances & pensions	-1.5	-1.5	-1.8	-.8	-.8	-.9	-.9
<u>Current account (ex. Gov't grants)</u>	<u>-.8</u>	<u>-6.3</u>	<u>-4.0</u>	<u>-3.5</u>	<u>-2.8</u>	<u>-2.2</u>	<u>-1.7</u>
Gov't grants & capital	-4.4	-3.9	-5.0	-1.6	-2.3	-2.4	-2.5
Private long-term capital	-4.1	-1.7	-2.4	-.4	-1.3	-1.3	-1.2
U.S.	(-6.3)	(-5.9)	(-6.4)	(-2.8)	(-3.1)	(-3.2)	(-3.2)
Foreign	(+2.2)	(+4.2)	(+4.0)	(+2.4)	(+1.8)	(+1.9)	(+2.0)
<u>Balance on current account & long-term capital</u>	<u>-9.4</u>	<u>-11.8</u>	<u>-11.3</u>	<u>-5.5</u>	<u>-6.3</u>	<u>-5.9</u>	<u>-5.4</u>
Nonliquid short-term capital	-2.4	-.6	-.5	-.1	-.5	-.3	-.3
Errors & omissions	-10.9			-.2			
Liquid private capital	-7.8			+1.4			
<u>OSB (ex. SDR allocations)</u>	<u>-30.5</u>			<u>4.5</u>			



November 6, 1972

Table 3. GOODS & SERVICES - PROJECTED
billions of dollars, seasonally adjusted annual rates

A. BALANCE OF PAYMENTS DATA:

	EXPORTS			IMPORTS			NET		
	Goods & Services	Goods	Services	Goods & Services	Goods	Services	Goods & Services	Goods	Services
1971	66.1	42.8	23.4	65.4	45.5	19.9	.7	-2.7	3.4
1972	73.1	48.6	24.5	77.8	55.2	22.6	-4.7	-6.6	1.9
1973	83.9	56.3	27.6	86.1	60.7	25.4	-2.2	-4.4	2.2
1972 - 1 actual	71.1	47.2	23.8	75.7	53.9	21.8	-4.7	-6.7	2.0
2 actual	69.4	45.9	23.5	75.6	53.6	22.0	-6.2	-7.7	1.5
3 preliminary	73.8	49.1	24.7	78.7	55.8	23.0	-4.9	-6.7	1.8
4 projected	78.1	52.0	26.0	81.1	57.4	23.7	-3.1	-5.4	2.3
1973 - 1 projected	80.3	53.8	26.5	83.1	58.9	24.2	-2.8	-5.1	2.3
2 "	82.8	55.5	27.3	85.5	60.4	25.1	-2.7	-4.9	2.2
3 "	84.9	57.0	27.9	87.2	61.4	25.8	-2.3	-4.4	2.1
4 "	87.5	59.0	28.5	88.5	62.0	26.5	-1.0	-3.0	2.0

B. GOODS & SERVICES DATA IN THE GNP ACCOUNT:^{1/}

	Exports of G & S	Imports of G & S	Net G & S
1971	66.1	65.4	.7
1972	73.4	77.6	-4.2
1973	84.5	85.7	-1.2
1972 - 1	71.1	75.7	-4.7
2	69.4	75.6	-6.2
3	74.4	78.2	-3.8
4	78.6	80.7	-2.1
1973 - 1	80.9	82.7	-1.8
2	83.4	85.1	-1.7
3	85.4	86.7	-1.3
4	88.1	88.1	0

^{1/} Differs from actual balance of payments data because of lags in including revisions.



Table 4

MERCHANDISE TRADE and SERVICES: PROJECTED
 millions of dollars, seasonally adjusted

<u>MERCHANDISE TRADE</u>	1971	1972	1973	1972				1973				
				Qtr.1	Qtr.2	Qtr.3	Qtr.4	Qtr.1	Qtr.2	Qtr.3	Qtr.4	
<u>Exports</u>												
a) Basic estimate	42,770	48,550	55,025	11,809	11,463	12,272	13,006	13,350	13,675	13,850	14,150	
b) Effect of exchange rate changes	--	--	+1,300	--	--	--	--	+100	+200	+400	+600	
c) Exports - projected	42,770	48,550	56,325	11,809	11,463	12,272	13,006	13,450	13,875	14,250	14,750	
<u>Imports</u>												
a) Basic estimate	45,459	54,165	61,575	13,242	12,932	13,740	14,251	14,675	15,200	15,650	16,050	
b) Effect of exchange rate change	--	+1,000	-900	+240	+460	+200	+100	+50	-100	-300	-550	
c) Imports - projected	45,459	55,165	60,675	13,482	13,392	13,940	14,351	14,725	15,100	15,350	15,500	
<u>Trade Balance</u>												
a) Basic estimate	-2,689	-5,615	-6,550	-1,433	-1,469	-1,468	-1,245	-1,325	-1,525	-1,800	-1,900	
b) Effect of exchange rate changes	--	-1,000	+2,200	-240	-460	-200	-100	+50	+300	+700	+1,150	
c) Trade Balance - projected	-2,689	-6,615	-4,350	-1,673	-1,929	-1,668	-1,345	-1,275	-1,225	-1,100	-750	
<u>SERVICES</u>												
Exports of services - receipts	23,363	24,528	27,550	5,954	5,884	6,180	6,510	6,625	6,825	6,975	7,125	
Imports of services - payment	19,947	22,625	25,400	5,455	5,501	5,740	5,929	6,050	6,275	6,450	6,625	
Net services	+3,416	+1,903	+2,150	+499	+383	+440	+581	+575	+550	+525	+500	
<u>BALANCE ON GOODS & SERVICES</u>												
Balance before exchange rate change	+727	-3,712	-4,400	-934	-1,086	-1,028	-664	-750	-975	-1,275	-1,400	
Effect of exchange rate changes on trade	--	-1,000	+2,200	-240	-460	-200	-100	+50	+300	+700	+1,150	
Balance after effect of exchange rate changes	+727	-4,712	-2,200	-1,174	-1,546	-1,228	-764	-700	-675	-575	-250	



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 1, 1973

To Chairman Burns

Subject: Preliminary Balance of

From Samuel Pizer
(through Ralph C. Bryant)

Payments Figures

The attached tables show the first preliminary data for the official settlements balance for 1972. The deficit of \$10.8 billion is somewhat larger than expected; the year-end inflows were probably less than in the past few years. On the liquidity basis the deficit for the year was \$15.4 billion, of which about \$4 billion came in the last quarter.

The second table shows the preliminary figures for increases in bank-reported claims on foreigners. These showed a very large increase in December -- \$1.3 billion -- bringing the total for the year to about \$3-1/2 billion. Unless revised downward, which is possible, this would be a larger outflow than was reported in 1971. We have no information yet on the character of the increase in banking claims, but it seems likely that it was influenced by tightening in foreign credit markets.

Attachments

cc: Mr. John Reynolds



STRICTLY CONFIDENTIAL (F.R.)

JANUARY 31, 1973

Table A.4 Financing of Balances - Continued
(In millions of dollars)

	1972 P/							
	Q I	Q II	Q III	OCT.	NOV.	DEC.	Q IV	YEAR
1. Change in liabilities, dec., (-)	3 201	2,983	5,643	1,661	962	454	3,077	14,904
A. To foreign official agencies <u>1/</u>	2,609	794	5,422	787	161	304	1,252	10,077
B. To private foreigners, liquid	592	2,189	221	874	801	150	1,825	4,827
Commercial banks abroad	514	1,980	107	627	641			
Foreign branches	-200	396	34	98	-530	336	-96	134
Other	714	1,584	73	529	1,171			
Other private foreigners	53	281	148	201	-77		186	105
Intl. and regional	25	-72	-34	46	237	-97		
2. U.S. reserve assets, inc., (-)	607	-53	122	-96	6	157	67	743
Gold stock	544	-	3	-	-	-	-	547
Special drawing rights <u>3/</u>	-	7	-	-	-	-	-	7
Reserve position in IMF	-1	185	-15	-5	-5	-5	-15	154
Convertible currencies	64	-245	134	-91	11	162	82	35
3. Liquid claims, inc., (-)	-729	113	-491					N.A.
Bank-reported	-439	300	-394					
Nonbank-reported	-290	-187	-97					
Balances (deficit -) <u>3/</u>								
Official settlements, N.S.A. (1A+2)	-3,216	-741	-5,544	-691	-167	-461	-1,319	-10,820
" , S.A.	-3,429	-1,027	-4,801				-1,563	-10,820
Liquidity, N.S.A. (1+2)	-3,808	-2,930	-5,765	-1,565	-968	-611	-2,942	-15,445
" , S.A.	-3,983	-2,216	-5,197				-4,049	-15,445
Net liquidity, N.S.A. (1+2+3)	-3,079	-3,043	-5,274					
" , S.A.	-3,310	-2,413	-4,630					N.A.

p/ Preliminary. n.a. Not available.

1/ Includes transactions in U.S. Govt. agency securities.

2/ Reflects termination of IMF gold

investment (\$400 million) and withdrawal of gold deposits (\$144 million).

3/ Excludes allocation of \$710 million of SDRs by IMF on Jan. 1, 1972.

Note - Excludes Japanese purchases of U.S. corporate bonds which amounted to \$168 million in 1972.



January 31, 1973

STRICTLY CONFIDENTIAL (F. R.)

U. S. BALANCE OF PAYMENTS

Table A.10 Changes in Claims on Foreigners

Decrease or increase (-)
(In millions of dollars)

1972 p/

	N. S. A.	S. A.	N. S. A.	S. A.	N. S. A.	S. A.				N. S. A.	S. A.	YEAR
	Q-I	Q-I	Q-II	Q-II	Q-III	Q-III	Oct.	Nov.	Dec.	Q-IV	Q-IV	
Bank-reported claims												
Short-term	-770	-1,120	475	779	-384	-857	81	-609	-1,057	-1,585	-1,066	-2,264
Liquid	-439	-533	300	312	-394	-449	342	-108				
Nonliquid	-331	-587	175	467	10	-408	-261	-501				
Long-term <u>1/</u>	-178	-178	-352	-352	-337	-337	-96	-41	-246	-383	-383	-1,250
Total	-948	-1,297	123	426	-721	-1,194	-15	-650	-1,303	-1,968	-1,449	-3,514
Nonbank-reported claims <u>2/</u>												
Short-term	-241	-157	-98	-12	-131	-236						
Liquid	-290	-140	-187	-115	-97	-118						
Nonliquid	49	-17	89	103	-34	-118						
Long-term <u>1/</u>	-78	-78	-71	-71	-10	-10						
Total	-319	-235	-169	-83	-141	-246						

p/ Preliminary
 S. A. Seasonally adjusted N. S. A. Not seasonally adjusted.
1/ This series not seasonally adjusted.
2/ Monthly data not available.



STRICTLY CONFIDENTIAL (FR)

THE U.S. BALANCE-OF-PAYMENTS PROBLEM:
RECENT DEVELOPMENTS AND PROSPECTS

Special Briefing for the Board of Governors
by the Division of International Finance

February 5, 1973



I. Introduction (Mr. Reynolds)

In recent months, our Division has been reassessing in some depth the current and prospective state of the U.S. balance of payments and the whole international payments problem.

It now appears to us that the causes of the deterioration in the U.S. international trade and payments position during the late 1960's and early 1970's were more deep-seated and persistent than was generally realized even as recently as one year ago. The Smithsonian exchange rate adjustments went a considerable distance towards correcting international imbalances, and we shall be benefiting substantially from their lagged effects during the next few years. But it is becoming increasingly clear that the Smithsonian adjustments did not go far enough.

Let me outline our presentation for you so you can see how the pieces fit together. Mr. Pizer will review very briefly the developments that led up to the U.S. emergency actions of August 1971. Mrs. Junz will discuss the adjustments that were sought, and those that were achieved, at the Smithsonian. Mr. Clark will describe developments during 1972, attempting to separate the effects of exchange rate changes from those resulting from business cycle swings and special factors. I will conclude with an estimate of the distance we still have to go to reach reasonable equilibrium in our international transactions.

I think it will be most useful to you if we speak our pieces first, and then invite your questions. But you should, of course, interrupt at any point if it is not clear what we are trying to say.

Mr. Pizer.



II. Background to the Smithsonian Agreement (Mr. Pizer)

In the first half of the 1960's there were persistent but relatively small overall deficits in our balance of payments. Even though these deficits were not worsening, liquid liabilities to foreign monetary authorities were piling up and U.S. reserves were declining.

At that time the trade balance was strong, as seen in the top panel of Chart 1, and seemed to be improving. The view was widely accepted that in consequence of the superior U.S. price performance after 1959, time was on our side. Rising capital outflows did cause some concern, and the IET was enacted. In fact, there was enough worry about the deficits to produce several Presidential messages on the balance of payments, all listing measures aimed at alleviating or financing what was thought to be a temporary problem.

By 1965, with the gap between actual and potential GNP closed, and the war in Vietnam adding to demands, the U.S. trade balance began to deteriorate. The worsening was interrupted only briefly in 1967, and in 1969-70, by slowdowns in U.S. demand relative to other industrial countries, and the worsening accelerated in 1971.

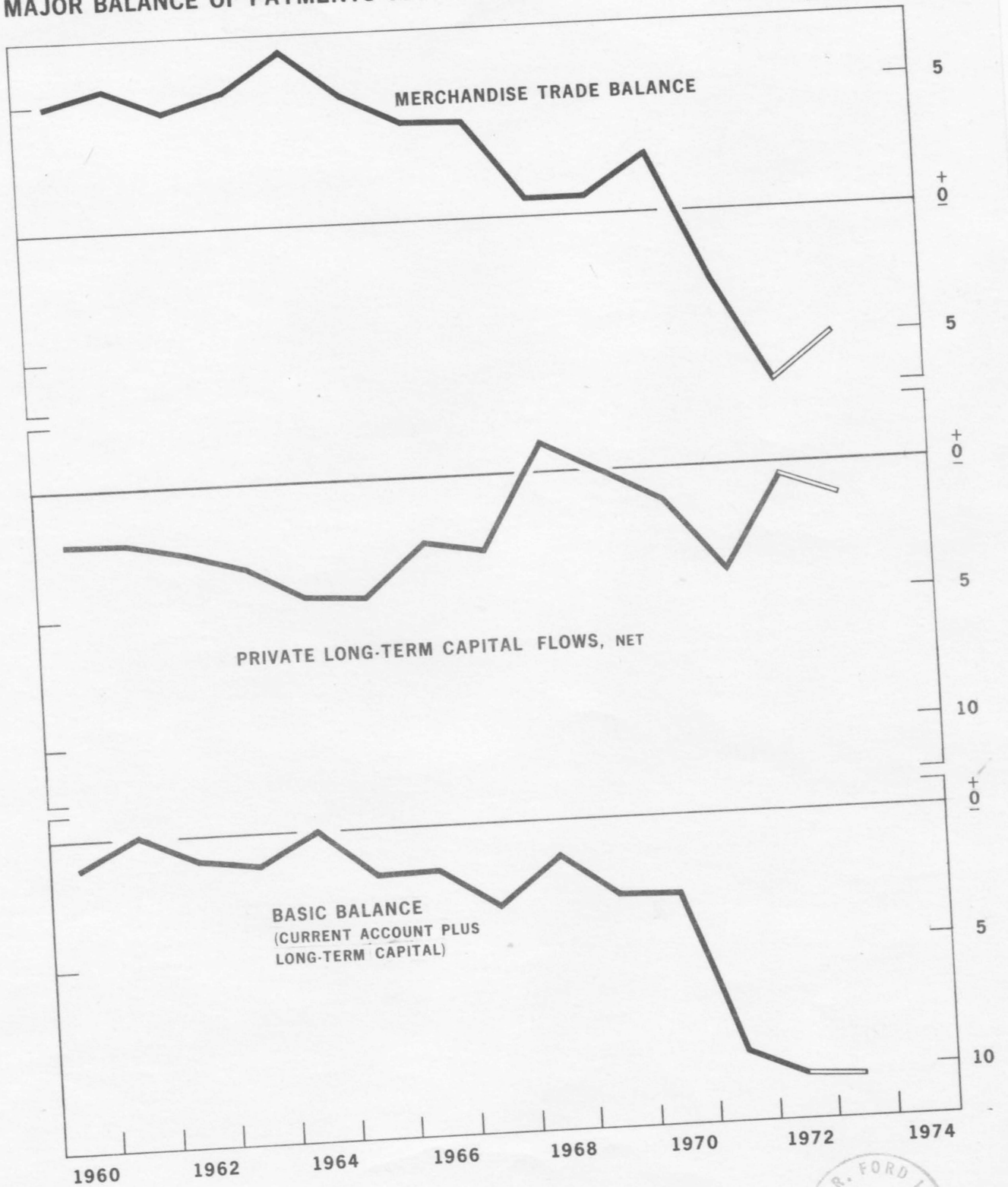
Meanwhile, private long-term capital outflows -- shown in the middle panel of Chart 1 -- which had been steadily growing larger, were reduced by the voluntary restrictions in 1965 and the



Chart 1

MAJOR BALANCE OF PAYMENTS SECTORS

Billions of dollars



more stringent mandatory controls imposed in 1968. This checking of long-term capital outflows offset the weakness of the trade balance for a time, and the basic balance -- given in the bottom panel of the chart -- showed only a slow worsening.

The top panel of Chart 2 repeats the plot of the basic balance. The middle panel of the chart shows recorded net private short-term capital flows and the errors and omissions item. As you can see, recorded short-term capital inflows temporarily swelled to enormous proportions in 1968-69, as U.S. banks reacted to tighter monetary conditions at home and the ready availability of liquid funds abroad. For a time, therefore, favorable shifts in capital flows offset the decline in the trade balance and kept the official settlements deficit within a relatively narrow band. Indeed, as shown in the bottom panel of the chart, there were surpluses in this overall measure in 1968 and 1969, which caused some relaxation of concern.

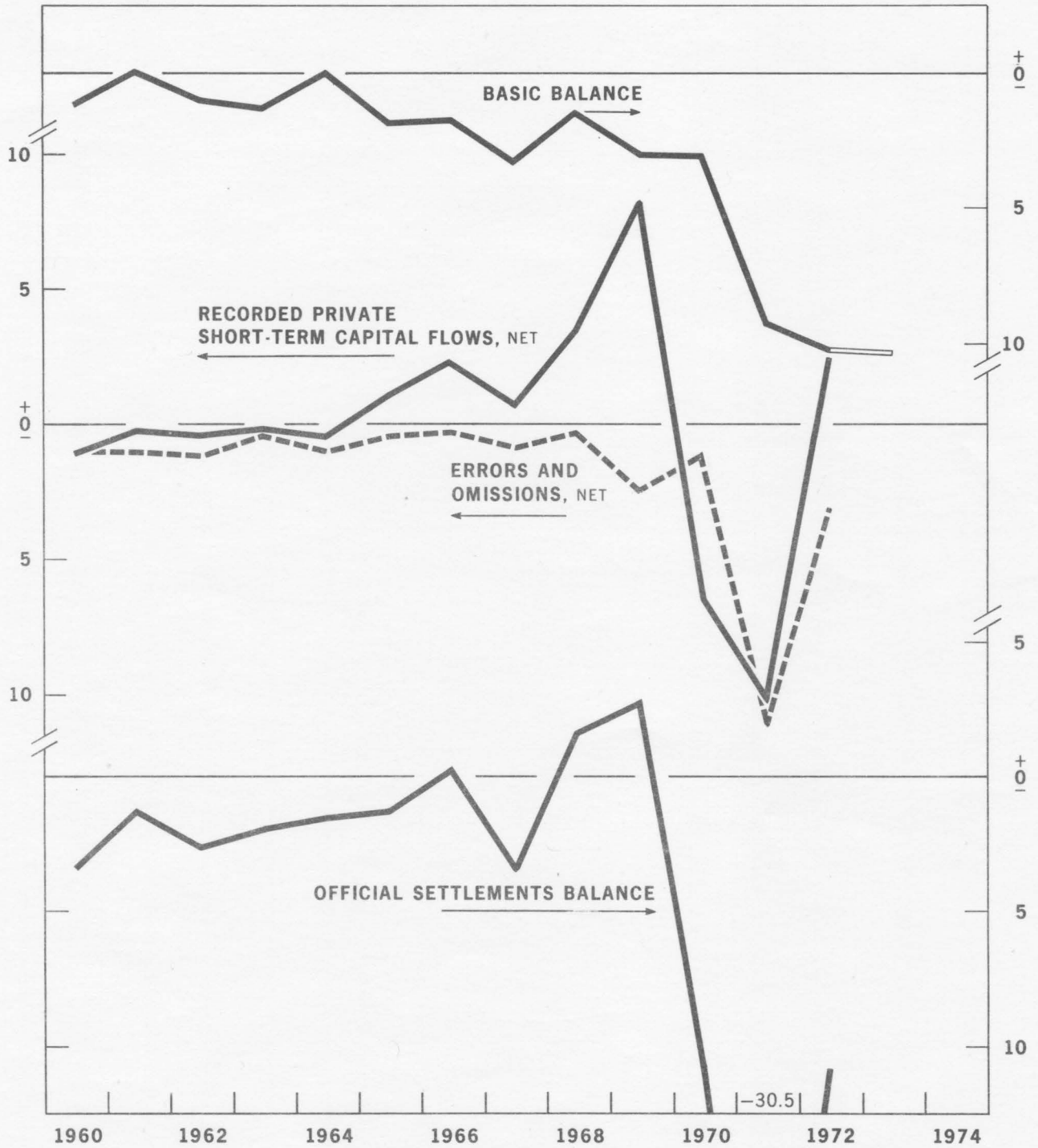
This situation changed abruptly in 1970, when the slowdown in the U.S. economy produced only a mild gain in the trade accounts, while the accommodating posture of monetary policy resulted in a reverse flow of dollars borrowed earlier by U.S. banks. Even then, however, neither we nor other observers, such as the OECD staff, expected more than minor further worsening in the trade balance in the period ahead. The course of Federal Reserve staff projections



Chart 2

OVERALL BALANCE OF PAYMENTS

Billions of dollars



of the trade balance is shown in Chart 3. When, in 1971, the trade balance weakened so much more than had been generally expected -- and when on top of that was piled the final liquidation of U.S. bank borrowings from the Euro-dollar market -- a massive speculative flow into foreign currencies began.

A central question for us is -- why did the U.S. trade balance deteriorate so rapidly after 1964? I believe most observers would concentrate on three factors: (1) relative trends in costs and prices, (2) the growth of productive capacity abroad and differences in attitudes of producers toward foreign markets, and (3) some specific instances of shifts in trade patterns that reflect institutional changes or changes in consumer tastes.

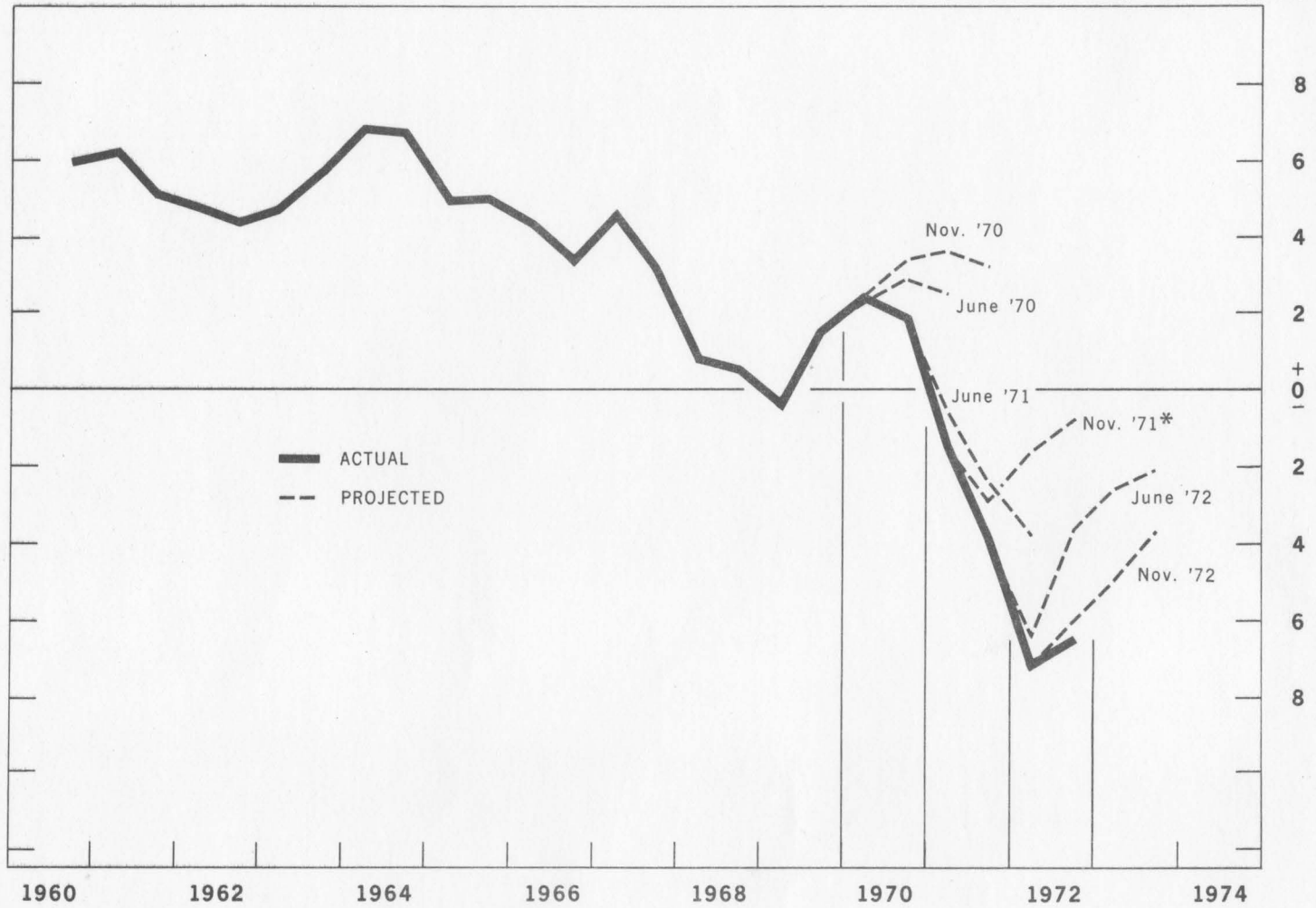
The most important underlying factor in the rapid and continuing worsening in the U.S. trade balance after 1964 was the sharp increase in U.S. prices relative to prices in other industrial countries. The change in price relationships is illustrated in Chart 4 in terms of export unit values of manufactures expressed in U.S. dollars. In that chart one can also see that revaluations and inflation are currently pushing up export prices of some of our main competitors. Nevertheless, there was a sharp break in our own price performance after 1964, creating opportunities for foreign producers, and probably still operating to our disadvantage.



Chart 3

U.S. TRADE BALANCE WITH F.R. PROJECTIONS

Half years, annual rates, billions of dollars



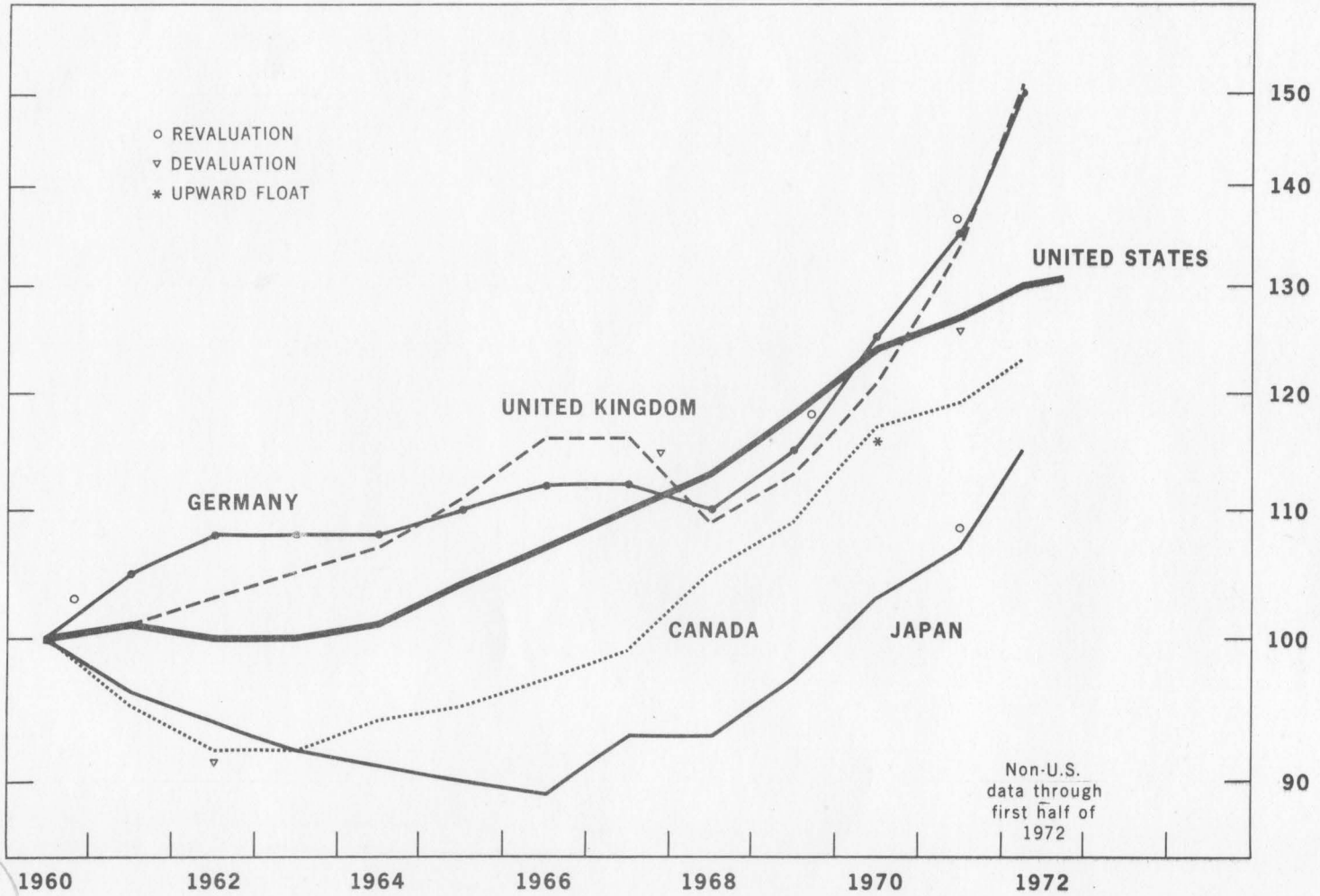
* Included assumption that the import surcharge would continue.



Chart 4

DOLLAR EXPORT PRICES OF MANUFACTURES

Ratio scale, unit values, 1960=100



Increased productive capacity abroad did not suddenly arrive on the scene in 1964, of course, but given its existence foreign producers were able to take advantage of the U.S. inflation, and of the growing pressures on our own supply capabilities. Foreign industrial firms usually depend much more on foreign markets than do their U.S. counterparts, and concentrate considerably greater effort on their export sales. Moreover, U.S. manufacturers have had a greater tendency to meet growing demand abroad by building foreign plants, rather than with exports from the home country. The formation of the European Common Market is an example of an institutional factor that affected trade -- especially our trade in agricultural products -- and also helped to convince U.S. firms to produce abroad. All of these influences have tended to reduce the U.S. share in world trade in manufactures, while the share of Japan, in particular, has increased sharply from a very low post-war base.

While U.S. exports have risen more slowly relative to GNP than has been the case in many other countries, U.S. imports have been increasing more rapidly relative to GNP than elsewhere. The faster rise of U.S. imports that began in the 1960's means that imports are now equal to nearly 5 per cent of GNP, compared to less than 3 per cent ten years ago -- a very sizable difference at the current rate of GNP.



A major feature of the growth of U.S. imports has been the steep rise in finished manufactures; these now account for over half of the total compared to about 25 per cent in the late 1950's. This growth has been quite general, but the most spectacular shift has been in automotive products, where our trade balance has worsened by \$4 billion since 1964. More recently, we have seen the beginnings of a steep rise in imports of fuels; such imports rose only about \$1 billion over the whole decade of the 1960's, but are now expected to rise by \$1-1/2 billion or more annually.

All these questions of just how fast our trade balance and basic balance were worsening, and what would be needed to reverse the trend, came to a head in August 1971.

Mrs. Junz will now pick up the story of the Smithsonian realignment.



III. The Smithsonian Adjustments (Mrs. Junz)

The three main questions that needed to be resolved in August 1971 were: first, how large was the U.S. payments imbalance? second, how was its counterpart distributed among other countries? and third, what pattern of exchange rate changes would correct these imbalances?

Most analysts focused on a rather short-range disequilibrium in considering the needed size of the U.S. adjustment. That is, we within the Fed as well as others tried to estimate the underlying disequilibrium -- apart from cyclical fluctuations -- that would exist in 1972. It is important to note that no allowance was made for the fact that large U.S. deficits would continue after 1972, while conditions leading to the adverse trend were being reversed. This omission resulted in part from the difficulty of reaching agreement even as to the size of the disequilibrium in 1972, let alone as to what the shape of the underlying trend would be two or three years hence. In part, it also reflected the assumption that future exchange rate changes, if needed, could be more easily obtained than before. Finally, it was judged that the full adjustments really needed were probably not negotiable.

In this connection, you will perhaps recall the shock reaction foreign officials had to the Treasury's estimate of a \$13 billion required swing in the U.S. payments balance.



The \$13 billion figure was derived from an estimate that the basic balance, cyclically adjusted, and in the absence of exchange rate changes or equivalent policy measures in 1971, would be in deficit by \$10 billion in 1972. To this \$10 billion figure was added a goal of an official settlements surplus of \$2 to \$3 billion a year, to replenish reserves and establish confidence. Given the trends in capital flows and government expenditures abroad, U.S. analysts arrived at the conclusion that virtually all of the adjustment would have to come in the current balance. If the requirement of a surplus was relaxed, this implied a needed improvement in the trade accounts of about \$10 billion. Although some observers, notably the OECD and, to a lesser extent the IMF, started out with much lower estimates, a compromise consensus was eventually reached that an adjustment of about \$8 billion should be aimed at.

From the point of view of the United States, the easiest way to achieve the desired improvement in our balance of payments would have been to get the highest possible rate of devaluation vis-à-vis our main competitors in the domestic market and in third markets. But such a devaluation pattern, while yielding the right amount for the United States, would not necessarily also have yielded a sustainable equilibrium for each of the other countries involved. Therefore, we had to form a view of how the counterpart of the U.S. disequilibrium was spread among our trading partners

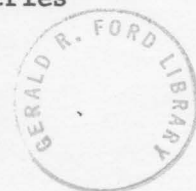


and translate this into an exchange rate pattern that was sustainable and negotiable.

Calculation of such an exchange rate pattern is an enormously difficult jigsaw puzzle. It involves taking account of the effect of the exchange rate changes on domestic cost levels of each of the countries, on the one hand, and the changes in countries' imports and exports that would result from the shift in competitive positions, on the other hand.

Putting all the elements of the puzzle together as best we could, we did derive a desired exchange rate pattern that, in fact, turned out to be not too different from the one that was finally negotiated at the Smithsonian meeting in December 1971. The main differences between our estimated pattern and that which finally resulted was that we had calculated a somewhat greater adjustment for the Japanese yen, a higher rate for the Canadian dollar than it has floated to, and a somewhat smaller rate increase than Great Britain agreed to and indeed, was unable to maintain.

Looking back now, a little over a year later, we recognize at least three important aspects in which our analysis fell short -- First, it was generally assumed that non-OECD countries would not change their exchange rates vis-à-vis the dollar and that they would respond any extra earnings that might result from their implied devaluations against the OECD area. However, a number of these countries, notably the oil countries



but also some others like Brazil, have been accumulating reserves for some time and are continuing to do so. Second, we failed to allow for the fact that revaluations by many industrial countries force up the dollar prices of primary commodities. This raised U.S. import values significantly in 1972. Third, and perhaps most important, too little attention was paid to the fact that lags are long in the adjustment process.

These lags should be thought of in terms of years rather than quarters because it takes time for importers, exporters, and domestic producers to become convinced that the changed profit opportunities are there to stay. And then it takes time to follow through with new investments and marketing programs. Of course, the effect of any specific exchange rate change is crucially influenced by the cyclical constellation at the time. The ideal cyclical position for a devaluing country would be for it to be on the downswing, while competing countries are near the top of their cycle. For example, the French devaluation of August 1969 was effected under near ideal circumstances in this respect. The Smithsonian agreement, unfortunately, came at a time when cyclical circumstances were particularly unfavorable for quick reactions: the United States was moving into a vigorous upswing, while demand abroad was slack.



Last year's misreading of the likely time path led to false expectations of how soon the adjustment results should become visible and consequently to some disenchantment with the efficacy of exchange rate changes as an adjustment instrument. But it should be clear that any lasting adjustment -- that is any fundamental change in the underlying trends -- can hardly take less than three years. During that time U.S. deficits continue -- albeit at a diminishing rate -- and liabilities cumulate.

In summary, we do not doubt that the exchange rate changes of 1971 have created the potential to arrest and reverse over the next few years the adverse trend in the U.S. trade position. But whether or not the full potential will be realized, depends upon demand management policies here and abroad; moreover, even if the full potential is realized, it will give us something less than we thought was needed.

Mr. Clark will now continue the story into 1972.



IV. Developments in the U.S. trade account since the Smithsonian Agreement (Mr. Clark)

When appraising the effects of the December 1971 Smithsonian Agreement, it is important to remember that the dollar began to be effectively devalued more than a year earlier. This can be seen in Chart 5, which depicts the value of the U.S. dollar in terms of foreign currencies, measured from the second quarter of 1969. The Canadian dollar was allowed to float upward in 1970 by about 5 per cent. There were further adjustments in the first part of 1971 as various other currencies appreciated or floated upward. While the Smithsonian exchange rate adjustments were ratified only at the end of 1971, they were in fact occurring throughout the year.

As far as magnitude is concerned, the U.S. devaluation as calculated in Chart 5 was about 10 per cent if measured against other G-10 countries, and only about 6-1/2 per cent against all currencies. There are other methods of calculation which would indicate somewhat larger magnitudes for the devaluation.

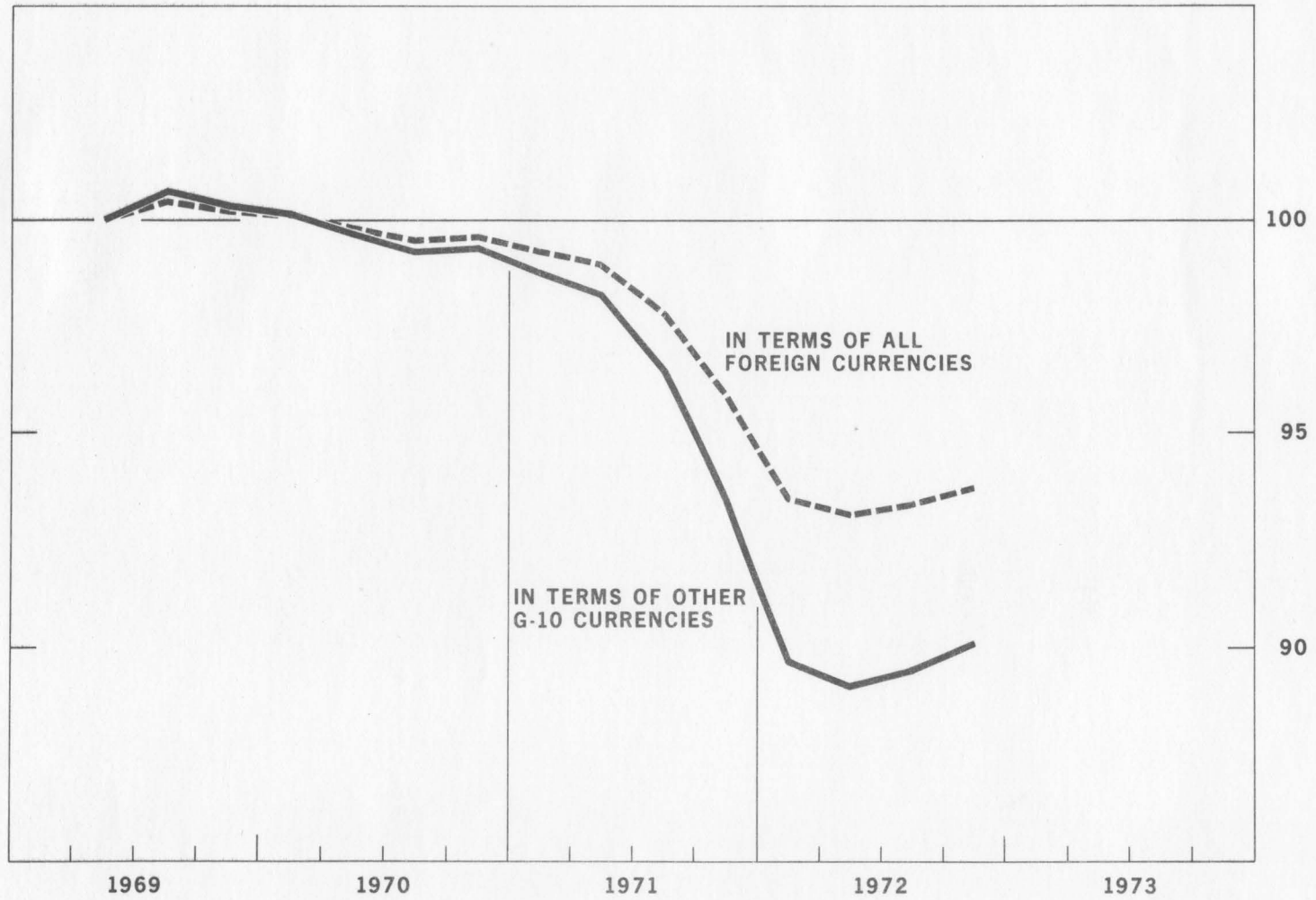
Mrs. Junz has described the anticipated long-run impact of the dollar devaluation and she has emphasized that its effects will be observed only with a considerably greater lag than was generally recognized a year ago. In analyzing the U.S. experience in 1972, it should be pointed out that the path of adjustment of the trade balance to a devaluation is usually "J-shaped," that



Chart 5

INTERNATIONAL VALUE OF THE U.S. DOLLAR

2nd quarter 1969=100



Note: Market exchange rates weighted by foreign trade in 1969.
Assumes no change in average exchange rates of non-G-10 countries against the dollar.



is, an initial perverse effect from an increase in import prices is only later followed by a shrinkage in import volume and growth in exports. As I shall explain in a moment, we believe that the United States has passed the bottom of the "J"; the net impact of the 1971 exchange rate changes on U.S. trade was unfavorable early in 1972, and had probably become favorable by the end of 1972. For the year as a whole, the net effect was approximately neutral.

I should emphasize that it is very difficult to separate out the early effects of exchange rate changes from the much larger effects of cyclical swings and special events such as dock strikes. Different assumptions and techniques, none of which can be rejected out of hand, lead to different results. Nevertheless, alternative calculations are consistent in that they do not point to large gross effects on export and import volumes and prices for 1972 as a whole, and what effects there are tend to be offsetting. Thus there is little dispute that the net effect of the currency realignment on the U.S. trade account in 1972 was minor.

With respect to exports, we estimate a positive effect in volume terms only for finished manufactures amounting to \$1/4 to \$1/2 billion. It appears that the dollar unit values of these



exports -- which of course lag behind new contract prices -- did not rise in 1972 measurably more than they would have in the absence of the dollar devaluation. Thus there was a relative decline in the foreign currency prices of these goods which induced an increase in the quantity sold to foreigners. There was probably no significant increase in the volume of exports other than finished manufactures as a result of the 1971 exchange rate changes. But we believe that the dollar prices of some of these goods rose as a result of the dollar devaluation, so that the value of these other exports increased from \$1/4 to \$1/2 billion. Thus we estimate that the increase in value of total exports in 1972 which can be ascribed to the dollar devaluation ranges from \$1/2 to \$1 billion.

With respect to imports, it should be pointed out that there will be a reduction in the dollar value of imports only if the decline in the quantity imported exceeds the increase in expenditures on imports caused by higher dollar prices. For imports of finished manufactures it appears that in 1972 the reduction in quantity imported roughly offset the rise in import prices resulting from the dollar devaluation. Thus the 1971 exchange rate realignment probably did not cause either a significant increase or decrease in the value of finished manufactured imports in 1972. However, for other goods, namely foods, materials,



and semimanufactures, there was an increase in import prices associated with the realignment which was apparently not offset by a reduction in the quantity imported. Consequently dollar expenditures for these imports increased. Our overall estimate is that the value of total imports may have increased by \$1/2 to \$1 billion in 1972 because import prices had risen as a result of the dollar devaluation.

In summary, we find that the rise in export earnings of \$1/2 to \$1 billion was roughly offset by larger expenditures on imports, and that therefore the trade deficit in 1972 was not materially affected by the exchange rate changes of 1971.

Why did the trade balance deteriorate by \$4 billion between 1971 and 1972? We think there were four main factors: (1) an abnormally high rate of growth in this country compared to most other countries; (2) increased expenditures on imports due to the steep rise in the dollar prices of primary commodities, much of which would have occurred even without the devaluation; (3) the lagged impact of the rapid inflation of 2-3 years ago, coupled with continued growth in the capacity of foreign countries to exploit the resulting cost-price differentials; and (4) a \$1 billion increase in oil imports, partly offset last year by a temporary surge in agricultural exports.



It is important to note that the large worsening in the trade deficit in 1972 does not itself call into question the general efficacy of parity changes. We have already observed in 1972 the beginnings of the anticipated responses in exports and imports to the 1971 exchange rate changes. We anticipate that for the year 1973 as a whole there will be an overall positive impact on the trade balance ranging from \$1-1/2 to \$2-1/2 billion, and we expect the beneficial effects in 1974 and 1975 to be substantially larger.

The question remains, however, whether they will be sufficient. Mr. Reynolds will discuss this question.



V. Outlook and Concluding Observations (Mr. Reynolds)

Mr. Clark has explained why the exchange rate changes of 1971 had little net effect on our trade and payments position in 1972. Mrs. Junz has explained why we expect that those rate changes during the next two or three years will be substantially improving our trade balance compared with what it would otherwise have been. Chart 6 presents a schematic, highly simplified, diagram of the way in which these exchange rate effects may work themselves out.

This diagram, I should note, has become the object of much controversy among those in the International Division who are working on this subject. No two economists would draw it in exactly the same way. Yet its general shape is agreed to by all, and illustrates four major points.

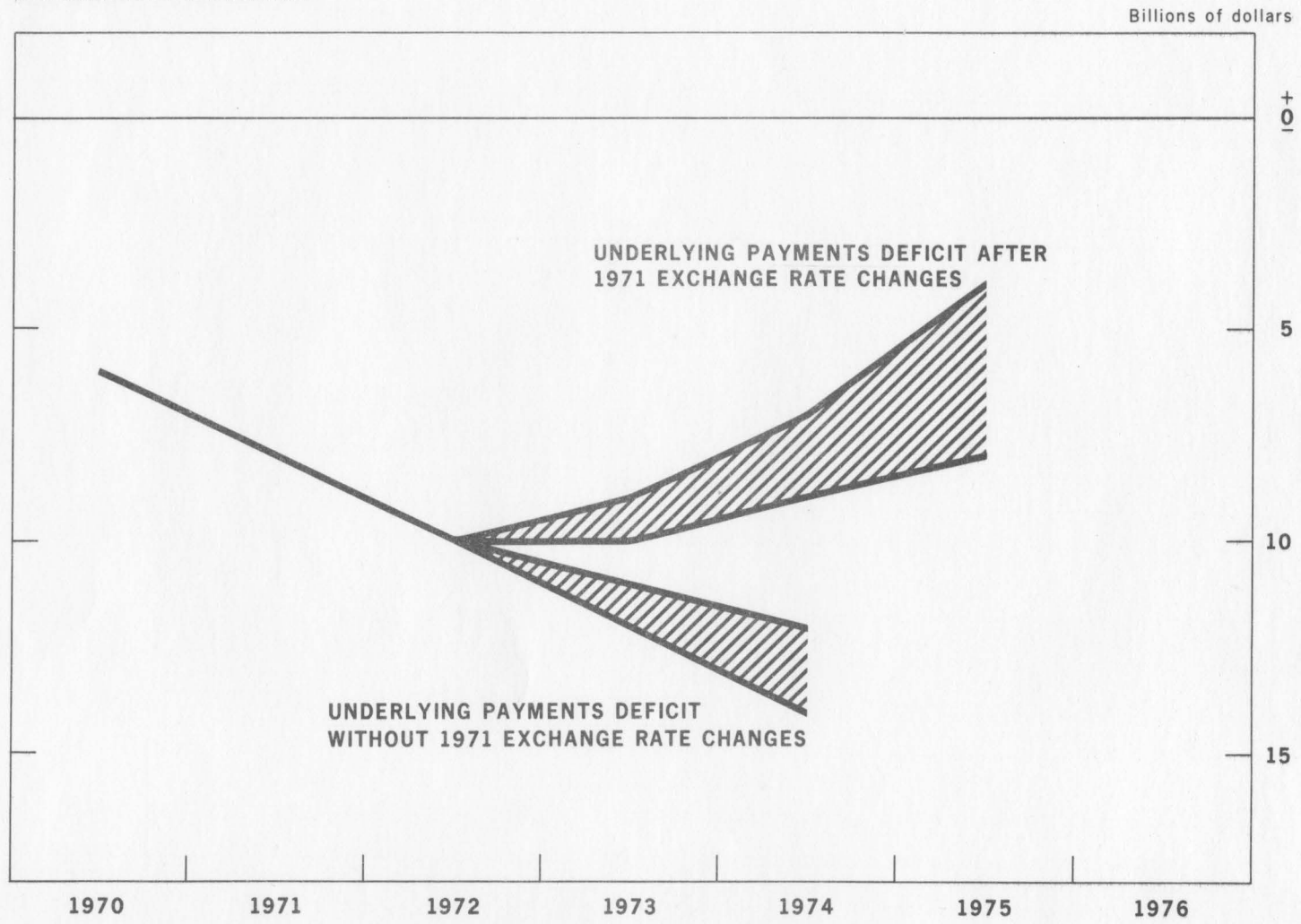
(1) First, the United States entered the 1970's with a large underlying payments deficit. By underlying deficit we mean the deficit on official reserve transactions adjusted for cyclical fluctuations and for abnormal capital flows.

(2) Second, this underlying deficit was tending to increase rapidly, primarily because of the deterioration on merchandise trade account. There is some uncertainty about what the trend actually was in 1970-72, and, of course, great uncertainty as to how the trend might have developed beyond 1972 if



Chart 6

SCHEMATIC DIAGRAM



there had been no exchange rate changes. The width of the lower shaded area in the diagram illustrates this uncertainty. We saw no point in extending what might have been beyond 1974.

(3) Third, all Division economists agree that the exchange rate changes of 1971 will work in the direction of reducing the underlying payments deficit below what it would otherwise have been, mainly by reducing the trade deficit below what it would otherwise have been. The amount of that improvement remains very uncertain, partly because we are not sure of our techniques of analysis, but even more because other developments in the United States and abroad are only dimly foreseeable. To encompass the full range of views of all the economists in the International Division, the upper shaded area in Chart 6 would have to extend from about -\$1 billion to about -\$9 billion in 1975, rather than the narrower range shown.

(4) Nevertheless, and this is the fourth point, we all agree that the probabilities are that the United States will still have a substantial underlying payments deficit in 1975 and beyond if no further adjustment actions are taken. And we are virtually certain that there will be large underlying deficits in the intervening period, 1973 and 1974. This will be so, as the schematic diagram indicates, in spite of the large beneficial effects we expect to result from the exchange rate changes of 1971. Hence,



U.S. liabilities to foreign reserve holders, shown in Chart 7, which are already enormous -- some \$61 billion at the end of 1972 -- will continue to accumulate this year and next.

It is interesting to consider the question: what would a satisfactory and sustainable U.S. balance of payments look like in the mid-1970's in a year not subject to abnormal capital flows and not characterized by cyclical deviations of economic activity from long-run trends? I have suggested an answer in the final column of Table 1, which shows a possible "target" pattern for 1975 compared with the actual results in recent years and the projected outcome for 1973 not adjusted for the business cycle. My 1975 "target" figures are similar to those submitted by the U.S. delegation to Working Party 3 as a statement of U.S. balance-of-payments aims.

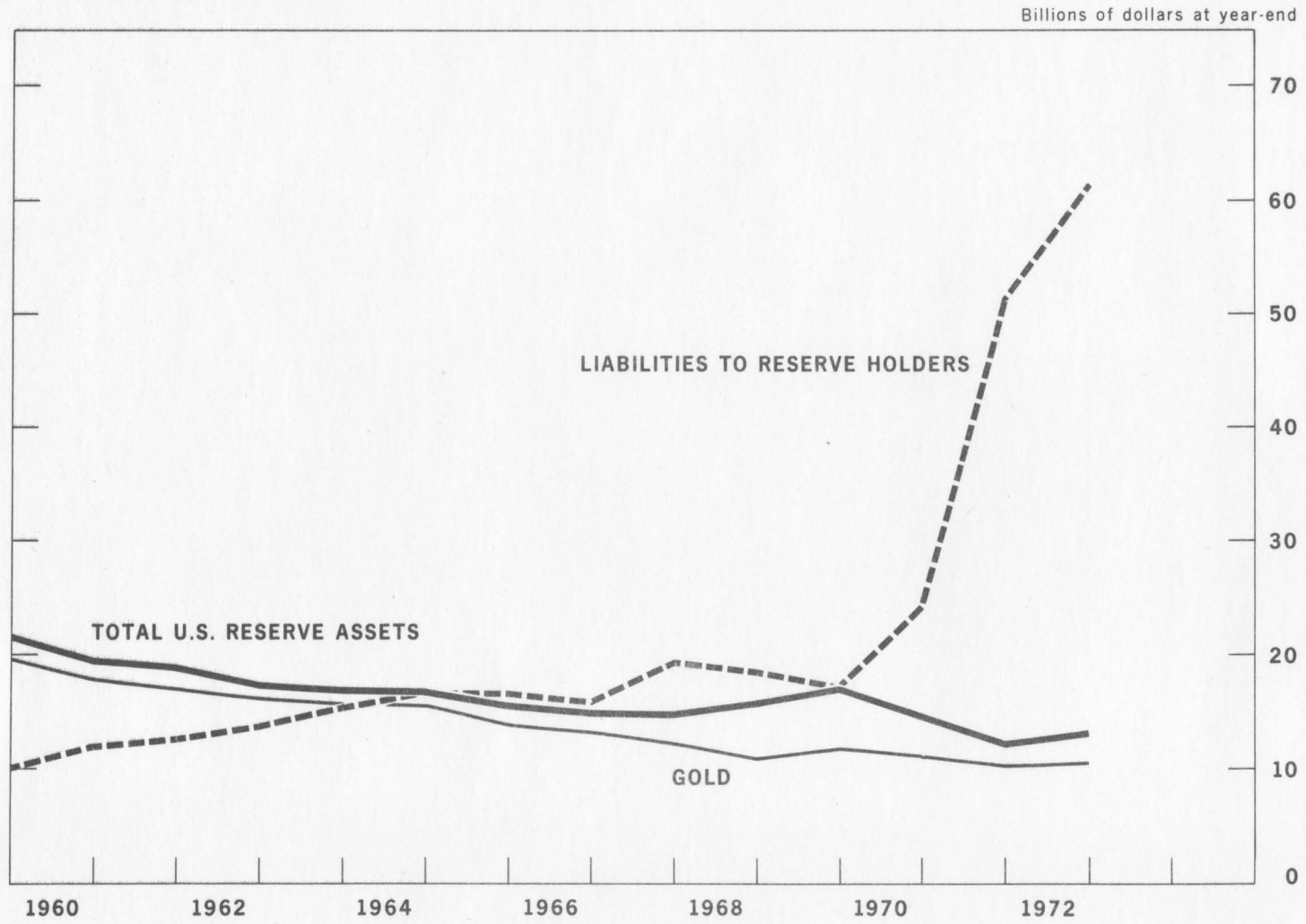
A satisfactory result for the balance of payments over-all probably requires balance or a small surplus on the official reserve transactions basis. This is indicated by the zero on the bottom line of the last column of Table 1.

Plausible estimates of likely net outflows of private and government capital in a normal year lead to the conclusion that the current account balance -- the middle line in the table -- will need to be in surplus by about \$9 billion or so. The nontrade current items all are reasonably predictable. We are left with the need



Chart 7

U.S. RESERVE POSITION



CONFIDENTIAL (FR)

Table 1. U.S. Balance of Payments, 1963-73,
Compared with Possible "Target" Pattern for 1975
(In billions of dollars)

	Average 1963-66	Average 1967-70	Actual		Pro- jected 1973	Possible "target" pattern for 1975 ^{1/}
			1971	1972(p)		
Trade balance	+5.2	+1.8	-2.7	-6.8	-5.0	+7
Investment income, net	+4.9	+6.1	+8.0	+7.7	+7.3	+9
Military transactions, net	-2.4	-3.2	-2.9	-3.5	-3.2	-3
Travel, including fares, net	-1.5	-2.0	-2.5	-2.9	-3.2	-4
Other transportation, net	+0.2	+0.2	+0.1	+0.3	+0.5	} +2
Other services, net	+0.2	+0.4	+0.7	+0.7	+1.0	
<u>BALANCE ON GOODS & SERVICES</u>	+6.7	+3.3	+0.7	-4.5	-2.6	+11
Remittances and pensions, net	-0.9	-1.3	-1.5	-1.5	-1.6	-2
<u>BALANCE ON GOODS, SERVICES AND REMITTANCES (Current Account)</u>	+5.8	+1.9	-0.8	-6.0	-4.2	+9
Govt. grants and capital, net	-3.3	-3.9	-4.4	-3.6	-4.8	-5
Private long-term capital, net	-3.7	-0.8	-4.1	-0.6	-1.4	-2-1/2
<u>BALANCE ON CURRENT AND LONG-TERM CAPITAL TRANSACTIONS</u> ("Basic Balance")	-1.2	-2.7	-9.3	-10.2	-10.4	+1-1/2
Private short-term capital, net	+0.7	+1.5	-10.1	+2.5	(?)	-1/2
Errors and omissions, net	-0.6	-1.2	-11.0	-3.1	(?)	-1
<u>BALANCE ON OFFICIAL RESERVE TRANSACTIONS</u> (Excl. SDR allocations)	-1.1	-2.4	-30.5	-10.8	(?)	0

(p) Preliminary.

^{1/} Assuming no abnormal capital flows and no cyclical deviations of economic activity in the United States and abroad from long-run trends.

February 5, 1973



for a trade surplus -- the top line -- of the order of \$7 billion in 1975.

It is very difficult to see how our trade position can approach that level by 1975. As we have said, we do expect very substantial beneficial effects from past exchange rate changes. Moreover, we expect some wearing off of unfavorable cyclical pressures of demand after 1973, and we hope for a good price-cost performance in this country. These favorable effects, however, seem quite unlikely -- even under the most optimistic assumptions -- to be sufficient. If one looks at Chart 8, showing the trade balance and its trend over a long period, one can see what a distance there is to go if the balance is to improve to anything in the neighborhood of \$7 billion. Thus it is our best judgment that a substantial adjustment problem remains -- quite possibly of the order of \$5 billion or more, and almost certainly not less than \$2 to \$3 billion.

These figures are necessarily very rough. But however one shades them, the broad conclusion still emerges that an adjustment problem remains, and that it is a sizable problem.

In conclusion, I would like to make two final observations.

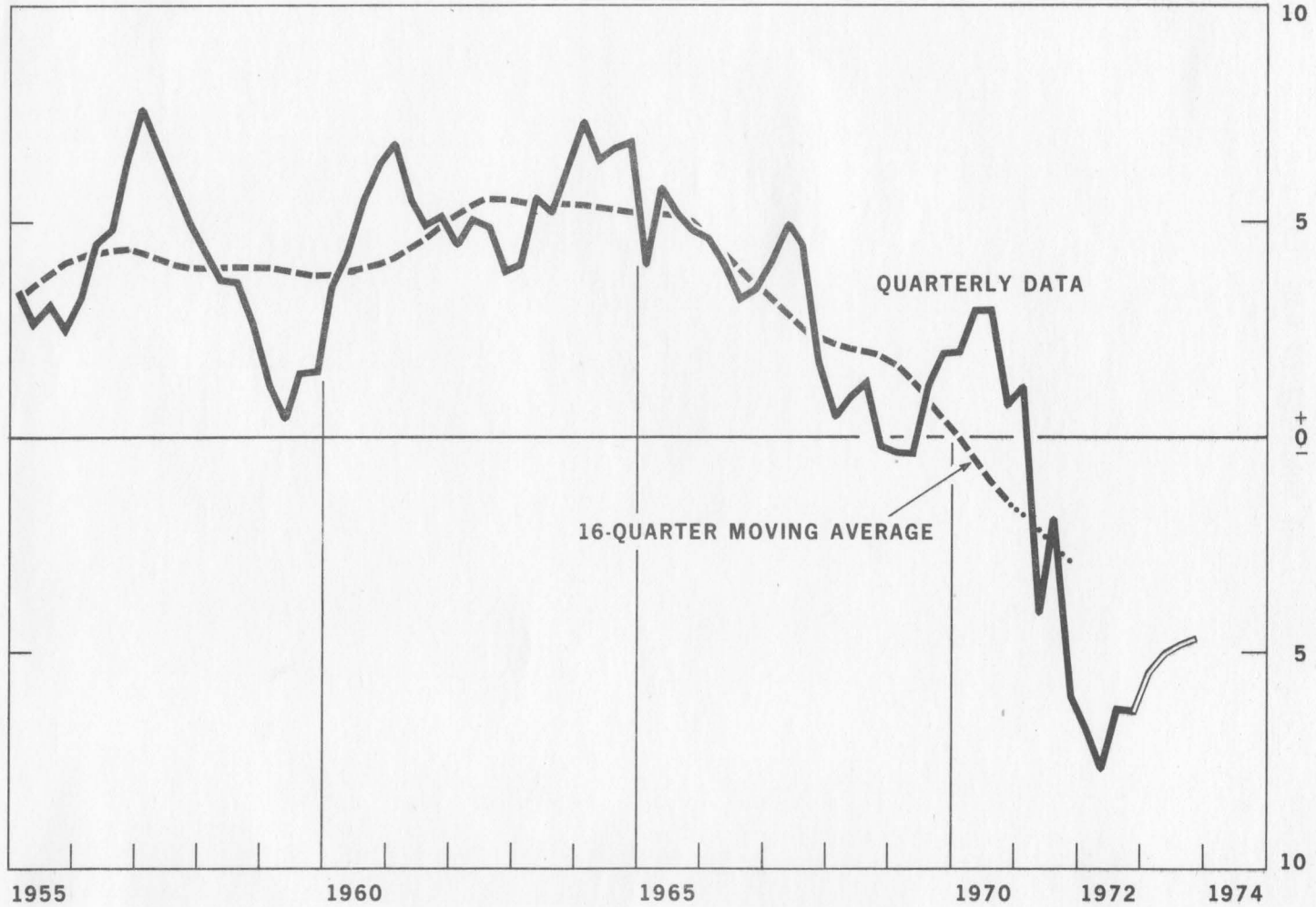
First, the size of what I have called the "remaining adjustment problem" depends critically on the evolution of our domestic economy and on the course of economic activity abroad. Our current projections for 1973 assume a significantly better cost-price performance in the United States than in other industrial countries. Our



Chart 8

U.S. FOREIGN TRADE BALANCE

Annual rates, billions of dollars



estimates of the size of the favorable exchange-rate effects to be expected this year and in 1974 and 1975 also depend on the assumption that an excessive boom is avoided here at home. If this assumption were to be proved incorrect, our appraisal of the long-run prospects for international payments equilibrium -- which in any case points to difficulties ahead -- would of course have to be revised in an adverse direction, and by a large amount.

The second observation I want to leave with you follows directly from our conclusion that, even under the most optimistic assumptions about a better cost-price performance in the United States, the United States will still have a remaining adjustment problem of substantial magnitude. We are going to need -- sooner or later, and from the point of view of international payments equilibrium, sooner would be preferable to later -- some further changes in exchange rates, certainly for Japan, and probably also for a number of other countries. Increasing perception of this likelihood has no doubt contributed to the uneasiness in foreign exchange markets in recent weeks, and can be expected to generate further market instability in the weeks to come.



STRICTLY CONFIDENTIAL (FR)

THE U. S. BALANCE-OF-PAYMENTS PROBLEM:
RECENT DEVELOPMENTS AND PROSPECTS

Special Briefing for the Board of Governors
by the Division of International Finance

February 5, 1973



I. Introduction (Mr. Reynolds)

In recent months, our Division has been reassessing in some depth the current and prospective state of the U.S. balance of payments and the whole international payments problem.

It now appears to us that the causes of the deterioration in the U.S. international trade and payments position during the late 1960's and early 1970's were more deep-seated and persistent than was generally realized even as recently as one year ago. The Smithsonian exchange rate adjustments went a considerable distance towards correcting international imbalances, and we shall be benefiting substantially from their lagged effects during the next few years. But it is becoming increasingly clear that the Smithsonian adjustments did not go far enough.

Let me outline our presentation for you so you can see how the pieces fit together. Mr. Pizer will review very briefly the developments that led up to the U.S. emergency actions of August 1971. Mrs. Junz will discuss the adjustments that were sought, and those that were achieved, at the Smithsonian. Mr. Clark will describe developments during 1972, attempting to separate the effects of exchange rate changes from those resulting from business cycle swings and special factors. I will conclude with an estimate of the distance we still have to go to reach reasonable equilibrium in our international transactions.

I think it will be most useful to you if we speak our pieces first, and then invite your questions. But you should, of course, interrupt at any point if it is not clear what we are trying to say.

Mr. Pizer.



II. Background to the Smithsonian Agreement (Mr. Pizer)

In the first half of the 1960's there were persistent but relatively small overall deficits in our balance of payments. Even though these deficits were not worsening, liquid liabilities to foreign monetary authorities were piling up and U.S. reserves were declining.

At that time the trade balance was strong, as seen in the top panel of Chart 1, and seemed to be improving. The view was widely accepted that in consequence of the superior U.S. price performance after 1959, time was on our side. Rising capital outflows did cause some concern, and the IET was enacted. In fact, there was enough worry about the deficits to produce several Presidential messages on the balance of payments, all listing measures aimed at alleviating or financing what was thought to be a temporary problem.

By 1965, with the gap between actual and potential GNP closed, and the war in Vietnam adding to demands, the U.S. trade balance began to deteriorate. The worsening was interrupted only briefly in 1967, and in 1969-70, by slowdowns in U.S. demand relative to other industrial countries, and the worsening accelerated in 1971.

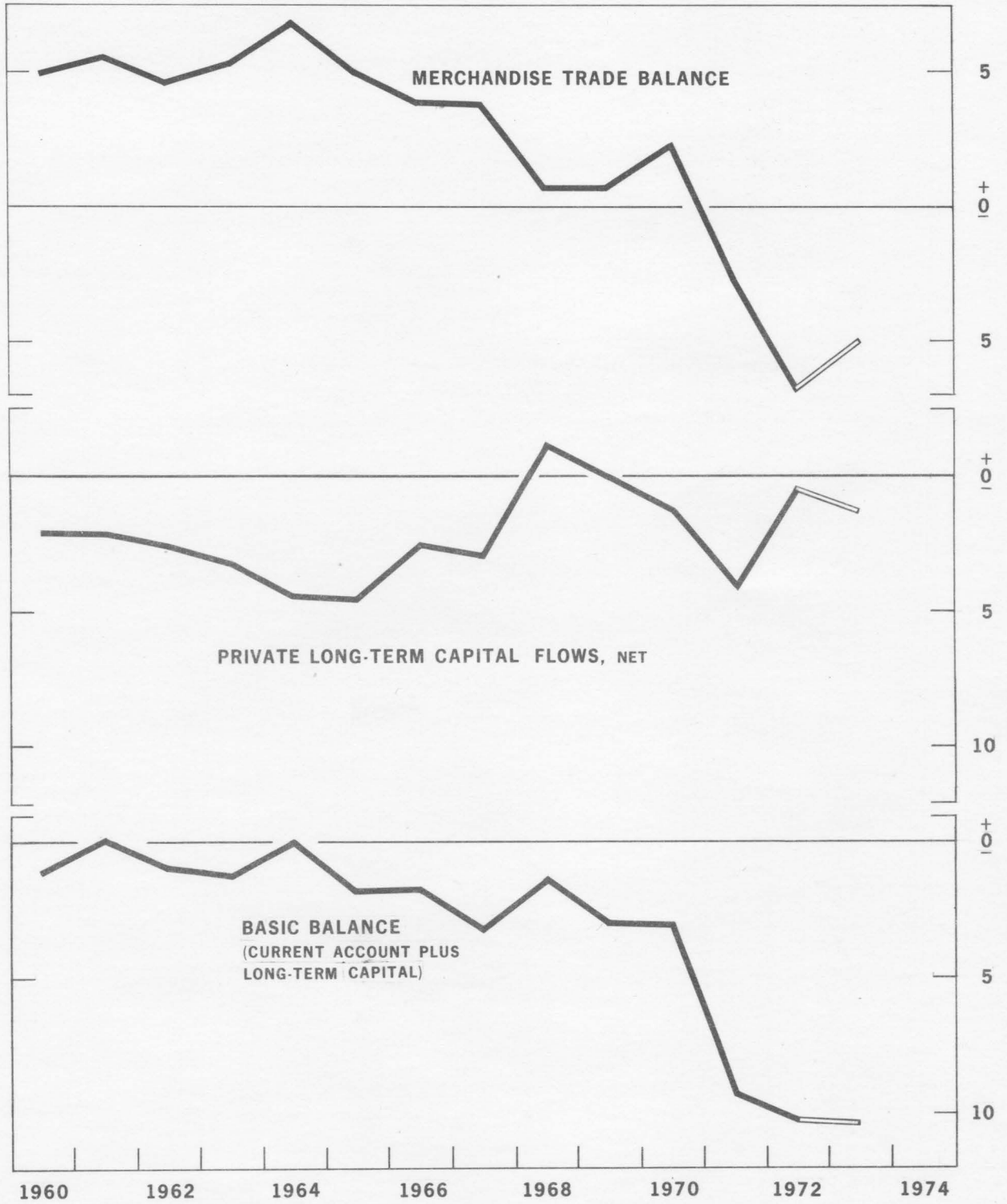
Meanwhile, private long-term capital outflows -- shown in the middle panel of Chart 1 -- which had been steadily growing larger, were reduced by the voluntary restrictions in 1965 and the



Chart 1

MAJOR BALANCE OF PAYMENTS SECTORS

Billions of dollars



more stringent mandatory controls imposed in 1968. This checking of long-term capital outflows offset the weakness of the trade balance for a time, and the basic balance -- given in the bottom panel of the chart -- showed only a slow worsening.

The top panel of Chart 2 repeats the plot of the basic balance. The middle panel of the chart shows recorded net private short-term capital flows and the errors and omissions item. As you can see, recorded short-term capital inflows temporarily swelled to enormous proportions in 1968-69, as U.S. banks reacted to tighter monetary conditions at home and the ready availability of liquid funds abroad. For a time, therefore, favorable shifts in capital flows offset the decline in the trade balance and kept the official settlements deficit within a relatively narrow band. Indeed, as shown in the bottom panel of the chart, there were surpluses in this overall measure in 1968 and 1969, which caused some relaxation of concern.

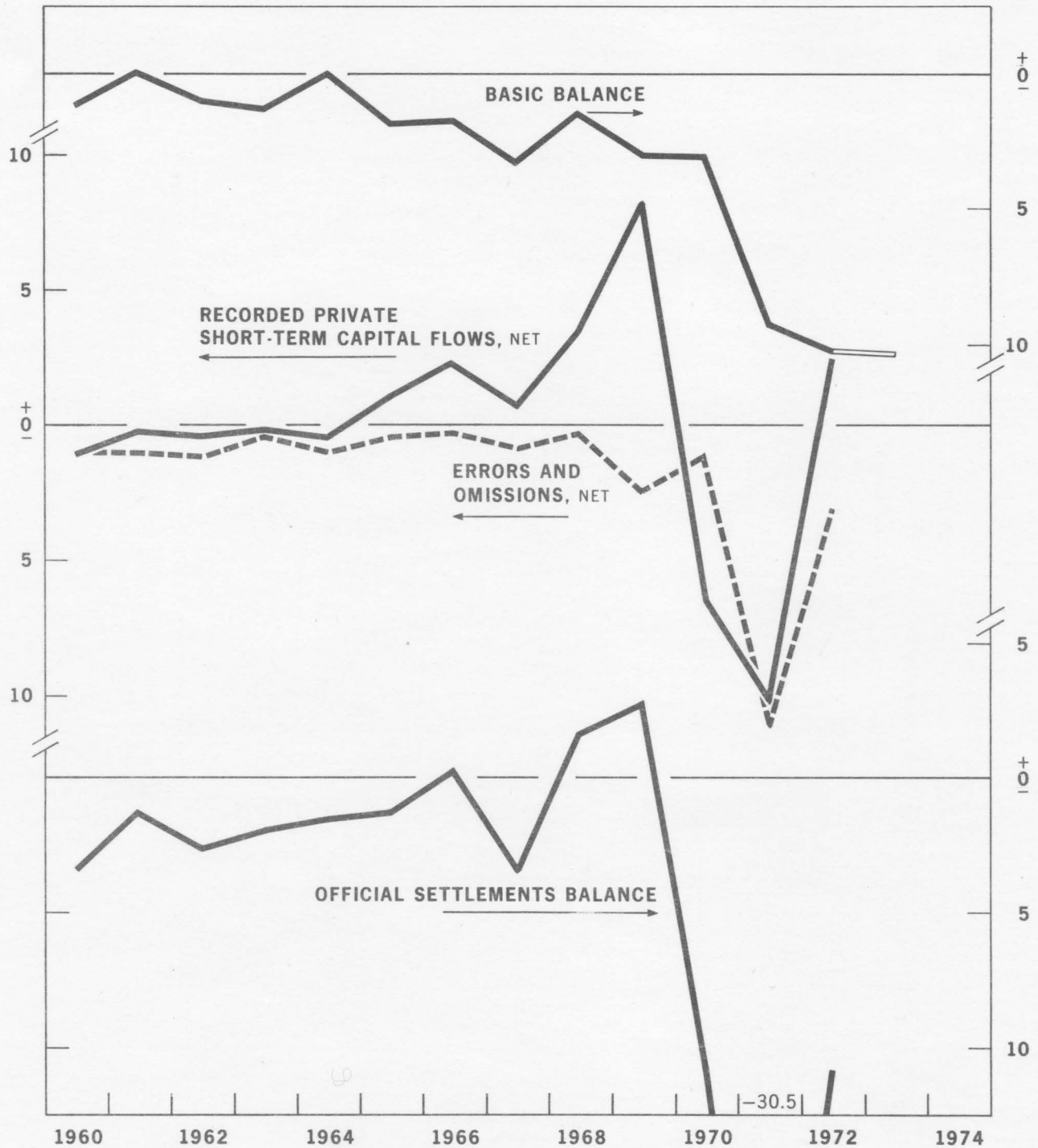
This situation changed abruptly in 1970, when the slowdown in the U.S. economy produced only a mild gain in the trade accounts, while the accommodating posture of monetary policy resulted in a reverse flow of dollars borrowed earlier by U.S. banks. Even then, however, neither we nor other observers, such as the OECD staff, expected more than minor further worsening in the trade balance in the period ahead. The course of Federal Reserve staff projections



Chart 2

OVERALL BALANCE OF PAYMENTS

Billions of dollars



of the trade balance is shown in Chart 3. When, in 1971, the trade balance weakened so much more than had been generally expected -- and when on top of that was piled the final liquidation of U.S. bank borrowings from the Euro-dollar market -- a massive speculative flow into foreign currencies began.

A central question for us is -- why did the U.S. trade balance deteriorate so rapidly after 1964? I believe most observers would concentrate on three factors: (1) relative trends in costs and prices, (2) the growth of productive capacity abroad and differences in attitudes of producers toward foreign markets, and (3) some specific instances of shifts in trade patterns that reflect institutional changes or changes in consumer tastes.

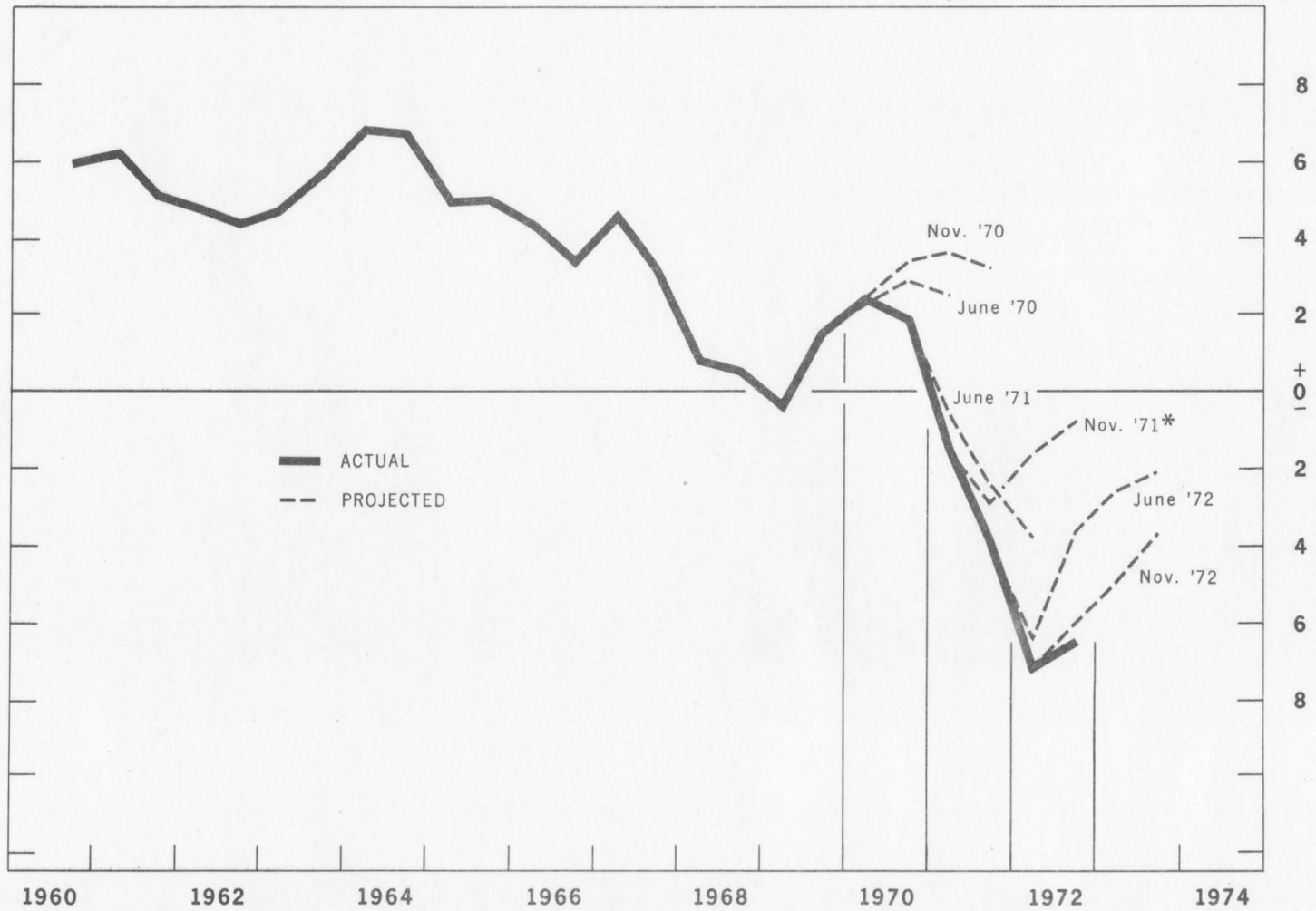
The most important underlying factor in the rapid and continuing worsening in the U.S. trade balance after 1964 was the sharp increase in U.S. prices relative to prices in other industrial countries. The change in price relationships is illustrated in Chart 4 in terms of export unit values of manufactures expressed in U.S. dollars. In that chart one can also see that revaluations and inflation are currently pushing up export prices of some of our main competitors. Nevertheless, there was a sharp break in our own price performance after 1964, creating opportunities for foreign producers, and probably still operating to our disadvantage.



Chart 3

U.S. TRADE BALANCE WITH F.R. PROJECTIONS

Half years, annual rates, billions of dollars



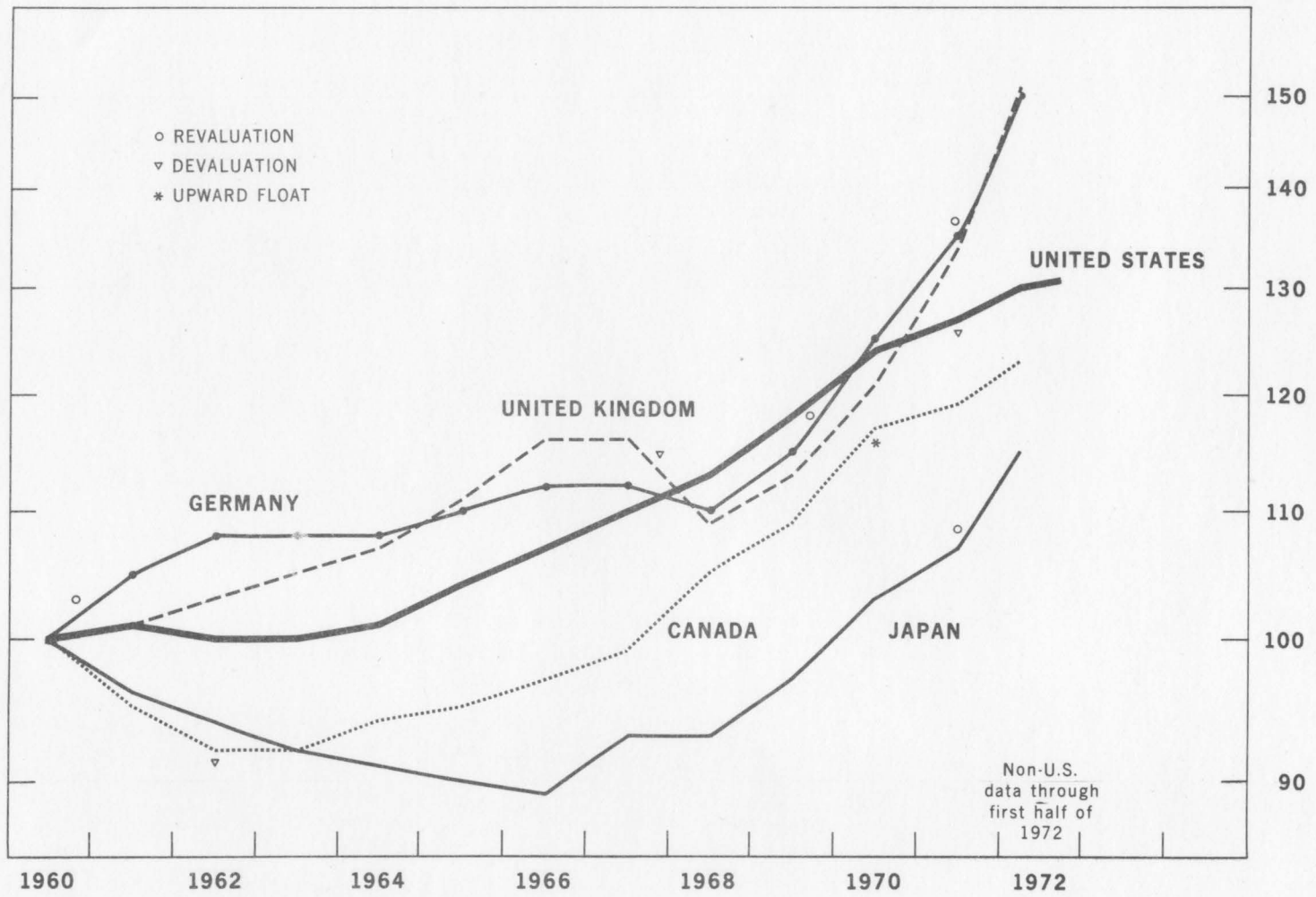
* Included assumption that the import surcharge would continue.



Chart 4

DOLLAR EXPORT PRICES OF MANUFACTURES

Ratio scale, unit values, 1960=100



Increased productive capacity abroad did not suddenly arrive on the scene in 1964, of course, but given its existence foreign producers were able to take advantage of the U.S. inflation, and of the growing pressures on our own supply capabilities. Foreign industrial firms usually depend much more on foreign markets than do their U.S. counterparts, and concentrate considerably greater effort on their export sales. Moreover, U.S. manufacturers have had a greater tendency to meet growing demand abroad by building foreign plants, rather than with exports from the home country. The formation of the European Common Market is an example of an institutional factor that affected trade -- especially our trade in agricultural products -- and also helped to convince U.S. firms to produce abroad. All of these influences have tended to reduce the U.S. share in world trade in manufactures, while the share of Japan, in particular, has increased sharply from a very low post-war base.

While U.S. exports have risen more slowly relative to GNP than has been the case in many other countries, U.S. imports have been increasing more rapidly relative to GNP than elsewhere. The faster rise of U.S. imports that began in the 1960's means that imports are now equal to nearly 5 per cent of GNP, compared to less than 3 per cent ten years ago -- a very sizable difference at the current rate of GNP.



A major feature of the growth of U.S. imports has been the steep rise in finished manufactures; these now account for over half of the total compared to about 25 per cent in the late 1950's. This growth has been quite general, but the most spectacular shift has been in automotive products, where our trade balance has worsened by \$4 billion since 1964. More recently, we have seen the beginnings of a steep rise in imports of fuels; such imports rose only about \$1 billion over the whole decade of the 1960's, but are now expected to rise by \$1-1/2 billion or more annually.

All these questions of just how fast our trade balance and basic balance were worsening, and what would be needed to reverse the trend, came to a head in August 1971.

Mrs. Junz will now pick up the story of the Smithsonian realignment.



III. The Smithsonian Adjustments (Mrs. Junz)

The three main questions that needed to be resolved in August 1971 were: first, how large was the U.S. payments imbalance? second, how was its counterpart distributed among other countries? and third, what pattern of exchange rate changes would correct these imbalances?

Most analysts focused on a rather short-range disequilibrium in considering the needed size of the U.S. adjustment. That is, we within the Fed as well as others tried to estimate the underlying disequilibrium -- apart from cyclical fluctuations -- that would exist in 1972. It is important to note that no allowance was made for the fact that large U.S. deficits would continue after 1972, while conditions leading to the adverse trend were being reversed. This omission resulted in part from the difficulty of reaching agreement even as to the size of the disequilibrium in 1972, let alone as to what the shape of the underlying trend would be two or three years hence. In part, it also reflected the assumption that future exchange rate changes, if needed, could be more easily obtained than before. Finally, it was judged that the full adjustments really needed were probably not negotiable.

In this connection, you will perhaps recall the shock reaction foreign officials had to the Treasury's estimate of a \$13 billion required swing in the U.S. payments balance.



The \$13 billion figure was derived from an estimate that the basic balance, cyclically adjusted, and in the absence of exchange rate changes or equivalent policy measures in 1971, would be in deficit by \$10 billion in 1972. To this \$10 billion figure was added a goal of an official settlements surplus of \$2 to \$3 billion a year, to replenish reserves and establish confidence. Given the trends in capital flows and government expenditures abroad, U.S. analysts arrived at the conclusion that virtually all of the adjustment would have to come in the current balance. If the requirement of a surplus was relaxed, this implied a needed improvement in the trade accounts of about \$10 billion. Although some observers, notably the OECD and, to a lesser extent the IMF, started out with much lower estimates, a compromise consensus was eventually reached that an adjustment of about \$8 billion should be aimed at.

From the point of view of the United States, the easiest way to achieve the desired improvement in our balance of payments would have been to get the highest possible rate of devaluation vis-à-vis our main competitors in the domestic market and in third markets. But such a devaluation pattern, while yielding the right amount for the United States, would not necessarily also have yielded a sustainable equilibrium for each of the other countries involved. Therefore, we had to form a view of how the counterpart of the U.S. disequilibrium was spread among our trading partners



and translate this into an exchange rate pattern that was sustainable and negotiable.

Calculation of such an exchange rate pattern is an enormously difficult jigsaw puzzle. It involves taking account of the effect of the exchange rate changes on domestic cost levels of each of the countries, on the one hand, and the changes in countries' imports and exports that would result from the shift in competitive positions, on the other hand.

Putting all the elements of the puzzle together as best we could, we did derive a desired exchange rate pattern that, in fact, turned out to be not too different from the one that was finally negotiated at the Smithsonian meeting in December 1971. The main differences between our estimated pattern and that which finally resulted was that we had calculated a somewhat greater adjustment for the Japanese yen, a higher rate for the Canadian dollar than it has floated to, and a somewhat smaller rate increase than Great Britain agreed to and indeed, was unable to maintain.

Looking back now, a little over a year later, we recognize at least three important aspects in which our analysis fell short -- First, it was generally assumed that non-OECD countries would not change their exchange rates vis-à-vis the dollar and that they would respond any extra earnings that might result from their implied devaluations against the OECD area. However, a number of these countries, notably the oil countries



but also some others like Brazil, have been accumulating reserves for some time and are continuing to do so. Second, we failed to allow for the fact that revaluations by many industrial countries force up the dollar prices of primary commodities. This raised U.S. import values significantly in 1972. Third, and perhaps most important, too little attention was paid to the fact that lags are long in the adjustment process.

These lags should be thought of in terms of years rather than quarters because it takes time for importers, exporters, and domestic producers to become convinced that the changed profit opportunities are there to stay. And then it takes time to follow through with new investments and marketing programs. Of course, the effect of any specific exchange rate change is crucially influenced by the cyclical constellation at the time. The ideal cyclical position for a devaluing country would be for it to be on the downswing, while competing countries are near the top of their cycle. For example, the French devaluation of August 1969 was effected under near ideal circumstances in this respect. The Smithsonian agreement, unfortunately, came at a time when cyclical circumstances were particularly unfavorable for quick reactions: the United States was moving into a vigorous upswing, while demand abroad was slack.



Last year's misreading of the likely time path led to false expectations of how soon the adjustment results should become visible and consequently to some disenchantment with the efficacy of exchange rate changes as an adjustment instrument. But it should be clear that any lasting adjustment -- that is any fundamental change in the underlying trends -- can hardly take less than three years. During that time U.S. deficits continue -- albeit at a diminishing rate -- and liabilities cumulate.

In summary, we do not doubt that the exchange rate changes of 1971 have created the potential to arrest and reverse over the next few years the adverse trend in the U.S. trade position. But whether or not the full potential will be realized, depends upon demand management policies here and abroad; moreover, even if the full potential is realized, it will give us something less than we thought was needed.

Mr. Clark will now continue the story into 1972.



IV. Developments in the U.S. trade account since the Smithsonian Agreement (Mr. Clark)

When appraising the effects of the December 1971 Smithsonian Agreement, it is important to remember that the dollar began to be effectively devalued more than a year earlier. This can be seen in Chart 5, which depicts the value of the U.S. dollar in terms of foreign currencies, measured from the second quarter of 1969. The Canadian dollar was allowed to float upward in 1970 by about 5 per cent. There were further adjustments in the first part of 1971 as various other currencies appreciated or floated upward. While the Smithsonian exchange rate adjustments were ratified only at the end of 1971, they were in fact occurring throughout the year.

As far as magnitude is concerned, the U.S. devaluation as calculated in Chart 5 was about 10 per cent if measured against other G-10 countries, and only about 6-1/2 per cent against all currencies. There are other methods of calculation which would indicate somewhat larger magnitudes for the devaluation.

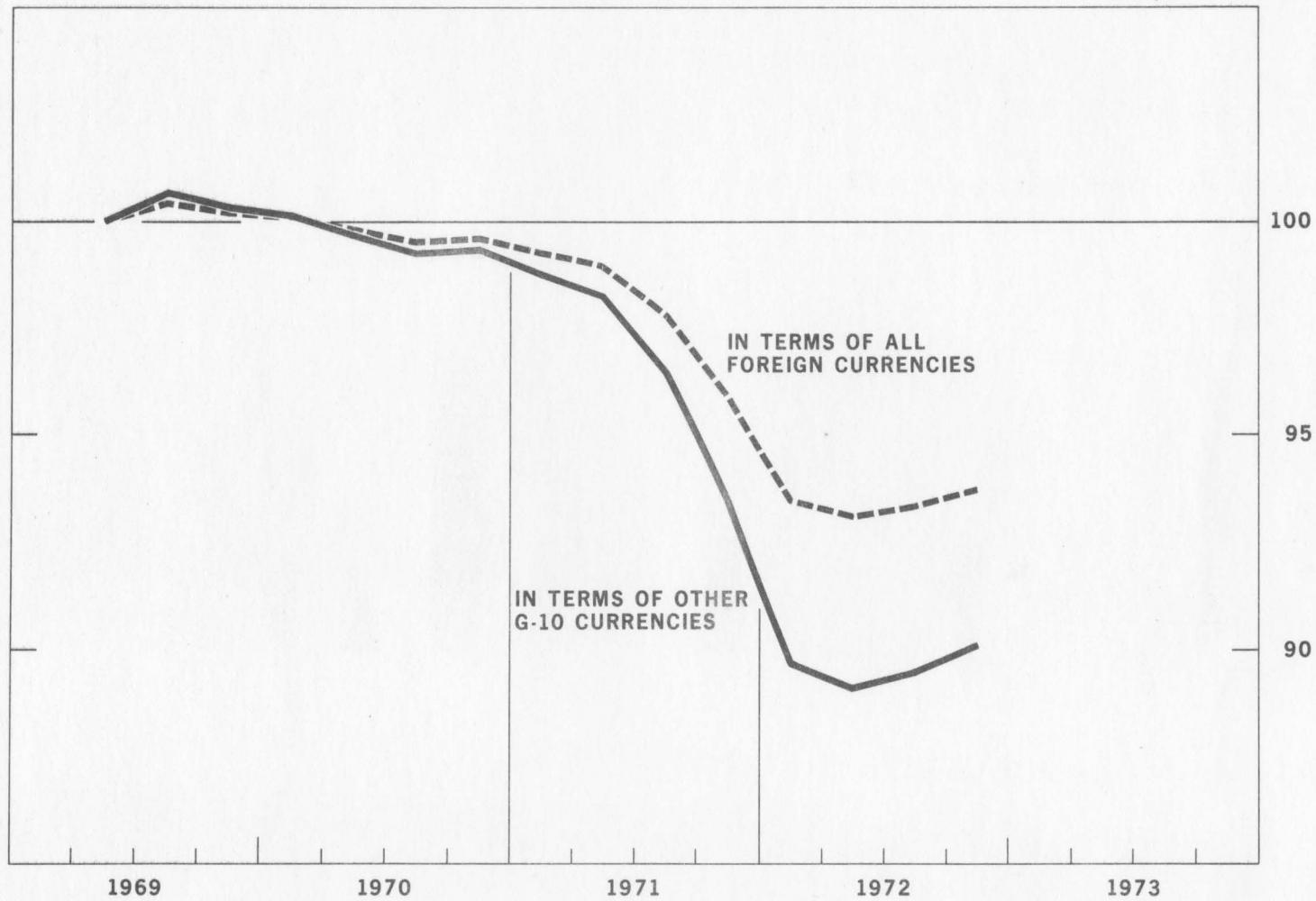
Mrs. Junz has described the anticipated long-run impact of the dollar devaluation and she has emphasized that its effects will be observed only with a considerably greater lag than was generally recognized a year ago. In analyzing the U.S. experience in 1972, it should be pointed out that the path of adjustment of the trade balance to a devaluation is usually "J-shaped," that



Chart 5

INTERNATIONAL VALUE OF THE U.S. DOLLAR

2nd quarter 1969=100



Note: Market exchange rates weighted by foreign trade in 1969.

Assumes no change in average exchange rates of non-G-10 countries against the dollar.



is, an initial perverse effect from an increase in import prices is only later followed by a shrinkage in import volume and growth in exports. As I shall explain in a moment, we believe that the United States has passed the bottom of the "J"; the net impact of the 1971 exchange rate changes on U.S. trade was unfavorable early in 1972, and had probably become favorable by the end of 1972. For the year as a whole, the net effect was approximately neutral.

I should emphasize that it is very difficult to separate out the early effects of exchange rate changes from the much larger effects of cyclical swings and special events such as dock strikes. Different assumptions and techniques, none of which can be rejected out of hand, lead to different results. Nevertheless, alternative calculations are consistent in that they do not point to large gross effects on export and import volumes and prices for 1972 as a whole, and what effects there are tend to be offsetting. Thus there is little dispute that the net effect of the currency realignment on the U.S. trade account in 1972 was minor.

With respect to exports, we estimate a positive effect in volume terms only for finished manufactures amounting to \$1/4 to \$1/2 billion. It appears that the dollar unit values of these



exports -- which of course lag behind new contract prices -- did not rise in 1972 measurably more than they would have in the absence of the dollar devaluation. Thus there was a relative decline in the foreign currency prices of these goods which induced an increase in the quantity sold to foreigners. There was probably no significant increase in the volume of exports other than finished manufactures as a result of the 1971 exchange rate changes. But we believe that the dollar prices of some of these goods rose as a result of the dollar devaluation, so that the value of these other exports increased from \$1/4 to \$1/2 billion. Thus we estimate that the increase in value of total exports in 1972 which can be ascribed to the dollar devaluation ranges from \$1/2 to \$1 billion.

With respect to imports, it should be pointed out that there will be a reduction in the dollar value of imports only if the decline in the quantity imported exceeds the increase in expenditures on imports caused by higher dollar prices. For imports of finished manufactures it appears that in 1972 the reduction in quantity imported roughly offset the rise in import prices resulting from the dollar devaluation. Thus the 1971 exchange rate realignment probably did not cause either a significant increase or decrease in the value of finished manufactured imports in 1972. However, for other goods, namely foods, materials,



and semimanufactures, there was an increase in import prices associated with the realignment which was apparently not offset by a reduction in the quantity imported. Consequently dollar expenditures for these imports increased. Our overall estimate is that the value of total imports may have increased by \$1/2 to \$1 billion in 1972 because import prices had risen as a result of the dollar devaluation.

In summary, we find that the rise in export earnings of \$1/2 to \$1 billion was roughly offset by larger expenditures on imports, and that therefore the trade deficit in 1972 was not materially affected by the exchange rate changes of 1971.

Why did the trade balance deteriorate by \$4 billion between 1971 and 1972? We think there were four main factors: (1) an abnormally high rate of growth in this country compared to most other countries; (2) increased expenditures on imports due to the steep rise in the dollar prices of primary commodities, much of which would have occurred even without the devaluation; (3) the lagged impact of the rapid inflation of 2-3 years ago, coupled with continued growth in the capacity of foreign countries to exploit the resulting cost-price differentials; and (4) a \$1 billion increase in oil imports, partly offset last year by a temporary surge in agricultural exports.



It is important to note that the large worsening in the trade deficit in 1972 does not itself call into question the general efficacy of parity changes. We have already observed in 1972 the beginnings of the anticipated responses in exports and imports to the 1971 exchange rate changes. We anticipate that for the year 1973 as a whole there will be an overall positive impact on the trade balance ranging from \$1-1/2 to \$2-1/2 billion, and we expect the beneficial effects in 1974 and 1975 to be substantially larger.

The question remains, however, whether they will be sufficient. Mr. Reynolds will discuss this question.



V. Outlook and Concluding Observations (Mr. Reynolds)

Mr. Clark has explained why the exchange rate changes of 1971 had little net effect on our trade and payments position in 1972. Mrs. Junz has explained why we expect that those rate changes during the next two or three years will be substantially improving our trade balance compared with what it would otherwise have been. Chart 6 presents a schematic, highly simplified, diagram of the way in which these exchange rate effects may work themselves out.

This diagram, I should note, has become the object of much controversy among those in the International Division who are working on this subject. No two economists would draw it in exactly the same way. Yet its general shape is agreed to by all, and illustrates four major points.

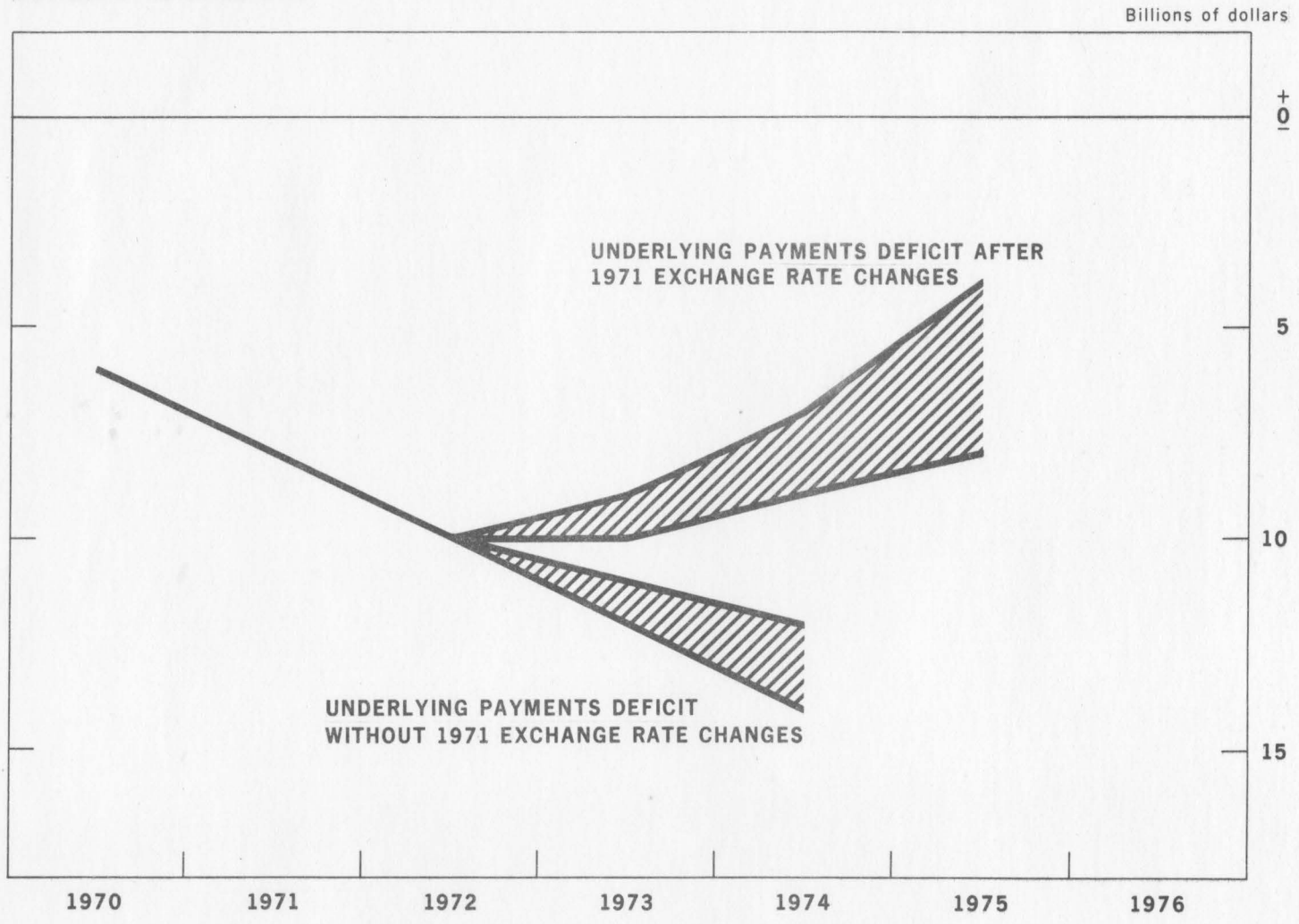
(1) First, the United States entered the 1970's with a large underlying payments deficit. By underlying deficit we mean the deficit on official reserve transactions adjusted for cyclical fluctuations and for abnormal capital flows.

(2) Second, this underlying deficit was tending to increase rapidly, primarily because of the deterioration on merchandise trade account. There is some uncertainty about what the trend actually was in 1970-72, and, of course, great uncertainty as to how the trend might have developed beyond 1972 if



Chart 6

SCHEMATIC DIAGRAM



there had been no exchange rate changes. The width of the lower shaded area in the diagram illustrates this uncertainty. We saw no point in extending what might have been beyond 1974.

(3) Third, all Division economists agree that the exchange rate changes of 1971 will work in the direction of reducing the underlying payments deficit below what it would otherwise have been, mainly by reducing the trade deficit below what it would otherwise have been. The amount of that improvement remains very uncertain, partly because we are not sure of our techniques of analysis, but even more because other developments in the United States and abroad are only dimly foreseeable. To encompass the full range of views of all the economists in the International Division, the upper shaded area in Chart 6 would have to extend from about -\$1 billion to about -\$9 billion in 1975, rather than the narrower range shown.

(4) Nevertheless, and this is the fourth point, we all agree that the probabilities are that the United States will still have a substantial underlying payments deficit in 1975 and beyond if no further adjustment actions are taken. And we are virtually certain that there will be large underlying deficits in the intervening period, 1973 and 1974. This will be so, as the schematic diagram indicates, in spite of the large beneficial effects we expect to result from the exchange rate changes of 1971. Hence,



U.S. liabilities to foreign reserve holders, shown in Chart 7, which are already enormous -- some \$61 billion at the end of 1972 -- will continue to accumulate this year and next.

It is interesting to consider the question: what would a satisfactory and sustainable U.S. balance of payments look like in the mid-1970's in a year not subject to abnormal capital flows and not characterized by cyclical deviations of economic activity from long-run trends? I have suggested an answer in the final column of Table 1, which shows a possible "target" pattern for 1975 compared with the actual results in recent years and the projected outcome for 1973 not adjusted for the business cycle. My 1975 "target" figures are similar to those submitted by the U.S. delegation to Working Party 3 as a statement of U.S. balance-of-payments aims.

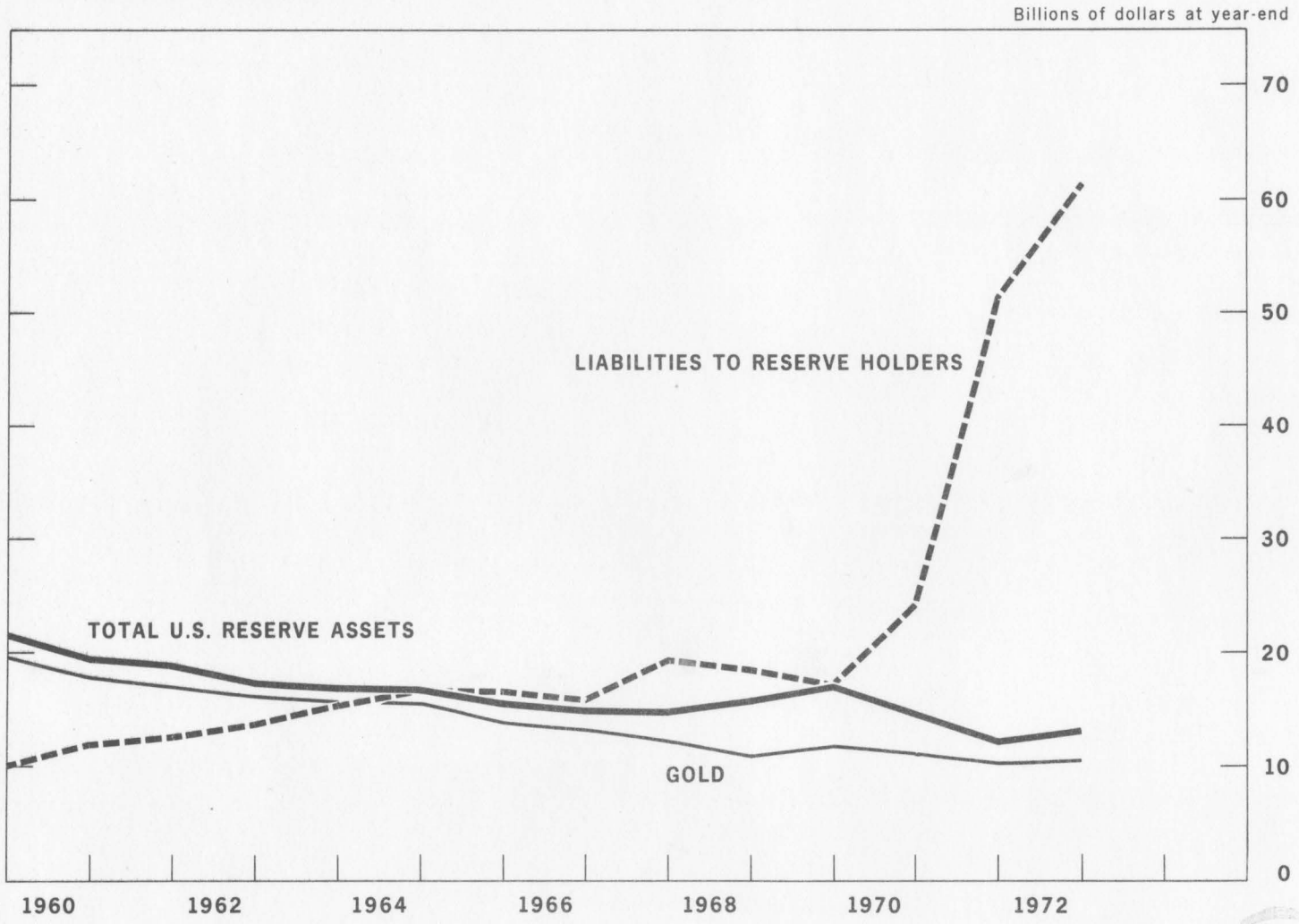
A satisfactory result for the balance of payments over-all probably requires balance or a small surplus on the official reserve transactions basis. This is indicated by the zero on the bottom line of the last column of Table 1.

Plausible estimates of likely net outflows of private and government capital in a normal year lead to the conclusion that the current account balance -- the middle line in the table -- will need to be in surplus by about \$9 billion or so. The nontrade current items all are reasonably predictable. We are left with the need



Chart 7

U.S. RESERVE POSITION



CONFIDENTIAL (FR)

Table 1. U.S. Balance of Payments, 1963-73,
Compared with Possible "Target" Pattern for 1975
(In billions of dollars)

	Average 1963-66	Average 1967-70	Actual		Pro- jected 1973	Possible "target" pattern for 1975 ^{1/}
			1971	1972(p)		
Trade balance	+5.2	+1.8	-2.7	-6.8	-5.0	+7
Investment income, net	+4.9	+6.1	+8.0	+7.7	+7.3	+9
Military transactions, net	-2.4	-3.2	-2.9	-3.5	-3.2	-3
Travel, including fares, net	-1.5	-2.0	-2.5	-2.9	-3.2	-4
Other transportation, net	+0.2	+0.2	+0.1	+0.3	+0.5	} +2
Other services, net	+0.2	+0.4	+0.7	+0.7	+1.0	
<u>BALANCE ON GOODS & SERVICES</u>	+6.7	+3.3	+0.7	-4.5	-2.6	+11
Remittances and pensions, net	-0.9	-1.3	-1.5	-1.5	-1.6	-2
<u>BALANCE ON GOODS, SERVICES AND REMITTANCES (Current Account)</u>	+5.8	+1.9	-0.8	-6.0	-4.2	+9
Govt. grants and capital, net	-3.3	-3.9	-4.4	-3.6	-4.8	-5
Private long-term capital, net	-3.7	-0.8	-4.1	-0.6	-1.4	-2-1/2
<u>BALANCE ON CURRENT AND LONG-TERM CAPITAL TRANSACTIONS</u> ("Basic Balance")	-1.2	-2.7	-9.3	-10.2	-10.4	+1-1/2
Private short-term capital, net	+0.7	+1.5	-10.1	+2.5	(?)	-1/2
Errors and omissions, net	-0.6	-1.2	-11.0	-3.1	(?)	-1
<u>BALANCE ON OFFICIAL RESERVE TRANSACTIONS</u> (Excl. SDR allocations)	-1.1	-2.4	-30.5	-10.8	(?)	0

(p) Preliminary.

^{1/} Assuming no abnormal capital flows and no cyclical deviations of economic activity in the United States and abroad from long-run trends.

February 5, 1973



for a trade surplus -- the top line -- of the order of \$7 billion in 1975.

It is very difficult to see how our trade position can approach that level by 1975. As we have said, we do expect very substantial beneficial effects from past exchange rate changes. Moreover, we expect some wearing off of unfavorable cyclical pressures of demand after 1973, and we hope for a good price-cost performance in this country. These favorable effects, however, seem quite unlikely -- even under the most optimistic assumptions -- to be sufficient. If one looks at Chart 8, showing the trade balance and its trend over a long period, one can see what a distance there is to go if the balance is to improve to anything in the neighborhood of \$7 billion. Thus it is our best judgment that a substantial adjustment problem remains -- quite possibly of the order of \$5 billion or more, and almost certainly not less than \$2 to \$3 billion.

These figures are necessarily very rough. But however one shades them, the broad conclusion still emerges that an adjustment problem remains, and that it is a sizable problem.

In conclusion, I would like to make two final observations.

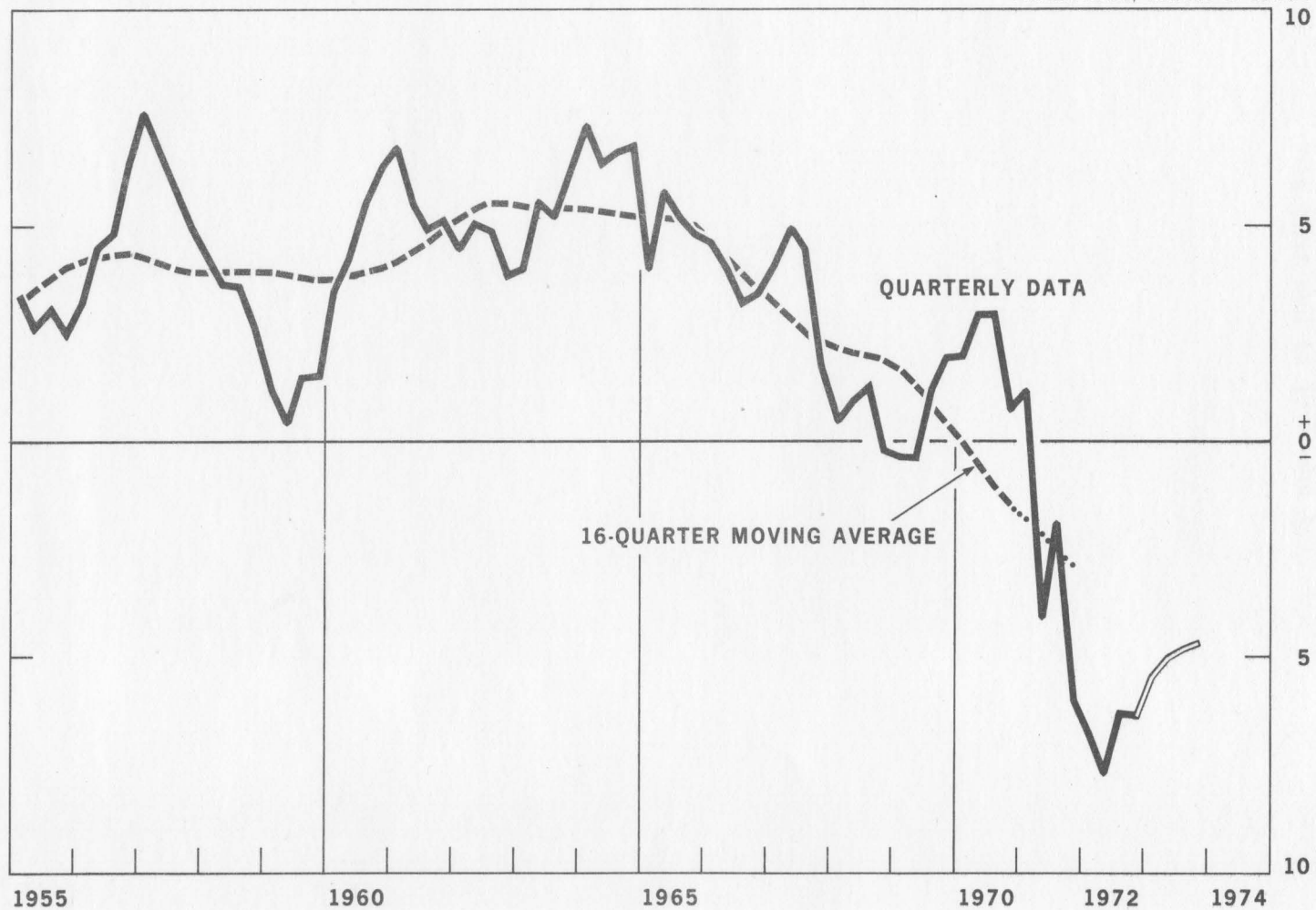
First, the size of what I have called the "remaining adjustment problem" depends critically on the evolution of our domestic economy and on the course of economic activity abroad. Our current projections for 1973 assume a significantly better cost-price performance in the United States than in other industrial countries. Our



Chart 8

U.S. FOREIGN TRADE BALANCE

Annual rates, billions of dollars



estimates of the size of the favorable exchange-rate effects to be expected this year and in 1974 and 1975 also depend on the assumption that an excessive boom is avoided here at home. If this assumption were to be proved incorrect, our appraisal of the long-run prospects for international payments equilibrium -- which in any case points to difficulties ahead -- would of course have to be revised in an adverse direction, and by a large amount.

The second observation I want to leave with you follows directly from our conclusion that, even under the most optimistic assumptions about a better cost-price performance in the United States, the United States will still have a remaining adjustment problem of substantial magnitude. We are going to need -- sooner or later, and from the point of view of international payments equilibrium, sooner would be preferable to later -- some further changes in exchange rates, certainly for Japan, and probably also for a number of other countries. Increasing perception of this likelihood has no doubt contributed to the uneasiness in foreign exchange markets in recent weeks, and can be expected to generate further market instability in the weeks to come.



BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

DATE: April 16, 1973

TO: Chairman Burns

FROM: RALPH C. BRYANT

For your information.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 12, 1973

To Mr. Samuel Pizer

Subject: Graphs on U.S. Balance-of-

From Sujin Shin

payments, S.A. : 4-quarter moving averages.

Attached are the charts on U.S. balance-of-payments, seasonally adjusted, from 1960-1Q to 1972-4Q. This time, at the request of Mr. Pizer, a 4-quarter moving average trend line has been drawn through the data.

The most recent data correspond to the March 1973 Survey of Current Business, Table 3.

The graphs appear in the following order:

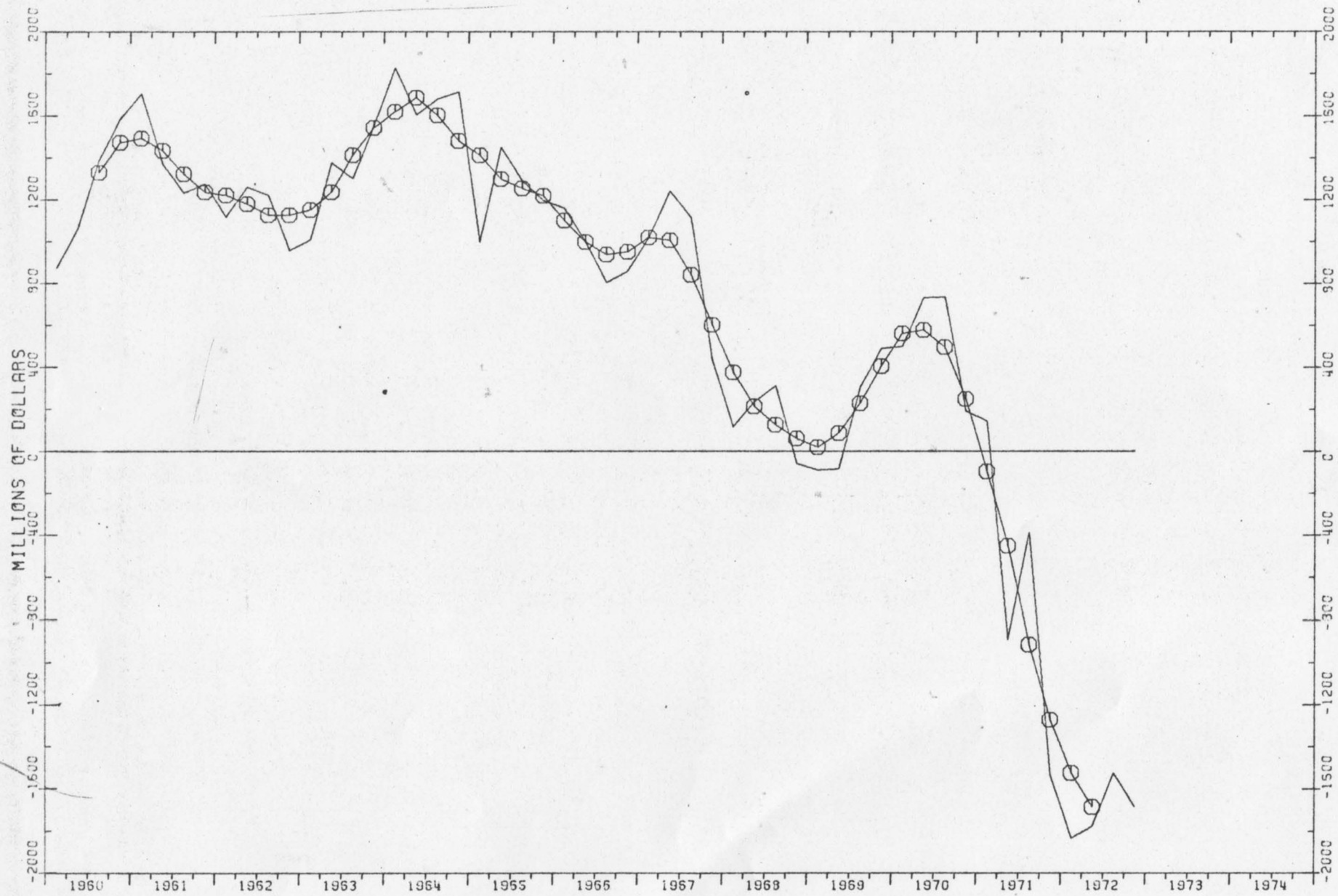
1. Trade balance
2. Balance on goods and services
3. Balance on goods, services, and remittances
4. Balance on current account
5. "Basic balance"
6. Net Liquidity balance
7. Changes in U.S. short-term private liabilities
8. Changes in U.S. short-term private assets
9. Errors and omissions
10. Official settlements balance

cc: Messrs. Bryant, Reynolds, Hersey, Siegman, Roxon, Truman,
Miss Morisse



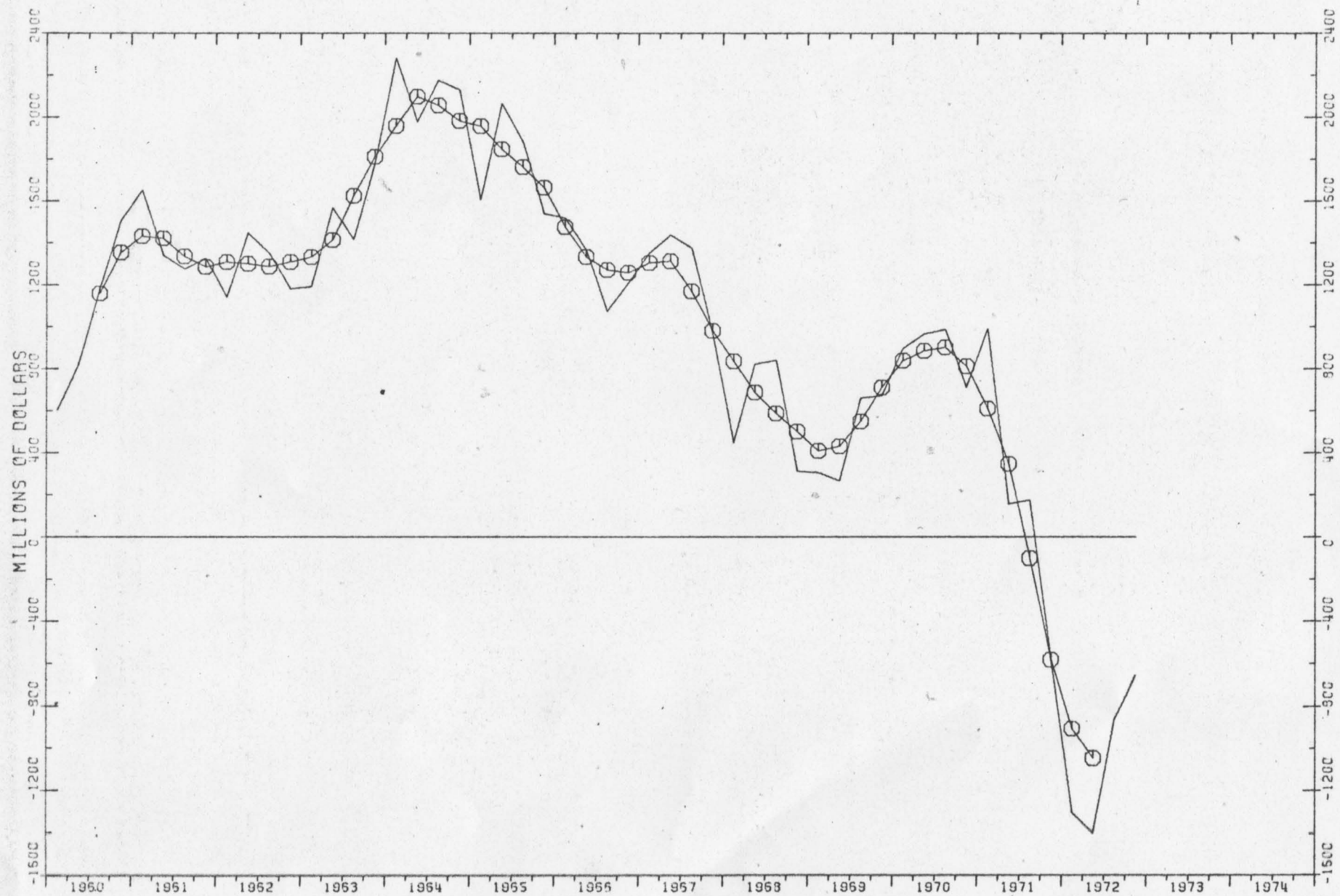
1. TRADE BALANCE

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



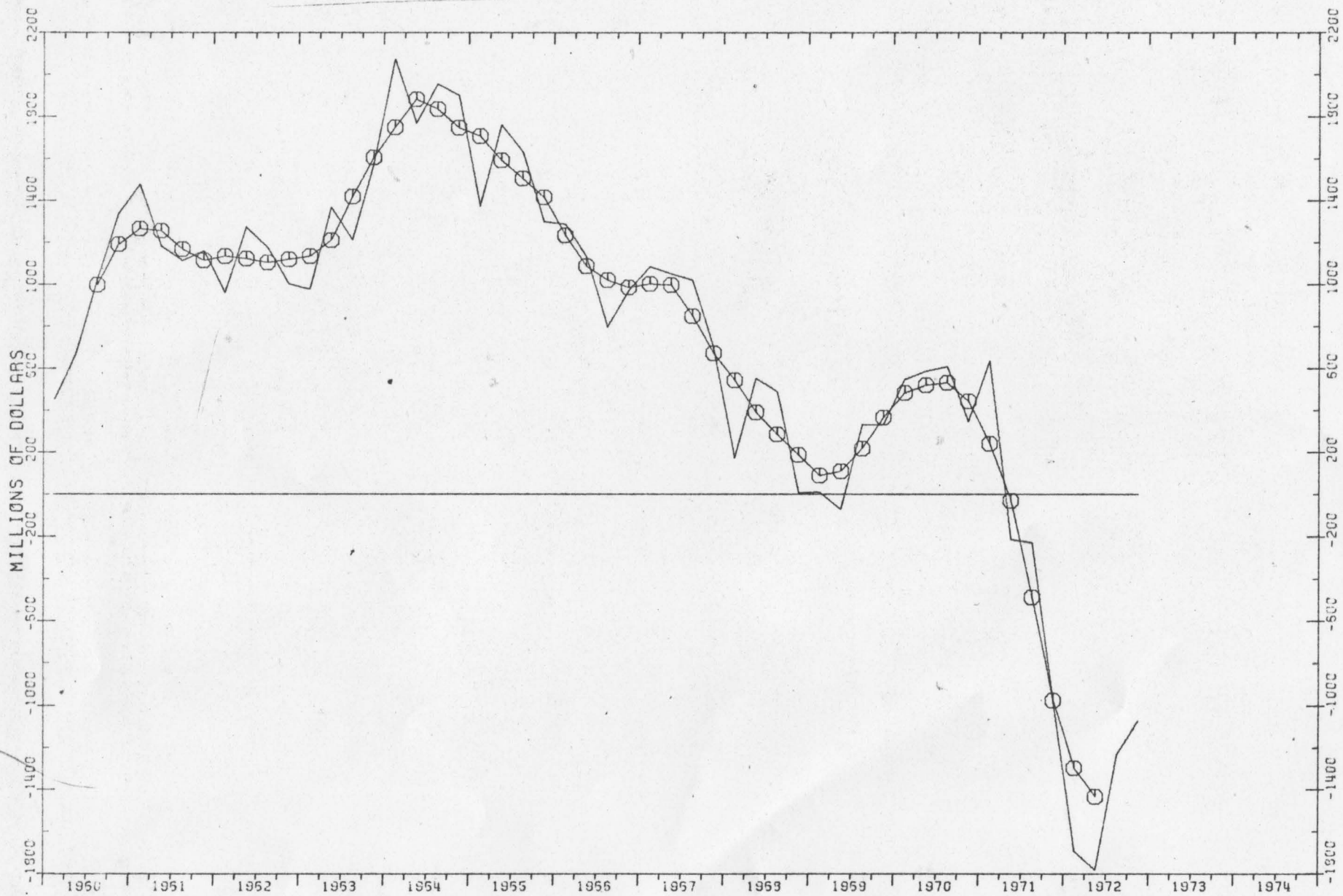
2. BALANCE ON GOODS AND SERVICES

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



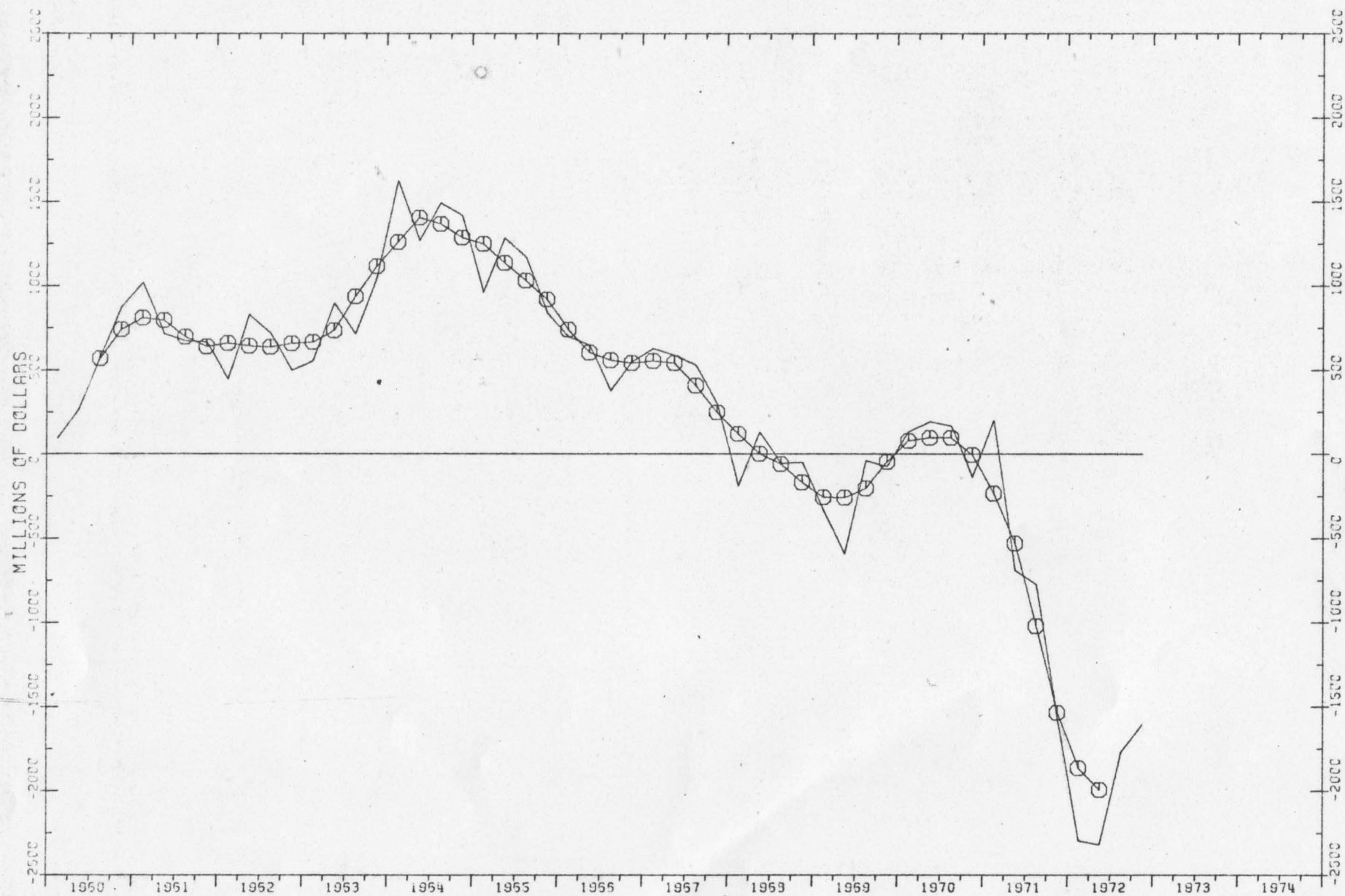
3. BALANCE ON GOODS, SERVICES, & REMITTANCES

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



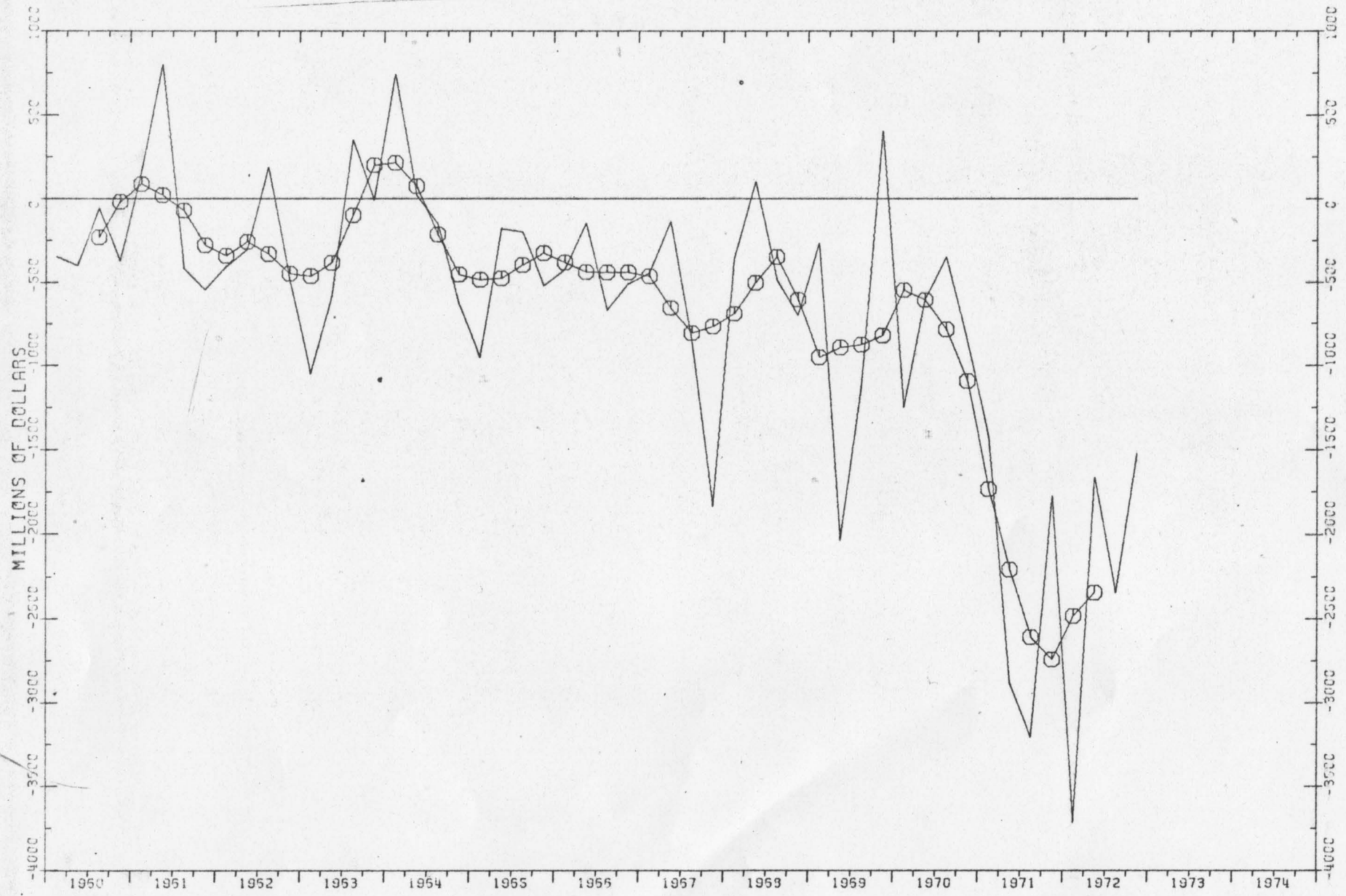
4. BALANCE ON CURRENT ACCOUNT

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



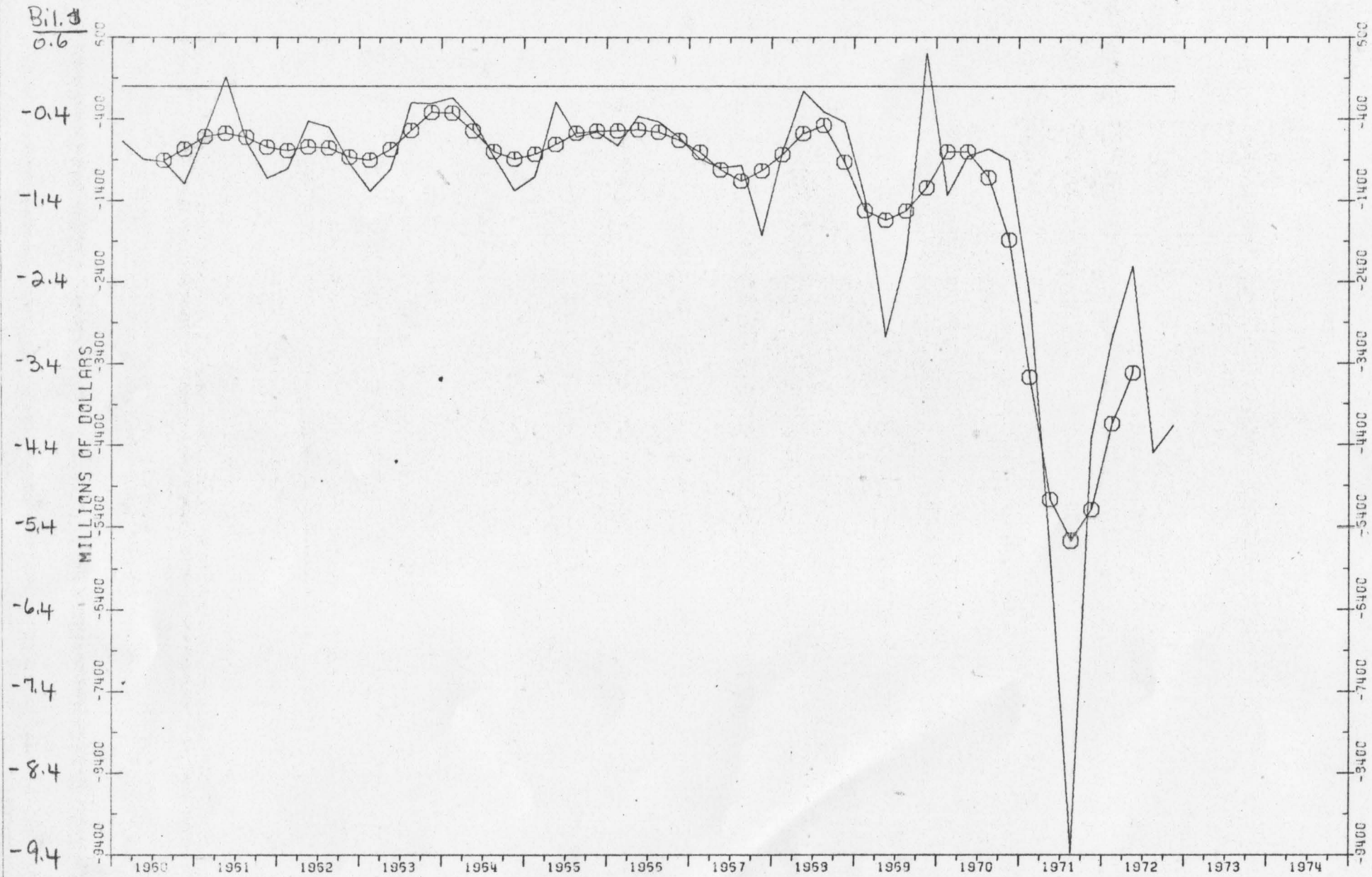
5. BASIC BALANCE

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



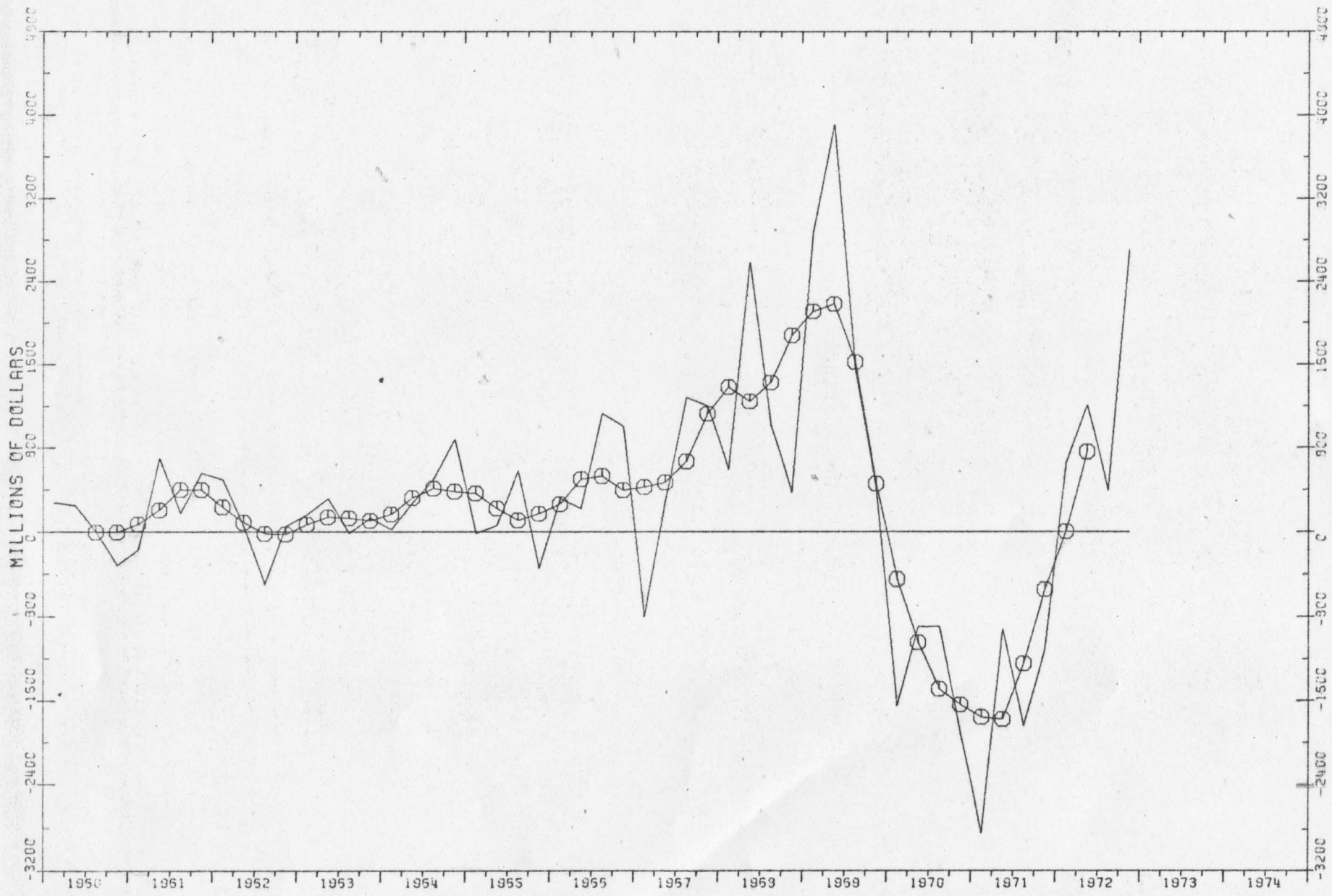
6. NET LIQUIDITY BALANCE

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



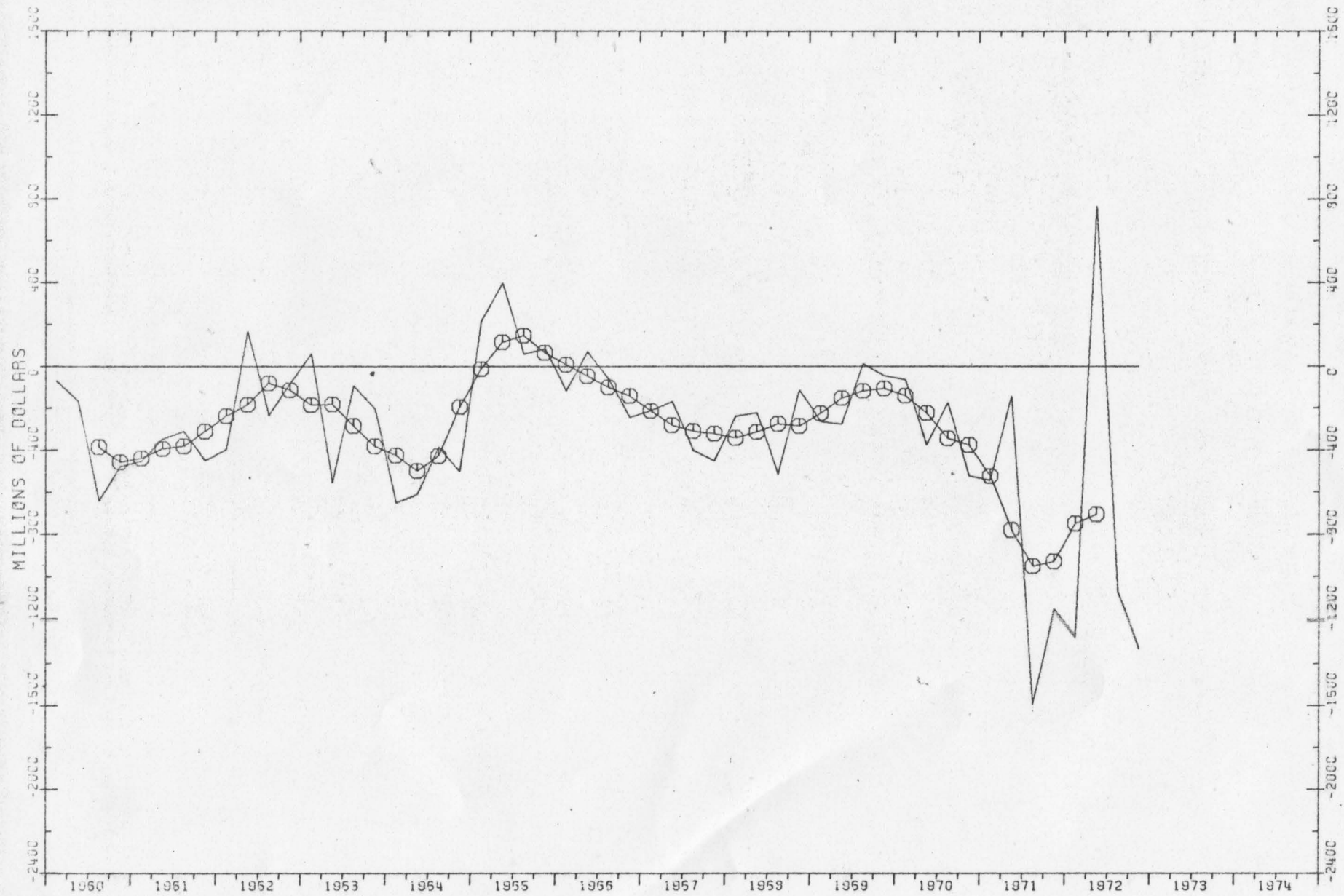
7. CHANGES IN U.S. SHORT-TERM PRIVATE LIABILITIES

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



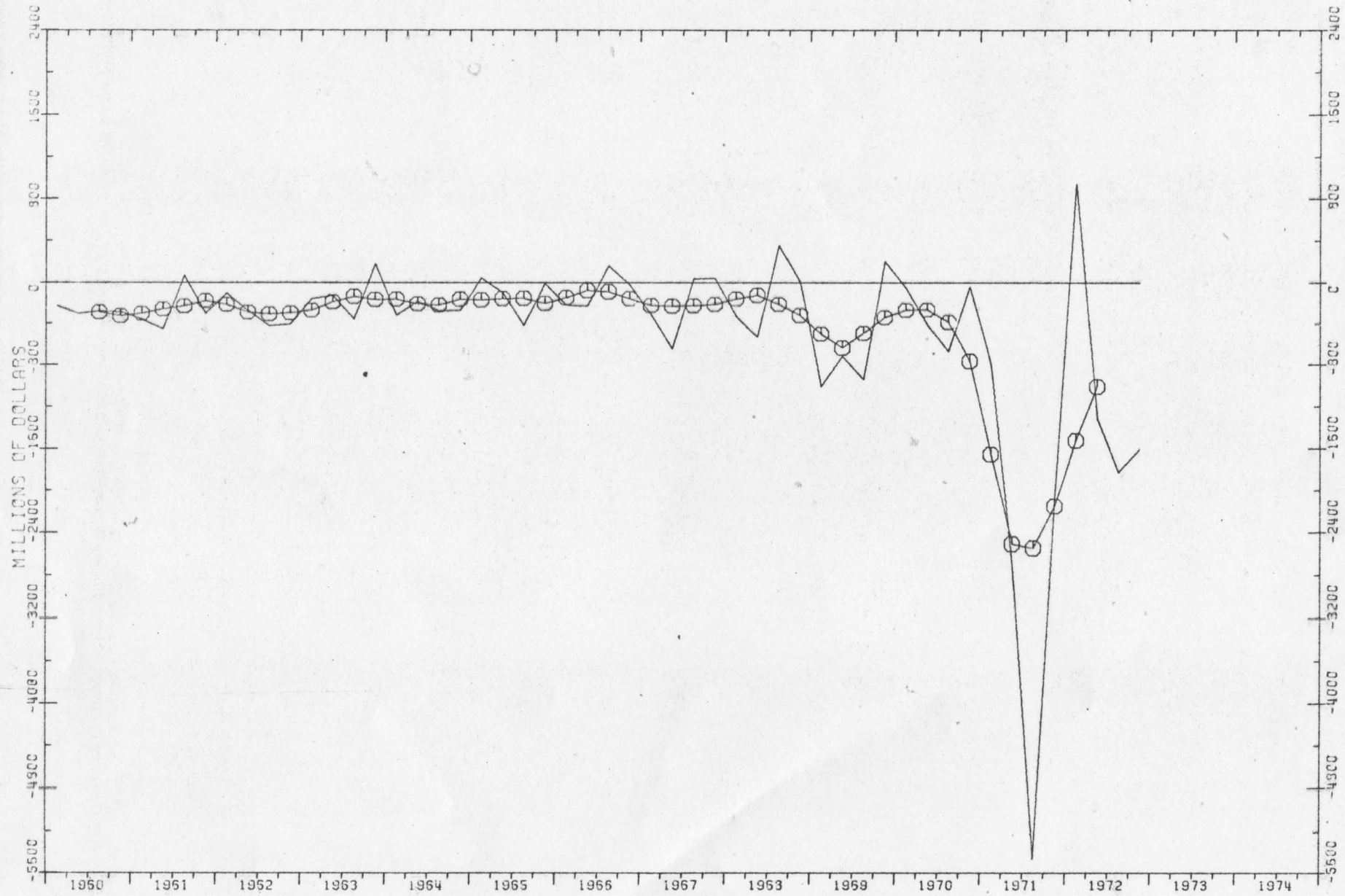
8. CHANGES IN U.S. SHORT-TERM PRIVATE ASSETS

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



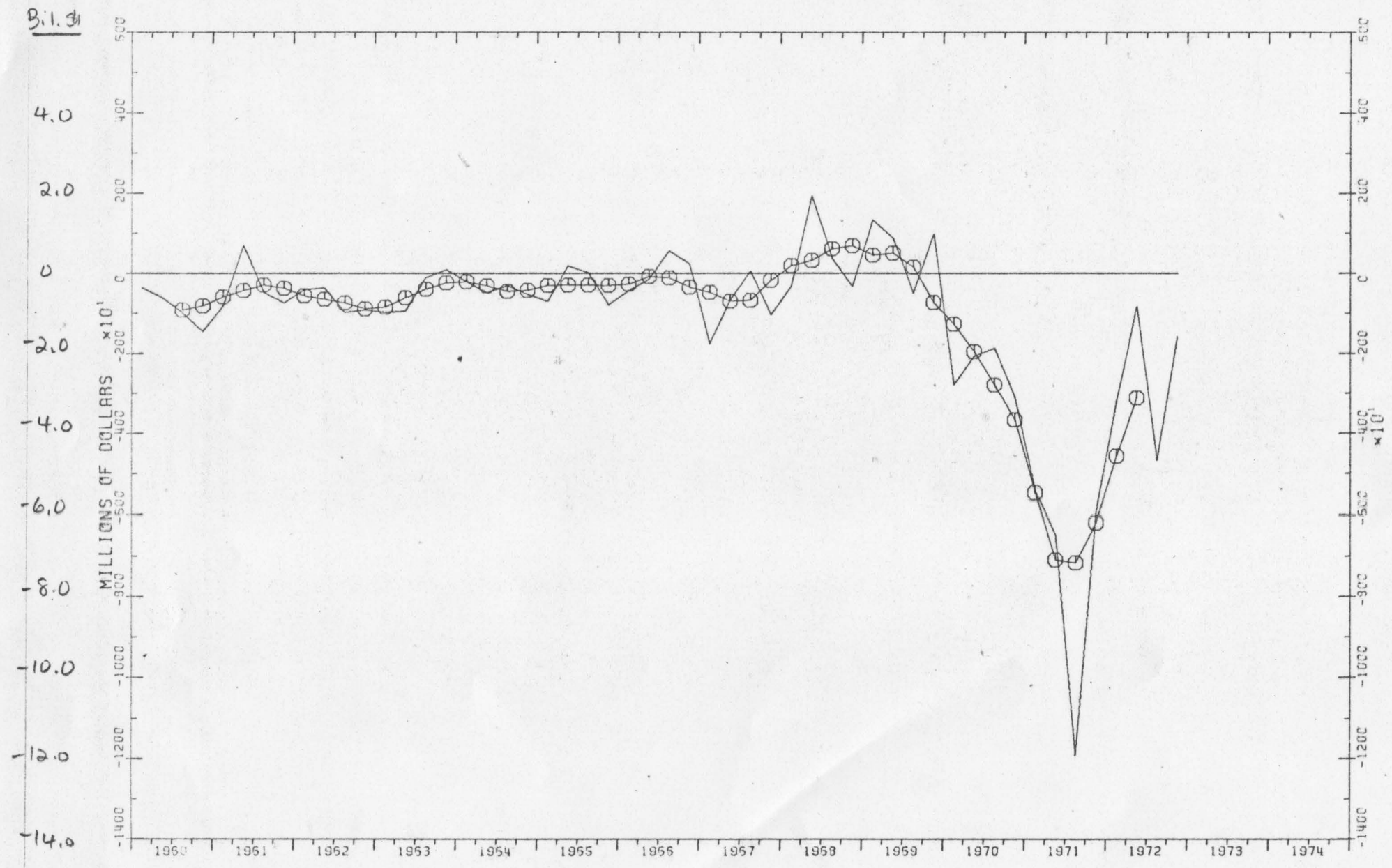
9. ERRORS & OMISSIONS

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



10. OFFICIAL SETTLEMENTS BALANCE

QUARTERLY, 1960-1 TO 1972-4, SEASONALLY ADJUSTED



Notes of Effects of Oil Supply Cutbacks
on Industrial Countries' Output and Trade

The first approximation of the effect of an average 20 percent cutback in world supplies to Europe, Japan and Canada from those Arab countries that participated in the boycott, shows a shortfall in industrial output for these countries combined of 4 percent below what otherwise would have been in the first half of 1974 (see Table 1). These estimates are based on the following set of rather simplified assumptions:

- (a) The flow of oil from Arab countries will again equal September, 1973 levels by June, 1974 for all countries other than the United States and The Netherlands;
- (b) Oil shortages will produce mainly supply problems and adequate levels of aggregate demand will be maintained;
- (c) Inventories of petroleum and petroleum products will not be drawn down below current levels, nor will inventories of finished goods;
- (d) No bottlenecks, aggravating the general situation, will appear on the supply side;
- (e) Assumption (a) implying a relatively short duration of the cutbacks also implies that there will be no switching to alternative sources of energy except to those that can be effected very quickly.



Under these assumptions it was possible, on the basis of the data of oil utilization for industrial purposes, shown in Table 2, and of certain additional assumptions about by how much oil consumption of households and for industrial and commercial heating purposes could be cut, to calculate approximate effects of oil shortages on industrial output. The calculation of shortfall in output was then related to import requirements of industrial materials. This yielded an estimated decline in imports of such materials from the United States of \$3/4 billion for 1974. Because of the assumption that final demand would not fall beyond the amounts directly related to the shortfall in industrial output, demand for finished goods (both for domestic consumption and for exports) would outrun supply capabilities to an estimated amount of \$1-3/4 billion for the period of the boycott. At the same time, U.S. import demand for goods from the industrial countries was estimated to fall by about \$1/2 billion for the year as a whole, reducing pressure on supply capabilities somewhat.

It is clear that these assumptions are essentially very optimistic. It is likely that the uncertainties caused by the current situation will affect the investment climate in the industrial countries. It would appear reasonable to assume that those investment projects that can be postponed would at least be put off until the situation becomes clearer. This is particularly so because already appropriated funds can currently be employed at relatively high rates of return.



Also, the assumption that no bottlenecks would appear tending to reduce output further than the general effects of the oil shortages would indicate, is not realistic. Finally, the differential effect on various sectors of the economy, notably effects on the automobile industry, travel and hotel business, implies at least some fall off in demand. But, so far, the governments in the countries concerned seem to feel that they are still faced with a situation of supply shortages, exacerbated by shortfalls of energy, rather than by shortfalls of demand.

Taking all these considerations together, one would conclude that the estimates cited above probably represent the most optimistic constellation of facts. A more realistic set of assumptions would imply greater declines in output and a greater shrinkage in world trade.



Table 1. EFFECTS OF OIL CUTBACK ON INDUSTRIAL PRODUCTION
(Index number, 1963 = 100)

	<u>Canada</u>		<u>Japan</u>		<u>France</u>		<u>Germany</u>		<u>Italy</u>		<u>U.K.</u>	
	<u>Orig</u>	<u>New</u>	<u>Orig</u>	<u>New</u>	<u>Orig</u>	<u>New</u>	<u>Orig</u>	<u>New</u>	<u>Orig</u>	<u>New</u>	<u>Orig</u>	<u>New</u>
1973 - Q1	182.3		304		183		173		156		137	
Q2	184.6		315		184		175		162		138	
Q3	182.8		320		188		174		168		138	
Q4	189.5		329		191		179		174		141	
1974 - Q1	191.3	} 190	337	} 318	193	} 190	181	} 175	179	} 176	142	} 139
Q2	193.7		347		195		183		181		144	

Percent change

First half 1974 new/
originally projected

-1 -7 -2 / -4 -2 -3



Table 2. IMPORTANCE OF PETROLEUM TO INDUSTRIAL OUTPUT
(Ratios)

	<u>Imports of Crude from Boycotting Arab Countries</u>	<u>Industrial Consumption of Petroleum</u>	<u>Industrial Consumption of Petroleum</u>
	Total Supply of Crude	Total Industrial Energy Consumption	Total Consumption of Petroleum
BELGIUM	.65	.31	.26
FRANCE	.46	.42	.35
GERMANY	.37	.38	.33
ITALY	.33	.39	.32
NETHERLANDS	.58	.19	.14
UNITED KINGDOM	.50	.47	.40
JAPAN	.39	.74 ^{a/}	.44
CANADA	.03	n.a.	n.a.

^{a/} Petroleum consumption as a percent of total energy consumption by all sectors of the economy



Possible Balance-of-Payments Impacts of Cutbacks in Arab Oil Production

The balance-of-payments projections presented in the November 19 Chart Show allowed for a temporary constriction of U.S. petroleum imports near the close of this year, but assumed a resumption of steady import growth toward the end of the first quarter of next year. This note considers the effect on the U.S. balance of payments of the following set of assumptions about the oil situation: (1) during the whole of 1974 the United States will receive no oil originating in Arab countries; (2) the United States will experience no oil shortages in production, but aggregate demand will be weakened by a reduced supply of petroleum products for consumption purposes; (3) by the middle of 1974 the flow of oil from the Arab countries to Western Europe and Japan will be restored to the rate of the third quarter of 1973; (4) ocean freight will not be constrained.

The shortage of oil assumed for Western Europe and Japan in the first half of 1974 would temporarily restrict output in these areas, so that European and Japanese demand for U.S. industrial materials would be weaker than was assumed in the November Chart Show. On the other hand, it is unlikely that final demand would be depressed to the same extent as output, so that European and Japanese demand for U.S. finished goods might well increase. On balance, it is estimated that U.S. merchandise exports in the first half of 1974 would be somewhat more than \$1 billion (annual rate) above the level projected in November, but that the November projection for the last half of the year would still obtain.



Under the new assumptions, U.S. merchandise imports in 1974 would probably be significantly lower than the level projected in November. The reduced flow of petroleum would lower imports by nearly \$2 billion, and weaker aggregate demand in this country would induce a further reduction of about \$0.9 billion.

Because of these estimated changes in exports and imports, the trade surplus for the year would be about \$7.5 billion, more than \$3 billion higher than projected in November. On the other hand, the balance on services would probably be less favorable than projected in November, since receipts of income, royalties, and fees would likely be appreciably lower. Consequently, the surplus on goods and services in 1974 might be about \$2.5 billion higher than projected in November, amounting to more than \$11 billion.

In November it was estimated that net capital flows in 1974 would be such as to yield a surplus in our basic balance (the balance on current account and long-term capital). Although the course of capital movements is now even more uncertain, a surplus on the basic balance still seems highly likely.

The dollar has appreciated significantly in the foreign-exchange markets since October of this year, at least partly because of the oil crisis, which the markets interpret as potentially more troublesome for many other countries than for us. If this appreciation were not reversed, the increase in the trade surplus would probably be somewhat less than the projection presented in this note.



Frequent revisions in balance-of-payments projections may be called for to take account of the emerging effects of oil shortages and of changes in oil policy throughout the world.

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Goods & Services Projections: 1969-74
(billions of dollars, seasonally adjusted annual rates)

	<u>Goods & Services</u>			<u>Merchandise Trade</u>			<u>Services</u>		
	<u>Exports</u>	<u>Imports</u>	<u>Net</u>	<u>Exports</u>	<u>Imports</u>	<u>Net</u>	<u>Exports</u>	<u>Imports</u>	<u>Net</u>
<u>Years:</u>									
1969	55.5	53.6	+1.9	36.4	35.8	+0.6	19.1	17.8	+1.3
1970	62.9	59.3	+3.6	42.0	39.8	+2.2	21.0	19.5	+1.5
1971	66.3	65.5	+0.8	42.8	45.5	-2.7	23.5	20.0	+3.5
1972	73.5	78.1	-4.6	48.8	55.7	-6.9	24.7	22.4	+2.3
1973	100.8	96.1	+4.6	69.7	69.0	+0.7	31.0	27.2	+3.9
1974	118.6	107.3	+11.4	84.8	77.2	+7.5	33.8	30.0	+3.9
<u>Quarters:</u>									
1971 - 1	65.9	62.1	+3.8	43.5	43.0	+0.5	22.5	19.2	+3.3
2	67.1	66.6	+0.5	43.2	46.8	-3.7	24.0	19.8	+4.2
3	69.1	68.0	+1.1	46.1	47.6	-1.5	23.0	20.4	+2.7
4	63.0	65.5	-2.2	38.3	44.4	-6.1	24.6	20.8	+3.9
1972 - 1	70.3	75.8	-5.5	46.6	53.9	-7.3	23.7	21.9	+1.8
2	69.9	75.6	-5.7	46.2	53.3	-7.1	23.7	22.3	+1.4
3	74.0	77.7	-3.8	49.4	55.7	-6.3	24.5	22.0	+2.5
4	79.7	83.2	-3.5	52.9	59.8	-7.0	26.8	23.3	+3.5
1973 - 1	90.4	89.8	+0.6	61.3	65.1	-3.8	29.2	24.7	+4.4
2	97.1	94.6	+2.5	67.0	67.9	-0.9	30.1	26.7	+3.4
3	104.9	97.8	+7.0	72.7	69.8	+2.9	32.0	28.0	+4.1
4	110.8	102.3	+8.4	78.0	73.2	+4.8	32.8	29.3	+3.5
1974 - 1	115.3	103.6	+11.7	83.3	74.2	+9.1	32.0	29.4	+2.6
2	118.6	106.8	+11.8	85.3	76.8	+8.5	33.3	30.0	+3.3
3	119.1	108.5	+10.6	84.5	78.3	+6.2	34.6	30.2	+4.4
4	121.4	110.1	+11.5	86.0	79.7	+6.3	35.4	30.4	+5.1

Note: Details may not add to totals because of rounding.



CHAIRMAN BURNS

For Information Only

December 5, 1975

TO: Board of Governors

FROM: Edwin M. Truman

EMT

CONFIDENTIAL (FR)

After Jeff Shafer's November 17 Pre-FOMC board briefing on recent and prospective U.S. international transactions, Governor Wallich sent him two questions:

1. Can the estimated relationship between the change in the dollar's exchange rate and the change in the U.S. trade balance be extended to larger exchange rate changes?

2. In light of the staff current account projection why is only a small depreciation of the dollar expected over the next five quarters?

We thought that you might be interested in the answers that Jeff supplied to these questions.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 5, 1975

To Governor Wallich

Subject: Answers to your questions

From Jeff Shafer *JAS*

concerning November 17 briefing

Can the estimated relationship that predicts an \$840 million increase in the U.S. trade balance after 7 quarters for a 1 per cent depreciation of the dollar be extended to larger exchange rate changes?^{1/}

The functional forms of the equations from which this figure was derived do imply a proportionate response; that is, an X per cent depreciation or appreciation leads to an eventual increase or decrease in the trade balance of \$840 million times X. Some alternative functional forms were tried in estimating the equations and did not provide as good a fit. However, the search over alternative functional forms was limited and the differences in explanatory power were not large. Moreover, one should not extrapolate the results for exchange rate changes to changes larger than those we have experienced.

The error in this type of prediction is proportional to the size of the exchange rate change, so that the width of a 95 per cent confidence interval for a 10 per cent exchange rate change is 10 times as wide as that for a 1 per cent exchange rate change. Moreover, since the trade balance forecast is derived from separate volume and value equations for exports and imports, the standard error of the trade balance response is a nonlinear function of the correlations of the errors across the individual equations. A direct computation of the

^{1/} The estimate excludes agricultural exports for which we have no satisfactory measure of exchange rate sensitivity. The figure of \$800 million was given in the briefing as a rounded off value.



standard error is impossible, but an impression of the accuracy of the prediction is given by the attached graph prepared by Peter Hooper (who has done the empirical work on which I am relying). The graph gives the widest and narrowest confidence intervals of 1 standard deviation that could arise depending on the correlations of errors across equations.

The size of the response depends somewhat on the initial trade balance position since the equations for exports and for imports have constant elasticities. We took September figures as the starting point.

Why do I expect only a small depreciation of the dollar if a substantial decline in the trade balance occurs next year?

As you point out, without changes in exchange rates the net capital outflow next year would likely be larger than the projected current account balance of approximately zero. In the absence of official intervention, I would therefore expect the exchange rate to depreciate until portfolio balance effects and, perhaps, the expectation of a subsequent appreciation of the dollar reduced the net capital outflow to equality with the current account (i.e., approximately zero).

The reason that my point estimate for the size of the likely depreciation over the next several quarters is small is that a declining trade balance next year is already widely anticipated by the market. The trade outlook depends heavily on the outlook for aggregate demand in the United States relative to the outlook for other countries and



specific judgments about relative prices and U.S. agricultural exports. There is a rough consensus on this. For example, Morgan Guaranty's "World Financial Markets" forecasts a decline in the current account that is only half as large as the decline we project, but the Morgan Guaranty projection is billed as optimistic. Other public forecasts are scarce, but our projection is in line with those of other government agencies. It seems reasonable that current exchange rates are based on widespread expectations that the U.S. current account balance will decline substantially and that the resulting pressures for a capital outflow, which you point to, must already be at work. I would conclude that the dollar would be even stronger right now if these cyclical developments were not widely expected to lie ahead. Although I would expect the pressure for further depreciation of the dollar arising from the outlook for the current account to be reduced to the extent that this pressure is reflected in the value of the dollar today, some scope for further downward pressure should remain.

As I mentioned in my briefing, unanticipated developments are likely to have an impact on the value of the dollar that are large relative to the effects of the projected trade balance swing. Not the least of the unanticipated developments could be the failure of our projection to materialize.

Another reason not to expect too large a decline in the value of the dollar by the usual measures is that the current account swing vis à vis small OECD countries and non-oil LDC's is likely to be larger than the swing vis à vis major industrial countries. The average values for the dollar that we normally look at are measured in terms of only the currencies of the large industrial countries.



Long Run Direct Impact of Alternative Exchange Rate Changes on the Trade Balance

Change in Trade Bal.
(\$ billions, SAAR)

