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Restricting Private Direct Investment Abroad to Narrow the Balance-of-Payments Deficit

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Introduction

The United States has been incurring deficits in its international accounts every year since 1950, with the sole exception of 1957. During the five-year period 1962-1966 the deficit averaged $2.1 billion a year, compared with $3.4 billion a year during the period 1958-1961. In 1966 it was $1.4 billion.

During the first three-quarters of 1967 the deficit was running at the annual rate of $2.2 billion. The outflow of gold, however, had declined to $158 million, which was about one-third the 1966 rate.

On the basis of these figures the expectation was that, although the payments balance had deteriorated somewhat since 1966, the deficit was still smaller than it was in 1963 and 1964 and was far removed from the $3.9 billion deficit of 1960.

However, at his press conference on January 1, 1968 the President announced that he was taking extraordinary measures to bring about balance in the international accounts because of the great deterioration in the country's balance of payments position in the fourth quarter of 1967.[1/] He said that the deficit for the full year 1967 was between $3.5 and $4.0 billion.

1/ Official figures for the fourth quarter of 1967 have not yet been released.

Presidential Announcement of January 1, 1968

A continuing deficit of this magnitude, according to the President, cannot be tolerated because it would endanger the strength of the entire free world economy, thereby threatening our own unprecedented prosperity. The actions that he has taken and proposed are predicated on the assumption that the strength of the dollar abroad depends on Americans earning abroad about as many dollars as they spend abroad. Vigorous action, he said, is necessary to bring the international accounts into equilibrium in 1968.

He announced the imposition of mandatory restrictions on direct investments abroad by American individuals and corporations and requested a series of other programs, legislative and voluntary, to narrow the payments gap.

Those who support the President's position maintain that, had the balance-of-payments statistics for the 4th quarter of 1967 been released without an accompanying announcement of corrective action, the result would have been to precipitate speculation against the dollar and to expose it to the risk of loss of confidence.

In introducing his new program the President made it clear that "the first line of defense of the dollar is the strength of the American economy". He went on to stress the importance of Congressional enactment of an anti-inflation tax and of the exercise of the utmost responsibility on the part of business and labor in reaching wage-price decisions. He directed the Secretaries of Commerce and Labor and the Chairman of the Council of Economic Advisers to work with leaders of business and labor in an endeavor to make more effective the voluntary program of wage-price restraint.

The Administration's new program consists of four temporary measures and three permanent, or long-term, measures.

The temporary measures affect American direct investments abroad, foreign lending by American financial institutions, travel abroad by Americans, and U.S. Government expenditures overseas. The measures affecting direct investments are mandatory and become effective immediately, whereas the others require enabling action, either by Congress or by governmental agencies.

The long-term measures are aimed at increasing U.S. merchandise exports, at modifying non-tariff trade barriers, and at stimulating investment and travel by foreigners in the United States.

Temporary measures:

1. Direct foreign investment. The President stated that, although the existing voluntary program to moderate the outward flow of direct long-term capital has been reasonably successful, the curtailment that is now necessary is beyond the reach of any voluntary program. He therefore invoked his authority, under Section 95A of the Banking Act, to establish a mandatory program to restrain new direct investments abroad.

The objective of this mandatory program is to reduce the balance-of-payments deficit by at least $ 1 billion in 1968.

2. Lending by financial institutions. The President announced that had requested the Federal Reserve Board to tighten its program for restraining foreign lending by banks and other financial institutions, with the objective of reducing the balance-of-payments deficit by another $500 million. It is anticipated that the reduction can be achieved without

harming the financing of U.S. exports and without jeopardizing the availbility of funds to the less-developed countries.

He announced that he has given the Federal Reserve Board stand-by authority to invoke mandatory controls should such action become necessary.

3. Curtailment of foreign travel by Americans. The American people are asked to defer for two years all non-essential travel outside the Western Hemisphere for the purpose of reducing the net travel deficit to $500 million (from its $2 billion level in 1967). The President has asked the Secretary of the Treasury to explore with the appropriate Congressional committees legislation to achieve this objective.

4. Government expenditures overseas. Although the United States cannot forego its essential commitments abroad, the President went on to say that every step must be taken to reduce their impact on the balance of payments without endangering the Nation's security. He has directed the Secretary of State to initiate negotiations with our NATO allies to minimize the foreign exchange costs of keeping American troops in Europe, through purchase in the United States of more defense needs and by increased investment on the part of our NATO allies in long-term U.S. securities. He also instructed the Director of the Budget to find ways for reducing the number of American civilians working overseas. The Secretary of Defense is asked to find ways to reduce the foreign exchange impact of personal spending by U.S. troops and their dependents in Europe.

Long-term measures:

1. Increase U.S. exports. The President announced his intention to ask Congress (a) to support an intensified 5-year, $200 million Commerce Department program to promote the sale of American goods overseas and (b)

to earmark $500 million of the Export-Import Bank authorization to provide more adequate export insurance, to expand guarantees for export-financing, and to broaden the scope of Government financing of exports.

2. Non-tariff trade barriers. He announced the initiation of negotiations with foreign countries, particularly those having balance-of-payments surpluses, with the objective of inducing them to minimize the disadvantages to U.S. exports which arise from differences between national tax systems and other types of non-tariff trade barriers. His expectation is that an improvement of $500 million in the balance of payments can be realized.

3. Foreign investment and foreign travel in the U.S. The flow of foreign funds into the United States, he says, can be achieved by an intensified program to attract larger investment by foreigners in U. S. corporate securities and by a program designed to attract more foreign visitors to the United States. A special task force is already at work on this problem.

The remainder of this memorandum is devoted to the mandatory program for curtailing direct private U.S. investments abroad.

Regulations with respect to Direct Foreign Investment

The new regulations provide three basic limitations on new direct foreign investment by American individuals and corporations which own, or acquire, an interest of 10 percent or more of the voting power, or capital, of a foreign business venture. The limitations are imposed on the direct investor's dealings with each of the ventures in which it has such an interest. The regulations provide for the following:

1. Annual limits on the amounts of new direct investment, which vary according to country, as follows--

In the less-developed countries transfers of new capital, when added to re-invested earnings, may not exceed in any year 110 percent of the direct investor's average investments in these countries in 1965-66.

With respect to Canada, Japan, Australia, the United Kingdom, and the oil-producing countries (countries in which a high level of capital inflow is essential for the maintenance of economic growth and financial stability) new direct investments, together with re-invested earnings, may not exceed 65 percent of the average of investments in these countries in 1965-1966.

With respect to all other countries (including continental western Europe except Greece and Finland) there is to be a moratorium on new direct investment. However, an investor may re-invest annually into his ventures in these countries up to 35 percent of the average of his total investment during 1965 and 1966.

2. Repatriation Requirements

It is required that each investor repatriate from his share of the earnings of all his foreign business ventures amounts equal to the greater of: (a) the same percentage of his share of total earnings from these three groups as he repatriated furing 1964-66, or (b) so much of his share of earnings as may exceed the limits of capital transfers in each group.

With respect to the continental European countries, where there is to be a moratorium on capital transfers, earnings in excess of 35 percent of historical investment in 1965 and 1966 must be repatriated.

Furthermore, short-term financial assets abroad held other than in direct investments are required to be reduced to the average level of 1965 and 1966.

3. Authorizations.

Specific authorizations will be required for any transactions subject to regulations and not falling within the targets indicated. An Office of Foreign Direct Investments is being created within the U.S. Department of Commerce to administer the new regulations. It will have power to issue specific authorizations. A special staff is being assembled for the purpose.

Significance of the New Direct Investment Controls

Although the short-run effect of curtailing the outflow of new U.S. direct investment abroad will be to narrow the overall U.S. balance-of-payments deficit, the longer-run effect will be to increase it. The outflow of U.S. funds for investment abroad, the inflow of earnings on existing investments, and U.S. merchandise exports are all structurally interrelated. It is almost impossible to take action with respect to any single variable for the purpose of diminishing the balance-of-payments deficit without affecting one or more other variables.

The immediate effect of new long-term capital investment by Americans abroad on the balance of payments is similar to an increase of merchandise imports. The intermediate and longer-run effects, however, are of greater significance than the short-run effects, because foreign investments yield continuing income to Americans.

Shortly after investment funds flow abroad there is a tendency for some of them to return to the United States as foreign affiliates of U.S.

firms import equipment and supplies from the United States for their own use. According to the U.S. Department of Commerce, exports to such affiliates in 1964 amounted to $6.3 billion and accounted for 25 percent of total U.S. exports.

In the longer run there is a tendency for funds to flow back to the investing country in the form of earnings on investment. This inward flow of funds has an effect on the balance of payments similar to that of increased exports and, if continued over a considerable period of time, will result in increased outward payments (as would a steady increase of exports) usually in the form of increased imports. A country that engages in large-scale foreign investment over a considerable period of time can expect that eventually its merchandise imports will tend to increase, relative to its merchandise exports. This is because the investing country receives returns on its investments, the anticipation of which was the reason for investing in the first place. This was the position of the United Kingdom during the latter part of the nineteenth century. Current earnings on the large British foreign investments that had been made throughout the earlier part of the century enabled Britons to pay for the country's substantial excess of merchandise imports over merchandise exports.

Foreign investment is also advantageous to borrowers because it facilitates economic development and expansion. Economic development of the less-developed areas of the world for some time has been an important objective of U. S. foreign policy.

The outflow of funds for direct investment between 1954 and 1966 was approximately $1.9 billion a year, while returns on existing investment, in the form of dividends, branch profits, interest etc., averaged $3.2 billion a year. Expressed as cumulative totals, the outflow of funds for new direct investment over the 13-year period amounted to $24.8 billion, while earnings on outstanding direct foreign investments over the same period amounted to $41.7 billion (see table).

New Direct Private Foreign Investment and Income from Outstanding Direct Foreign Investments, 1954 - 1966
(in billions)

Year	New U.S. direct investment abroad	Earnings received on direct investments abroad	Net effect on balance of payments
1954	$ - 0.7	$ + 1.9	$ + 1.2
1955	- 0.8	+ 2.1	+ 1.3
1956	- 2.0	+ 2.4	+ 0.4
1967	- 2.4	+ 2.5	+ 0.1
1958	- 1.2	+ 2.4	+ 1.2
1959	- 1.4	+ 2.6	+ 1.2
1960	- 1.7	+ 2.8	+ 1.1
1961	- 1.6	+ 3.2	+ 1.6
1962	- 1.7	+ 3.6	+ 1.9
1963	- 2.0	+ 3.8	+ 1.8
1964	- 2.4	+ 4.4	+ 2.0
1965	- 3.4	+ 4.9	+ 1.5
1966	- 3.5	+ 5.1	+ 1.6
Total, 1954-66	-24.8	+41.7	+16.9

Source: Department of Commerce, Survey of Current Business.

These figures do not include undistributed earnings of subsidiaries, which do not affect the balance of payments because they are not transferred internationally.

Total earnings on U.S. direct investments abroad amounted to $5.1 billion in 1966 and were second in importance, on the receipts side of the balance of international payments, only to the favorable balance on merchandise trade.

It is estimated that the book value of all U.S. direct investments abroad amounted to $54.6 billion at the end of 1966, which was more than $4\frac{1}{2}$ times larger than in 1950. Such investments are much larger than total direct investments by foreigners in the United States, which are estimated at about $9 billion.

There can be little doubt that the new policy will succeed in narrowing the country's balance-of-payments deficit. There is considerable difference of opinion, however, regarding the long-run desirability and effectiveness of such a policy. Private capital investment constitutes a net plus, rather than a net minus, in the country's balance of payments because, in due course, it returns more funds in the form of current income than the total of funds paid out currently in the form of new investment.

International Investment Position of the United States

The excess of American investments abroad over foreign investments in the United States is large and has been increasing. In 1950 U.S. foreign investments and claims on foreigners totaled $31.5 billion, while foreign investments and claims on the United States totaled $17.6 billion, an excess of almost $14 billion on the plus side. By 1966 American foreign investments and claims on foreigners had increased to $111.9 billion while foreign investments in the United States increased to $60.4 billion, a favorable balance of $51.5 billion. In the 16 year period 1950-66 the excess of American claims against foreigners over foreign claims against Americans increased by 270 percent.

International Investment Position of the United States
1950, 1963, and 1966 (end of year)

(in billions)

Types of Investment	1950	1963	1966
U.S. investments and claims on foreigners 1/	$ 31.5	$ 88.2	$ 111.9
Private investments and claims	19.0	66.4	86.2
Long-term	17.5	58.3	75.6
(Direct)	(11.8)	(40.6)	(54.6)
Short-term assets and claims	1.5	8.1	10.7
U.S. Government credits and claims	12.5	21.8	25.6
Long-term credits and claims	10.8	17.1	21.2
Foreign currencies & short-term claims	0.3	3.4	2.8
IMF gold tranche position and convertible foreign currencies	1.4	1.2	1.6
Foreign assets and investments in the U.S.	$ 17.6	$ 51.5	$ 60.4
Long-term	8.0	22.8	27.0
(Direct)	(3.4)	(7.9)	(9.1)
Short-term assets and U.S. Gov't obligations	9.6	28.7	33.4
Private obligations	(6.5)	(14.9)	(20.8)
U.S. Gov't obligations	(3.2)	(13.8)	(12.6)
Excess, U.S. investments abroad over foreign investments in the U.S.	+13.9	+36.7	+51.5

1/ Not including gold holdings.

Source: U.S. Department of Commerce, Survey of Current Business, September 1967.

Whereas over 85 percent of American claims against foreigners are long term in nature, over 55 percent of all foreign claims against Americans are short term (see table).

It remains to be seen whether the United States is entering a new phase in its long-term international financial position. If there is a substantial and prolonged increase in the movement of American capital abroad, relative to foreign capital invested in the United States, it is to be expected that eventually there will be a changed relationship between merchandise exports and merchandise imports, with the latter expanding in relation to the former as the income from existing investments abroad comes to exceed new capital outflow, allowing for payments in the form of military expenditures and foreign aid.