Kennedy and the Balance of Payments

In 1960 the United States had a balance of payments problem. American gold reserves were being drained, American products seemed to be losing some of their competitiveness, and the American dollar was under attack on international money markets. While the Eisenhower administration had taken a relatively passive approach to these difficulties, President-elect Kennedy committed his administration to a solution. As Arthur M. Schlesinger recounted: "Kennedy ... used to tell his advisers that the two things which scared him the most were nuclear war and the balance of payments deficit. Once, he half-humorously derided the notion that nuclear weapons were essential to international strength. 'What really matters' he said, 'is the strength of the currency. ' "[1]

Three Traditional Approaches to Balance of Payments Deficits

Kennedy's dilemma was that most of the traditional means for correcting balance of payments deficits were inconsistent with his other economic goals. For example, deflation is a frequently recommended strategy for reducing the outflow of a nation's currency. If Kennedy had employed restrictive fiscal and monetary policies, American firms and consumers would have had less disposable income to buy imports; and higher interest rates in the United States would have attracted investment from foreign capital. But if Kennedy had wanted to keep his pledge to "get the country moving again," a deflationary strategy would not have been acceptable (see **Table A**).

Another traditional way to deal with balance of payments problems was to change the exchange rate. A devaluation of the dollar would make American exports relatively cheaper and foreign imports relatively more expensive. All other things being equal, cheaper exports should cause the demand for American exports to rise. In the meantime, a devaluation should lead Americans to substitute cheaper domestic products for more costly foreign products.[2] Devaluation, however, was not an easy option for the United States in 1960-1961. Under the rules of the international monetary system established at Bretton Woods, New Hampshire, in 1944, the U.S. dollar was pegged at $35 per ounce of gold. In addition, all other currencies were pegged to the U.S. dollar. Any hint that the

[1] Martin Mayer, *The Fate of the Dollar* (New York: Truman Talley Books, 1980), p. 85.
[2] The "all other things being equal" is related to the concept of price elasticity—the degree to which supply or demand for a good responds to changes in price. Cheaper exports, for example, may not stimulate greater foreign demand if the exports are of poor quality; similarly, domestic consumers may not cut back expensive imports if the imported goods are essentials, such as oil or food.

Assistant Professor David B. Yoffie prepared this case with the assistance of Research Associate Jane Kenney Austin as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Kennedy administration might change the value of the dollar would lead to a collapse in confidence in the American currency and would undermine the Bretton Woods system.

Table A U.S. Gross National Product (US $ billions)

	Current	1960 Prices	Real Growth (per annum)
1950	$284.6	$362.3	8.4%
1951	329.0	392.0	8.2
1952	347.0	406.8	3.8
1953	365.4	425.5	4.6
1954	363.1	416.8	(2.0)
1955	397.5	449.7	7.9
1956	419.2	459.2	2.1
1957	442.8	467.8	1.9
1958	444.2	459.7	(1.7)
1959	482.1	490.6	6.7
1960	503.2	503.2	2.6

Source: *Economic Report of the President*, 1961, GPO, Washington, D.C., 1962.

A third option for correcting balance of payments deficits was to reduce international commitments and place controls on the outflow of capital or the inflow of foreign goods. By raising import barriers, restricting American investment abroad, and bringing home American troops stationed overseas, Kennedy might have been able to reverse the trends toward growing deficits. Yet here again, all of these policies were contrary to existing U.S. goals. During the post-war period, American foreign policy promoted global security. The United States was making large military expenditures and maintaining substantial forces abroad to counter Soviet assertiveness. Reducing those expenditures might have been viewed as capitulation to the U.S.S.R. The United States was also fostering European cooperation and integration in the interest of political stability and economic growth. Since rapid economic development was viewed as the best defense against the spread of communism, it was not desirable to restrict capital outflow to American allies or to erect trade barriers.

All of these obligations confronted Kennedy with a dilemma. If the United States sustained an active foreign policy with a worldwide political, economic, and military role, the balance of payments might continue to deteriorate. But a weak U.S. balance of payments could jeopardize America's ability to pursue postwar objectives. Hence, each of Kennedy's standard options appeared to be constrained: adopting deflation, devaluation, retrenchment, capital controls or trade controls implied sacrificing important objectives. Kennedy, therefore, charged his advisers with the responsibility of finding a satisfactory solution. To understand Kennedy's dilemma, it is helpful to understand the origins of the American participation in international trade and the background to the monetary and trade institutions of the post-World War II period from a historical perspective.

The Rationale for International Trade

The modern debate over trade policy has its roots in the 1600s and 1700s when international trade operated on the principles of mercantilism. Based on the assumption that economic power and welfare would be enhanced by positive balances of trade and the accumulation of precious metals, countries commonly used export subsidies and high import duties to build trade surpluses. A positive balance of payments could fund a country's military, provide state treasuries with money for emergencies, and build the most visible forms of wealth and prestige. An eighteenth century English scholar recounted: "The general measures of the trade ... at present are gold and silver, which are ...

the ultimate objects of trade.... If the exports of Britain exceed its imports, foreigners must pay us the balance in treasure, and the nation grows rich. But if the imports of Britain exceed its exports, we must pay foreigners the balance in treasure, and the nation grows poor."[3] The world trading system was viewed by the major actors as a zero-sum competition in which one country's gain was necessarily another's loss.

Adam Smith's *Wealth of Nations* (1776), however, attacked mercantilism as an economic doctrine. For the first time, countries were told that national real income could be maximized by specializing in the export sector and importing goods that others could make for less. David Ricardo took this argument one step further with his exposition of the theory of comparative advantage in *The Principles of Political Economy and Taxation* (1821). By demonstrating that open trade was mutually beneficial to two countries, even if one nation was more productive in all commodities, Ricardo articulated an extraordinarily powerful theory that has provided the foundation for international trade analysis.

The theory of comparative advantage is best explained through an illustration. Picture two economies, the United States and the continental Europe, for example, which are identical in most ways. Assume that both economies have similar endowments of land, labor, and capital. Imagine that they each produce only two crops—cotton and wheat. The single difference between the two is that the United States has a better climate than Europe. Therefore, a production unit in the United States can produce more wheat and more cotton than an equivalent production unit in Europe. The question then arises: Does the United States need Europe as a trading partner, or would it be better off relying exclusively on its own resources?

It is tempting to say that the United States should go it alone. Such an analysis, however, would miss the Ricardian logic of comparative advantage. Take, for example, the case of a successful business consultant who is also the world's best typist. Should that consultant do his own typing since he can do it better and more efficiently than someone hired to do the job? In the same way the consultant can make more money consulting by paying a typist, the United States can have more wheat and more cotton if it trades with Europe. (A numerical illustration of this conclusion is presented in the **Appendix**.)

The theory of comparative advantage suggested a powerful proposition for international economics: When countries lower trade barriers and exchange goods on the basis of comparative advantage, everyone is better off. When prices and relative productivity levels are introduced into the model, the same conclusion holds. Thus, we should find that even the most inefficient, poor countries in the world have some comparative advantage that they can exploit. And, theoretically, all countries should favor free trade policies.

When this theory is applied to the real world, however, the results are no longer so clear cut. Ricardian comparative advantage is a static concept that assumes constant returns to scale. It helps to identify the gains from trade that are available through international specialization, but government policymakers have never been totally committed to free trade, and countries continue to use a variety of tools to protect their domestic economies.

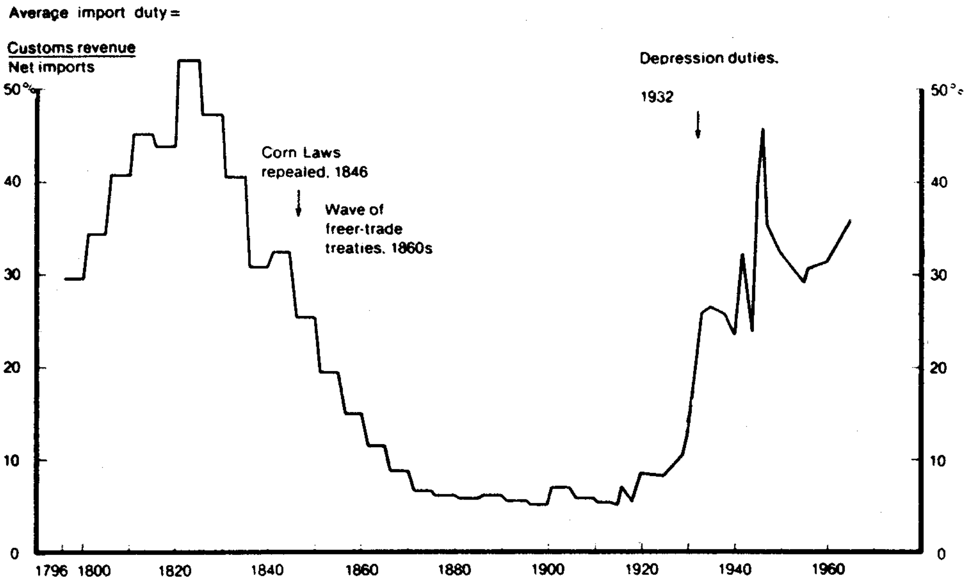
Background to the Modern Trading System

The first movement toward global free trade began in the 1840s in Great Britain. In an effort to end the political dominance of the landed gentry and redistribute wealth more equitably, the Tory

[3] Matthew Decker, *An Essay on the Causes of the Decline of the Foreign Trade*, 1756, pp. 1-2. cited by Jacob Viner, *Studies in the Theory of International Trade* (New York: Harper and Brothers Publishers, 1937), pp. 18-19.

government of Sir Robert Peel repealed the high tariffs on grain known as the Corn Laws. While most countries in the world were using tariffs to generate revenue and protect their domestic markets, Britain took the bold step of unilaterally lowering its trade barriers (see **Figure A**).

Figure A Average Import Duties, United Kingdom, 1796-1960



Source: Charles P. Kindleberger and Richard H. Lindert, *International Economics*, 6th ed. (Homewood, Ill Richard D. Irwin, 1978), pp. 221-22. Reprinted by permission.

There was great trepidation at first, but instant success vindicated the British policy. The rapidly growing population of Europe, coupled with the expansion of the money supply,[4] created a worldwide demand for British goods. On the supply side, the reduced cost of imports restrained pressures on wages, and the new technologies of the industrial revolution lowered transportation costs and spurred increased productivity. The result was prosperity throughout the British economy. Export trade in particular boomed as Britain became the "workshop of the world."

Three factors can account for British behavior: First, British elite were swayed by the power of Smith and Ricardo's arguments. The intellectual appeal of laissez-faire was growing at the time. Second, export interests were well organized to influence the course of politics. Export-minded industrialists banded together to offset the political power of protectionist groups. Third, Britain's position in the world was rising. With the defeat of Napoleon in 1815, there was no rival to Britain's political, military, or economic power in the world. Free trade for Britain was a way to exercise further leadership. In fact, hegemonic states generally favor free trade. Low trade barriers and open borders reinforce the most advanced country's supremacy, maintain political and social stability in the system, and increase aggregate income in the international system.

By the 1860s the British momentum toward free trade had become contagious. Britain negotiated tariff reductions with France, France negotiated tariff cuts with German custom unions, and so on. Furthermore, countries agreed to generalize trade concessions by employing an unconditional most-favored-nation policy (MFN). MFN provided that countries would treat all signator nations equally in trade relations, without requiring compensation. If, for example, France made a separate agreement with Italy to lower a tariff, then the French would be obliged under the MFN clause in other treaties to lower its tariff on that good to all its other trading partners. The net

[4] The discovery of new gold fields after 1849 almost doubled the stock of the world's basic monetary unit during the following 25 years.

impact of these generalized reductions in tariff barriers was a dramatic growth in world trade and capital flows.

Free trade, however, can be difficult to sustain. The advantages of low-cost imports are usually widely diffused across the economy, while those hurt by import competition are often concentrated groups. If growth slows, if large unemployment in particular sectors occurs, if strategic industries begin to go out of business, protectionist coalitions tend to form. Unless export and free trade interests can counterbalance these coalitions in the domestic political arena, or unless a hegemonic state can compel countries to maintain low trade barriers, protectionism will frequently result.

During a depression in the 1870s and.1880s, for example, protectionist interests were able to gain prominence in Europe. The British remained committed to low trade barriers, but they no longer possessed the power to offset a resurgence in tariffs. In the 1890s trade wars broke out on the Continent. Free trade declined as military goals, colonialism, and economic nationalism became the order of the day at the end of the nineteenth century.

The Twentieth Century

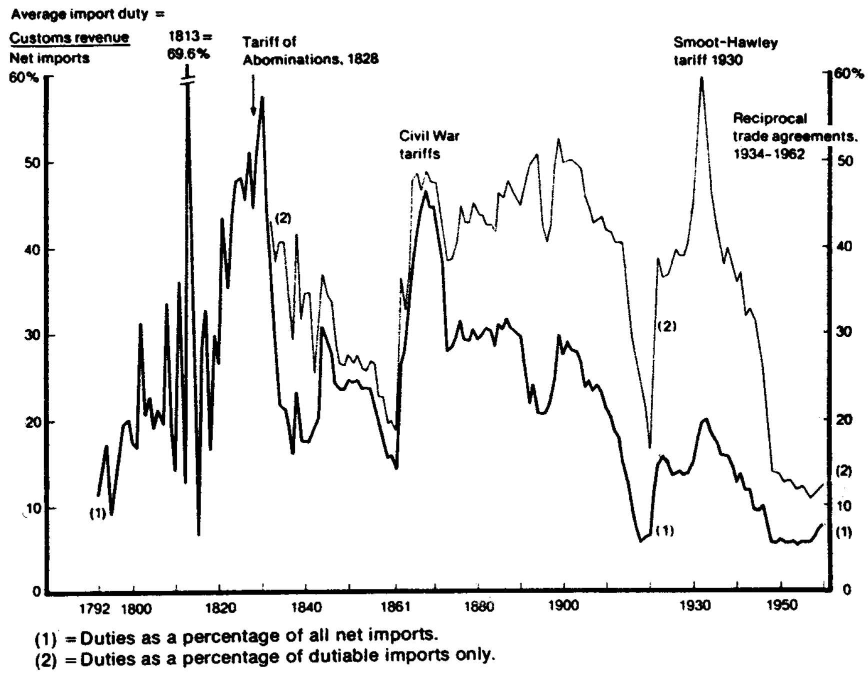
World War I marked the end of British dominance in the international economy. The war bankrupted Europe in general and Britain in particular. After the end of the hostilities, the Allies were heavily in debt to the United States, the Axis nations were burdened by reparations to the Allies, and the United Kingdom had sold off many of its foreign investments to finance the war. No country was then both willing and able to reestablish order. Britain was willing but not able; the United States was able but not willing.

The United States was the only country which had survived the war with its industry intact. Moreover, the outside world owed billions in war debts to the United States and could only pay Americans back if the United States maintained low trade barriers. With free trade, foreigners could earn the dollars necessary to service their debts. Yet, instead of trying to stabilize international trade, as the British had done in the past, the U.S. Congress reacted to the first downturn in the 1920s by raising tariffs (see **Figure B**). The only positive move made by the United States at this time was to adopt an unconditional most-favored-nation policy. The Americans hoped that by reducing their own discrimination, others would stop discriminating against U.S. exports.[5]

Amid signs of a general economic crisis, the slide toward global protectionism accelerated in the late 1920s. The League of Nations did its best to prevent a trade war, but all hope collapsed after the U.S. stock market crash in 1929. Industry after industry pleaded with the Congress for import restrictions to maintain employment. With no organized export interests, and no global leader, there was nothing to brake the protectionist drive. In what has been called an "orgy of log-rolling,"[6] Congress erected some of the highest tariff barriers in American history. The Smoot-Hawley tariff of 1930 raised the average import levy to almost 60%.

[5] John Jackson, *International Economic Relations* (St. Paul: West Publishing Co., 1972), p. 517.
[6] Peter Kenen and Raymond Lubitz, *International Economics*, 3rd ed. (Englewood Cliffs: Prentice-Hall, Inc., 1971), p. 28.

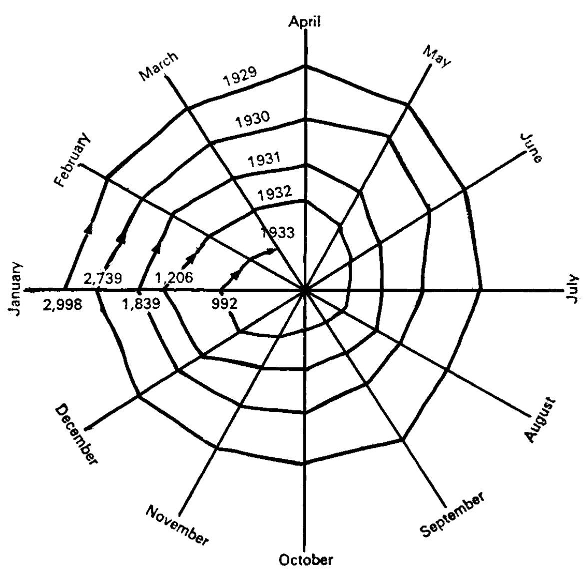
Figure B Average Import Duties, United States, 1792–1960



Source: Charles P. Kindleberger and Richard H. Lindert, *International Economics*, 6th ed. (Homewood, Ill.: Richard D. Irwin, 1978), pp. 221-22. Reprinted by permission.

The new American tariffs set off a wave of global retaliation. Countries ranging from Australia to Cuba to France responded with their own increased duties, boycotts, and quotas. A number of countries devalued their currencies to stimulate exports, while others imposed exchange controls to defend their foreign reserves. The combination of economic depression, high trade barriers, exchange restrictions, and competitive devaluations led to a severe contraction in world trade (see **Figure C**). Between 1928 and 1938 global imports dropped from $60 billion to $25 billion.

Figure C The Contracting Spiral of World Trade, January 1929 to March 1933: Total Imports of 75 Countries



Source: Charles Kindleberger, *The World in Depression* (Berkeley: The University of California Press, 1973), p. 172. Reprinted by permission.

Note: Monthly values in terms of old U.S. gold dollars, millions.

It did not take long for the new Roosevelt administration in the early 1930s to realize that the Smoot-Hawley tariff was self-defeating. Therefore, FDR asked Congress to give the executive branch the authority to negotiate tariff reductions on a reciprocal basis. If other countries would lower their trade barriers, the president told Congress, then there would be "a resumption of international trade (which) cannot but improve the general situation of other countries, and thus increase their purchasing power. Let us well remember that this in turn spells increased opportunity for American sales. "[7]

When Congress passed the Reciprocal Trade Act of 1934, it marked a turning point in U. S. trade policy and the history of world trade. For the first time in the United States, the leading role for setting tariffs passed from the Congress to the executive branch. This not only reduced the influence of protectionist groups over American trade policy, it also arrested the worldwide trend toward increasing protection.

Using its new authority to negotiate tariff cuts by as much as 50%, the U.S. government signed 31 bilateral treaties between 1934 and the outbreak of World War II. The most-favored-nation clause was reintroduced and tariff levels dropped slightly below their 1930 levels.[8] Free trade, however, was never realized during this period. Roosevelt was still more interested in lowering others' trade barriers than allowing foreigners to compete with American industries.

The Early Postwar System

It was widely recognized that "beggar-thy-neighbor" policies partly caused the economic disaster of the 1930s. If the world was going to avoid a return to depression in the 1940s, American officials believed that trade barriers would have to be eliminated, anticompetitive policies would have to be stopped, and a whole new international order created. And unlike the 1920s, the United States realized that this time it would have to take the lead. As the Department of State put it in 1945, "The only nation capable of taking the initiative in promoting a worldwide movement toward the relaxation of trade barriers is the United States."[9]

The United States's objective was an era of Pax Americana. The goal would be the "establishment of a liberal trading system," said the American secretary of state, "and the attainment of an expanding world economy."[10] The American strategy to achieve these goals was to promote long-range political objectives, even if it required the sacrifice of specific American economic interests.

The first policy stemming from this strategy was for the United States to commit itself to free trade—no matter what the consequences. To aid the reconstruction 'of the postwar trading system, the United States had already allowed its average tariff levels to decline significantly before 1945: Since many U.S. duties were *specific*, wartime inflation had eroded the *ad valorem* tariff values to 1919 levels. The United States planned to leave its borders open to create greater trading opportunities for the capitalist world, even though most other industrial and nonindustrial countries. were using tariffs and quotas to exclude American exports.

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7 Ibid., p. 39.

8 Part of the decline of U.S. tariffs can be explained by the rise in prices of imports during the slow recovery from the depression. The majority of U.S. tariffs were *specific*, i.e., they levied a fixed tax on imports, regardless of the import prices. As prices rose, the percentage tariff, or *ad valorem* rate, fell.

9 Quoted in Joan Spero, *The Politics of International Economic Relations*, 2nd ed. (New York: St. Martin's Press, 1981), p 76.

10 Quoted in Joyce and Gabriel Kolko, *The Limits of Power* (New York: Harper & Row, 1972), p. 12.

The second component of the U.S. strategy was to find some way to liberalize world trade. Liberalizing trade, however, could not be done in isolation from an international monetary system. Unless nations could agree on a system of payments, it would be difficult for the world to progress beyond the barter of the 1930s. Therefore, the next order on the American agenda was to create a set of rules that would provide monetary stability and worldwide liquidity.

The outcome of this effort was a series of agreements in 1944 at Bretton Woods, New Hampshire. These agreements, which later became known as the Bretton Woods system, included the creation of two international organizations—the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), and the establishment of guidelines for managing the world's money. The central principle of the Bretton Woods system was that countries would fix their exchange rates. Convinced that the collapse of international economic activity during the Great Depression was aggravated by the instability of floating exchange rates, public officials believed that fixed rates would be most conducive to expanded trade. Hence, the signatories at Bretton Woods agreed to fix their currencies in terms of gold and to defend that parity rate within plus or minus 1%.

Once the outline of the monetary system was in place, the United States proceeded to sponsor an international organization that would regulate a world trade system based on the principles of comparative advantage, competitive markets, and nondiscrimination. Beggar-thy-neighbor policies would be gone—international negotiations would take their place. But unlike America's apparent success in the monetary realm, the United States was unable to convince countries to give up substantial control of national trade prerogatives. It took several years of agonizing negotiations before an agreement on an International Trade Organization (ITO) could be reached, and when it was finally signed, it turned out to be complicated and filled with exceptions. To some it went too far in the direction of free trade; to others, it did not go far enough. When the Truman administration realized that its own Congress would not ratify the agreement, the ITO died.

Fortunately, major trading nations had agreed to an interim arrangement in 1947 that would provide a set of trading rules until the ITO could be implemented. Known as the General Agreement on Tariffs and Trade (GATT), this agreement incorporated many of the principles of the ITO, without some of its complexity and thoroughness. Once the United States pulled out of the ITO, the GATT became the guiding document.

The core of this agreement centered on three principles: (1) all signatories would extend unconditional most-favored-nation treatment to all member nations; (2) nontariff barriers, particularly quantitative restrictions, were to be abandoned; and (3) countries should consult on a multilateral basis to avoid trade disputes. Other features included commercial codes on dumping and subsidies, remedies for noncompliance, the granting of waivers from GATT commitments if there were international consensus, and the principle of reciprocity. Since the GATT was originally designed as a temporary arrangement, however, it did not include provisions for commodity agreements, regulations of state trading or restrictive business practices, and codes for such nontariff barriers as bilateral quotas. Nor was the GATT a formal international organization. As an institution, the General Agreement was more analogous to the Chicago Board of Trade than the IMF or the World Bank. The GATT, with offices and a small staff located in Geneva, Switzerland, merely provided a forum and a set of procedures for member nations to negotiate agreements. Although the GATT was a giant leap forward, it had little power of its own and numerable loopholes.

Sources of U.S. Balance of Payments Difficulties

If U.S. postwar efforts had created a truly Ricardian world complete with monetary stability, the United States might never have had a balance of payments problem when John Kennedy came into office. But the theory of monetary stability and trade liberalization did not operate as smoothly as Roosevelt and Truman had hoped. The dislocations of the war made it difficult for the Europeans and the Japanese to lower their trade barriers and accept responsibility for their currencies. Moreover, the United States preferred to manage the international system unilaterally: If the United States accepted the economic costs of managing the world economy, it gained political and economic influence over its allies. By 1960, however, the costs of America's hegemony seemed to be getting out of control. Three things in particular worried Kennedy: the creation of the European Community in 1957, the structure of the Bretton Woods system, and the slow progress toward liberalizing trade barriers under the GATT.

The EEC

In the aftermath of the Great Depression and World War II, the world was plagued with extensive trade barriers. Through the late 1950s, however, this was not a great concern of the United States. In fact, the United States took an active role in encouraging certain types of protectionism in Japan and Europe. During the American occupation of Japan, for example, the United States made no effort to dismantle trade barriers that restricted American imports. The Occupation's first economic priority was to help Japan recover. Therefore, the United States left its borders open to the Japanese exports while it urged other nations to take more goods from Japan.

In addition, the idea behind the European Economic Community (EEC) originated in the United States, even though customs unions of the EEC variety were traditionally considered discriminatory and at odds with the principle of free trade. When Secretary of State George Marshall put forth the offer of U.S. aid to Europe in 1947, he recommended that the Europeans reduce their internal barriers to trade to stimulate long-term competitiveness. The underlying economic logic behind this suggestion was that a customs union would create a large internal market in Europe, thus permitting greater specialization according to each nation's comparative advantage. It would also allow European industries to realize greater economies of scale. This was consistent with America's strategy because American officials believed that European recovery was essential to the freedom and prosperity of the capitalist world. And since the Europeans urgently needed aid and were critically dependent on the United States for military and economic assistance, the United States had powerful leverage to get its way.

The creation of a European community, however, could create long-term problems for American exports and balance of payments. When the Treaty of Rome establishing the EEC was signed on March 25, 1957, there were six signatories—Belgium, the Federal Republic of Germany, France, Italy, Luxembourg, and the Netherlands. The purpose of the treaty was to facilitate the free movement of goods, a common agricultural policy, free movement of persons, services and capital, and a European transportation network. The free movement of goods was to be attained by reducing and eventually eliminating tariffs among the members and by creating a common external tariff wall. (Technically, the external tariffs were accepted under GATT because they were the arithmetical average of the duties applied by the countries prior to the Treaty.) The free movement of goods was also to be attained by the removal of any quantitative import restrictions between member states.

If the EEC achieved this objective, the nations within the community would inevitably trade more among themselves and less with the United States. Furthermore, if the Treaty of Rome successfully eliminated capital controls and exchange restrictions, it could encourage capital outflows from the United States by causing American firms to invest in Europe rather than export from the United States.

The Bretton Woods System

The emergence of the European Community was not the only problem on Kennedy's mind concerning the deteriorating balance of payments. Of equal importance was the U.S. position on the Bretton Woods system. Under the rules of Bretton Woods, European nations had a great deal of latitude: they did not have to convert their currencies into gold until the early 1960s; and they were allowed to devalue their currencies to correct a fundamental disequilibrium in their balance of payments. These countries took advantage of their positions by maintaining capital controls and inconvertible currencies through 1958 and by devaluing their currencies whenever they had balance of payments problems. The United States, however, held special obligations under the conventions of Bretton Woods: it was the only nation obliged to defend the par value of its currency, which was $35 per ounce; it was the only nation committed to convert its currency freely into gold; and it was the only nation allowing unrestricted capital flows.

Fulfillment of these unique obligations posed no problem for the United States in the years immediately after the war. The prospect of American balance of payments deficits was dismissed lightly because the United States held the great bulk of the world's monetary gold (see **Exhibit 3**), and it had a strong economy with a big technological lead. During the years 1946 to 1949 the U.S. balance of trade totaled $32 billion; even after the Marshall Plan and other aid disbursements, the United States enjoyed a favorable balance of payments position. In fact, the United States in 1949 forced devaluations of the European and Japanese currencies against the dollar, ranging from 30% for British sterling to 98% for the Japanese yen, to make these countries more competitive. Although the U.S. current account balance shifted into deficit in 1950, the greatest concern among governmental officials was that there would be a sustained dollar shortage lasting well into the 1960s. Economies in war-ravaged Europe needed liquidity to rebuild and to trade. Until the late 1950s, foreign monetary authorities were far more anxious to obtain dollars than exchange dollars for gold.

America's commitment to unrestricted capital flows further enhanced the dollar's international role. Since the United States was the world's largest and freest capital market, and American interest rates were generally favorable (see **Exhibit 4**), foreign governments found it attractive to issue bonds in the United States. America's political stability and economic strength also led many foreigners to deposit their dollars in U.S. banks or buy T-bills. In addition, American multinationals and to some extent banks were an important source of funds for Europe and the developing world. The outflow of private capital from the United States rose steadily after World War II, with a sharp jump in 1956 and 1957 due to the acquisition of Venezuelan oil concessions.

As long as foreigners were content to hold and use dollars, and as long as the United States had adequate gold stocks to back its foreign liabilities, a net outflow of U.S. dollars was viewed positively by foreign governments. Since dollars were being used to finance world trade, U.S. deficits were critical for maintaining international liquidity. But as the 1950s wore to a close, the outflow of dollars and gold from the United States began to reach crisis proportions (see **Exhibits 1**, **2**, and **3**).

The American government first became sensitive to this problem around 1958. Concerned with domestic inflation, President Eisenhower introduced austerity measures that caused a recession. But for the first time in the postwar period, a recession in the United States did not produce a strong reduction in imports of foreign goods and services. The increasing quality of imports and the growing competitiveness of America's trading partners kept the demand for imports high. The result was that the U.S. current account surplus, which had been strongly positive in 1956 and 1957, all but disappeared (see **Exhibits 1** and **2**).[11] When U.S. growth picked up again in 1959, demand for imports rose even further and a major steel strike in the United States made matters worse.

The balance of payments situation was further aggravated by a declining demand for dollars. An increase in U.S. foreign investment in Europe and growing dollar reserves overseas reduced the incentive for foreign governments to hold U.S. currency. With the formation of the EEC and the restoration of convertibility among the Europeans, their need for dollars to finance internal trade declined. The dollar shortage was turning into a dollar glut. As a result, foreign central banks began to exchange dollars for gold; in 1958, $2.3 billion in gold flowed out of the United States, an amount equivalent to one-tenth of all U.S. holdings. Ad hoc measures were taken to ease the pressure on U.S. reserves, including a 1958 arrangement for the Germans to prepay a half billion dollar loan. By 1960, however, it was clear that foreign dollar holdings would soon exceed U.S. gold reserves (see **Exhibit 3**).

This reversal in the American balance of payments position threatened to topple the entire Bretton Woods system. Foreign governments needed dollars to finance international trade but the persistent U.S. deficits were lowering their confidence in America's ability to redeem their dollars for gold. Even though the dollar was pegged at $35 per ounce, speculators believed that under these conditions it was preferable to hold gold over dollars. Hence, foreign monetary authorities increased their conversions of dollars into gold, while private investors began to acquire more of the metal on the London Gold Exchange—a small, private commodity market that the British government supported with its own reserves. For one day, on October 20, 1960, the British stopped supporting the price of gold on the London Exchange, causing the price to shoot up to $40 per ounce. The price was quickly reduced to official levels when the United States provided Britain with new gold reserves. Yet the psychological impact of breaking the official price, even for one day, was dramatic.

As he entered office in January 1961, President Kennedy's options were severely limited. If he wanted to keep the Bretton Woods system intact, the United States could not easily devalue its currency—a measure open to other countries. Since all currencies were valued in terms of the dollar, any effort to reduce the dollar's value would undermine all confidence in the American currency and destroy the supposed stability of the fixed rate system. Furthermore, any effort to reverse America's balance of payments deficits could lead to a liquidity problem. If fewer dollars were available to finance world trade, there could be a stifling effect on world economic growth.

Slow Progress Toward Free Trade

The final problem that concerned the Kennedy administration was the lack of progress toward freer world trade. The GATT had sponsored five rounds of tariff-cutting negotiations between 1947 and 1960, but none of these efforts realized much success. Part of the problem was that these negotiations were built around the rule of the principal supplier. Under this rule, a country would only request a tariff concession if it was the principal supplier (or largest exporter) of that specific good. Since an importer would have to generalize the tariff reduction under the most-favored-nation clause in the GATT, it would be reluctant to negotiate concessions with any country other than the principal supplier. The effect of this rule was to exclude a large number of countries from meaningful tariff bargaining during this period. Countries that were not the principal supplier of any product, such as many developing nations, were completely left out of the process.

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[11] In summer 1956, Egypt nationalized the Suez Canal, a step which provoked a military response by England, France, and Israel. In the aftermath of the conflict, the canal remained closed and oil supplies from the Middle East to Europe were disrupted. Therefore, the United States shipped oil to its European allies, which led to a temporary surge in American exports.

In addition, the negotiations were being conducted on a product-by-product, country-by-country basis. The negotiations were exceedingly laborious, as participants would bargain for reciprocal tariff cuts on every individual item that they imported and exported. With the advent of the EEC, this process became even harder. After 1957 each proposal considered by EEC nations had to proceed through lengthy internal discussions to insure that tariff cuts did not weigh disproportionately on specific members.

Yet here again, President Kennedy's options to foster world trade appeared limited. The president's authority to negotiate tariff reductions was circumscribed by the Congress. No Congress in the past 25 years had allowed a president to go beyond the powers provided in the 1934 Reciprocal Trade Act, i.e., item-by-item reductions on a reciprocal, bilateral basis. If Kennedy wanted to find some way to correct the United States' deteriorating balance of trade, he would find no easy answer in the GATT procedures or at home.

Exhibit 1 U.S. Balance of Payments—Systematic Presentation, 1950-1960 (US$ millions)

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960
A. GOODS AND SERVICES, NET	2,090	4,285	3,045	1,078	2,396	2,812	5,008	6,988	3,046	1,047	4,964
1. Merchandise, f.o.b., net	1,009	2,921	2,481	1,291	2,445	2,763	4,575	6,099	3,312	972	4,736
a) Imports	9,108	11,202	10,838	10,990	10,354	11,527	12,804	13,291	12,952	15,310	14,723
b) Exports	10,117	14,123	13,319	12,281	12,799	14,280	17,379	19,390	16,264	16,282	19,459
2. Transport, net	215	582	373	117	145	202	209	398	2	-113	-283
a) Debit	818	974	1,115	1,081	1,026	1,204	1,408	1,569	1,636	1,759	1,988
i) Shipping	643	787	911	864	805	946	1,125	1,226	1,255	1,309	1,416
ii) Other	175	187	204	217	221	258	283	343	381	450	572
b) Credit	1,033	1,556	1,488	1,198	1,171	1,406	1,617	1,967	1,638	1,646	1,705
i) Shipping	859	1,331	1,242	972	942	1,137	1,323	1,639	1,291	1,238	1,284
ii) Other	174	225	246	226	229	269	294	328	347	408	421
3. Foreign travel, net	-335	-284	-290	-355	-414	-499	-570	-587	-635	-708	-776
a) Debit	754	757	840	929	1,009	1,153	1,275	1,372	1,460	1,610	1,744
b) Credit	419	473	550	574	595	654	705	785	825	902	968
4. Investment income, net	1,509	2,050	2,196	2,112	2,347	2,730	3,102	3,384	2,965	3,071	3,363
a) Debit	559	583	555	624	582	676	735	796	825	1,061	1,113
i) Official	31	47	64	86	59	94	154	201	139	281	332
ii) Private direct investment[a]	359	355	315	358	338	367	344	344	369	451	423
iii) Other private	169	181	176	180	185	215	237	251	317	329	358
b) Credit	2,068	2,633	2,751	2,736	2,929	3,406	3,837	4,180	3,790	4,132	4,476
i) Official	109	198	204	252	272	274	194	205	307	349	349
ii) Private direct investment[a]	1,769	2,243	2,342	2,268	2,427	2,874	3,346	3,612	3,066	3,317	3,609
iii) Other private	190	192	205	216	230	258	297	363	417	466	518
5. Government transactions, n.e.s., net	-542	-1,213	-1,988	-2,329	-2,376	-2,640	-2,741	-2,800	-3,094	-2,698	-2,609
a) Debit	800	1,492	2,301	2,826	2,836	3,090	3,151	3,444	3,666	3,351	3,302
i) Military	576	1,270	2,054	2,615	2,642	2,901	2,949	3,216	3,435	3,107	3,048
ii) Other	224	222	247	211	194	189	202	228	231	244	254
b) Credit	258	279	313	497	460	450	410	644	572	653	693
i) Military	..	..	..	192	182	200	161	375	300	302	335
ii) Other	258	279	313	305	278	250	249	269	272	351	358
6. Other services, net	234	229	273	242	249	266	433	494	496	523	533
a) Debit	153	202	221	245	258	304	389	384	427	427	433
b) Credit	387	431	494	487	507	570	822	878	923	950	966
B. UNILATERAL TRANSFERS, NET	-4,033	-3,524	-2,535	-2,483	-2,290	-2,514	-2,431	-2,371	-2,389	-2,481	-2,565
7. Private, net	-444	-386	-417	-476	-486	-444	-530	-543	-540	-575	-628
a) Debit	474	416	449	516	527	473	562	577	573	609	660
b) Credit	30	30	32	40	41	29	32	34	33	34	32
8. Official, net	-3,589	-3,138	-2,118	-2,007	-1,804	-2,070	-1,901	-1,828	-1,849	-1,906	-1,937
a) Debit	3,742	3,261	2,203	2,110	1,869	2,112	1,956	1,900	1,888	1,940	1,971
b) Credit	153	123	85	103	65	42	55	72	39	34	34
C. CAPITAL AND MONETARY GOLD, NET	1,964	-1,238	-1,111	1,066	-279	-801	-3,120	-5,774	-1,145	1,022	-1,807
NON-MONETARY SECTOR, NET	-1,333	-1,483	-2,025	-1,357	-1,241	-1,558	-3,501	-4,697	-4,122	-2,482	-4,589
9. Private direct investment, net[a]	-826	-1,000	-1,509	-1,240	-1,083	-1,401	-2,727	-3,493	-1,872	-1,990	-2,633
a) Liabilities	270	259	266	321	286	384	399	312	254	471	315
b) Assets	-1,096	-1,259	-1,775	-1,561	-1,369	-1,785	-3,126	-3,805	-2,126	-2,461	-2,948
10. Other private long-term, net	-336	-309	-142	140	-70	178	-74	-314	-1,268	-273	-413
a) Liabilities	-19	114	35	71	149	193	363	235	-17	472	282
b) Assets	-317	-423	-177	69	-219	-15	-437	-549	-1,251	-745	-695
11. Private short-term, net	-15	-18	46	-39	-181	-25	-71	68	-11	134	-438
12. Official long-term, net	-156	-156	-420	-218	93	-310	-629	-958	-971	-353	-1,105
a) Repayment of debt: liabilities	-	-	-	-	-	-	-	-	-	-	-
b) Repayment of debt: assets	295	305	429	475	497	407	467	627	530	1,028	613
c) Other liabilities	..	..	..	..	..	..	..	..	..	..	..
d) Other assets	-451	-461	-849	-693	-404	-717	-1,096	-1,585	-1,501	-1,381	-1,718
13. Official short-term, net	..	..	..	..	..	..	..	..	..	..	..
MONETARY SECTOR, NET	3,297	245	914	2,423	962	757	381	-1,077	2,977	3,504	2,782
14. Private institutions, net	38	422	382	905	84	-363	506	-246	700	-629	298
a) Long-term liabilities	7	1	-1	-1	1	-	-2	9	-8	-1	7
b) Long-term assets	-178	-14	-37	116	-101	-226	-166	-310	-193	-181	-155
c) Short-term liabilities	321	482	514	634	672	25	1,060	311	1,252	-390	1,441
d) Foreign exchange assets e) Other short-term assets	-112	-47	-94	156	-488	-162	-386	-256	-351	-57	-995
15. Central institutions, net[b]	3,259	-177	532	1,518	878	1,120	-125	-831	2,277	4,133	2,484
a) Long-term liabilities	-	-	-	-	-	-	-	-	-	-	-
b) Long-term assets	-	-	-	-	-	-	-	-	-	-	-
c) E.P.U. short-term balance, net	-	-	-	-	-	-	-	-	-	-	-
d) I.M.F. position, net	16	19	-36	95	182	141	-363	-367	17	260	741
e) Other short-term liabilities	1,500	-143	947	262	398	938	544	334	-15	2,798	41
f) Gold and foreign exchange reserves	1,743	-53	-379	1,161	298	41	-306	-798	2,275	1,075	1,702
g) Other short-term assets	-	-	-	-	-	-	-	-	-	-	-
D. ERRORS AND OMISSIONS, NET	-21	477	601	339	173	503	543	1,157	488	412	-592
Memorandum item: Short-term liabilities of the monetary sector to foreign official institutions	..	..	..	..	..	..	930	20	735	948	1,240

Source: OECD, *Statistics of Balance of Payments*, 1950-1961, Paris: 1964.

Note: OECD balance of payments statistics for the United States are based on U.S. Department of Commerce data. Due to differences in definitions and presentation, however, the statistics may differ from those issued by the Department of Commerce.

[a] Included reinvested earnings of subsidiaries. [b] Included the Federal Reserve banks.

Exhibit 2 U.S. Balance of Payments—Analytical Summary (US$ millions)

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959
1. Trade balance f.o.b.	1,009	2,921	2,481	1,291	2,445	2,753	4,575	6,099	3,312	972
2. Services, net	1,081	1,364	564	(213)	(49)	59	433	889	(266)	75
3. Balance on goods and services	2,090	4,285	3,045	1,078	2,396	2,812	5,008	6,988	3,046	1,047
4. Private transfers, net	(444)	(386)	(417)	(476)	(486)	(444)	(530)	(543)	(540)	(575)
5. Official transfers, net	(3,589)	(3,138)	(2,118)	(2,007)	(1,804)	(2,070)	(1,901)	(1,828)	(1,849)	(1,906)
6. Current balance	(1,943)	761	510	(1,405)	106	298	2,577	4,617	657	(1,434)
7. Nonmonetary sector's long-term capital, net	(1,318)	(1,465)	(2,071)	(1,318)	(1,060)	(1,533)	(3,430)	(4,765)	(4,111)	(2,616)
8. Monetary sector's long-term capital, net	(171)	(13)	(38)	115	(100)	(226)	(168)	(301)	(201)	(182)
9. Balance on current and long-term capital transactions	(3,432)	(717)	(1,599)	(2,608)	(1,054)	(1,461)	(1,021)	(449)	(3,655)	(4,232)
10. Non-monetary sector's short-term capital, net	(15)	(18)	46	(39)	(181)	(25)	(71)	68	(11)	134
11. Errors and omissions, net	(21)	477	601	339	173	503	543	1,157	488	412
12. Overall balance[a]	(3,468)	(258)	(952)	(2,308)	(1,062)	(983)	(549)	776	(3,178)	(3,686)
13. Private monetary institutions' short-term liabilities	321	482	514	634	672	25	1,060	311	1,252	(390)
14. Private monetary institutions' short-term assets	(112)	(47)	(94)	156	(488)	(162)	(386)	(256)	(351)	(57)
15. I.M.F. position, net	16	19	(36)	95	182	141	(363)	(367)	17	260
16. Official gold and foreign exchange reserves	1,743	(53)	(379)	1,161	298	41	(306)	(798)	2,275	1,075
17. Central monetary institutions' other liabilities and assets, net	1,500	(143)	947	262	398	938	544	334	(15)	2,798

Source: OECD, *Statistics of Balance of Payments*, 1950-1961, Paris: 1964.

Note: OECD balance of payments statistics for the United States are based on U.S. Department of Commerce data. Due to differences in definitions and presentation, however, the statistics may differ from those issued by the Department of Commerce.

[a] This calculation of the overall balance differed from the more commonly encountered overall balance. The OECD excluded from the overall balance private monetary institutions' short-term assets and liabilities, and central monetary institutions' other liabilities and assets (lines 13, 14, and 17). Most other presentations included lines 13, 14, and 17 in their calculations of the overall balance.

Exhibit 3 U.S. Gold and Foreign Exchange Position, 1952-1960 (US$ billions)

	1952	*1953*	*1954*	*1955*	*1956*	*1957*	*1958*	*1959*	*1960*
Gold	23.25	22.09	21.79	21.75	22.06	22.86	20.58	19.51	17.81
Short-term foreign assets	1.05	.90	1.38	1.55	1.95	2.20	2.54	2.62	3.55
Short-term foreign liabilities	8.96	10.02	11.15	11.72	13.49	13.64	14.62	16.23	17.42
By class of holder									
Official	4.91	5.85	6.98	7.29	8.27	7.92	8.66	9.14	10.37
Banks	2.37	2.39	2.36	2.65	3.19	3.47	3.52	4.69	4.83
Other	1.68	1.78	1.80	1.78	2.08	2.25	2.43	2.40	2.21
By form of liability									
Deposits with Federal Reserve banks	.55	.42	.49	.40	.32	.36	.27	.34	.22
Deposits with other banks	5.19	5.61	6.42	6.49	7.23	7.21	8.21	7.69	8.87
Government securities	2.69	3.32	3.53	4.08	4.88	4.68	4.83	6.55	6.59
Other	.54	.67	.71	.74	1.07	1.40	1.31	1.64	1.75
By area									
Latin America	1.61	1.77	1.91	2.00	2.35	2.58	2.40	2.41	2.41
Continental Europe	2.71	3.63	4.61	5.39	5.57	5.52	6.18	6.90	7.06
United Kingdom	.82	.71	.64	.55	1.01	1.28	.85	.97	1.67
Other countries	3.82	3.91	4.00	3.78	4.56	4.27	5.19	5.95	6.27
Foreign owned government bonds and notes	.90	.81	.75	1.31	1.10	1.22	.98	1.50	–
Canada	.31	.23	.09	.44	.37	.46	.34	.45	–
Latin America	.05	.06	.15	.20	.19	.18	.11	.10	–
Continental Europe	.30	.25	.26	.34	.29	.31	.27	.49	–
United Kingdom	.20	.23	.22	.28	.20	.20	.19	.32	–
Other Countries	.04	.04	.03	.06	.06	.08	.07	.13	–
Net IMF position	1.46	1.37	1.19	1.04	1.61	1.98	1.96	2.00	1.56

Source: IMF, *International Financial Statistics.*

Exhibit 4

	1955	1956	1957	1958	1959	1960
A. Selected Treasury Bill or Call Money Rates (% per annum)						
United States	1.74%	2.66%	3.26%	1.84%	3.42%	2.94%
France	–	–	5.35	6.49	4.07	4.08
Germany	3.13	4.70	4.08	2.93	2.67	4.55
United Kingdom	3.73	4.93	4.80	4.56	3.37	4.88

B. Selected Yields on Long-Term Government Bonds (% per annum)

	1955	1956	1957	1958	1959	1960
United States	2.80%	3.06%	3.47%	3.43%	4.07%	4.02%
France	5.21	5.28	5.92	5.68	5.27	5.15
Germany	–	6.23	6.64	6.28	5.86	6.40
United Kingdom	4.17	4.73	4.98	4.98	4.82	5.43

Source: IMF, *International Financial Statistics.*

Note: Average yields on issues with at least 12 years to maturity.

Appendix Illustration of Comparative Advantage

Consider the hypothetical situation in which both the United States and Europe have similar endowments of land, labor, and capital, with the sole difference being that the United States has a better climate. The table below shows how much cotton and wheat the United States and Europe can produce without trade, and the asterisks indicate which bundle of goods each chooses to consume.

Production Possibilities of the United States and Europe
(each country contains 10,000 production units)

	United States		Europe	
Use of Production Units	Cotton (000 bales)	Wheat (000 bushels)	Cotton (000 bales)	Wheat (000 bushels)
10,000 in cotton; 0 in wheat	100	0	80	0
7,500 in cotton; 2,500 in wheat	75	15	60	5
5,000 in cotton; 5,000 in wheat	50	30	40*	10*
2,500 in cotton; 7,500 in wheat	25*	45*	20	15
0 in cotton; 10,000 in wheat	0	60	0	20

The above table demonstrates that the United States is more efficient in wheat compared to Europe. For every 10,000 uses of production units, the United States produces 100 bales of cotton vs. Europe's 80 (a ratio of 5:4), and 60 bushels of wheat to Europe's 20 (a ratio of 3:1). Therefore, America's *comparative advantage* is greater in wheat than in cotton, while Europe is *relatively* more productive in cotton than wheat.

If both countries specialized fully in the products they make best, the two countries would both have more cotton and more wheat to consume. As one can see in the table above, total specialization would produce 80,000 bales of cotton and 60,000 bushels of wheat. Assuming that a pattern of trade and barter developed as represented in the table below, the United States would be able to consume 30,000 bales of cotton and 48,000 bushels of wheat with free trade compared to 25,000 bales and 45,000 bushels that were available with no trade. At the same time, Europe ends up with 50,000 bales and 12,000 bushels against the 40,000 bales and 10,000 bushels it would have produced in isolation.

The United States and Europe in Specialization and Trade

	United States Trades			Europe Trades		
	Produces	(imports +, exports –)	Consumes	Produces	(imports +, exports –)	Consumes
Cotton (000 bales)	0	+30	30	80	–30	50
Wheat (000 bushels)	60	–12	48	0	+12	12

Source: Adapted from Raymond Vernon and Louis T. Wells, Jr., *Manager in the International Economy*, 4th ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1981) pp. 87-88.