

While the preliminary data fail to identify movements in certain sectors, including the direct investment sector, they do show that an important part of the fourth quarter deficit resulted from a nonrecurring type transaction, namely the liquidation by the British Government of some \$500 million of U.S. securities in order to defend the exchange value of the British pound. Another important factor was a \$720 million decline in our non-military merchandise trade surplus reflecting a sharp rise in imports and a small decline in exports.

These two items account for some two-thirds of the total deficit. While other major adverse movements have not yet been identified, there is no reason to suppose that capital outflows into direct private investment (i.e., investment in brick and mortar as opposed to portfolio investments and the buildup of other dollar assets abroad) contributed to the large adverse movement in the fourth quarter. On the contrary, one would expect direct investment, unlike other types of private capital, to be generally insensitive to currency devaluations. Accordingly, it is particularly unfortunate that the Administration applied hastily devised controls to the direct investment sector. Indeed, there is still no indication that stringent direct investment controls were called for at all. Developments in this sector were very favorable in the first three quarters of last year, as described below.

Growing Controls Over Private Sector

This is the crux of the problem in our view. Recent history leads us to question whether the government really has the will to make and execute the difficult decisions necessary to assure a healthy payments position in the absence of controls. A more likely prospect seems to be a continuation of strict controls on the private sector while the government attempts some restraints in certain areas within the public sector but continues to increase its overall world commitments.

Certain steps have, of course, been taken from time to time within the government sector but they have been entirely inadequate as is conspicuously demonstrated by recent events. Further, prospects are not good for a matching of commitments with availabilities in the foreseeable future.

The Vietnam war has, of course, resulted in a rapid acceleration in our international commitments. At the same time, there has been no clear evidence that, prior to the new program, any really strong efforts were made to cut back significantly in other public sector areas. We may note, for example, that U.S. government grants (excluding military) and capital outflows, after declining somewhat in 1964 and 1965, accelerated sharply to a new peak of \$4.7 billion in 1966 from \$4.3 billion in the preceding year, and sharply further to an annual rate of \$5.2 billion in the first three quarters of 1967. While much of this was probably Vietnam-related, the fact that the size of the increases was so large suggests that efforts to undertake cutbacks in other areas probably were minimal. Yet, additional steps could have been taken as evidenced by the fact that several measures have just been initiated. But, relying in part, no doubt, on beneficial effects from the voluntary balance of payments program in limiting private capital outflows, the government simply had an inadequate sense of urgency until it felt forced to take further strong measures, and again the major burden of these measures is placed on the private sector.

There is little reason to believe, against this background, that government intends that the present controls will be lifted in the near future. Insofar as U.S. international commitments are concerned, there is certainly nothing on the horizon to indicate that they will be reduced any time soon. Indeed, the contrary would seem to be indicated in view of the continuing Vietnam conflict, trouble in Korea, and Britain's increasing withdrawal from world commitments which creates strong pressures for a corresponding increase in U.S. commitments. Further, the longer controls on the private direct investment sector remain in effect the more difficult it will be for control-minded government to rationalize removing them. For the favorable impact of such investments will tend to diminish with time as a result of their reduction, while the potential investment opportunities will accumulate. It follows that the adverse short-run effects of removing the controls will increase over time.

Danger of Restricting Ability of Private Sector To Contribute to Reductions in Payments Deficits

The tragedy of maintaining these controls over an extended period is evident. As our international commitments continue to mount, a major means of support-