25X1

Approved For Release 2005/01/11 : CIA-RDP85T00875R001500220019-8

CIA/OER/IM 68-16 FILES

Confidential

25X1

DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Effect on Foreign Countries of US Balance-of-Payments Measures

Confidential

Copy No. 69

ER IM 68-16
5 February 1968

Approved For Release 2005/01/11 : CIA-RDP85T00875R001500220019-8

WARNING

This document contains information affecting the national defense of the United States, within the meaning of Title 18, sections 793 and 794, of the US Code, as amended. Its transmission or revelation of its contents to or receipt by an unauthorized person is prohibited by law.

GROUP 1
EXCLUDED FROM AUTOMATIC
DOWNGRADING AND
DECLASSIFICATION

CONFIDENTIAL

25X1

CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
5 February 1968

INTELLIGENCE MEMORANDUM

Effect on Foreign Countries of US Balance-of-Payments Measures

Summary

The US program to reduce its balance-of-payments deficit by $3 billion in 1968 should work no major hardship on any country, although the impact on the United Kingdom may be quite significant. Most foreign governments agree that the US program is necessary, and the economies on which most of the impact will fall are strong enough to absorb it without serious repercussions. The largest saving to the United States and the most adverse effect on other countries will result from the curtailment of direct investment overseas by US companies. The impact from reduced US bank loans and tourism will be smaller and more easily overcome.

The US program will cause a considerable reduction in the dollar earnings of Western European countries. This loss will lead to a tightening of credit and adversely affect economic activity unless offsetting domestic measures are introduced. How safely the European countries can pursue expansionary policies in the face of the US restrictions depends greatly on the strength of each country's balance of payments. Germany is in the most favorable balance-of-payments position; the French position is marginal but French reserves are enormous. Prospects in most other continental countries are greatly dependent on the rate of economic expansion and on economic policies in France and Germany.

Note: This memorandum was produced by CIA. It was prepared by the Office of Economic Research.

Within Western Europe, the United Kingdom and Belgium are in a poor position to adjust to the US measures. The loss in dollar receipts to the United Kingdom will be painful because the British are already making a valiant effort to reduce a large payments deficit. Belgium, which has keyed its economic development program to American investment, may experience a decline in its rate of economic growth if the US program extends over a number of years.

In areas outside Western Europe, the adverse effects of the US program will be small. In the Near East, Lebanon and Iran appear to be the only countries that might be hurt, although not seriously. Asian countries will not be greatly affected. Most of them are less developed countries where US direct investment is permitted to increase and where tourist earnings are small. Latin American countries might actually gain from the US program because tourism in the Western Hemisphere is expected to accelerate while no significant reduction is expected in direct investment. In Africa the small reduction in dollar earnings from US tourism and direct investment will impose no major hardships.

Introduction

1. In an effort to reduce the net flow of US dollars abroad, and indirectly to strengthen the Free World monetary system, the United States announced on 1 January a comprehensive program to improve its balance of payments, which has been in deficit in 17 of the last 18 years. The program aims to reduce the net dollar outflow by $3 billion during 1968, as follows:

a. Mandatory controls on new direct foreign investments by US companies were invoked by the President through his authority under the banking laws. This involves new funds flowing out of the United States and reinvested earnings of US companies abroad. There is a moratorium on all new investment flows to continental Western Europe (except Greece and Finland) and to South Africa (Schedule C countries).* Investment (from new funds and reinvested earnings) is limited in a group consisting mainly of developed countries including the United Kingdom (Schedule B countries) to 65 percent of the 1965-66 average and in most less developed countries (Schedule A countries) to 110 percent of the 1965-66 average. Moreover, current earnings abroad by all US companies must be returned to the United States at a rate at least as high as in 1964-66.** The controls on investment apply to individual US companies, not to countries, and a company is free to invest in any country provided it does not exceed the maximum investment permitted in each of the three country groups. Thus a company may

* *For the designation of countries in each group, see the Appendix.*
** *A company's direct investment from transfers and reinvested earnings cannot exceed the investment ceiling, and earnings in excess of this amount must be repatriated even if they are larger than the 1964-66 rate. For Schedule C countries, reinvested earnings must not exceed 35 percent of average direct investment in 1965-66.*

transfer investments from one country to another within the same group, but not from one group to another. Announced savings goal: $1 billion; probable effect $1-1/2 billion unless major exceptions are granted.

b. US lending institutions were asked to impose voluntary restraints supervised by the Federal Reserve Board with power to make the restraints mandatory if necessary. Banks are asked to limit lending in 1968 to 103 percent of foreign loans outstanding 31 December 1964, not to renew outstanding loans of a year and longer to developed continental Europe, and to reduce short-term loans there by 40 percent of the amount outstanding on 31 December 1967. Other financial institutions, such as insurance companies, have similar restraints. Savings goal: $500 million.

c. US citizens are asked to defer non-essential travel outside the Western Hemisphere for the next two years. Legislation to help achieve this objective is being explored with Congress. Savings goal: $500 million.

d. The cost of keeping US troops and civilian personnel abroad is to be reduced, probably through reduction in the number of civilian personnel overseas, more offset and neutralization agreements with foreign countries, and lower spending by US forces and their dependents abroad. Savings goal: $500 million.

e. Adjustment of non-tariff barriers to world trade and a long-term program to increase US exports. Savings goal: $500 million.

2. Only the effects of restrictions on direct investments, loans, and tourism are discussed in this memorandum. The restrictions on tourism depend on Congressional action and may not be adopted or may

have less effect than planned. The proposed adjustments in US government expenditures abroad and the hoped-for reductions in non-tariff trade barriers have yet to be spelled out and depend on complex negotiations.

3. Although the restrictions weigh more heavily on Western Europe than on any other area, they are not likely to cause serious economic disturbance there in the months ahead. Reactions from foreign governments, bankers, and businessmen have been a mixture of mild protest over the impact on their own economies and a recognition that the US steps are necessary to strengthen the dollar and ease uncertainty in international exchange markets. In 1966, direct investment outflows from the United States were about $3.5 billion, and US companies reinvested about $1.7 billion of profits earned abroad. US tourists going abroad spent $4 billion in 1966, some $2 billion more than US receipts from foreign tourists.

4. This memorandum considers some of the general effects that the US program is likely to have in Western Europe, the Near East, Asia, Latin America, and Africa. It excludes Canada, Japan, Australia, and New Zealand, where the effects of the program are more difficult to discern at present.

Effect on Western Europe

5. Most European governments agree that the US program is necessary and in fact long overdue, but officials, bankers, and businessmen on the continent are anxious about the impact of an abrupt termination of US direct investments and a reduction in tourist receipts. The EEC countries, which as a group for much of this decade have had surpluses almost equal to the deficit in the US balance of payments, will be the most affected. The impact on their combined balance of payments will be on the order of $1.3 billion (out of a total projected US balance-of-payments saving of $2 billion). When added together, reduced dollar flows from the investment moratorium, reductions in credits from US banks, and lower tourist expenditures will have a considerable effect on the balance of payments for

every European OECD country shown in Table 1. Table 1 compares estimated balance-of-payments losses in 1968 from the US program with the estimated balance of payments in 1967. Losses in 1968 were calculated from the actual flows of US direct investment in 1965-66 (1967 for the United Kingdom), and from the reduction in short-term bank credits outstanding at the end of 1967 and in tourist expenditures. No allowance was made for the reduction in long-term bank loans, because of the lack of information regarding the maturities of existing loans. Reductions in long-term bank loans might account for an additional loss of $200 million in Western Europe as a whole. The actual distribution of losses may be quite different than shown in Table 1 because the limitations on direct investment, loans, and tourism apply to groups of countries, and companies and tourists may distribute their funds among the individual countries as they wish.

6. Western European countries will feel the restrictions on direct investment more than those on bank loans and tourism, both in terms of the immediate worsening in their balance of payments and the secondary effects in their economies. The reduction in direct investment will represent a substantial loss of dollars, and the effort to replace US funds with local financing will make borrowing more difficult and tend to restrict economic expansion. The loan restrictions will have a similar effect, but their savings goal is half that for direct investment. Because restraints on travel abroad by US tourists have not yet been formalized, it is difficult to estimate their impact on Western Europe. Restraint has not been asked in travel by Americans to Canada and other Western Hemisphere nations. Therefore, most of the saving of $500 million will have to come from Europe, Asia, and Africa. Western Europe is traditionally the area of heaviest US tourist travel, and expenditures in this area may have to drop by at least $300 million to realize the program's overall goal. This would imply a reduction in spending by US travelers in Europe of about 40 percent from the 1966 level.

7. Most of the European countries could easily absorb the loss of dollars caused by the US restrictions out of current earnings or out of reserves.

CONFIDENTIAL

Table 1

Estimated Balance of Payments Effects on Western Europe
of the Key Components of the US Payments Program a/
1968

Million US $

Country	Estimated Basic Balance 1967 b/	Total Estimated Payments Loss 1968 c/	Sources of Payments Loss		
			Reduced US Direct Investment d/	Reduced US Travel Outlays e/	Reduced US Bank Credits f/
Belgium-Luxembourg	220	155	120	5	30
France	150 g/	185	120	40	25
West Germany	1,780	510	400	30	80
Italy	25	240	155	55	30
Netherlands	15	135	115	10	10
Denmark	-20	50	25	10	15
Norway	10	40	15	5	20
Spain	-150	120	80	20	20
Sweden	10	85	50	5	30
Switzerland	40	160	90	20	50
United Kingdom	-720	400	315	60	25

a. Rounded to the nearest $5 million.

b. "Basic Balance" refers to the balance on current and long-term capital accounts.

c. Based on the assumption that all countries share in the loss in proportion to their past shares of Europe's dollar earnings from these three sources.

d. For all countries except the United Kingdom, the data reflect average capital outflows in 1965-66 from the United States for direct investment by US companies in Europe. Changes in repatriated earnings are ignored because the actual rate of repatriation in 1964-66 will apply in most cases. Estimates could not be made for 1967. For continental Western Europe as a whole, the net flow of US funds (after deduction of repatriated earnings) in 1967 probably was slightly larger than the 1965-66 average, so that the calculated loss is slightly understated in comparison with 1967.

For the United Kingdom, the figure shown is the estimated loss of UK net earnings in 1968 in comparison with the estimated 1967 level. The estimate for 1968 was obtained by calculating total allowable investment (from US funds and undistributed earnings) and the required repatriation of profits according to the US regulations. The net loss to the United Kingdom based on the 1965-66 average, rather than the 1967 level, would be about $220 million.

e. Based on the assumption that US tourist expenditures in Western Europe in 1968 will be about 60 percent of such expenditures in recent years.

f. For data on bank credits: all data except those of the United Kingdom represent 40 percent of outstanding US short-term bank claims at the end of 1967 (estimated). Data for the United Kingdom represent 6 percent of total US banking claims (long-term and short-term) at the end of 1967, reflecting the required reduction in credits from 109 to 103 percent of that base period level.

g. Including the Franc Zone. Metropolitan France alone probably had a deficit in 1967. Estimates of payments losses for 1968 cover only Metropolitan France and exclude the Franc Zone.

CONFIDENTIAL

All except the United Kingdom, Spain, and Denmark had balance-of-payments surpluses in 1967. This was a year of unusually slow growth, however, and the more rapid growth expected for 1968 probably would reduce some surpluses and change others into deficits even without the US restrictions. West Germany, whose economic recession in 1967 adversely affected its trade partners, is in the easiest balance-of-payments position. The French balance-of-payments position is marginal, but French reserves are enormous. The balance-of-payments prospects of most other continental countries in 1968 depend greatly on the rate of economic expansion in Germany and France, which depends in turn on how willing the German and French governments will be to pursue expansionary policies in the face of US restrictions. The French government is apparently planning a moderate expansionary program, judging by its announcement of 24 January to increase both public and private spending and to run a budget deficit. In Germany, the issue of fiscal policy is unresolved, but apparently the Bundesbank intends to follow an easy money policy in 1968.

8. Although the US regulations treat the United Kingdom more liberally than continental Western Europe, their effect on the United Kingdom will be severe. There may be a drastic decline in new direct investment flows and an increase in repatriated earnings. At most, the net loss will be about $300 million for direct investment alone, or about $400 million including short-term credits and tourism. Such a loss would absorb about one-third of the gain the British hope for in 1968 as a result of the devaluation. There is a possibility that the adverse effects to the United Kingdom will not be as severe as indicated above. For example, US companies, prevented from transferring funds from the United States to continental Europe for direct investment, may divert to the United Kingdom some of their allowable direct investment under Schedule B. In this way, facilities that may have been planned for the continent would be built in the United Kingdom instead. It is also possible that tourists will find lower British costs from devaluation attractive enough to offset an American disincentive to travel abroad. Even a loss much smaller than $400 million would be painful, however. The British are already bending

every effort to increase their foreign exchange earnings and eliminate their large payments deficit. They have planned to cut expenditures abroad and to hold down domestic spending, and the US restrictions may now force them to take even more drastic defla- tionary measures.

9. Germany, France, and several other European countries are in a sufficiently strong balance-of- payments or reserve position to expand the domestic money supply and feed dollars into the Eurodollar market. Nevertheless, the actions taken by European governments and central banks may not compensate entirely for the loss of US funds. Conservative attitudes are strong, and European capital markets are narrow and inflexible. Consequently, curtailing the outflow of dollars to the continent probably will cause some tightening of credit and a rise in interest rates. A restriction of credit will tend to dampen domestic economic expansion in Europe during 1968. A rough indication of the role of US direct investment in the total investment of European countries is shown in Table 2.

10. If interest rates in Europe rise, dif- ferentials between rates in the United States and on the continent could cause renewed flows of short-term funds (owned by foreigners) out of the United States. This movement of short-term funds may be impossible to halt by domestic US monetary measures if European interest rates rise precipi- tously. The effect would be to reduce the impact of the US program in Europe and on the US balance of payments. The Europeans have considerable resources to shift back to the continent. At the end of 1967, US short-term bank liabilities alone to continental Western Europe totaled about $10 billion.

11. Apart from the effect on the balance of payments, the drop in US tourist expenditures would not have much overall impact on the European economies. There would be considerable localized difficulties in regions deriving large amounts of their incomes from tourism, and these difficulties may lead to intensified political pressures for defensive action against the US program.

Table 2

Total Investment and US Direct Investment in Western Europe a/
1966

Country	Total Investment b/ (Million US $)	US Direct Investment c/ (Million US $)	US Investment as Percent of Total Investment (Percent)
Belgium-Luxembourg	2,910	120	4
France	16,060	90	1
West Germany	23,790	610	3
Italy	8,150	150	2
Netherlands	4,330	160	4
Norway	1,860	10	1
Spain	4,600	110	2
Sweden	3,730	60	2
Switzerland	2,880	30	1
Denmark	1,820	20	1
United Kingdom	15,060	380	3

a. Value figures are rounded to nearest $10 million. Percentages are calculated on the basis of unrounded figures and may not conform exactly to those calculated on the basis of rounded amounts shown.
b. Adjusted to exclude residential construction.
c. Funds transferred by US companies from the United States for direct investment in Western Europe.

12. The US program could have considerable adverse effects if it remains in effect for long. For example, Belgium has keyed its economic development program to foreign investment, particularly from the United States. Although the immediate impact on the Belgian economy will be small, the loss of US direct investment will disrupt plans for development that are designed to raise the rate of economic growth. Therefore, continuation of Belgium's receptive policy toward US funds will depend on the duration of the US program. If it is short-lived, Belgium is likely to absorb the loss of economic growth in anticipation of an early resumption of US investment. On the other hand, if the US program continues over a number of years, Belgian economic policy will be substantially reoriented, and the United States may lose the support of one of Europe's most ardent champions of US investment.

Effect on the Near East and North Africa

13. Iran and Lebanon appear to be the only countries in the Near East and North Africa that will be hurt by the US program, and the damage in these two countries should not be great. The operations of US oil companies in Saudi Arabia and Bahrain may be circumscribed by the direct investment limitations. Morocco, Tunisia, and Egypt also could feel some repercussions from US efforts to limit tourist expenditures abroad. Controls on commercial bank loans may make Egypt's debt consolidation and servicing activities slightly more expensive.

14. The countries of the Near East and North Africa normally run a very large deficit in their balance-of-payments transactions with the United States, but most of this flow of funds into the United States originates in sales to the major oil importing countries (the United Kingdom, West Europe, and Japan). A major improvement in the US balance of payments with the Near East countries can come only from curtailment of US investment in the oil industry or by repatriation of bank balances held abroad. The flow of funds from the

United States for direct investment in the Near East and North Africa totaled about $255 million in 1965, but declined sharply to $100 million in 1966, partly in response to the US program for voluntary restraints on overseas investment. As a result the 1965-66 average, the base period for calculating direct investment in 1968, is a relatively low $210 million, of which $200 million represents the oil industry. If US direct investment drops substantially in 1968, the oil companies will be able to obtain non-US funds from Western Europe and Japan because of the high profitability of oil investments in that area.

15. Iran will be adversely affected by all aspects of the US programs; the effect of any one part may not be great, but the combination of small hurts may be enough to cause problems. Limitations on direct private investment -- 65 percent of the average investment in 1965-66 -- probably will not hamper the plans of the international consortium that operates the major portion of Iran's oil industry, but some other investors may be forced to curtail or postpone their plans. The Shah has been hoping to attract more direct US investment in a TVA-type scheme in southeastern Iran. The development plan for the March 1968 - March 1973 period requires foreign borrowing of $2 billion, of which $800 million remains to be arranged. The amount that will be provided by US direct investment probably will be reduced because of the new program, and borrowing from other sources will be more expensive. Iran also can expect some reduction in tourist revenues, which amounted to about $25 million in 1966.

16. Lebanon will experience a reduction of foreign exchange income as a result of the US program, and it also may undergo some recession of business activity in tourist-related fields and in banking activity. Lebanon normally derives about 20 percent of its foreign earnings from tourism, more than half of which is from the United States. An extended depression in tourism will have repercussions throughout the economy. Total investment may decline if the drop in tourism causes postponement of plans for new hotels and restaurants or new port and airport facilities. The entire banking

sector in Lebanon (banking accounts for more than 5 percent of GNP) presumably will be affected by newly adopted US requirements for reduction of bank loans by US firms operating in Lebanon. As the financial and commercial center of the Near East, Lebanon is the natural home for large amounts of money kept abroad for operating purposes or tax reasons. Some of these funds will soon be withdrawn because of the new regulations and will put strains on the banking sector, which has recently experienced a loss of confidence following the failure of IntraBank, one of the largest in the country.

Effect on the Far East

17. The impact of the US program on Far Eastern countries will be negligible, except possibly in Hong Kong and Indonesia. In the base period 1965-66, the Far East accounted for $120 million out of the $900 million directly invested by US firms in Schedule A countries, where investment in 1968 may be 110 percent of the base period. Most of this investment was highly concentrated in a few of the countries: 40 percent in the Philippines and nearly 30 percent in the group comprised of Taiwan, Thailand, and South Korea. If there is no change in the distribution of US investment among Schedule A countries, the Philippines would receive about $53 million in 1968, an amount that probably would not have been exceeded even in the absence of the regulations.

18. US private direct investment in Indonesia has been quite small and has been confined primarily to investments by US-owned oil companies. In 1965 the total invested by all foreign-owned oil companies in Indonesia was less than $20 billion. Because of the great need to stimulate economic activity in Indonesia, it will be important to encourage direct US investment on a scale much higher than 10 percent above the average 1965-66 level. Increased US investment funds for Indonesia could be made available through some exemptions from the new regulations or through the redistribution by US firms of their investments among Schedule A countries.

19. The value of average annual US investment in Hong Kong in 1965-66 was $24 million, an amount equal to perhaps 10 percent of the total foreign investment in the Colony. Thus a decline of US investment could have an impact of some significance on Hong Kong's balance-of-payments position and on its economic growth potential. Economic growth in Hong Kong was probably down in 1967 as a result of political disturbances, and if the political climate does not improve, lack of confidence may prevent a resumption of the normal flow of investment to Hong Kong. If the investment climate improves sufficiently, however, US firms might shift some of their investments from other Schedule B countries to overcome the 65 percent limitation in Hong Kong.

20. In 1966 the Far East accounted for only 5 percent of expenditures abroad by US tourists. These expenditures in the Far East probably will not drop appreciably, because tourists who make the long and expensive trips to this region can more easily afford a travel tax or other additional cost that may be imposed.

Effect on Latin America

21. The US program, as intended, will not reduce the overall flow of dollars to Latin American countries. Indeed, the penalties on tourist expenditures probably would permit Latin America to gain more from an acceleration of tourism than it will lose from the mild restraints imposed on transfers of capital. If continued for several years, however, the new restrictions on Western European countries might reduce their demand for exports from Latin America and restrict the flow of credit to Latin America.

22. Because US direct investment in Latin America was at a high level in the 1965-66 base period, the restriction on transfers of capital to 110 percent of the base will not impede investment in the region as a whole during the next year or two. Adverse effects might be experienced, however, by some of the smaller countries such as Panama,

Surinam, Guyana, and the British West Indies, where US direct investments recently have been growing rapidly and comprise a sizable share of total investment. Even here, the effects could be mitigated to some extent by the ability of large US firms operating in several countries to divert their investments from one country to another.

23. The new restrictions on the extension of bank credit to Latin American countries are unlikely to have a major adverse impact in 1968. Any growth of demand for credit could be supplied by Western Europe, although at higher interest costs. However, if the sharp curtailment of US investment and credit to Western Europe should lead to substantially higher interest rates for long-term credit in Europe, or to a significant contraction of its availability, Latin American countries might have to postpone large-scale investment projects. If extended over several years, these delays would lower the rate of economic growth in a number of countries.

24. Continued normal growth of US tourist expenditures in Latin America, the diversion of expenditures from Europe, and additional spending in Mexico as a result of the Summer Olympics probably will boost total expenditures in 1968 to between $1.15 billion and $1.2 billion, compared with $900 million in 1966. The gains in 1968 probably will have an appreciable economic impact only in Mexico. Because of Mexico's poor export performance in 1967, large and rising debt servicing obligations, and likely strong demand for imports in 1968, increased US tourist expenditures could help considerably to avoid strains in the balance of payments this year.

Effect on Africa

25. The role of US private direct investment and tourism in most African economies is negligible, and no major problems are likely to arise as the new US regulations are enforced. US direct investment averaged $205 million in 1965-66, more than a third of which was in South Africa. US tourist expenditures in sub-Saharan Africa in 1966 were approximately $25 million.

26. Direct investments in all sub-Saharan African countries may be 110 percent of the base period, with the exception of South Africa, which is under the same moratorium as Western Europe. The loss to South Africa of investment funds, which averaged $60 million during 1965-66, would have only a small adverse effect on the balance of payments, and the effects on the domestic economy could easily be made up by local financing. There already is concern among many South Africans that US investment is too high. Direct US investment in the rest of Africa could increase to a maximum of $160 million in 1968, but these countries could be adversely affected if European countries reduce their capital flows to Africa to compensate in part for the loss of US funds.

CONFIDENTIAL

Appendix

Designation of Countries, by Category, in the US Direct Investments Program

Schedule C: Developed countries; a moratorium on all direct investment.

Austria	Monaco
Belgium	Netherlands
Denmark	Norway
France	Republic of South Africa
Germany	San Marino
Italy	Spain
Liechtenstein	Sweden
Luxembourg	Switzerland

Schedule B: Developed countries in which a high level of capital flow is essential; investment in 1968 is limited to 65 percent of a company's average investment in these countries during 1965-66.

Abu Dhabi	Ireland
Australia	Japan
The Bahamas	Kuwait
Bahrain	Kuwait - Saudi Arabia Neutral Zone
Bermuda	Libya
Canada	New Zealand
Hong Kong	Qatar
Iran	Saudi Arabia
Iraq	United Kingdom

Schedule A: All foreign countries designated as less developed countries; investment in 1968 is limited to 110 percent of a company's average investment in these countries during 1965-66.

CONFIDENTIAL