An idiot’s guide to the 1960’s balance of payments problem

After WWII, more US goods were exported than goods were imported to the US, a trade surplus (because US industry was not bombed.)

In the early 1960’s, the US still had a trade surplus, but it was surpassed by the larger capital deficit created by an exodus of dollars abroad to pay for large military and aid expenditures overseas (Marshall Plan, aid to developing nations, etc.) and by Americans enticed to large foreign investments by a very high dollar relative to European currencies. The expansion of the Vietnam War certainly added to this capital deficit, but so did the obligations to provide military defense for NATO and particularly West Germany and the obligations of aid to the developing world.

A Balance of Payments takes into account both the balance of goods traded as well as cash. The net deficit created by the sum of the US trade surplus and the much bigger capital deficit created a “balance of payments problem.”

The flipside to this was the growing balance of payments *surpluses* in Germany and Japan, strong export economies and major beneficiaries of US defense spending who were being saturated with dollars.

The Bretton Woods accord, was put in place to prevent dangerously wild swings in international economics. It not only fixed all European currencies vis-a-vis the dollar it also fixed the price of gold in dollars and made the dollar the international reserve currency. (The dollar could substitute for gold).

The Balance of Payments deficit was bad because it would fuel inflation. (When there are too many dollars chasing the same amount of goods, the tendency is for the price of goods to go up or inflation, which would mean the value of each dollar was less because it would buy fewer goods.) Inflation was bad because it would mean the cost of goods would go up relative to every currency. One way to stave off inflation is to lower the value of the dollar rather than have the price of goods go up. But the dollar was fixed under Bretton Woods, so this was not available as a tool unless it was negotiated internationally and the “surplus” countries didn’t want that because their flood of dollars would be worth less and devaluing any one currency could produce a chain reaction in competitive devaluations. (Other countries might devalue their currency too in order to maintain export levels. If their currency was worth more relative to the dollar, their export goods would be more expensive.) Bator called this “jungle economics” and a series of competitive devaluations could result in a major recession because everyone’s money would suddenly be worth less.

The dollar’s value was higher than it would have been if it were allowed to be priced in an open exchange because there were more dollars in the “surplus” countries than they needed (because of US spending overseas.)

The other way to stave off inflation is to raise taxes. If Americans had less to spend, goods and serviced would be competing against a smaller number of dollars and prices would tend not to go up. But Johnson, in his policy of going forward with Kennedy’s agenda, went forward with a planned tax cut as he came into office. This fueled the problem with more dollars in the market. And, on top of that, his Great Society expenditures would further fuel a US economic boom. He wanted to keep the economy hopping because he wanted more of the Great Society programs passed and if everyone, including Congress, was feeling rich, they were more likely to go along. So there was no tax hike likely.

In theory, the IMF (which was created at Bretton Woods) was set-up to address balance of payments deficits. But the US balance of payments problem was becoming structural (ie. permanent) and beyond the scope of an IMF shot-in-the-arm tools thanks to the massive overseas defense spending and infrastructure financed through inflationary monetary expansion.

Then there was the issue of gold. Traditionally payment imbalances were settled by shipments of gold.  Were the US to devalue, then by definition the value of gold would rise which is hardly what say Germany would want since its surplus dollars would be worth less in gold. Gold was at a fixed price in dollars, yet the supply of gold was not increasing in line with the supply of dollars.  (greater quantity of dollars in circulation relative to the gold available) Effectively, a potential devaluation of the US dollar against gold was taking shape undermining faith in the US dollar and there was fear of a run on the dollar. This threatened the stability of the US dollar as a world reserve.

By 1965, the significant balance of payments deficit caused an exodus of gold from the US as speculation that the dollar was overvalued. The dollar price of gold was fixed in the US at a rate lower than one could get for it in Europe. ($35 vs $40 in the UK) causing investors, particularly France, to turn the flood of US dollars in Europe into gold, taking it out of the country. This created a negative feedback loop because fewer gold reserves meant there wasn’t enough gold to cover the dollars making it vulnerable, making more speculation. (That’s why they were interested in the gold stockpile the Soviet may or may not have had.)

Britain, which as a small island nation still recovering from the war, relied heavily on all kinds of imports from food to oil. This meant that it too had a balance of Payments deficit. Those B of P deficits encouraged speculation against Britain’s pound Sterling too, on the very sensible reasoning that an overvalued currency could only move in one direction, i.e., a devaluation.   Britain suffered a run on the pound sterling and had to devalue and there was great fear at the time that it could make the chain reaction cited above.  To try to deal with its balance of payments, Britain told the US that it would withdraw its troops from Germany, another source of its deficit. But this would mean the US couldn’t reduce its troop levels in Germany, which it was being pressured to do by a congress sick of underwriting Europe’s defense when Europe was recovering economically but not helping more in supplying conventional forces to NATO or contributing what many thought was its “fair share” of aid to developable nations.

They were desperately seeking a way to control the balance of payments problem without allowing a major economic crisis and without ending (at least too abruptly) the US economic ride. Rather than devalue the dollar or do away with Bretton Woods, which too many in the world were not ready for because it was seen as inviolable, and to avert a crisis without facing the problems square on, the Johnson administration resorted to a series of part way measures to kick the economic can down the road far enough to avoid interference with his elections campaign. A “pretense” as Francis Bator called it.

They reduced foreign spending, but not too much. They kept liquidity in the European markets and preventing a collapse of the Sterling, by creating a new instrument, which didn’t last long, but long enough to get the job done. To avert a run on US gold, they created a two tiered gold system, which would allow gold to float for private purchase while keeping the $35 rate for exchanges between “official authorities.” This prevented speculators from making a run on US government gold.

Had Bretton Woods continued, in the absence of the necessary exchange rate adjustments to reflect/equilibrate payments deficits/surpluses there would have been every likelihood of much greater import restrictions and a general collapse of global free trade provoking another depression, the very thing that Bretton Woods was set up to avoid. And, Johnson was working hard to complete the new round (Kennedy Round) of GATT (General agreement on tariffs and trade) to loosen trade restrictions, not limit them.

Germany and France: Meanwhile, de Gaulle was working against nearly every monetary reform the US and Britain wanted to try, so they needed to keep Germany in their camp to help put them through. That in turn meant that Germany had a lot of persuasive power over the US and probably contributed to the long, slow death of the MLF. The US and Germany had a deal whereby the US would provide troops and supplies and so on, on the proviso that Germany bought a certain amount of US weapons and goods as an “offset” to the US expenditures to try to help the balance of payments. But Germany was facing an internal budgetary problem and announced it would renege on this deal. That would make it harder for congress to agree to keep up US troop levels in Germany and in fact, there was a resolution put forward by Senator Mansfield attempting to remove US troops from Europe. But if that happened, then the pressure on European countries to develop their own national nuclear deterrents would become extreme.

Got it?