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1. Introduction*

Studying Balance of Payments Policy

International relations theorists have recently shown an increased interest in international economic relations. Numerous articles on imperialism, dependence, interdependence, etc., have been added to the already voluminous literature on economic integration. This relative change of interest may well be due to the stabilization of strategic stalemate and the attendant shift of international political competition to the economic sphere. International economic relations have been very salient in international politics, however, since national governments began to intervene in, and be responsible for, the activity of the economic sector.

This paper is a traditional foreign policy analysis of a seldom studied issue area, balance of payments policy. Studying such an issue area as balance of payments policy has great utility for a number of research endeavors in international politics.

Linkages. A great deal has been written about linkage theory. The truth is that there is no linkage theory; there are only conceptions' about the relationship between domestic and foreign policy. In economic issue areas the trade-offs are more clearly visible and measurable, and linkages can be easily studied.

International political economy. Much has been written lately about

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dependence and interdependence. The assumption is that dependence or interdependence affect domestic policy and autonomy. This can be most clearly tested in studying national economic policies.

Political and economic factors in decision-making. Governmental decision-making in any area generally involves economic and political factors. While this has been widely understood, political scientists have not studied the political factors in economic decision-making. The relationship between political and economic factors in policy decisions can be most easily studied in economic issue areas.

Bureaucratic politics. Bureaucratic politics in foreign policy analysis has come into vogue. Foreign economic policy is a much more interesting area in which to study bureaucratic politics. At least half a dozen executive departments and even more advisory groups are directly involved in foreign economic policy.

The specific focus of this paper is the balance of payments policy of the Kennedy Administration since Kennedy's was the first postwar presidency that had to deal with a balance of payments problem and therefore had to consider the foreign effects of domestic economic policy. While the thrust of the paper is substantive with some preliminary generalizations, a complimentary purpose is to illustrate the utility of foreign policy analysis to the study of international political economy.

2. Alternative Balance of Payments Policies

Traditionally, there have been two polar alternatives for dealing with a balance of payments problem (whether surplus or deficit): internal or external economic measures. External measures include such things as export subsidies, tariffs, capital controls, and the like. Internal measures involve either expansive or restrictive fiscal, monetary, and tax policies. For a nation experiencing a balance of payments deficit, the choices are clearly differentiated. Either a nation takes disciplinary internal measures to constrict demand or conflictual international measures.

These alternatives correspond to the often used distinction between internally determined and externally determined foreign policy. A nation taking internal measures to deal with a deficit is generally following a policy determined by the external environment. A nation adopting external measures to deal with a deficit is usually responding to conditions in the domestic environment. Such choices can be stark ones with deleterious consequences. In the 1930's, internal measures were not feasible due to the already existing domestic depression and the result was beggar-thy-neighbor policies that led to trade wars.

To avoid facing such stark choices, an alternative possibility was devised for the postwar economic system. This was the choice of financing the deficit with liberal liquidity. As the system evolved, the United States came to play the role of world banker, since the IMF had insufficient resources for the task. The United States provided the rest of the world with liquidity by running a deficit in its international payments. An American payments deficit was therefore a necessity and not a problem. Should the day come when other countries would not wish to amass dollars, however, the American deficit would become a problem and the alternative of liberal liquidity would not exist for the United States. After all, who could play banker to the world's banker? If such a situation were to arise, the United States would be forced to the position of choosing between the two polar alternatives: internal measures to constrict demand or external measures conflictual to other nations.[1]

3. The New Frontier and Problems on the Horizon

John F. Kennedy took office as the United States was facing changing international economic circumstances. Despite a regular surplus trade balance, the United States had run a continuous overall payments deficit because of investments, loans, and governmental aid programs. The deficit had been desirable in an age of dollar shortage, but conditions had changed by the late 1950's.

By 1958 the European nations had more than recovered from the ravages of the Second World War. At the same time that the Common Market was created, ten European countries made their currencies convertible, and all European countries began to hold these other currencies as reserves. Both of these factors lessened the need for further American deficits.

American deficits, however, were growing at just the time that they should have been diminishing. American corporations were investing heavily in Europe as a way of jumping over the Common Market tariff wall. Direct yearly American investment in Europe almost doubled between 1959 and 1960. The American payments deficit that had averaged $1.4 billion yearly in the early 1950's, grew to $3.9 billion in both 1959 and 1960. Not wishing to hold on to overly large dollar holdings, European nations began converting some of their dollars into gold. In the five years from 1952 through 1956, the total American gold outflow was $1 billion. In 1958 the gold outflow was $2.3 billion, in 1959 it was $1.1 billion, and in 1960 it was $1.7 billion. In those three years the gold supply had shrunk by$5.1 billion. Thus, the American gold supply that in 1951 had represented two-thirds of the free world's total, had shrunk to $18.7 billion by September

[1] It should be noted that internal and external measures can be combined in a policy mix. The discussion of alternatives is sharply dichotomized to highlight the consequences and trade-offs involved. Moreover, liberal liquidity can only be viewed as an alternative in the short run, and with the hope that the payments problem is not an intractable one.

of 1960 and represented less than half of the free world total of $40.7 billion. At the same time, dollar liabilities held by foreigners had grown from $8.5 billion in 1951 to $23.4 billion by September of 1960. Thus, in 1960, the amount of dollars held by foreigners surpassed the value of American gold holdings.

The domestic economic picture was not any brighter when Kennedy acceded to office. The United States had just suffered its fourth postwar recession in 1960. During the 1950's, the American economic growth rate had been so sluggish that economists were even beginning to predict that the Russians would surpass the American GNP during the 1960's. In February of 1961, American unemployment stood at 7%.

The new President was committed to the task of getting America moving again, but was beset by political problems. He had been elected by the narrowest of margins and was distrusted by the business community. He had even greater problems abroad, however. In addition to the possibility that Europe would exclude American goods and therefore create a run on the gold supply, it was also possible that because Europe was unsure of American deterrent credibility it might try to become an independent actor in the world arena. Moreover, the Soviet Union was making the most of what the world believed was a missile gap favoring the Russians. To an America facing such problems, John F. Kennedy had promised restoration of domestic prosperity and international preeminence.

4. Early Formulations

One possibility that was not mentioned in any of the various policy reports that the new President had commissioned after his election was that of ignoring the payments problem by not admitting that it even existed. The President had received a number of such reports. Adlai Stevenson had drawn up a report for the President-elect in 1960, and George Ball headed two task forces on foreign economic policy and on the balance of payments. All three of these reports labelled the payments deficit as a major problem that should be dealt with immediately. Even the Task Force on National Security, headed by Paul Nitze, made reference to the gravity of the problem and the necessity for immediate action (Schlesinger 1965, 133, 157).

The main reason for choosing not to ignore the situation was political. The American political and military position in the world was seen as dependent on a strong balance of payments. Without a strong balance of payments position, American military forces would have to return home and American economic aid would have to be cut. National power depended on a strong currency, which in turn rested on a strong balance of payments position. Numerous quotations can be proffered as evidence, but one will suffice. Schlesinger (1965, 654) notes an occasion when the President derided nuclear weapons and said, "What really matters is the strength of the currency. It is this, not the *force de frappe*, which makes France a factor. Britain has nuclear weapons, but the pound is weak, so everyone pushes it around."

Working from assumptions about the relationship of national power and currency strength, and desirous of maintaining American political preeminence in the world via maintenance of the Atlantic alliance, American policymakers came to the conclusion that the problem had to be confronted head on. Moreover, such starting points precluded even considering the option of devaluation (Sorensen 1965, 408).

Besides ignoring the situation, there was one other possibility that might have made it possible to avoid the stark choices discussed above. The Stevenson and Ball reports suggested negotiating international monetary reform. Generally, they suggested internationalizing national reserves. This position was supported by the Council of Economic Advisers and would have opened the alternative of liberal liquidity and avoid the stark choice between internal and external measures. This position was vociferously opposed by the Treasury Department, however. Treasury engineered its own task force headed by Allan Sproul (Roosa 1967). The Treasury position was that such monetary reform would end the United States' role as banker for the world. Further, until the dollar was strengthened, Treasury argued, the United States would not have enough bargaining power in any monetary negotiations. Moreover, even with reform, the American deficit would still have to be dealt with, and in the years of negotiation an interim policy would still have to be formulated. The Treasury set of arguments won out.

5. Kennedy Game Plan I

Having foreclosed the possibilities of ignoring the situation or changing the rules of the game, the United States was left with the two alternatives outlined earlier. Without international reform, the alternative of liberal liquidity did not really exist for the United States. Some action, either to eliminate or cut the deficit, was required to restore European confidence in and willingness to hold American dollars. The United States was thus left with the choice of taking internal or external measures (or some mix) to deal with the payments deficit.

With the assumptions and concerns outlined above, it was perhaps a foreclosed proposition that the United States would not take external measures since such policies might wreck relations with Europe, and would hark back to the 1930's. Instead, the United States would take the road of internal measures despite the state of the American economy. The Kennedy Administration formulated a coordinated game plan in 1961. The plan had four parts: (1) cosmetic measures designed to cut some of the deficit, but mostly to show that action was being taken; (2) disciplinary internal measures in fiscal, monetary, and tax policy; (3) short-term European cooperation to protect the American gold supply; and (4) long-term European cooperation to restructure Atlantic relationships. The Administration instituted a series of measures that were minor but that gave the appearance of action. To decrease payments slightly the duty free allowance for returning American tourists was to be reduced from \$500 to \$100; a "See America Now" campaign was started; a "Buy America" plan was initiated to cut foreign goods that were being bought by government agencies; and foreign aid was to be tied to purchases in the United States. To increase receipts, the United States encouraged Europeans to pre-pay their debts, while American businesses were encouraged to increase exports.

The pivotal element in this strategy was the Administration's domestic economic program. Despite his commitment to restore prosperous times, the President followed a policy of domestic discipline. During the Kennedy years, the money supply increased by only 1 % a year. The Administration had hoped for a balanced budget in 1961. Only the Berlin crisis caused a budget deficit. Indeed during the crisis, there was some talk of a surtax so as to avoid going into deficit. While the surtax proposal was dropped, the Administration committed itself to a balanced budget in fiscal year 1963. All told, virtually all increases in government expenditures were for military programs during the Kennedy years.[2]

In fact, the percentage of the budget devoted to civilian programs steadily declined during that period. In the area of tax policy, the Administration ignored the advice of many economists and refused to cut taxes. The Administration's anti-recessionary policies typically consisted of measures such as speeded distribution of tax refunds and G.I. life insurance benefits. Indeed, the only major anti-recession program was the business investment tax credit. In conjunction with the various restrictionist economic policies, the Administration undertook a voluntary wage-price control program. The details are not important here, but the highlight of the Administration's willingness to play tough at home was the Presidential rollback of steel price increases in 1962.

In return for following such externally determined economic policies, the Administration expected reciprocation by the European countries. In the short term, the United States expected cooperation in technical manipu-

[2]It should be noted that an Administration's expansionary or contractionary policy cannot be adduced from the actual deficit or surplus. Often, a contractionary policy will lead to budget deficits because the contraction will affect tax revenue. For this reason, economists look at the full-employment estimate of the budget surplus or deficit. A budget that would be in surplus given full employment is a sign of contractionary fiscal policy. During each of the Kennedy years the budget showed a full-employment surplus that was greater than the full-employment surplus in the years 1956-1959 (United States President 1964,43).

lations to prevent speculation and to insulate the American gold stock. Again, the details are not important. Briefly, there were a series of cooperative arrangements established by the major central banks: Basel Agreement, Gold Pool, General Agreements to Borrow, Roosa Bonds. The United States also took some unilateral steps to protect its gold supply, such as entering the forward exchange markets.

The key reciprocation desired by the United States, however, was a willingness by the Europeans to restructure Atlantic relations by creating, in effect, a North Atlantic free trade area. The Kennedy Administration hoped to do this in a new set of GATT negotiations. To start this off, the Administration opted for not renewing the Reciprocal Trade Act and pushed instead for its own Trade Expansion Act. The Act would give the President wide authority to negotiate tariff reductions with the European Common Market. The Act was predicated on British entry into the Common Market (Reuss 52; Schlesinger 1965, 845; Taber 1969, 49-50). The hope was to restructure Atlantic relationships and solve Atlantic problems via such negotiations. The Administration was thus willing to take short-term disciplinary measures at home in the hope of getting a long-term economic agreement that would again open up the European market and would alleviate the need American corporations felt to invest abroad.

The heart of the coordinated game plan was the restrictive domestic economic policy. What were the factors that were involved in the Kennedy Administration's decision to institute disciplinary domestic economic policies that were determined by the demands of the external environment? First, political assumptions about America's world role and its requisites dictated the parameters in which the situation was conceived. Such assumptions made necessary a recognition of a problem and foreclosed certain alternative options (devaluation, high tariffs, etc.). There still remained the choice between internal measures and international monetary reform. Commitment to America's world role, however, tended to foreclose the alternative of reform. The issue was clinched because of the existence of an internal bureaucratic lobby or advocate for externally determined policy (Treasury Department). Moreover, despite election promises and the narrow victory, there seemed to be enough breathing room before the next election to make restrictive short-term domestic economic measures acceptable. Finally, there was the Administration hope that in return there would be an opportunity for a long-term restructuring of the Atlantic relationship on American terms and conforming to an American vision.

6. Collapse and Game Plan II

To begin with, the expected European reciprocation was not forthcoming. The DeGaulle veto of British entry into the E.E.C. had made sections of the Trade Expansion Act inoperative. Moreover, in the early Kennedy

Round discussions, begun in 1963, tariff reduction was floundering because of a disagreement on chickens.

The original game plan had been, at best, only partially successful in dealing with the deficit. The technical manipulations had been only partially successful in insulating the American gold supply.

The domestic economic picture was bleak. Unemployment still hovered at 6% (4% was an announced Administration goal.) The recovery from the 1960 recession had been anemic and resembled the recoveries from the Eisenhower recessions of the 1950's. Economists were predicting another recession for late 1963 unless expansive domestic measures were taken. The Council of Economic Advisers was urging, as it had been since 1961, an expansionary tax cut.

In this atmosphere, the business community and the Treasury Department dropped their hostility to a tax cut. This was due not only to the domestic economic picture, but also because of the business community's pleasant experience with the investment tax credit of 1961. In accepting expansive domestic economic policies, the Treasury shifted in its willingness to support international monetary reform as an alternative.

Thus, in the short period of a few months in 1963, conditions had turned around. The domestic picture was bleak, and with eyes focused on a 1964 reelection bid there were no arguments for continuing restrictive internal economic measures. A tax cut in an election year appeared quite attractive. Moreover, the expected long-term advantage that was to be reaped for short-term hardship was not materializing. The bureaucratic advocate for external determination had disappeared.

The new Administration game plan called first for a domestic tax cut. This expansive measure would increase the payments deficit in the short-term, but it was needed to avoid another recession. Again there were cosmetic features. This time they included a grain deal with the Soviet Union.

Having rejected internal measures, the Administration moved to adopt external measures in the form of some controls on capital (Interest Equalization Tax of 1963). Political memories, however, did not allow such external measures as high tariffs or import surcharges. This left the Administration with the alternative long proposed by the Council of Economic Advisers: pressing for international monetary reform. The Treasury began to study and discuss various proposals that eventually culminated in the creation of Special Drawing Rights (SDR's).

The Administration also switched in its Grand Design to restructure Atlantic relationships. With the Kennedy Round stalled, the Administration picked up on the MLF proposal in 1963. This proposal for nuclear sharing with the allies had been discussed at lower levels but had not been an element of American policy. With the stalled tariff negotiations, the

Administration picked it up as the only other existing proposal for restructuring Atlantic relationships.

7. Conclusion

The Kennedy Administration abruptly shifted from its original economic game plan in 1963. Originally the Administration decided to deal with a balance of payments deficit by taking disciplinary internal measures (externally determined). By 1963 a new strategy was adopted that involved external measures and a commitment to international monetary reform (internally determined). Though no propositions can be offered, it appears that the acceptability of external determination of domestic (and foreign) policy is a function of the degree and proximity of electoral pressure (upcoming elections), the existence of an internal bureaucratic advocate for external determination, and expectations of future external cooperative reciprocation.

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